

*THE FINAL REPORT OF THE  
COMMISSION OF INQUIRY INTO  
THE AFFAIRS OF  
THE MASTERBOND GROUP  
AND INVESTOR PROTECTION  
IN SOUTH AFRICA*

*CORPORATE LAW AND  
SECURITIES REGULATION  
IN SOUTH AFRICA*

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# CHAPTER 8 SECURITIES REGULATION — THE PRIMARY MARKET—DISCLOSURE AND THE MERIT REVIEW

**8.1** In England, the regulation of securities was preceded by the regulation of markets. The common law offences of engrossing (buying in a quantity of corn etc. to sell again at a high price), forestalling (raising the price of certain goods by holding up supplies etc.) and regrating (buying corn or other grain in any market so as to raise the price, and then selling it again in the same place) were rendered statutory offences in 1363.<sup>(1)</sup>

Investor protection started during the 16<sup>th</sup> century with bankruptcy laws<sup>(2)</sup> which sought to protect creditors, followed in the 17<sup>th</sup> century by laws which attempted to eliminate dishonest brokers<sup>(3)</sup>. In 1720 the 'Bubble Act' outlawed unincorporated joint stock companies<sup>(4)</sup> and in 1734 trading in futures and options and short sales were prohibited<sup>(5)</sup>. The Joint Stock Companies Act of 1844 required the filing at the Registry Office of prospectuses and documents such as advertisements which were addressed to the public and related to the formation of companies. It also required the filing of annual balance sheets and auditors' reports and prohibited the purchase and sale of shares of the company by its directors except with the consent of the shareholders at a general meeting.

**8.2** Later reforms in securities regulation in the United Kingdom were mainly scandal-driven and except for developments during the last decade which led to the establishment of the Financial Services Authority (the FSA), the United Kingdom could certainly not have served as a model for other jurisdictions.

"Almost every significant reform of the law or its administration in Britain has occurred as a direct result of the concern felt after a major scandal which has either dramatically illustrated the incompetence of the existing law or a significant lacuna in regulation. Sadly this has meant that experimentation and refinement of the law and regulatory devices have been pragmatic and have generally only been viable when

they can be conveniently attached to `the coat-tails of some measure that is justified by public outrage".<sup>(6)</sup>

**8.3** During the 20<sup>th</sup> century and after a period in its history when fraud and corruption permeated all levels of society including the presidency, the judiciary, financiers, brokers and the like, the United States of America became the world leader in the field of securities regulation and supervision. Each state has its own securities law and in addition there are a number of federal laws, such as those which created the present Securities and Exchange Commission (the SEC).

**8.4** During that unfortunate period in its history, the dishonesty which was endemic in the American economy is virtually beyond belief. Fortunes were made and lost in fraudulent and speculative ventures in gold mines, oil wells and railways. The stock market was often manipulated to 'corner' markets and the 'robber barons' ruled supreme.

**8.5** Some of the methods used by the 'robber barons' are described by Edward Chancellor, and serve to illustrate the background to and the necessity for the far-reaching powers of regulators and supervisors which the American legislators bestowed upon State regulators and the SEC.

"The promoters of the mining companies harnessed the mood of the day with age-old ploys. First, a claim in some unknown place was purchased for a pittance in cash or a quantity of shares and specimens of ore were submitted to an assay and certificated by a mineralogist. Then, a wealthy and respectable merchant, joined by other notables, was brought onto the board in return for a free distribution of shares. The capital of the company would be inflated to many times its value. For instance, the property of the Titan Ledge and Black Mountain Gold, Silver and Copper Company was bought for a thousand dollars and later capitalised at a million dollars. A broker was hired and advertisements placed in the papers announcing a 'limited' subscription. On street corners, boys were employed to hand out prospectuses with lavish descriptions of the company's prospects. Scouts, known as 'bubble-blowers', were hired to lure the bigger investors. Several companies were brought under the control of the same directors, who used the capital raised for one company to pay the unearned dividends of another.

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The great stock operators did not trifle with the transient mining and petroleum bubbles. Their attention was focused almost exclusively on the market for railroad stocks, where manipulation was a fine art and consequently the investment returns more certain. The great aim of the operator was to achieve one of the railroad corners which recurred with unprecedented frequency throughout the period. Among the most notorious corners were those in Harlem (1863 and 1864), Michigan Southern (1863 and 1866), Prairie du Chien (1865), Erie (1866, 1867, and 1868) and Chicago and Northwestern (1867 and 1872). The profits could be enormous : Henry Keep's pool in the Chicago and Northwestern Railroad in 1867 netted over \$2 million. These operations were not without danger, as corners could be broken by 'watering' existing stock with new issues or by repatriating stock held in Europe. Therein lay the excitement of the game.

A pool operator would start by simulating weakness in a particular stock in order to shake out those holders on small margins and entice others to sell the stock short (this was known as the 'partridge trick'). The pool even lent from its own stockholding to facilitate short sales. Disreputable brokers provided 'wash sales', which set misleading prices. In a market hungry for 'points' or tips, false rumours were rife. Broken speculators, known as 'pointers', 'singed cats', or 'ropers-in', were commissioned to put out specious stories and solicit short sales. False rumours became so common that many acted contrary to what they were advised in the market, a practice known as 'coppering'. Once the stock had been oversold, the operator would catch out the short-sellers and force up the price (this was known as the 'scoop game'). A corrupt press was a useful tool in the hands of a stock manipulator. The notorious operator Jay Gould (of whom more later) controlled several newspaper editors, who in exchange for share tips would print whatever story he told them. After his death, the *New York Times* remarked:

Mr. Gould's editors were known to the public as stool pigeons. It was their function to entice the incautious investor or speculator within reach of his ammunition; to 'hammer' securities that he wished to acquire, and to exalt by artful misrepresentation the quotations of those he desired to 'unload'.

Away from the stock exchange, other ways were found to manipulate securities. Influence over the board of directors was the most common and effective method, as Daniel Drew had shown with the Erie Railroad. Drew was frequently a bear, even in the stock of his own company, since his ability to issue new Erie shares made it almost impossible for other operators to corner him. 'Railway directors,' wrote James Medbery, 'are the heavy artillery of the stock market, and no corner can attain

Napoleonic victory without them'. Directors manipulated dividends to suit their speculative activities (sometimes paying them out of capital), broadcast false rumours (in 1869, the directors of the Pacific Mail circulated stories of an impending dividend increase in order to unload their shares), passed expected dividends, and issued unauthorised stock. Occasionally, speculating directors went even further. When Jim Fisk was a director of the Erie Railroad, he sold short the stock of the United States Express Company, which had a contract with the Erie, and then cancelled the contract. Once the express company's share price had fallen, Fisk covered his shorts, bought more shares, and then reinstated the contract. This technique was refined later in the century by the notorious gambler and speculator John 'Bet-a-Million' Gates, who shut down his Chicago steel plant during a period of prosperity and put thousands out of work, claiming that the business was not making money. Like Fisk beforehand, Gates had sold the stock short and after making a killing in market, he reopened his factories.

The behaviour of speculating directors corrupted the relationship between directors and shareholders (especially the British shareholders, who, on the other side of the Atlantic, were unable to influence events and were led like lambs to the slaughter). It appeared to justify Adam Smith's claim that joint-stock companies were beset by 'negligence and profusion' since the personal interests of directors differed from those of their shareholders. In his *Theory of Business Enterprise*, Thorstein Veblen contended that it was the custom of American directors to mislead the stock market in order to profit from successive over- and undervaluations of stock. Jay Gould, who once described the Erie Railroad as his 'plaything', was accused by Matthew Josephson of pursuing

a deliberate policy of mismanagement, 'as a matter of principle', deriving his gains from the discrepancies between the real value of the affair and its supposed or transient value in the securities markets. In good times, he would give an appearance of gauntness and misery to his enterprises; in bad times he would pretend affluence".<sup>(7)</sup>

**8.6** In recent years a number of jurisdictions have drawn upon the American experience for the regulation of their own securities and financial markets. Taking into account the diversity and complexity of the American financial markets and the ingenuity of its white collar criminals, this seems to be a commendable course, and the development of the American securities laws will be sketched in some detail.

8.7 In the United States the first securities act ('Blue Sky Law') was passed in the state of Kansas in 1911. By 1933, 47 of the then 48 states had securities laws. Following upon the stock market crash in 1929, the Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted. The latter created the Securities and Exchange Commission (the SEC) as an independent agency of the United States Government.<sup>(8)</sup>

"After the adoption of that first act (by Kansas in 1911), the idea of securities regulation began to spread. By 1913, twenty-three other jurisdictions had adopted securities acts. By the beginning of the depression in 1929, virtually all the states had some form of securities act. However, as some of the schemes of the 1920's illustrated, state securities regulation, with its limited jurisdiction, was not the total answer. The stock market crash of 1929 precipitated a movement to create a federal securities agency that could deal with schemes involving interstate commerce. This movement culminated in the passage of the Securities Act of 1933, and the Securities and Exchange Act of 1934. Thus, state securities regulation predated federal securities regulation by some twenty-two years. This fact is important in understanding both the scope of the federal securities acts and the interface between state and federal acts.

The state securities acts are generally known to those who deal with them as 'blue sky laws'. This name apparently comes from a comment by the United States Supreme Court in one of the early cases upholding the constitutionality of the early state acts that these statutes were passed to control schemes which had no more substance than so many feet of the blue sky. (**Hall v Geiger-Jones Co.**, 242 U.S. 539 [1917])

Professor Loss, *Loss & Cowett* at 7, indicates that the term may have originated much earlier and may have been in common usage in Kansas at the time of the passage of the Kansas Act in 1911. He also quotes from a 1916 article which is often credited with coining the term. Mulvey, 'Blue Sky Law', 36 Can. L. Times 37 (1916):

'A definition of 'Blue Sky Law' is necessary. The State of Kansas, most wonderfully prolific and rich in farming products, has a large proportion of agriculturists not versed in ordinary business methods. The State was the hunting ground of promoters of fraudulent enterprises; in fact their frauds became so barefaced that it was stated that *they would sell building lots in the blue sky in fee simple. Metonymically they became known as blue sky*

*merchants, and the legislation intended to prevent their frauds was called Blue Sky Law' "(9)*

**8.8** In his lectures on 'The Protection of Investors' delivered during September 1962, Professor Loss of the Harvard Law School and former member of the SEC, sketched the Federal Controls which then existed in the United States:

"The Securities Act of 1933, the first in the series of SEC statutes, requires, with certain exceptions, the federal registration of all new issues which are offered to the public by use of the mails or any instrumentality of interstate or foreign commerce. The registration requirement also applies to secondary distribution of outstanding securities by persons who are in a relationship of control with the issuer. And a prospectus containing the basic information in the registration statement must be given to each buyer.

The Act includes a civil liability provision which, like sections 80 and 76 of the South African Companies Act, was largely modelled on the British Companies Act. But it also contains administrative machinery which is not found in Great Britain. The prospectus and various other documents, which are collectively called the registration statement, are carefully examined by the SEC. The Commission has no power to pass on the merits of securities, and it is a criminal offence to represent that it does. But it may issue a so-called stop order, subject to judicial review in a federal appellate court, upon a finding that the registration statement is materially incomplete or misleading. Since this administrative power exists, it seldom has to be exercised. An informal procedure has been developed whereby the registration statement is examined by a group of financial analysts, accountants, lawyers and engineers on the Commission's staff and then amended to repair any deficiencies which are thus found. This detailed examination, if it frequently proves annoying to registrants and their lawyers, is essentially welcomed by the financial and legal communities as a cheap form of insurance against what might otherwise be disastrous civil judgments.

It is this examination, moreover, which distinguishes the American system from that in either England or South Africa, or apparently anywhere else except for Japan and the *Commission Bencaire* in Belgium. The Jenkins report goes only a small way in suggesting that the Registrar of Companies be empowered (subject to judicial review) to refuse to accept for registration any prospectus offering shares or debentures for which a quotation on a prescribed stock exchange is not being sought 'if it either does not set out the information required by the Act or does so in a manner likely to create a false impression on the mind of an unwary or inexperienced investor. We do not

expect the Registrar to do more than reject prospectuses which, on the face of them, appear to him to be cast in a misleading form. He would not be expected to check the accuracy of the contents'. In the hands of a strong Registrar, this 'false impression' language might conceivably be the seed of an examination process almost as detailed as in America. But the Jenkins report itself suggests otherwise, without analysis of the 'false impression' phrase, and at this writing it is anybody's guess how the proposed amendment will operate in practice if it is adopted.

The Securities Act of 1933 was the first, but by no means the last, of the federal statutes. Almost annually for the next seven years Congress added a new statute, until now there are seven under which the SEC functions.

The Securities Exchange Act of 1934, the second statute in the series, is concerned with trading in securities already issued rather than the process of capital formation. Every stock exchange must be registered with the commission, which has certain supervisory functions with respect to their rules. Every security which is listed for trading on a stock exchange must likewise be registered. Annual or other periodic reports must be filed to keep registration data current. The Commission has a quasi-legislative power to adopt rules to regulate the solicitation of proxies. Directors, officers and beneficial owners of 10 per cent or more of any class of listed equity security must file monthly reports of their holdings, and must surrender to the corporation any profits they make from trading in their corporation's securities within any period of less than six months.

These several provisions apply only to securities listed on exchanges. So far as the over-the-counter market is concerned, the securities themselves are not registered unless they are the subject of a distribution which falls within the 1933 statute. But brokers and dealers in the over-the-counter market must themselves be registered and file annual financial statements. Moreover, the Commission has very broad powers to define fraudulent practices by rules; to enforce the statute and its regulations by investigation, injunction and criminal prosecution; to control various stock exchange practices such as short selling, stabilization, floor trading, and the hypothecation of customers' securities; and to suspend or expel stock exchange members, as well as to revoke the registration of over-the-counter brokers and dealers, for illegal conduct. And all this regulation is supplemented on an ethical plane by the National Association of Securities Dealers, an organization of over-the-counter brokers and dealers which has semi-official status.

The 1934 statute also attempts to control the amount of the nation's credit which is channelled into the securities markets by authorizing the Board of Governors of the Federal Reserve System to promulgate margin rules, which are enforced by the Commission. In this respect, the South African system of margin regulation under the Stock Exchanges Control Act, with its 50 per cent initial margin requirement except when both broker and customer are members of a South African stock exchange or a foreign exchange recognized by the Minister of Finance for the purpose, perhaps comes as close as any to the American scheme. There are traces in the American statute and its legislative history of three separate philosophies here, which are not altogether consistent: (1) prevention of the 'excessive use of credit for the purchase or carrying of securities'; (2) protection of the margin purchaser 'by making it impossible for him to buy securities on too thin a margin'; and (3) prevention of undue market fluctuations and stabilization of the economy generally. The Board of Governors of the Federal Reserve System has emphasized the first of these three philosophies in its administration of the margin provisions. Nevertheless, severe market movements have usually been followed sooner or later by increases or decreases in the margin requirement. The market break of late March, 1962, was followed in early July by a decrease in the margin requirement from 70 to 50 per cent.

These statutes of 1933 and 1934, which have been several times amended, are the two basic laws governing securities generally. The later statutes are more specialized.

The next year, 1935, brought the Public Utility Holding Company Act, which was an outgrowth of the holding company abuses in the area of electric and gas utilities. It took the SEC a quarter of a century to complete the Herculean task of integrating these holding company systems geographically and simplifying their corporate structures. The integrated and simplified holding company systems which have survived this process are subjected to stringent controls which go far beyond the disclosure philosophy of the 1933 statute.

In 1938 Congress amended the Bankruptcy Act to adopt a revised procedure whereby insolvent corporations may be reorganized instead of being liquidated. This statute gives the Commission no administrative authority in the usual sense. Instead it embodies a novel experiment in administrative – judicial co-operation by making the Commission the impartial and expert adviser to the federal courts in reorganization proceedings. The South African reader will notice a general resemblance to the judicial management under his Companies Act, although the South African courts receive no administrative help from the Government.

The next statute in the SEC series came in 1939 with the Trust Indenture Act. Its purpose is to assure that indentures under bond or debenture issues will have independent trustees to protect and enforce the rights of debenture holders. The mechanics of this statute are keyed in with the registration procedure under the Securities Act of 1933. Every debenture or other debt security which is offered to the public by use of the mails or the channels of interstate or foreign commerce must be issued under an indenture which has been qualified by the Commission. And no indenture may be qualified unless it provides for a corporate trustee which satisfies the exacting statutory definition of independence and in other respects meets the statutory requirements.

The last two Acts were passed in 1940. These are the Investment Company Act, which covers fifty-eight pages in the statute book and is the most complex of the entire series, and the Investment Advisers Act, a simple little statute which requires the registration of investment advisers and was little more than a continuing census until it was substantially tightened up in 1960".<sup>(10)</sup>

**8.9** In his three-volume treatise on the securities laws of the United States, Professor Long points out that from the outset the focus of the blue sky statutes was on protecting its citizens from 'bad' investments.

"As a result, the early acts were clearly *parens patrie* or *public welfare*-type statutes. They were *parens patrie* statutes, in that the state, like a parent, was primarily interested in protecting its investors from their own ignorance and greed.

Since the turn of the century, both the state and federal governments have passed, under the police power, a myriad of public welfare statutes, such as the pure food and drug acts, aimed at protecting the physical health and well being of American citizens. The states, through merit regulation in the securities area, attempted to apply this same protective concept to the financial health and well being of its citizens. It is equally destructive of a citizen's well being to allow him to be stripped of his financial security, as it is to allow him to destroy his own physical health through the use of drugs or impure food.

To confirm the validity of this proposition, one need only look at the example of the *Lincoln Federal* and *Charles Keating*<sup>(11)</sup> case. Keating and his savings and loan swindled thousands of elderly people of their life savings. In so doing, he not only stole their dignity, but condemned many to a life of eating cat food and worrying about

whether they will become a burden upon their families or society in general. These fears are very real in that many have a life expectancy of ten years or more.

This merit regulation was accomplished by the state securities agency weeding out those offerings which were not 'fair, just, or equitable' to the investor or which were not 'based upon sound business principles'. Such offerings were simply denied registration and, therefore, could not be lawfully sold in the state. Under these merit statutes, while disclosure to investors of information about the securities and the company offering them was a consideration, it was clearly secondary to preventing the sale of securities considered undesirable in the eyes of the administrator. Most state securities acts, both early and modern, do not attempt to further define the 'fair, just, and equitable' standard. This was left to administrative interpretation on a case-by-case basis or through administrative rule".<sup>(12)</sup>

**8.10** In contrast to the 'merit regulation' statutes, the main focus of the Securities Act of 1933 (the Federal act) was and still is on full disclosure in, amongst others, the statutory prospectus.

**8.11** However, Professor Long points out that full disclosure in a prospectus does not protect the ordinary investor. In his view few of the investors who actually read prospectuses are able to form intelligent investment decisions based thereon because the prospectus has largely become a formalistic legal document used by the issuer to lay a foundation for its defence to any future allegations that full disclosure had not been made.

"The ultimate goal of the Securities Act is, of course, investor protection. Effective disclosure is merely a means. The entire legislative scheme can be frustrated by technical compliance with the requirements of the Securities and Exchange Commission's Form S-1 for preparation of registration statements in the absence of any real intent to communicate. It is for this reason that the SEC, through its rule making power, has consistently required 'clearly understandable' prospectuses. The Wheat Report at 78.

Unfortunately, the results have not always reflected these efforts. '[Even] when an investor [is] presented with an accurate prospectus prior to his purchase, the presentation in most instances [tends] to discourage reading by all but the most knowledgeable and tenacious'. Knauss, A Reappraisal of the Role of Disclosure, 62 Mich. L. Rev. 607, 618-619 (1964). These documents are often drafted so as to be comprehensible to only a minute part of the investing public.

In at least some instances what has developed in lieu of the open disclosure envisioned by the Congress is a literary art form calculated to communicate as little of the essential information as possible while exuding an air of total candor. Masters of this medium utilize turgid prose to enshroud the occasional critical revelation in a morass of dull, and — to all but the sophisticates — useless financial and historical data. In the face of such obfuscatory tactics the common or even the moderately well informed investor is almost as much at the mercy of the issuer as was his pre-SEC parent. He cannot by reading the prospectus discern the merit of the offering".<sup>(13)</sup>

**8.12** Some states, such as the State of New York and the District of Columbia, largely rely upon anti-fraud statutes such as Article 21-A (Fraudulent Practices in Securities) and Article 23-A (Fraudulent Practices in Respect to Stocks) of the General Business Law of New York. The latter also prohibits chain distributor schemes (pyramid sales).<sup>(14)</sup>

**8.13** According to Professor Long, experience has shown that anti-fraud statutes alone cannot protect investors because effective prosecution is lacking, and the reality is that in most cases the entire investment has been lost by the time a fraudster is arrested,

"Administrative or injunctive actions are simply not effective against professional criminals or scam artists who are continually offering fraudulent securities. These professionals may be offering commodity option contracts this year. Next year it might be oil and gas lease lotteries. The year after it might be interests in FCC cellular telephone or wireless cable license lotteries or build-outs of licenses won. These people tend to move from hot investment area to hot investment area, taking their customer lists with them. Further, these professional criminals are often in contact with each other and exchange ideas for new scams and investor 'sucker' lists. They also will sell their investor lists to other third parties. As a result, the same investors are often victimized several times, either in different schemes or different parts of the same scheme.

These people normally ignore summary cease and desist orders issued by state securities agencies. If the agency on its own motion sets the order for hearing or seeks an injunction, they will normally do either of two things. They will offer to enter into a consent order and rescind the investments made in that particular state. Or they will fight the action, using every delaying tactic possible. In either case, they gain time to continue their scam until it fails of its own weight, at which time they move on to the next scheme or company. The costs of fighting these actions, including exorbitant attorney's fees and paying any assessed fines or required rescissions, are merely costs of doing business.

The only way to stop these schemes and the people who perpetrate them is criminal prosecution. Yet, few criminal cases are ever brought. As a result, the chances of prosecution are extremely low, about three percent. For example, Glenn Turner<sup>(15)</sup> of 'Dare to Be Great' and 'Koscot Cosmetics' fame, operated at least four or five similar pyramid schemes before being convicted in Arizona. Further, the chances of spending any substantial 'hard' jail time are even lower, somewhere in the neighborhood of one percent. Michael Milken, the junk bond king, allegedly made over a billion dollars, but was sentenced to only a couple of years in jail. This reflects the attitude prevalent in the federal, and some state, courts that white collar criminals, who steal by their wits and fountain pens, should not do much 'hard' time. Charles Keating<sup>(16)</sup>, convicted of defrauding hundreds of senior citizens of their life savings, received a relatively light sentence when compared with the average armed robber who steals under \$100 and receives a twenty-five year sentence.

The second reason that after-the-fact fraud regulation only does not work is because in most cases the entire investment is lost. In a few cases, the investment money has actually been spent for the purposes it was raised for in an effort to try to make the project work. However, in most cases, the promoter has simply converted the money to his own use and either dissipated it through high living or secreted it in a foreign numbered bank account. In either case, the investors are unlikely to recover even a small percentage of their investment. After-the-fact fraud regulation is another example of closing the barn door after the horse has departed. What is needed is a system of regulation which has a chance of stopping the fraud before the loss occurs.

To verify this point, it is only necessary to compare the estimated losses to the success of agency recovery activities. Estimates on the amount of loss in the United States to fraudulent securities schemes each year range from \$330 million to over \$40 billion. The SEC has engaged in the last several years in a vigorous disgorgement program. While the program has been quite successful, the amount of disgorgement ordered is only a small fraction of the actual loss sustained. Further, the amount of money actually recovered for investors is only a small percentage of that ordered by the courts".<sup>(17)</sup>

**8.14** Professor Long is also of the view, and convincingly so, that investor protection is best achieved by full disclosure with the addition of antifraud measures and a merit review.

"The full disclosure plus fraud statute is a great improvement over a fraud only statute. It provides the investor with some prophylactic protection *before* the offer or sale is

made, not *after*. Hopefully, such protection will prevent many frauds from taking place so there will be less need for the liability provisions after the sale. Further, the theory of providing the investor with full and accurate information, but not interfering with his ultimate investment decision, as is done in merit regulation statutes, is more in keeping with the American idea of freedom of choice.

However, this simple truth is that disclosure plus antifraud regulation doesn't work. Only when merit review is also added does the public have full investor protection.<sup>(18)</sup>

**8.15** In the United States, regulation by means of merit review (the concept of 'fair, just and equitable') is largely restricted to seven regulatory areas.

- Marketing costs and selling expenses which are generally limited either by statutes or rules which specifically limit the percentage such expenses may comprise (usually between 10 and 30 per cent) and which enables the regulators to determine what an excessive or unreasonable amount would be. As an example, Section 306(a)(2)(F) of the Uniform Act provides that registration may be denied if 'the offering has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation.
- Options and warrants which are issued to underwriters, insiders and promoters to provide additional compensation at no expense to the issuer.

"The evil that merit regulation of this area is attempting to control is quite simple. The investors, purchasing under the registration statement, will have their investment diluted if the options are exercised. The extent of this dilution is the difference between the option price and the market price of the securities when the option is exercised.

In the case of the issuer's promoters and insiders, this additional compensation represents further payment for the promoters' and insiders' efforts in organizing and running the issuer to the time of the registration. In the case of the underwriters or unaffiliated institutional investors making a contemporaneous loan to the issuer, the options are additional inducement to underwrite the offering or to make the loan. Usually such options are in lieu of a higher underwriting fee or interest rate on the loan. Finally, options are often issued to existing shareholders in various types of acquisitions and reorganizations. Here the purpose is to sweeten the exchange package to induce the shareholder to agree to the acquisition or other reorganization,

Because of the dilution effect caused by the issuance of options, many states, as part of their merit regulatory scheme, provide restrictions on the amount, type, and permissible holders of options and warrants. The statutory authority for such restrictions are based upon language similar to that of Section 306(a)(2)(F) of the Uniform Act. This section provides that registration may be denied if "the offering has been or would be made with.....unreasonable amounts or kinds of options".

- Cheap stock issued to underwriters, insiders and promoters. Once again, placing limits on the issuance of cheap stock prevents the excessive dilution of the public's investment.
- The offering price. Restrictions are placed on the offering price where there is no established market for the security. The offering prices are required to relate to book value, earnings history and for industry price/earnings multiples and require the price to be no lower than say \$2 in any event or no more than 25 times earnings. These restrictions are placed to protect the public from the marketing ability of the underwriter or promoter.
- Voting rights. It is deemed to be unfair and thus a ground for refusing registration if the class of securities being offered has voting rights unequal to those of other classes. Equal voting rights are necessary to ensure basic fairness to the investing public whose funds are being used to capitalize an entity. (*cf* the iniquitous South African N-vote shares).
- Promoters' investments. Some states require promoters to contribute assets in the form of cash or other tangible assets equal to approximately 10 to 15 percent of the equity to be offered to the public. This is justified on the basis that it is a fairly easy way to test the promoter's faith in the issuing entity.
- Interest and dividend coverage. States which apply this merit standard will often require that companies wishing to issue preferred stock or debt securities meet certain interest and dividend coverage tests. This is widely regarded as the most effective method to protect the public.

"The desirability of requiring that certain issuers demonstrate the ability to meet promised dividend or interest payments is founded on simple fairness and would appear beyond question. This is quite possibly the reason that of all the merit standards discussed, interest and dividend coverage restrictions are the least criticized and have proved to provide the highest level of investor protection" <sup>(19)</sup>

**8.16** Some examples of merit review provisions in the United States and in other jurisdictions are

**Arizona** "1. (When) The application for registration, prospectus, any financial statement, or any document or exhibit filed with the application, or any amendment or supplement thereto, is incomplete, inaccurate or misleading, or the information contained therein is insufficient for a true appraisal of the securities.

3. (When) The sale of the securities works or would tend to work a fraud or deceit upon the purchasers thereof, or is or would be unfair or inequitable to the purchasers".

(Title 44 – 1921)

**Arkansas** "(2) (If)  
(A) The registration statement is incomplete in any material respect or contains any statement which was, in the light of the circumstances under which it was made, false or misleading with respect to any material fact;

(D) The issuer's enterprise or method of business includes or would include activities which are illegal where performed;

(E) (i) The offering has worked or tended to work a fraud upon purchasers or would so operate; or

(ii) Any aspect of the offering is substantially unfair, unjust, inequitable, or oppressive;

(F) The offering has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, unreasonable amounts of promoters' profits or participation, or unreasonable amounts of kinds of options".

**California** "25410. (a) (1) The commissioner may issue a stop order denying effectiveness to, or suspending or revoking the effectiveness of, any qualification of an underwritten offering of securities under Section 25111, 25112 or 25131 or may suspend or revoke any permit issued under Section 25113 or 25122 if he or she finds (A) that the order is in the public interest and (B) that the proposed plan of business of

the issuer or the proposed issuance or sale of securities is not fair, just, or equitable, or that the issuer does not intend to transact its business fairly and honestly, or that the securities proposed to be issued or the method to be used in issuing them will tend to work a fraud upon the purchaser thereof".

## **India**

"10.1.1. No public or rights issue of debt instruments (including convertible instruments) in respect of their maturity or conversion period shall be made unless credit rating from a credit rating agency has been obtained and disclosed in the offer document

10.1.2 For a public / rights issue of debt security of issue greater than or equal to Rs.100 crores (±R150million) two ratings from two differing credit rating agencies shall be obtained.

10.1.3 Where credit rating is obtained from more than one credit rating agencies, all the credit rating/s, including the unaccepted credit ratings, shall be disclosed.

10.1.4 All the credit ratings obtained during the three (3) years preceding the public or rights issue of debt instrument (including convertible instruments) for any listed security of the issuer company shall be disclosed in the offer document.

### 10.9 Additional Disclosures in respect of debentures

The offer document shall contain:-

- e. The existing and future equity and long term debt ratio.
- f. Servicing behaviour on existing debentures, payment of due interest on due dates on term loans and debentures.
- g. That the certificate from a financial institution or bankers about their having no objection for a second or pari passu charge being created in favour of the trustees to the proposed debenture issues has been obtained"

**Kansas** "(12)(a) The commissioner may issue a stop order denying effectiveness to, or suspending or revoking the effectiveness of, any registration statement if he finds that such an order would be in the public interest, and that:

- (1) The issuer's plan of business is unfair, inequitable, dishonest or fraudulent;
- (2) the issuer's or registrant's literature or advertising is misleading and calculated to deceive the purchaser or investor;
- (3) the securities offered or to be offered, or issued or to be issued, in payment for property, patents, formulae, goodwill, promotion or intangible assets, are in excess of the reasonable value thereof, or the offering has been, or would be, made with unreasonable amounts of options;
- (4) the enterprise or business of the issuer, promoter or guarantor is unlawful;
- (8) there has been a failure to keep and maintain sufficient records to permit of an audit satisfactorily disclosing to the commissioner the true situation or condition of such issuer"

**Latvia** "(9) The Commission (the Securities Market Commission shall have the right to

4. terminate or refuse authorization for putting securities into circulation, if the interests of investors, or of other participants in the securities market, are materially affected;

The Commission will not register securities for putting into public circulation if:

- 19(2) information contained in the documents submitted for registration is not accurate or truthful, or if it does not meet the requirements of this Law and other laws".

**Oklahoma** "§.306 (a) The Administrator may issue a stop order denying effectiveness to, or suspending or revoking the effectiveness of, any registration statement if the Administrator finds that:

1. the order is in the public interest; and
2. (A) the registration statement as of its effective date or as of any earlier date in the case of an order denying effectiveness, or any report under Section 305(i) of this title is incomplete in any material respect or contains any

statement which was, in the light of the circumstances under which it was made, false or misleading with respect to any material fact;

(D) the issuer's enterprise or method of business includes or would include activities which are illegal where performed;

(E) the offering has worked or tended to work a fraud upon purchasers or would so operate;

(F) the offering has been or would be made or is being made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promoters' profits or participation, or unreasonable amounts or kinds of options, profits, compensation, or remuneration paid directly or indirectly to any officer, director, employee, contractor or agent".

**Ontario**

"61(2) The Director shall not issue a receipt for a prospectus if it appears to the Director that,

(a) the prospectus or any document required to be filed therewith,

(i) fails to comply in any substantial respect with any of the requirements of this Part or the regulations,

(ii) contains any statement, promise, estimate or forecast that is misleading, false or deceptive, or

(iii) contains a misrepresentation;

(b) an unconscionable consideration has been paid or given or is intended to be paid or given for promotional purposes or for the acquisition of property;

(c) the proceeds from the sale of the securities to which the prospectus relates that are to be paid into the treasury of the issuer, together with other resources of the issuer, are insufficient to accomplish the purpose of the issue stated in the prospectus;

(d) having regard to the financial condition of the issuer or an officer, director, promoter, or a person or company or combination of persons or companies holding sufficient of the securities of the issuer to affect materially the control of the issuer, the issuer cannot reasonably be

expected to be financially responsible in the conduct of its business;

- (e) the past conduct of the issuer or an officer, director, promoter, or a person or company or combination of persons or companies holding sufficient of the securities of the issuer to affect materially the control of the issuer affords reasonable grounds for belief that the business of the issuer will not be conducted with integrity and in the best interests of its security holders;
- (h) in the case of a prospectus filed by a finance company, as defined in the regulations,
  - (i) the plan of distribution of the securities offered is not acceptable,
  - (ii) the securities offered are not secured in such manner, on such terms and by such means as are required by the regulations, or
  - (iii) such finance company does not meet such financial and other requirements and conditions as are specified in the regulations".

## **Pakistan**

"22(4) The Commission when exercising its powers under the Act shall have regard, so far as relevant to the circumstances of the particular case, to —

- (a) The viability of the company or body corporate;
- (b) The quality and capability of the management of the company or body corporate;
- (d) The interest of public investors, existing or potential, in the company or body corporate;
- (f) The general public interest.

## **USA**

Proposed Revised Uniform Securities Act

"(306)(a) The [Administrator] may issue a stop order denying effectiveness to, or suspending or revoking the effectiveness of, a registration statement if the [Administrator] finds that the order is in the public interest and that:

- (4) the issuer's enterprise or method of business includes or would include activities that are illegal where performed;

- (5) the offering has worked or tended to work a fraud upon purchasers or would so operate; [alternative subparagraph (5): the offering is being made on terms that are unfair, unjust, or inequitable;]
- (6) the offering has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promoters' profits or participation, or unreasonable amounts or kinds of options;"

**Utah** "61-1-12(1) Upon approval by a majority of the Securities Advisory Board, the director may issue a stop order that denies effectiveness to, or suspends or revokes the effectiveness of, any securities registration statement and may impose a fine if he finds that the order is in the public interest and that:

- (a) the registration statement, as of its effective date, is incomplete in any material respect, or contains any statement that was, in the light of the circumstances under which it was made, false or misleading with respect to any material fact".

**8.17** The need for restrictions on the advertisement, issue or sale of securities without prior approval by a securities regulator is self-evident. Also self-evident is the need for measures to ensure that the extent of disclosure is such that the regulator is able to conduct a suitable merit review.

As pointed out<sup>(20)</sup>, if such measures had been in place in South Africa, the disastrous Masterbond, Supreme Bond and Owen Wiggins debenture bond schemes would not have occurred.

**8.18** In addition, as in the State of New York<sup>(21)</sup>, pyramid sales or chain distribution schemes must be prohibited. At present, and by R76 Notice 1135 of 1999, certain 'multiplication' schemes, 'chain letter' schemes and 'pyramid promotional' schemes are declared harmful business practices and hence unlawful. Unfortunately, the wording of the notice is virtually unintelligible.<sup>(22)</sup> It should be withdrawn and replaced by wording similar to that of the New York statute. Investment contracts should also be included in the definition of 'regulated securities' or 'financial products'.

**8.19 It is recommended that the South African Securities Regulator be enjoined and authorised to**

**(a) call for such disclosure of information by the applicant for the registration of securities as it may deem fit;**

**(b) refuse the registration of securities if it appears to the Regulator that**

**1. the prospectus or any document required to be filed with the application for registration,**

**(i) fails to comply in any substantial respect with any of the requirements set,**

**(ii) contains any statement, promise, estimate or forecast that is misleading, false or deceptive.**

**2. the proceeds from the sale of the securities to which the prospectus or other documents relate together with other resources of the issuer, will be insufficient to accomplish the stated purpose of the issue;**

**3. having regard to the financial condition of the issuer or of an officer, director, promoter, or of a person or company or combination of persons or companies holding sufficient of the securities of the issuer to materially affect the control of the issuer, the issuer cannot reasonably be expected to be financially responsible in the conduct of its business;**

**4. the past conduct of the issuer or an officer, director, promoter, or a person or company or combination of persons or companies holding sufficient of the securities of the issuer to materially affect the control of the issuer affords reasonable grounds for belief that the business of the issuer will not be conducted with integrity and in the best interests of its security holders;**

5. the issuer's enterprise or method of business includes or would include activities that are illegal where performed;
6. the offering is being made on terms that are unfair, unjust, or inequitable;
7. the issuer's plan of business is unfair, inequitable, dishonest or fraudulent;
8. the offering has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promoters' profits or participation, or unreasonable amounts or kinds of options;
9. the consideration offered or to be offered in payment for property, patents, formulae, goodwill, promotion or intangible assets, are in excess of the reasonable value thereof;
10. the viability of the issuing company or body corporate is suspect;
11. there has been a failure to keep and maintain sufficient records to permit an audit satisfactorily disclosing the true situation or condition of the issuer;
12. in respect of a proposed issue of debentures and having regard, *inter alia*, to
  - (a) the existing and future equity and long term debt ratio of the issuer, and the
  - (b) servicing behaviour on existing debentures, payment of due interest on due dates on term loans and debentures,
  - (c) any other factor;

**it is uncertain whether the issuer will be able to meet its obligations.**

.....

## NOTES

1. **Gilligan, Dr George P.** : 'The Origins of UK Financial Services Regulation'.  
and see Statutes of the Realm (1363), 37 Edw. III C.8.
2. **34 & 35 H.8 C 4** (1542/3).  
**13 Elis. C 4** (1570).  
**1 Jac. C 15** (1603).
3. **1 Jac. C 21** (1603) 'An Act against Brokers'.  
**8 & 9 Gul. III C 32** (1697) 'An Act to Restrain the Number and ill practice of Brokers and Stock Jobbers'.
4. **6 G I. C 18** (1720).
5. **7 G II. C 8** (1734) 'An Act to prevent the infamous Practice of Stock-jobbing'.
6. **Rider, Prof. Barry A.K.** : 'The Control of Insider Trading - Smoke and Mirrors!' Journal of Financial Crime Vol 7 No. 3 p. 227. (Institute of Advanced Legal Studies - Henry Stuart Publications, London, January 2000.).
7. **Chancellor, Edward** : 'Devil Take the Hindmost - A History of Financial Speculation', p. 167 - 173. (Macmillan, London, 1999).
8. **The Banking and Finance Commission of Belgium** has a similar history:  
  
"The Banking Commission was created in the wake of the Great Depression. At that time, banks and savings institutions were allowed, in their capacity as 'mixed banks', to hold shares in financial as well as industrial and commercial companies, without any legal limitation. The crisis in the 1930s led to major

losses on shares and loans, thus creating serious solvency and liquidity problems for the credit institutions concerned.

In order to restore confidence in the banking system, the government took the draconian measure of prohibiting mixed banks in Royal Decree 2 of 22 August 1934.

As a result, mixed banks were required to split their activities into two separate entities: firstly, a 'deposit-taking bank' which was not allowed to hold any shares in industrial or commercial companies, and secondly, a 'holding company' which was free to acquire and manage such shares.

A few months later, Royal Decree 42 of 15 December 1934 imposed on private savings institutions a strict regulatory system, the supervision of which was entrusted to the Office central de la petite eargne/Central Bureau voor de Kleine Spaarders, created a few days earlier.

The economic and monetary climate worsened in the ensuing months. Increased distrust of the Belgian franc caused massive withdrawals of deposits and a dramatic flight of capital out of the country, with the real risk of the whole banking system being crippled.

The new government which took office in March 1935 carried out an important reform by adopting the Royal Decree 185 of 9 July 1935 on the supervision of banks and the rules governing the issue of securities. Title I of that Decree – which remained enforced until the Law of 22 March 1993 – set out the regulatory system for banks.

Since holding companies and their subsidiaries were the main issuers of shares and bonds, it was also decided that the information to be provided to investors for public issues of securities would be supervised, whereby the government also hoped to restore the creditworthiness of listed companies and of the stock exchange in general, which had been badly affected in the aftermath of the Great Crash. Today, these matters are still governed by Title II of Royal Decree 185, although that original text has been amended several times since.

At the same time, a new institution was created: the Banking Commission. It was charged with the supervision of compliance with the provisions of both titles of Royal Decree 185.

Over the years, the tasks of the Commission have gradually been extended. In 1990, the legislator changed the name of the Banking Commission to the 'Banking and Finance Commission' as an acknowledgement of its increased responsibilities'.

9. **Long, Joseph C** : Blue Sky Law – Vol. 12 1.02 [1].
10. **Published** in the SA Law Journal Vol. LXXX (1963) p 53.
11. **People v Keating** – 19 Cal. Rptr. 2d 899 (1993) in which the Court described the methods used to encourage the public to buy unsecured debenture bonds, namely a higher rate of interest and seemingly excellent security.

"Meanwhile, Fidel, as president of Lincoln, began to develop concerns about ACC's ability to withstand a requirement to repay the debt service on the bonds. His concerns stemmed from a third quarter loss recorded by ACC and bad media the parent holding company was receiving. In November 1988, the one-year bonds began to mature and Keating instructed Fidel to inspire the bond representatives to send letters to these bondholders encouraging a rollover to another bond. Keating further instructed Fidel to continue to pursue additional new bond sales.

In late December 1988 or the first week of January 1989, Keating held a meeting in Irvine, which included both bond representatives and Lincoln employees, to announce the sale of Lincoln to the Spencer Scott Group. He indicated that, after the sale, ACC would have even greater opportunities, and encouraged the bond sales to continue. Immediately thereafter, Keating had all of the bond representatives flown to Phoenix for a day at ACC corporate headquarters and a tour of the facility, speeches by Keating and Wischer, and lunch at the Phoenician Resort Hotel. Fidel testified that, after this trip, the bond representatives went back to business as usual, quite enthusiastically" – (a typical Masterbond scenario).

12. **Long, Joseph C.**.. *ibid*, 1-68-69.
13. **Fed. Sec. L. Rep. (CCH) P93**, 163 FEIT V. LEASCO DATA PROCESSING EQUIP. CORP., 332 F. Supp. 544 (E.D. NY 1971). per Judge Weinstein.

**14. "§ 359-fff. Chain distributor schemes prohibited.**

1. It shall be illegal and prohibited for any person, partnership, corporation, trust or association, or any agent or employee thereof, to promote, offer or grant participation in a chain distributor scheme.
2. As used herein a 'chain distributor scheme' is a sales device whereby a person, upon condition that he make an investment, is granted a license or right to solicit or recruit for profit or economic gain one or more additional persons who are also granted such license or right upon condition of making an investment and may further perpetuate the chain of persons who are granted such license or right upon such condition. A limitation as to the number of persons who may participate, or the presence of additional conditions affecting eligibility for such license or right to recruit or solicit or the receipt of profits therefrom, does not change the identity of the scheme as a chain distributor scheme. As used herein, 'investment' means any acquisition, for a consideration other than personal services, of property, tangible or intangible, and includes without limitation, franchises, business opportunities and services, and any other means, medium, form or channel for the transferring of funds, whether or not related to the production or distribution of goods or services. It does not include sales demonstration equipment and materials furnished at cost for use in making sales and not for resale.
3. A chain distributor scheme shall constitute a security within the meaning of this article and shall be subject to all of the provisions of this article".

**15. The Glenn Turner** type of scheme was a typical pyramid or chain distributor scheme. In **Sec v Glenn W. Turner Enters., Inc.**, 474 F.2d 476 (9<sup>th</sup> Cir.), the Court described the scheme as follows:

**"I. The Adventures and the \$1000 Plan – the facade.**

The five courses offered by Dare ostensibly involve two elements. In return for his money, the purchaser is privileged to attend seminar sessions and receives tapes, records, and other material, all aimed at improving self-motivation and sales ability. He also receives, if he purchases either Adventure III or IV or the \$1,000 Plan, the opportunity to help to sell the courses to others; if successful he receives part of the purchase price as his

commission. There is no doubt that this latter aspect of the purchase is in all respects the significant one.

## **II. The Adventures and the Plan in operation.**

It is apparent from the record that what is sold is not of the usual 'business motivation' type of courses. Rather, the purchaser is really buying the possibility of deriving money from the sale of the plans by Dare to individuals whom the purchaser has brought to Dare. The promotional aspects of the plan, such as seminars, films, and records, are aimed at interesting others [F.2d 479] in the Plans. Their value for any other purpose, is, to put it mildly, minimal.

Once an individual has purchased a Plan, he turns his efforts toward bringing others into the organization, for which he will receive a part of what they pay. His task is to bring prospective purchasers to 'Adventure Meetings'.

### **A. The Meetings.**

These meetings are like an old time revival meeting, but directed toward the joys of making easy money rather than salvation. Their purpose is to convince prospective purchasers, or 'prospects', that Dare is a sure route to great riches. At the meetings are employees, officers, and speakers from Dare, as well as purchasers (now 'salesmen') and their prospects. The Dare people, not the purchaser-'salesmen', run the meetings and do the selling. They exude great enthusiasm, cheering and chanting; there is exuberant handshaking, standing on chairs, shouting, and 'moneyhumming'. The Dare people dress in expensive, modern clothes; they display large sums of cash, flaunting it to those present, and even at times throwing it about; they drive new and expensive automobiles, which are conspicuously parked in large numbers outside the meeting place. Dare speakers describe, usually in a frenzied manner, the wealth that awaits the prospects if they will purchase one of the plans. Films are shown, usually involving the 'rags-to-riches' story of Dare founder Glenn W. Turner. The goal of all of this is to persuade the prospect to purchase a plan, especially Adventure IV, so that he may become a 'salesman', and thus grow wealthy as part of the Dare organization. It is intimated that as Glenn W. Turner Enterprises, Inc. expands, high positions in the organization, as well as lucrative opportunities to purchase stock, will be available. After the meeting, pressure is applied to the prospect by Dare people, in an effort to

induce him to purchase one of the Adventures or the plan. The sale is sometimes closed by the purchaser who brought the prospect to the meeting, but primarily, by Dare salesmen, specialists in the 'hard sell'.

The format of the meeting is preordained. A script created by Dare is strictly adhered to. The format applies even to the sale, there being a standard procedure for inducing the prospect to sign his name to the agreement and to part with his money. While no express guarantee of success is made at the meetings, and the statement is made that the purchaser must expect to work, the impression which is fostered is of the near inevitability of success to be achieved by anyone who purchases a plan and follows Dare's instructions.

Dare also arranges, in addition to the Adventure Meetings, 'GO Tours', or 'Golden Opportunity Tours'. Prospects are taken by plane or bus to one of Dare's regional centres where further meetings and sales efforts are undertaken. A significant effort is made during the trip itself to sell the plans to prospects. Much the same atmosphere as at the meetings pervades the trip – exuberant shouting, chanting, handshaking, relating of success stories, and lavish displays of cash.

In a scheme such as this, the possibility that a market will become 'saturated' is a real one. Saturation has in fact occurred in some markets, but this is not mentioned at the meetings. Few, if any, purchasers of these plans have achieved any success remotely approaching that described by defendants and their agents".

16. See note 11 above.

17. Long, Joseph C., *ibid*, 1.78 - 1.80.

18. Long, Joseph C, *ibid*, 1 - 81.

19. Long, Joseph C., *ibid*, 1.92 - 1.105.

**U.S. Securities and Exchange Commission.** Report on the Uniformity of State Requirements for Offerings that are not 'Covered Securities'. (October 11, 1997.).

"a. Merit review

As noted previously, in addition to reviewing offerings for adequate disclosure of all material information, approximately 40 states undertake a 'merit review' of the filing. A merit review of a filing involves a substantive review of the issuer and the offering and is intended to 'prevent promotion of fraudulent or inequitable issues'. Common merit review provisions relate to the following matters:

- **'Cheap stock'** - limiting sales of stock to insiders and promoters that are proximate to the offering at a significantly discounted price.
- **Loans to and other affiliate transactions** - requiring all insider loans to be repaid before the public offering; other material transactions must be on similar terms available from unaffiliated third parties and be ratified by a majority of the independent directors;
- **Debt securities** - requiring cash flow in the past fiscal year that is sufficient to cover fixed charges, meet debt obligations as they become due and service the debt being offered; requiring a trust indenture meeting the requirements of the Trust Indenture Act of 1939; requiring the establishment of a sinking fund or other redemption requirements;
- **Impoundment of proceeds** - subjecting the proceeds from any offering especially best efforts and minimum/maximum offering(s) to impound;
- **Options and warrants** - limiting stock underlying such securities, at the time of the public offering to, for example, 15 percent of the outstanding common stock; dictating terms of exercisability to not less than 85 percent of fair market value of the underlying common stock on the date of grant; and limiting underwriters compensatory issuances;
- **Preferred stock** - requiring net income in the past fiscal year that is sufficient to cover fixed charges, preferred stock dividends and redemption requirements of the preferred stock being offered; and requiring the establishment of redemption provisions;
- **Promoters' equity investment** - with respect to development stage companies, requiring the promoters' equity interest to be more than 10 percent of the aggregate public offering;

- **Promotional shares** - requiring the escrow of shares or the reduction of the offering price where equity securities of a development stage company have been issued to promoters for a value less than 85 percent of the proposed public offering price;
- **Selling expenses and selling security holders** - limiting expenses to a percentage of the offering amount; requiring selling security holders to pay a pro rata share of the additional expenses due to the inclusion of their shares in the public offering;
- **Unequal voting rights** - prohibiting these, unless accompanied by preferential dividend or liquidation provisions;
- **Capitalization requirements** - prohibiting the issuance of any security except common equity the issuer is 'unseasoned'; and
- **Specifying offering price** - requiring such prices to relate to book value, earnings history and/or industry price/earnings multiples where there is no established market for the security; requiring the price to be no lower than, e.g., \$2 in any event, or no more than 25 times earnings; and forbidding certain types of offerings such as ones with a planned 'step-up' pricing mechanism.

**b. Model merit review standards**

NASAA is an association of securities administrators from each of the fifty states, the District of Columbia, Puerto Rico, Guam, Mexico, and several Canadian provinces. NASAA has published Statements of Policy that contain model merit standards of general applicability. NASAA also has published Statements of Policy that contain model merit standards that relate to specific investments".

A similar merit review in South Africa would have precluded the Masterbond, Supreme and Owen Wiggins groups from selling debentures and would have prevented losses which exceeded one billion rand.

20. See note 19 above.

21. See note 14 above.

22. The draftsmanship of the Notice is so poor that no useful purpose will be served by reciting the text.

.....

# CHAPTER 9 - DISCLOSURE AND THE SECONDARY MARKET

**9.1** In South Africa (as in many other jurisdictions) securities regulation has traditionally focused on new offerings of securities and mainly by means of the compulsory disclosure of the affairs of the company in a prospectus or in similar documents.

**9.2** One of the requirements regarding the contents of a prospectus relates to the future prospects of the company. A matter which must be stated is (Schedule 3)

(i) The opinion of the directors, stating the grounds therefor, as to the prospects of the business of the company and of its subsidiary and of any subsidiary or business undertaking to be acquired'.

**9.3** While securities legislation remains focused on the primary market and the prospectus, most investment activity occurs in the secondary market.

As examples of the investment activity in the secondary market, available statistics indicate that in Canada the secondary market is approximately 25 times larger and in the United States approximately 35 times larger than the primary market.<sup>(1)</sup>

**9.4** In South Africa, compulsory disclosure of the affairs of a public company after the initial issues of shares is limited to the contents of its financial statements. Some additional disclosure is required by the listing requirements of the stock exchange.<sup>(2)</sup>

**9.5** The Companies Act provides for

- duly audited annual financial statements which must be made out before the annual general meeting of the company which has to be held not more than 9 months after the end of the financial year (sec. 286 and 179);
- unaudited provisional annual financial statements within 3 months of the financial year-end if the annual statements had not been issued within this period (sec. 304);

— half-yearly interim reports within 3 months after the expiration of the first six months of the company's financial year (sec. 303).

9.6 These periods were introduced in 1973 and since that date the advance in technology relating to computerized accounting systems and the internet has been ignored.

9.7 There is a growing realization that financial statements as presently prepared have serious deficiencies and often offer very little assistance to investors when issued. More often than not the contents are irrelevant and misleading because

— the statements reflect historical positions which often have no relevance to the future;

— the statements, often published many months after year-end, are normally out of date;

— no direct statements as to the future prospects of the company are required from the directors or from the external auditors;

9.8 The views of some commentators about financial statements as reported by the Jenkins Committee<sup>(3)</sup> are

“The **American Accounting Association Committee on Accounting and Auditing Measurement**, 1989-1990, concluded that ‘.....the most general criticism to be leveled at **financial statements in their present form is that they are seriously incomplete**’.

**U.K. accountancy bodies** issued several documents challenging current business reporting.

*Making Corporate Reports Valuable (1988)*. ‘The present model for corporate reporting is not satisfactory.....**Present-day financial statement packages seldom given any indication of the overall objectives of the entity**; and even crucial information about its management and ownership is provided only on a limited scale’.

*Financial Reporting. The Way Forward (1990)*: ‘What is principally wrong with present financial statements is that **they do no reflect the economic reality of a company’s progress and position** .....Present-day financial statements are deficient in that **they concentrate on .....past events rather than the future**’.

*The Future of Financial Reports (1991):* ‘There is increasing support for the view that the **existing financial reporting package is not adequate to meet the needs of users. The balance sheet and profit and loss account have evolved from the limited requirements of reporting in the developing industrial economy of the nineteenth century, and extensive tinkering has not been sufficient to bring them in line with the requirements of the late twentieth century market economy.....The contents of financial reports should be user driven.....**’ “

**9.9** Mr **John Whitney**, the Executive Director of the **Columbian Business School’s Deming Centre** (at the **1997 World Congress of Accountants**) summarised one of the problems associated with financial statements and the traditional audit as

#### **"Timeliness**

We are all painfully aware of the time it takes to complete an audit. By the time the audit is finished and the financial statements are printed, two things will have happened: people will have lost interest and the world will have changed. Moreover, financial statements are lagging indicators”.

**9.10** More recently, the American Securities and Exchange Commission issued a consultation paper known as the 'Aircraft Carrier Report' in which it expressed the view that information provided ninety days after a fiscal year end, is stale.

"Since 1970, annual reports have been due 90 days after a reporting company's fiscal year end. Quarterly reports, since they were first required in 1946, have always been due within 45 days after the end of a quarter. Many companies file, or ostensibly could file, their periodic reports before they are due.

In this age of computers, instantaneous communications and electronic filing, we believe it is possible for reporting companies to file their annual and quarterly Exchange Act reports sooner than they are currently due. Public companies, as a group, have had decades of experience in preparing Exchange Act periodic reports within 90 and 45 days.

As the proposed registration system makes clear, the securities markets move faster than they did before. Commentators have long remarked that because the due dates for quarterly reports are so lengthy, the information required by Form 10-Q or 10-QSB is stale by the time the reports are available. Annual information — when provided 90

days after a fiscal year end — is also viewed as stale. We believe investors and the market would realize immediate and ongoing benefits if domestic reporting companies filed their annual and quarterly reports earlier than currently due. We also believe earlier due dates would provide investors with more timely disclosure as well as shorten the period during which periodic results would be available to only certain investors".<sup>(4)</sup>

**9.11** Electronic communication offers the potential for rapid and less costly dissemination of information.

"Electronic lodgment has advantages for both the regulator and investors. It is potentially cheaper for the regulator to process, maintain, track and retrieve lodged information. It also provides the opportunity for efficient and effective dissemination of filed information to members of the public who have access to the means to receive it. Moreover, depending on the system adopted, electronically lodged information may be more useful to investors than the same information provided in paper format, since many electronic formats have the potential to be searched and for information (for example, the financial statements) to be imported into spreadsheets for the purpose of analysis".<sup>(5)</sup>

**9.12** The Canadian Securities Administrators have issued a 'Concept Proposal for an Integrated Disclosure System' in which a system of continuous disclosure of information to all market participants is proposed.

"The objective of the CSA is to foster fair and efficient capital markets in a changing market environment in a way that facilitates capital formation without compromising the protection of investors. More specifically, the CSA seek to:

- facilitate prompt and flexible access by business to capital;
- enhance the ability of investors to make informed investment decisions using more useful and reliable information from securities issuers; and
- achieve a better match of regulatory effort to existing and prospective market conditions.

The key to achieving these objectives, in view of the the CSA, lies in integrating and upgrading the quality of information made available on a continuous basis to all market participants.

The proposed 'integrated disclosure system' (the 'IDS') would integrate the information required to be provided by reporting issuers to investors in both the primary and secondary securities markets in a common continuous disclosure base. The foundation of the IDS would be an upgraded 'IDS disclosure base' that offers the public timely access to information relating to an issuer and its business, comparable to the information currently provided in a prospectus. The IDS disclosure base, with its comprehensive and timely information available to all investors, would represent an important advance in investor protection.

With its IDS disclosure base in place, a participating issuer would be able to respond immediately to opportunities in the primary market by using an abbreviated securities offering document that incorporates by reference the issuer's IDS disclosure base and undergoes streamlined regulatory screening".<sup>(6)</sup>

**9.13** Continuous disclosure of events which might have an impact on the value of the shares of a company is normally regulated by the listing requirements of stock exchanges.

**9.14** The New Zealand Stock Exchange requires the release of all 'relevant information', which is defined as

"[A]t any time information received or generated and held by an Issuer about its undertaking, activities, business environment, prospects, financial position or financial performance which is not reasonably available to an informed investor in the market in a form substantially as useable as the form in which it is available to the Issuer, and which upon disclosure to the market would, or would likely to, affect materially the market price of any of the Issuer's Quoted Securities".

It is also stated that

".... It shall not be a sufficient reason to withhold Relevant Information, that release of it may adversely affect the market price of any of the Issuer's Quoted Securities, or its ability to attract and retain debt financing on favourable terms".

**9.15** The continuous disclosure of relevant information, the definition of relevancy and the exclusion of certain information from immediate disclosure are debated worldwide.<sup>(7)</sup>

**9.16** While the listing requirements in South Africa are set and supervised by a private entity, the JSE Securities Exchange SA, no useful purpose will be served by a lengthy discussion about the continuous disclosure of relevant information.

The JSE seems to lack the ability or the necessary will to set listing requirements which could adequately protect investors.<sup>(8)</sup>

As recommended in Chapter 7, the Securities Exchange should be controlled by the Securities Regulator.

**9.17** As pointed out, the South African Companies Act requires public companies to issue half-yearly and annual financial statements.

The advent of computerized accountancy systems has made daily disclosure possible. There is no practical reason why all listed public companies should not be required to issue quarterly financial statements.

**9.18** The existing time periods allowed for the issue of financial statements have their roots in the old accounting systems based on manual bookkeeping.

There can be no practical reason why companies should not be able to issue quarterly statements within 30 days of the end of the quarter and annual financial statements within 45 days after the end of the financial year.

**9.19** An impediment to the prompt issue of financial statements is the often widespread use of journal entries (often long after year-end) to manipulate financial data.

"Currently the information presented in financial statements is too often only collated after year end and subsequently adjusted by an array of sometimes random closing and correcting entries to reflect preplanned sets of information. What is being achieved is a belated manipulated collation of data, for release after the so-called year end audit".<sup>(9)</sup>

**9.20** As in Ontario and as suggested by the SEC, quarterly statements of all listed companies should be subject to review by the external auditor.

**9.21 It is recommended that all public companies should be required to publish**

— **quarterly reports within 30 days after the end of each of the first three quarters of the financial year;**

— **annual financial statements within 45 days after the end of the financial year.**

**9.22 It is further recommended that all listed public companies should be required to have their quarterly reports reviewed by the external auditor.**

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## NOTES

1. **Concept Proposal for an Integrated Disclosure System** (Canadian Securities Administrators. January 2000) p. 3.

2. **Some** of the disclosures required by the listing requirements in South Africa are

"3.43 An issuer must, without delay, subject to the approval by the Listings Division, release an announcement giving details of:

(a) circumstances or events that have or are likely to have a material effect on the financial results, the financial position or cash flow of the issuer and/or information necessary to enable holders of the issuer's listed securities and the public to avoid the creation of a false market in its listed securities; and

(b) any new developments in its sphere of activity which are not public knowledge and which may by virtue of the effect of those developments on its assets and liabilities or financial position or in the general course of its business, lead to material movements in the ruling price of its listed securities.

Save where otherwise expressly provided, the requirements of this paragraph are in addition to any specific requirements regarding notification contained in the Listings Requirements.

3.76 Information required by and provided in confidence to, and for the purposes of, a government department, the South African Reserve Bank, the SRP, the Financial Services Board or any other statutory or regulatory body or authority need not be published.

3.19 Interim reports shall be distributed to all shareholders as early as possible after the expiration of the first six month period of a financial year, but not later than three months after that date. Where the financial period covers 15 months or longer, interim reports shall be distributed in respect of the first and second six of this period. In the case of companies which report to shareholders on a quarterly basis, the quarterly reports shall be distributed to all shareholders as soon as possible after the expiration of each quarter, provided that where the quarterly report is in respect of the second quarter, such report shall be distributed within three months after the expiration of such period.

#### **Requirement for review by auditors**

3.24 The following provisions apply in respect of unaudited interim reports, and unaudited provisional reports:

- (a) subject to (b), unaudited interim reports are not required to be reviewed by a listed company's auditors;
- (b) unaudited interim reports shall be reviewed by a listed company's auditors if the company's auditors have qualified or disclaimed their opinion, or produced an adverse opinion, on the company's latest annual financial statements, unless the Committee otherwise decides;
- (c) unaudited provisional reports shall be reviewed by a listed company's auditors;
- (d) unaudited quarterly reports are not required to be reviewed by a listed company's auditors, unless otherwise requested by the Committee;
- (e) when conducting a review of an unaudited interim or provisional report, the auditor shall follow the guidelines issued by the South African Institute of Chartered Accountants;

- (f) if an interim provisional report has been reviewed by an auditor, this and the name of the auditor shall be stated in the published interim or provisional report, if such report is modified, details of the nature of such modification shall also be stated therein. If the report of the auditor is not included in the published interim or provisional report, it shall state that the report of the auditor is available for inspection at the company's registered office; and
- (g) if during the course of a review of a provisional report, the auditor becomes aware of any unresolved matter which could result in a qualified disclaimer of or an adverse audit opinion on the annual financial statements for the period under review, that fact shall be stated.

#### **Annual financial statements**

3.25 Every listed company shall, within six months after the end of each financial year and at least twenty-one clear days before the date of the annual general meeting, distribute to all shareholders; submit to the Listings Division in accordance with paragraph 16.21; and make available to the South African Press Association:

- (a) a notice of annual general meeting; and
- (b) the annual financial statements for the relevant financial year which financial statements will have been reported upon by the company's auditors".

3. **Jenkins Committee Report.** "Improving Business Reporting: A Customer Focus". Report of the Special Committee of AICPA on Financial Reporting (1993).

4. **Aircraft Carrier Report.**

5. **Boros, Dr Elizabeth :** 'The Online Corporation's Electronic Corporate Communications' (Centre for Corporate Law and Securities Regulation. University of Melbourne. December 1999) p.26.

6. **Canadian Securities Administration.** "Concept Proposal for an Integrated Disclosure System" (Jan. 2000) Part 2.
7. **Oesterle, Prof. Dale Arthur.** : 'The Inexorable March Towards a Continuous Disclosure Requirement For Publicly Traded Corporations : Are We There Yet?' (Cardozo Law Review Vol. 20) p 136.
8. **See the recent retraction by the JSE of a perfectly normal requirement that the benefits of directors should be disclosed (Cape Times Business Report : 23 February 2001):**

**"JSE postpones requirement to disclose directors' fees**

Johannesburg – In a move that is regarded as a blow to corporate governance, the JSE Securities Exchange (JSE) has decided to postpone implementation of its listing requirement relating to the disclosure of directors' emoluments.

The decision was taken largely in response to the possible threat of legal action around the issue of retrospective legislation.

Russel Loubser, the president of the JSE, said the additional time would allow companies to 'manage and communicate' the implications of the disclosure.

He also warned that companies should not attempt to change the relationship between themselves and their directors in order to avoid compliance with the requirement.

The requirement, which included disclosure of individual directors' remuneration, should have been effective for companies with a financial year ending after October 1 last year. It will now only become applicable in respect of financial years commencing on, or after, March 1 this year.

This means that shareholders will only get access to the information from annual reports that are published from about May 2002 onwards instead of next month.

John Burke, who is the head of the JSE's listings department, denied that the decision to postpone implementation was because of pressure from black

business leaders who feared that the publication of such data would make them targets for unwelcome activity.

'We discussed the issue with leading black businessmen and women and they expressed unhappiness with the perception that blacks were seen as an impediment to a change that they regard as necessary,' he said.

Others claimed that the toughest opposition came from a relatively small number of high-profile and powerful white business leaders. This opposition was only voiced after the new listings requirements took effect. There was little dissension expressed during the consultation period".

See also the comments by Ann Crotty in **Business Report, Sunday Argus** 25 February 2001:

"Johannesburg — The international reputation of the JSE Securities Exchange suffered a blow this week when it announced it was postponing implementation of the new requirement relating to disclosure of directors' remuneration until March next year. The postponement means the JSE will be several years behind the major international bourses.

John Burke, the head of the JSE listings department, urged companies to disclose details of their directors' remuneration this year and not wait until they were obliged to.

On Friday Burke and Russell Loubser, the chief executive of the JSE, announced they had reluctantly given into pressure from the directors of a 'minority of companies' and decided to postpone the implementation of the new disclosure requirement from last October to March next year.

This means stakeholders in corporate South Africa will only get access to useful information on directors' remuneration from about May next year, when the end-March 2001 [sic] annual reports are released.

Ironically, South African shareholders in London-listed companies such as SAB, Billiton, Old Mutual, Dimension Data and Anglo American have access to detailed information on their directors' remuneration. To date none of the executives of these companies, who spend a considerable amount of

time in South Africa, have reported any consequent disruptions to their corporate or personal lives.

The lobbying to block implementation began after October 1 last year, which was the original date of implementation. This was despite corporate executives and members of the public having access to the consultation draft of the new listings requirements as early as August last year. There was very little discussion of the requirements relating to disclosure of directors' remuneration during this consultation period.

'We followed the due process, which included a period of consultation, but it was only after October 1 that the objections started,' said Loubser.

This indicates that key members of corporate South Africa either do not take the JSE seriously, or believe they have enough power to change the rules after the fact".

9. **Wenzelburger, Norman R** : 'The Failure of the Audit Function in Managing Risk' (September 2000).

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# CHAPTER 10 - REGULATION AND SUPERVISION OF INTERMEDIARIES

**10.1** As pointed out, in modern economies all members of society are actively encouraged to save some portion of their earnings and to invest it in pension funds, unit trusts, life insurance policies, shares of listed companies and the like. When unable to depend upon their own resources, they are invited to place their futures in the hands of professional advisers or so-called 'intermediaries'.

**10.2** In South Africa these 'intermediaries' are usually unregulated and no qualifications, no skills and no adherence to codes of ethics are required by law when they ply their trade.

**10.3** In response to the Consultative Paper 'Regulation of Retail Investment Services in South Africa' issued by the Policy Board of Financial Services and Regulations (12 July 1996), the Commission stated that **intermediaries** (brokers, agents, financial advisers, etc.)

- **are normally indispensable links in the chain when fraud is being perpetrated on the public;**
- **are virtually never prosecuted and are hardly ever in the position to satisfy claims based on their negligent, reckless or even fraudulent conduct;**
- **are often motivated by greed when they target the elderly and trusting members of society;** <sup>(1)</sup>
- **that no qualifications, no skills and no adherence to codes of ethics are required from them;**
- **that there are approximately 20 000 – 30 000 persons, loosely described as 'brokers', active in South Africa; and**
- **that according to evidence presented in the High Court in the matter of Durr v Absa Bank and Myles Stuart, the typical South African 'broker'**

- (i) **cannot distinguish between a prospectus and marketing material containing information;**
- (ii) **does not know what the legal requirements of a prospectus are;**
- (iii) **cannot read and understand financial statements;**
- (iv) **is not able to assess the institutional risk attaching to a particular company or group of companies, and**
- (v) **would not make enquiries as to the nature of the security underlying secured debentures.**

**10.4** In the vast majority of the well regulated economies of the world it is recognized that regulation, supervision and licensing of all financial advisers and intermediaries are necessary

— to provide protection to investors from unfair, improper and fraudulent practices; and

— to foster fair and efficient capital markets and confidence therein. <sup>(2)</sup>

**10.5** In these economies, licensing only occurs after the applicants have satisfied the regulators, whether by way of examination or by other means, that they are suitably qualified to perform their functions.

**10.6** The **Australian Securities Commission** stated

'While no form of regulation can completely protect investors from fraudulent or dishonest players, the ASC believes that regulation can promote efficiency and raise the quality of the advisory process by addressing some market imperfections'.

'Extensive regulation of advisers would not be necessary if competitive market forces could remove incompetent and dishonest advisers quickly and before any substantial losses occur. However, in the absence of all the information and understanding necessary for consumers to make informed choices, competition may not produce optimal outcomes'.

'The most significant problems include inadequate consumer information and an imbalance of knowledge between advisers and investors; difficulties in ascertaining

the quality of an advisory service at the point of purchase because of the long term nature of financial contracts, the tendency of investors to use imperfect substitutes for reliable information; issues relating to conflicts of interest between investor and intermediary; the complexities of financial markets and technicalities of some financial products'.

'The objective of regulation in this context should be to promote investor confidence and market efficiency through : investor education; cost-efficient regulation; encouraging the industry to set and improve market standards; maintaining a significant role in enforcement and surveillance of the industry and promoting effective complaints resolution mechanisms. In the context of a relative fragmented and young market for advisory services and a relative inexperienced investing community, it is considered appropriate for the ASC to maintain a licensing role. Regulation which imposes requirements on advisers before they can enter the industry is considered justified having regard to the needs of retail investors who rely largely on assumptions as to the competence and integrity of advisers rather than undertake this assessment themselves'."<sup>(3)</sup>

If the above is a true reflection of the Australian market, regulation which imposes requirements on advisers before they are allowed to enter the industry would be even more essential in the South African market.

**10.7** To illustrate the recognition by many of the well-regulated economies of the need to regulate, supervise and license all financial advisers and intermediaries, reference will be made to legislation or proposed legislation in Hong Kong, Singapore, the United Kingdom and the United States.

**10.8** In the Consultation Paper on the Review of the Licensing Regime issued by the **Hong Kong Government** (June 1999), the necessity for a licensing regime in respect of all intermediaries with barriers to entry which would exclude the incompetent or unfit is stressed.

"4.1 The International Organization of Securities Commission (IOSCO) has adopted three core objectives of securities regulation. These are:

- The protection of investors.
- Ensuring that markets are fair, efficient and transparent.
- The reduction of systemic risk.

4.2 In achieving these objectives, IOSCO recommends the need for a 'licensing' (rather than 'registration', 'certification' or 'negative licensing') regime. The right to provide financial services should be conditional upon practitioners satisfying a licensing authority of their ability to meet certain predetermined criteria. Principle 21 of the IOSCO Objectives and Principles provide: 'Regulation should provide for minimum entry standards for market intermediaries'.

4.3 Hong Kong faces increasing competition from our neighbours in the region and, due largely to advances in technology and communications, competition from further afield. The financial markets are an important part of the Hong Kong economy. The presence in Hong Kong of a pool of competent licensed intermediaries is vital to the growth and development of the local markets. To maintain Hong Kong's position as a leading financial centre, the licensing regime must provide:

- minimum barriers to entry that exclude the incompetent and those unfit to enjoy a position of trust as a financial intermediary;
- equal and fair access to all suitably qualified applicants for a licence;
- entry criteria that have regard to the business plan of the applicant and do not permit the provision of services outside the applicants' area of competence;
- entry criteria that are clear and certain in their application;
- entry criteria that set initial and ongoing capital and other prudential requirements;
- entry criteria that set standards for internal organisation and operational conduct that aim to protect the interests of clients and under which management of the intermediary accept primary responsibility for these matters;
- a transparent licensing process in which key information on licensed persons is publicly available, including the category of licence held,

the scope of authorized activities, the identity of senior management and those authorized to act in the name of the intermediary;

- a process requiring a comprehensive assessment of the applicant and all who are in a position to control or materially influence the carrying on of regulated activities by the applicant;
- protection of the interests of investors, recognising that the initial entry barrier cannot be set too high and that investor protection is complemented by the availability of information, facilitating informed choices by investors and availability to the Commission of inspection, investigatory and disciplinary powers in respect of the intermediary;
- power for the Commission to withdraw or restrict a licence or to sanction the licensee whenever the entry criteria are not fulfilled or other misconduct occurs; and
- a requirement that changes of control over, or material influence of an intermediary should be made known to the Commission and be subject to approval in order to allow for a review of the licensed person's suitability".

**10.9** The **Monetary Authority of Singapore** licenses dealers in securities, investment advisers and investment representatives (sections 24 – 26 of Act 15 of 1986). It grants or renews a licence if it has no reason to believe that the applicant will not perform its duties efficiently, honestly and fairly (sec. 30).

**10.10** In the **United States** the National Conference of Commissioners on Uniform State Laws published the Uniform Securities Act in 1956.

The 1956 Act has been adopted in whole or in part in 37 jurisdictions.<sup>(4)</sup>

**10.11** In 1985 an updated version, the Uniform Securities Act (1985), was published. It provides for the licensing of broker-dealers, sales representatives and investment advisers (sections 201 – 205), and for the examination, oral or written, of an applicant or a class of applicants for licensing, and of a class of persons who will represent an investment adviser in performing an act that requires licensing as an investment adviser. (Section 207)<sup>(5)</sup>

**10.12** Generally speaking, the individual States in the United States require all intermediaries to be licensed and they are only licensed after having satisfied the authorities of their competence.

**10.13** The **Alabama Securities Act** is used as an example.<sup>(6)</sup> It defines intermediaries (agents, dealers, brokers, investment advisers, investment adviser representatives and salesmen) as follows -  
(Sec. 8-6-2):

**"Agent.**

Any individual other than a dealer who represents a dealer or issuer in effecting or attempting to effect sales of securities, but such term does not include an individual who represents an issuer in:

- a. Effecting transactions in a security exempted by subdivisions (1), (2), (3), (4), (9) or (10) of Section 8-6-10;
- b. Effecting transactions exempted by Section 8-6-11; or
- c. Effecting transactions with existing employees, partners, or directors of the issuer if no commission or other remuneration is paid or given directly or indirectly for soliciting any person in this state. A partner, officer, or director of a dealer or issuer is an agent if he otherwise comes within this definition.

**Dealer.**

Any person engaged in the business of effecting transactions in securities for the account of others or for his own account. Such term does not include:

- a. An agent, issuer, bank, savings institution, savings and loan association, credit union, or trust company, or
- b. A person who has no place of business in this state if he effects transactions in this state exclusively with or through the issuers of the securities involved in the transactions and other dealers.

**Broker.**

A dealer, as hereinabove defined.

**Investment adviser.**

- a. Any person, who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as a part of a regular business, issues or promulgates analyses or reports concerning securities. 'Investment adviser' also includes financial planners and other persons who, as an integral component of other financially related services, provide the foregoing investment advisory services to others for compensation and as part of a business or who hold themselves out as providing the foregoing investment advisory services to others for compensation.

'Investment adviser' does not include: (a. An investment adviser representative.....)

**Investment adviser representative.**

Any partner, officer, director of (or a person occupying a similar status or performing similar functions) or other individual employed by or associated with an investment adviser, except clerical or ministerial personnel, who:

- a. Makes any recommendation or otherwise renders advice regarding securities,
- b. Manages accounts or portfolios of clients,
- c. Determines which recommendation or advice regarding securities should be given,
- d. Solicits, offers, or negotiates for the sale of or sells investment advisory services, unless the solicitation, offering, or selling activities are solely incidental to his or her profession and such person is a dealer or salesman registered under Section 8-6-3 and the person would not be an investment adviser representative except for the performance of activities described in subdivision (18)d. of this section, or
- e. Supervises employees who perform any of the foregoing.

**Salesman.**

An agent, as hereinabove defined.

**10.14** Section 8-6-3 of the **Alabama Securities Act** prohibits the transaction of business as an investment adviser or investment adviser representative unless registered as such. Registration is not possible without having passed an examination (8-6-3-f).

**"Section 8-6-3 : Registration and bonds of dealers and salesmen.**

- (a) It is unlawful for any person to transact business in this state as a dealer or agent for securities unless he is registered under this article. It is unlawful for any dealer or issuer to employ an agent unless the agent is registered.
  
- (b) It is unlawful for any person to transact business in this state as an investment adviser or as an investment adviser representative unless:
  - (1) He is so registered under this article.
  - (2) .....
  - (3) .....
  
- (c) It is unlawful for any investment adviser required to be registered to employ an investment adviser representative unless the investment adviser representative is registered under this article. The registration of an investment adviser representative is not effective during any period when he is not employed by an investment adviser registered under this article. When an investment adviser representative begins or terminates employment with an investment adviser, the investment adviser shall promptly notify the commission.
  
- (d) A dealer, agent, investment adviser, or investment adviser representative may apply for registration by filing with the securities commission, or its designee, an application, together with a consent to service of process pursuant to Section 8-6-12 and payment of the fee prescribed in subsection (h) of this section. The application shall contain whatever information the commission requires concerning such matters as:
  - (1) The applicant's form and place of organization;
  - (2) The applicant's proposed method of doing business;

- (3) The qualifications and business history of the applicant and, in the case of a dealer or investment adviser, any partner, officer, or director, any person occupying a similar status or performing similar functions, or any person directly or indirectly controlling the dealer or investment adviser;
  - (4) Any injunction or administrative order or conviction of a misdemeanor involving moral turpitude, a security or any aspect of the securities business, any conviction of a felony;
  - (5) The applicant's financial condition and history; and
  - (6) Any information to be furnished or disseminated to any client or prospective client, if the applicant is an investment adviser.
- (e) The commission shall by rule or order require all or any class of applicants to post surety bonds, or cash, in an amount not less than &dollar, 50 000, and shall determine their conditions.
- (f) .....The commission shall require as conditions of registration that:
- (1) All or any class of applicants and, in the case of a corporation or partnership, the officers or partners, pass an examination, either written or oral, the form, content, and conduct of which the commission shall prescribe by rule or order.
  - (2) A dealer shall have and maintain a minimum net capital as the commission shall prescribe by rule or order. The commission may by rule establish minimum financial requirements for investment advisers, which may include different requirements for those investment advisers who maintain custody of clients' funds or securities or who have discretionary authority over same and those investment advisers who do not.
  - (3) Every registration expires December 31 unless renewed as hereinafter provided.
- (g) .....

- (h) .....
- (i) Every registered dealer and investment adviser shall make and keep such accounts and other records as the securities commission by rule prescribes. All records so required shall be preserved for five years unless the commission prescribes otherwise for particular types of records. The commission may require that certain information be furnished or disseminated by a registrant as necessary or appropriate in the public interest or for the protection of investors and advisory clients. To the extent determined by the commission in its discretion, information furnished to clients or prospective clients of an investment adviser pursuant to the Investment Advisers Act of 1940 and the rules thereunder may be used in whole or partial satisfaction of this requirement. All the records of any registrant are subject at any time or from time to time to such reasonable periodic, special, or other examinations by representatives of the commission, within or without this state, as the commission deems necessary or appropriate in the public interest or for the protection of investors".<sup>(7)</sup>

**10.15** The usual examination for an investment adviser representative is known as the 'Series 65 Exam' which has been designed to qualify candidates as investment adviser representatives. This is the examination referred to in the Georgia Securities Act <sup>(8)</sup> which was developed by the North American Securities Administration Inc. (NASAA). NASAA is the organisation of the Securities Administrators of Canada, Mexico, 50 States of the USA and of the District of Columbia and Puerto Rico.

**10.16** The 'Modified' Series 65 Examination replaced the old Series 65 and became effective on January 1, 2000. The required study outline is set out in the notes hereto.<sup>(9)</sup>

**10.17** In the **United Kingdom** the Financial Services and Markets Act 2000 prohibits the carrying on of a regulated activity unless authorised thereto by the Financial Services Authority (sec. 17). Regulated activities include the giving or offering of investment advice (sec. 20 and schedule 2).

The FSA may refuse an application for registration if it appears to it desirable in the interest of consumers or potential consumers

(sec. 42 (3)) after having been provided with such information as it reasonably considers necessary (sec. 49).

The stated intention of the FSA is the assessment of the competence and capability of the applicant to carry out the function which he will be performing.<sup>(10)</sup>

**10.18** In response to the Consultative Paper issued by the South African Policy Board of Financial Services and Regulation during July 1996, the Commission made the following key recommendations:

- **No person should be allowed to give investment advice for reward unless licensed so to do so by a competent and independent supervisor.**
- **Before being licensed, such a person should satisfy the supervisor that he or she is a fit and proper person and qualified to advise on investment in a particular field or fields before registration.**
- **The licence should state in which particular field such person is allowed to give advice.**
- **Any unlicensed person and any employer of such a person should be personally liable for the immediate repayment of any investment made as a result of the activities of such a person if and when called upon to do so by the investor.**
- **Any person who gives investment advice for reward without being licensed to do so or contrary to the terms of the licence or not in accordance with prescribed rules of conduct, should be guilty of a criminal offence carrying heavy penalties, such as, say, imprisonment up to 10 years or a fine of up to one million rand or both.**
- **Alternative civil remedies should be made available to investors who have claims against any regulated person or entity. The proceedings should be expeditious and inexpensive and the claims adjudicated upon by tribunals whose members have particular expertise.**

**10.19** During April 1999 the Financial Services Board issued a Draft Financial Advisers Bill for comment. The draft bill specifically excluded representatives or 'agents' from regulation and supervision by the regulator.

**10.20** In its response thereto the Commission restated its views on the regulation and supervision of intermediaries and also referred extensively to legislation in other jurisdictions.<sup>(11)</sup>

**10.21** A Revised Draft 'Financial Advisory and Intermediary Services Bill 2000' was issued during June 2000.

**10.22** The Financial Services Board still refuses to accept the responsibilities which regulators in modern economies regard as cornerstones of investor protection, namely

- the registration of all financial advisers, whether employers, employees or the thousands of 'agents' and only after having been satisfied of their competence,
- the regulation and supervision of virtually all financial products;<sup>(12)</sup>
- the independence of the regulator.

**10.23** In its final form the proposed bill has completely abandoned the concept of an independent regulator.

In terms of section 5 of the Bill an 'Advisory Committee on Financial Service Providers' will be created which will consist of a chairperson and **other members representative of product suppliers, financial service providers** [own emphasis] and clients.

**10.24** The very entities which created the necessity to regulate and supervise, and the very entities against which the public have to be protected, will thus be appointed to advise the registrar

- which financial products should be exempted from the provisions of the Act (section 2);
- which advisory activity should be excluded from the provisions of the Act (section 3(a)(v));
- which intermediary services should be exempted from the provisions of the Act (section 3(b)(iii).

(An intermediary service is defined as meaning

"any act other than the furnishing of advice, performed by a person –

- (a) the result of which is that a client may enter into, offers to enter into or enters into any transaction in respect of a financial product with a product supplier; or
- (b) with a view to –
  - (i) managing, administering, keeping in safe custody, maintaining or servicing a financial product purchased by a client from a product supplier or in which the client has invested;
  - (ii) collecting or accounting for premiums or other moneys payable by the client to a product supplier in respect of such financial product; or
  - (iii) receiving, submitting or processing of claims of a client against any such product supplier; ".)

- advise the registrar as to the submission of reports and the manner and matters to be reported upon by a compliance officer (section 17(4));

- advise the Board as to which person should be appointed as an Ombudsman (section 21(1));
- advise the Board and Minister whether to remove the Ombudsman from office (section 21(4));
- advise the Board in the making of rules (section 26) -

"... including different rules in respect of different categories of complaints or Ombudsman investigations, regarding -

- (a) (i) any matter which is required or permitted under this Act to be regulated by rule;
- (ii) the category of persons qualifying as complainants;
- (iii) the type of complaint justiciable by the Ombudsman, including a complaint relating to a financial service rendered by a person not authorised as a financial services provider or a representative of such provider;
- (iv) the rights of complainants in connection with complaints, including the manner of lodging of a complaint to the authorised financial services provider or representative involved;
- (v) the rights and duties of any such provider or representative on receipt of any complaint, particularly in connection with the furnishing of replies to the complainant;
- (vi) the rights of a complainant to submit a complaint to the Ombudsman where the complainant is not satisfied with any reply received from the provider or representative concerned;

- (vii) the circumstances under which a complaint may be dismissed without consideration of its merits;
    - (viii) the power of the Ombudsman to fix a time limit for any aspect of the proceedings and to extend a time limit;
  - (b) the payment to the Office by the authorised financial services provider or representative involved in any complaint lodged with the Ombudsman of case fees in respect of the consideration of a complaint by the Ombudsman".
- advise the board as to the imposition of special levies on authorised financial providers for the purposes of funding the office of the Ombudsman (section 26(3));
  - advise the registrar whether a particular business practice should be declared undesirable for all or a particular category of authorised financial service providers, or for any specific provider (section 34(1));
  - advise the Minister relating to the making of any regulation (section 35(1)).

**10.25** A remarkable abandonment of any semblance of the independence of the regulator is provided by section 15(1):

"15 (1) The registrar shall in consultation with the Advisory Committee and with such other representatives of the financial services industry and client and consumer bodies determined by the Advisory Committee, draft a code of conduct for authorised financial services providers which, if approved by that Committee, shall be published by notice in

the *Gazette*, and which shall on any such publication become binding on all authorised financial services providers and representatives referred to therein".

**10.26** This section means that the registrar will be obliged to consult with

- the Advisory Committee; and
- representatives of the financial services industry and client and consumer bodies **determined by the Advisory Committee** (own emphasis); and
- that these entities will have to approve the contents of any proposed rule of conduct before such rule can be published and become binding.

**10.27** The effect of this section is that the very entities whose conduct has to be regulated will have the authority to veto any rule which might seek to curb their excesses.

**10.28** While the contents of section 15 can be described as 'a remarkable abandonment of any semblance of the independence of the regulator', the contents of section 6 defies description.

**10.29** Section 6 must certainly be unique in legislation which purportedly seeks to curb the excesses of the financial services industries.

**10.30** The essence of section 6 is that, if enacted in its present form, it will create a mechanism whereby each and every function of the Minister and of the Registrar can be delegated to

**'a body of persons which represents a category of authorised financial service providers.'**

This will enable the financial service providers to control virtually all the facets of the hawking and selling of financial products.

**10.31** Virtual control by the financial service providers would follow if the powers to delegate which has been introduced into the Bill are used.

It

- enables the Minister to delegate any power conferred upon him by the Act to, *inter alia*, the Registrar (section 6(1));
- enables the Financial Services Board to delegate any power conferred upon it by the Act to, *inter alia*, the Registrar (section 6(2)(a));
- enables the Registrar to delegate any power conferred upon him by the Act, including any power which has been delegated to him, to, *inter alia*, any body recognized by the Financial Services Board for that purpose (section 6(3)(a)(iii));
- enable the Financial Services Board, for the purposes of the delegation of such powers to it, to recognize any body of persons which represents a category of authorised financial service providers or representatives (section 6(4)(a)).

**10.32** In addition to these criticisms, the final draft of the proposed Bill is decidedly less friendly towards the long-suffering public than previous drafts.

Provisions seeking to protect the public, such as those relating to 'cold calling' and 'cooling-off' periods, have disappeared without any explanation.

**10.33** The Commission is of the view that at best the contents of the proposed Bill do not provide adequate protection to the public, and at worst the contents constitute a cynical attempt to allow control of financial intermediaries to be handed over to the financial services industry.

**10.34** It is recommended that the proposed Bill should be rejected and redrafted with a specific instruction to the draftsman that the contents of the Bill should be focused on the protection of the public and on the protection of the financial markets.

**10.35** It is further recommended that

- No person should be allowed to give investment advice for reward unless licensed so to do so by a competent and independent supervisor.
- Before being licensed, such a person should satisfy the supervisor that he or she is a fit and proper person and qualified to advise on investment in a particular field or fields before registration.
- The licence should state in which particular field such person is allowed to give advice.

- **Any unlicensed person and any employer of such a person should be personally liable for the immediate repayment of any investment made as a result of the activities of such a person if and when called upon to do so by the investor.**
  
- **Any person who gives investment advice for reward without being licensed to do so or contrary to the terms of the licence or not in accordance with prescribed rules of conduct, should be guilty of a criminal offence carrying heavy penalties, such as, say, imprisonment up to 10 years or a fine of up to one million rand or both.**

.....

## NOTES

1. **See also** - Under the heading '**Big commission debate hots up**', Bruce Cameron wrote the following (Personal Finance, The Argus, September 30, 2000):

"The widespread switch from defined benefit to defined contribution pension funds has forced many members to take responsibility for the investment of their retirement savings at retirement. This has brought about a war between various financial services sectors for the billions at stake. The war is being won and lost on the commissions and other incentives, such as luxury foreign holidays, on offer to those selling financial products.

Life assurers have been losing out because they cannot match the higher commissions paid by other sectors to intermediaries because life assurance is the only sector with regulated commissions.

.....

The commission war has become so acute and absurd that wrap fund managers, who pull together underlying investments, and whose funds are the main investment vehicle used for living annuities, are now paying higher annual commissions to the people who sell the investments than they receive for their investment expertise. The intermediaries are paid for doing very little.

.....

However, it is in the lump sum business that most mis-selling by intermediaries has taken place in recent years. Much of the mis-selling has been based on ever higher commissions being paid to intermediaries by the non-assurance sector of the financial services industry for lump sum investments, most of which are pension pay-outs from retirement funds.

Despite evidence of the mis-selling of lump sum investments, particularly living annuities, published over a number of months in Personal Finance, Gerhard Joubert, chief executive of the LOA, says: 'I am not aware of the alleged mis-selling of living annuities and would appreciate receiving information about specific cases!'

2. **See e.g. Securities Act of Ontario** : Section 1.1
3. **Australian Securities Commission**, Licensing Review (August 1995).
4. **Long, Joseph C** : Blue Sky Law Vol. 12 B. App. D.I.- 3. (The West Group 1999).

5. **Ibid** : App. D. I. Par 11.

**See also** sections 401(d)(2), 403(a)(1) – (6) and 405(a) (A-K) of the Proposed Revised Uniform Securities Act as follows (Jan. 2000):

"401(d)(2) Except as provided in §402, the [Administrator] may register any investment adviser representative of a federal covered investment adviser who has a place of business within the State. The registration of such an investment adviser representative is not effective during any period when the investment adviser representative is not employed by or associated with the federal covered investment adviser. When an investment adviser representative begins or terminates employment by or association with a federal covered investment adviser, or begins or terminates activities which make him or her an investment adviser representative, the investment adviser representative or federal covered investment adviser shall promptly notify the [Administrator].

403(a) **[REGISTRATION PROCEDURE FOR BROKER-DEALERS, AGENTS, INVESTMENT ADVISERS, AND INVESTMENT ADVISER REPRESENTATIVES]**

A broker-dealer, agent, investment adviser, or investment adviser representative may obtain an [initial or renewal] registration by filing with the [Administrator] or his or her designee an application together with a consent to service of process complying with §510. Each application shall contain whatever information the [Administrator] by rule requires concerning such matters as

- (1) the applicant's form and place of organization;
- (2) the applicant's proposed method of doing business;
- (3) the qualifications and business history of the applicant; in the case of the broker-dealer or investment adviser, the qualifications and business history of each partner, officer, or director, any person occupying a similar status or performing similar functions, or any person directly or indirectly controlling the broker-dealer or investment adviser;

- (4) any injunction or administrative order or conviction of a felony of the applicant or any person specified in §403(a)(3);
- (5) the applicant's financial condition and history; and
- (6) if the applicant is an investment adviser, any information concerning the investment adviser to be furnished or disseminated to any client or prospective client.

405

**[DENIAL, REVOCATION, SUSPENSION CANCELLATION, AND WITHDRAWAL OF REGISTRATION].**

- (a) The [Administrator] shall by order deny, suspend or revoke any registration, or bar or censure any registrant agent or investment adviser representative from employment by or association with a registered broker-dealer, investment adviser, or federal covered investment adviser, or bar or censure any officer, director, partner or person occupying a similar status or performing similar functions for a registered broker-dealer or investment adviser, from employment by or association with a registered broker-dealer or registered investment adviser, or restrict or limit a registrant as to any function or activity of the business for which registration is required in this state, if the [Administrator] finds (1) that the order is in the public interest and (2) that the applicant or registrant
  - (A) has filed an application for registration which as of its effective date, or as of any date after filing in the case of an order denying effectiveness, was incomplete in any material respect or contained any statement which was, in light of the circumstances under which it was made, false or misleading with respect to any material fact;
  - (B) has willfully violated or willfully failed to comply with any provision of this Act or a predecessor act or any rule or order under this Act or a predecessor act, or any provision of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, the

Investment Company Act of 1940, or the Commodity Exchange Act within the past ten years;

- (C) has been convicted, within the past ten years, of any felony or any misdemeanor involving a security or any aspect of the securities business;
- (D) is permanently or temporarily enjoined by any court of competent jurisdiction from engaging in or continuing any conduct or practice involving any aspect of the securities business;
- (E) is the subject of an order entered within the past five years by the securities administrator of any other state or by the Securities and Exchange Commission denying, revoking, or suspending registration as a broker-dealer, agent, investment adviser, or investment adviser representative, or the substantial equivalent of those terms as defined in this Act, or is the subject of an order entered within the past five years by the [Administrator] of any State or by the Securities and Exchange Commission with a registered broker-dealer or registered investment adviser, or the substantive equivalent of these terms or is the subject of an order of the Securities and Exchange Commission suspending or expelling him from a national securities exchange or national securities association registered under the Securities Exchange Act of 1934, or is the subject of a United States Post Office fraud order; but (i) the [Administrator] may not institute a revocation or suspension proceeding under this paragraph more than one year from the date of the order relied on, and (ii) [the Administrator] may not enter an order under this paragraph on the basis of an order under another state act unless that order was based on facts which would currently constitute a ground for an order under this Subsection;
- (F) is the subject of an adjudication or determination, after notice and opportunity for hearing, within the past ten years by securities or commodities agency or administrator of

another state or a court of competent jurisdiction that the person has willfully violated the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, the Investment Company Act of 1940, or the Commodity Exchange Act, or the securities or commodities law of any other state;

- (G) is insolvent, either in the sense that the person's liabilities exceed the person's assets or in the sense that the person cannot meet the person's obligations as they mature; but the [Administrator] may not enter an order against a broker-dealer or investment adviser under this paragraph without a finding of insolvency as to the broker-dealer or investment adviser;
- (H) is not qualified on the basis of such factors as training, experience, and knowledge of the securities business, except as otherwise provided in §405(b);
- (I) has failed reasonably to supervise the person's agents or employees if the person is a broker-dealer, or the person's investment adviser representatives or employees if the person is an investment adviser, to ensure their compliance with this Act, if such agents, investment advisers representatives or employees are subject to the person's supervision and have committed a violation of the Act;
- (J) [after notice,] has failed to pay the proper filing fee;
- (K) has willfully violated the law of a foreign jurisdiction governing or regulating any aspect of the business of securities or banking or, within the past five years, has been the subject of an action of a securities regulator of a foreign jurisdiction denying, revoking or suspending the right to engage in the business of securities as a broker-dealer, agent, investment adviser or investment adviser representative, or is the subject of an action of any securities exchange or self-regulatory organization operating under the authority of the securities regulator of a foreign

jurisdiction suspending or expelling such person from membership in such exchange or self-regulatory organization; or

- (b) The following provisions govern the application of 405(a)(2)(H):
- (1) The [Administrator] may not enter an order against a broker-dealer on the basis of the lack of qualification of any person other than (A) the investment adviser if the person is an individual or (B) an agent of the broker-dealer.
  - (2) The [Administrator] may not enter an order against any investment adviser on the basis of the lack of qualification of any person other than (A) the investment adviser if the person is an individual or (B) an investment adviser representative.
  - (3) The [Administrator] may not enter an order solely on the basis of lack of experience if the applicant or registrant is qualified by training or knowledge or both.
  - (4) The [Administrator] shall consider that an agent representative who will work under the supervision of a registered broker-dealer need not have the same qualifications as a broker-dealer and that an investment adviser representative who will work under the supervision of a registered investment adviser need not have the same qualifications as an investment adviser.
  - (5) The [Administrator] shall consider that an investment adviser is not necessarily qualified solely on the basis of experience as a broker-dealer or agent. When the [Administrator] finds that an applicant for [initial or renewal] registration as a broker-dealer is not qualified as an investment adviser, the [Administrator] may by order condition the applicant's registration as a broker-dealer upon her or his not transacting business in this state as an investment adviser.

(6) The [Administrator] may by rule provide for an examination, including an examination developed or approved by an organization of securities administrators, which examination may be written or oral or both, to be taken by any class of or all applicants. The [Administrator] may by rule or order waive the examination requirement as to a person or class of persons if the [Administrator] determines that the examination is not necessary for the protection of investment adviser clients".

6. See also as further examples the **Insurance Code of California** and the **Texas Securities Act**.

**Insurance Code of California:**

"1621. An insurance agent is a person authorised by and on behalf of an insurer to transact all classes of insurance, except life insurance. The term 'insurance agent' as used in this chapter does not include a life agent as defined in this article.

1622. A life agent is a person authorised by and on behalf of a life, disability, or life and disability insurer to transfer life, disability, or life and disability insurance.

1623. An insurance broker is a person who, for compensation and on behalf of another person, transacts insurance other than life with, but not on behalf of, an insurer.

1624. An insurance solicitor is a natural person employed to aid an insurance agent or insurance broker in transacting insurance other than life.

1625. A fire casualty licensee is a person authorised to act as an insurance agent, broker, or solicitor, and a fire and casualty broker-agent license is a license so to act.

1626. A life licensee is a person authorized by and on behalf of a life, disability, or life and disability insurer to transfer life, disability, or life and disability insurance, and a life agent license is a license so to act.

1675. A license is a permit to act in the capacity specified therein. A person licensed is the holder of the license. The commissioner may deny an application for any license issued pursuant to this chapter **if**:

(a) The applicant is not properly qualified to perform the duties of a person holding a license applied for.

1676. Except as set forth in Sections 1675 and 1679, the commissioner shall not issue a permanent license pursuant to this chapter to an applicant therefor unless such applicant has within the 12-month period next preceding the date of issue of the license taken and passed the qualifying examination for such license.

1677. Every qualifying examination for a license under this chapter shall be in writing and shall be of sufficient scope to satisfy the commissioner that the applicant has sufficient knowledge of and is reasonably familiar with the insurance laws of this State and with the provisions, terms and conditions of the insurance which may be transacted pursuant to the license sought, and has a general and fair understanding of the obligations and duties of the holder of such license”

#### **Texas Securities Act. Art. 581 – 13.D**

The Commissioner shall require as a condition of registration for all registrations granted after the effective date of this Subsection D that the applicant (and, in the case of a corporation or partnership, the officers, directors or partners to be licensed by the applicant) pass successfully a written examination to determine the applicant’s qualifications and competency to engage in the business of dealing in and selling securities as a dealer or as a salesman, or rendering services as an investment adviser. This condition may be waived as to any applicant or class of applicants by action of the State Securities Board”.

#### **7. Also compare (not an exhaustive list):**

Alaska Securities Act :	Chapter 45.55.
Arizona Securities Act :	Chapter 44-1962.
Connecticut Uniform Securities Act :	Sec. 36b – 15.
District of Columbia :	A. Sec. 35 – 1324.
Delaware Securities Act :	Sec. 7316.

Georgia Securities Act :	Sec. 590-4-8-02.
Illinois Securities Law of 1953 :	Sec. 8.
Iowa Securities Act :	Sec. 502.301 - 304.
Missouri Securities Act :	Sec. 409.204.
Missouri Code of State Regulations :	15 CSR 30-51-020.
Pennsylvania Securities Act of 1972 :	Sec. 301 - 303.
Texas Securities Act :	Sec 12 - 13.
Utah Uniform Securities Act :	Sec. 61-1-3.

- 8. See also** the examination requirements set out in section 590-4-8-07 of the Georgia Securities Act.

**"590-4-8-07 Examinations.**

The following provisions shall govern investment adviser and investment adviser representative examination requirements:

- (a) unless waived pursuant to subparagraph (b), (c), or (d) of this rule, each investment adviser representative and investment adviser must show proof of passage of the NASD Series 65 Uniform Investment Adviser State Law Examination; and one of the following general examinations or combinations of general examinations:
1. Any part of the examination for Chartered Financial Analysts administered by the Institute of Chartered Financial Analysts of Charlottesville, Virginia; or
  2. Part one of the examination for the Chartered Financial Consultant Examination designation administered by the American College of Bryn Mawr, Pennsylvania; or
  3. Part one of the examination for the Certified Financial Planner designation administered by the International Board of Standards and Practices for Certified Financial Planners, Inc., of Englewood, Colorado; or
  4. The National Association of Securities Dealers, Inc., Series 7 General Securities Registered Representative Examination or the National

Association of Securities Dealers, Inc., Series 2 Nonmember Examination; or

5. The National Association of Securities Dealers, Inc., Series 6 Investment Company Products/Variable Contracts Representative Examination; and the National Association of Securities Dealers, Inc., Series 22 Direct Participations Programs Representative Examination; or
  6. The examination for the Accredited Financial Planning Specialist designation administered by the American Institute of Certified Public Accountants; or
  7. The examination required for admission to The Registry of the Financial Planning Practitioners administered by the International Association for Financial Planning, Inc., of Atlanta, Georgia.
- (b) With respect to investment advisers, the examination requirement in subparagraph (a) of this rule is waived for any applicant, who, prior to October 2, 1989, shows proof satisfactory to the Commissioner that such applicant was engaged in business activities on April 7, 1988, which activities would have required registration as an investment adviser, had the amendments to the Act which became effective on April 1, 1989, been in effect on April 7, 1988.
- (c) With respect to investment adviser representatives, the examination requirement in subparagraph (a) of this rule is waived for any applicant who, prior to the date which is six months after the date on which the Central Registration Depository, described in Section 10-5-10(g) of the Act, is fully operational with respect to the registration of investment adviser representatives, shows proof satisfactory to the Commissioner that such applicant was engaged in business activities on April 7, 1988, which activities would have required registration as an investment adviser representative, had the amendments to the Act which became effective on April 1, 1989, been in effect on April 7, 1988.
- (d) An investment adviser or investment adviser representative who wishes to rely on passage of any examination other than those enumerated in subparagraph (a) above or who wishes to request a waiver of the examination

requirements of this rule must submit a written request for consideration, identifying the examination in question, its content, and the agency administering the examination, and the reason why a waiver should be granted by the Commissioner. Acceptance of such examination results or the waiver of the examination is solely within the Commissioner's discretion. An investment adviser or investment adviser representative who wishes to request an extension of time in which to show proof of compliance with subparagraph (a) above must submit a written request for consideration, identifying the extenuating circumstances which necessitate such a request. The granting or denial of such a request for extension of time is solely within the Commissioner's discretion.

- (e) An investment adviser who is not an individual shall meet the examination requirement imposed by this rule by showing proof of compliance on a continuing basis with the provisions of subparagraph (a), (b), (c), or (d) of this rule by any one of its investment adviser representatives who is currently engaged in the management of the investment adviser's business in the State of Georgia, including the supervision or conduct of such business or the training of investment advisory representatives or employees for any of those functions."

9. **The study outline** reads as follows:

**"NASAA Uniform Investment Adviser Law (Series 65) Exam Specifications**

**CONTENT AREA**

**I. Economics and Analysis**

**A. Understand basic economic concepts**

1. Inflation/deflation
  - a. Definitions
  - b. Causes of inflation/deflation
2. Interest rates and yield curves
  - a. Graphs
  - b. Definitions
  - c. Interest rate = cost of money
3. Basic economic indicators

- a. GDP
- b. Employment indicators
- c. Trade deficit
- d. Balance of payments
- e. CPI

**B. Identify components of business's financial statements to determine investment merits**

- 1. Income statement
  - a. Revenues
  - b. Cost of goods sold
  - c. Pre-tax margins
  - d. Cash flow
- 2. Balance sheet
  - a. Assets
  - b. Liabilities
  - c. Working capital
  - d. Owner's equity
  - e. Footnotes

**C. Demonstrate understanding of quantitative methods to evaluate investments**

- 1. Time value of money
- 2. Expected return
- 3. Net present value
- 4. Internal rate of return
- 5. Inflation-adjusted return (real return)
- 6. After-tax return/yield
- 7. Risk-adjusted return
- 8. Total return
- 9. Holding period return
- 10. Yield-to-maturity
- 11. Yield-to-call
- 12. Current yield
- 13. Risk measurement (e.g., Beta, standard deviation, duration)

14. Valuation ratios (e.g., P/E, price-to-book)
15. Benchmark portfolios
16. Annualized return

**D. Identify risks (i.e. definitions, impact on the market, companies, and personal investments)**

1. Business
2. Market
3. Interest rate
4. Inflation
5. Regulatory (e.g., tax law changes)
6. Liquidity
7. Opportunity cost

**II Investment Vehicles**

**A. Evaluate cash and cash equivalents**

1. Types and characteristics of cash and cash equivalents
  - a. Certificates
  - b. Money market funds
  - c. Treasury bills
2. Benefits/risks of owning cash and cash equivalents

**B. Evaluate fixed income securities**

1. Types of characteristics of fixed income securities
  - a. U.S. government and agency securities
  - b. Mortgage-backed securities
  - c. Corporate bonds (i.e., investment grade and high yield)
  - d. Convertible bonds
  - e. Municipal bonds
  - f. Zero-coupon bonds
2. Benefits/risks of owning fixed income securities

**C. Evaluate equity securities**

1. Types and characteristics of equity securities
  - a. Common stock (e.g., voting rights, etc.)
  - b. Preferred stock
  - c. Convertible preferred stock
2. Methods used to determine the value of equity securities (e.g., technical and fundamental analyses, dividend discount)
3. Benefits/risks of owning equity securities

**D. Evaluate investment company securities**

1. Types and characteristics of investment companies
  - a. Open-end investment companies (mutual funds)
  - b. Closed-end investment companies
  - c. Classes of shareholders, expense ratios, sales load, breakpoints, 12b-1 fees
2. Benefits/risks of owning investment company securities

**E. Recognize derivative securities and their benefits/risks**

**F. Understand unique aspects of international investing**

1. Emerging vs. developed markets
2. American Depository Receipts (ADRs)
3. Currency influences (concept of risk)

**G. Understand real estate partnerships and investment trusts (REITs) and variable annuities**

1. Definitions
2. Benefits/risks

**III. Investment Recommendations and Strategies**

**A. Determine and analyze the financial profile of the client to develop a suitable investment policy and strategy**

1. Type of client

- a. Individual
  - b. Sole proprietorship
  - c. General partnership
  - d. Limited partnership (including family limited partnership)
  - e. Limited liability company
  - f. C corporation
  - g. S corporation
  - h. Trust
  - i. Estate
2. Financial goals
  3. Current financial status (e.g., cash flow, balance sheet)
  4. Capital needs (e.g., current, retirement, death, disability)
  5. Current investments and strategies
  6. Time horizon
  7. Non-financial investment considerations (e.g., values, attitudes, experience, demographic characteristics)
  8. Risk tolerance
  9. Tax situation

**B. Understand portfolio management strategies, styles, and techniques (fixed income equities)**

1. Portfolio management styles and strategies
  - a. Strategic and tactical asset allocation (e.g., style, asset class, rebalancing)
  - b. Active vs. passive
  - c. Growth vs. value
  - d. Market capitalization (micro, small, mid, large)
  - e. Buy/hold
  - f. Indexing
  - g. Diversification
2. Funding techniques
  - a. Dollar-cost averaging
  - b. Income reinvestment (e.g., dividend, interest, cap gain)

**C. Recognize fundamental taxation issues**

1. Individual income tax (e.g., capital gains, tax basis, retirement distribution, alternative minimum tax)
2. Corporate, trust, and estate income tax
3. Estate and gift tax

**D. Recognize types of retirement plans and related issues**

1. Retirement plans
  - a. Individual Retirement Arrangements (IRA)
  - b. 403(b) plans
  - c. Qualified retirement plans (e.g., pension and profit sharing, 401(k))
  - d. Nonqualified ERISA issues
2. Important ERISA issues
  - a. Fiduciary responsibility (e.g., 404(c))
  - b. Investment policy statement
  - c. Prohibited transactions

**E. Define the fundamental terms and concepts of trading securities**

1. Terminology (e.g., bids, offers, quotes)
2. Role of broker-dealers, specialists, market-makers
3. Types of orders (e.g., market, limit, stop, short sale)
4. Types of accounts (e.g., cash, margin, option)
5. Commissions, markups, spread

**F. Calculate performance**

1. Calculate performance
  - a. Total return (i.e., yield plus growth)
  - b. Inflation-adjusted return
  - c. After-tax return/yield
  - d. Current yield

**IV. Ethics and Legal Guidelines**

**A. Understand relevant aspects of securities acts and other rules and regulations in order to comply as an investment adviser representative**

1. Investment Company Act of 1940
2. Investment Advisers Act of 1940
3. Securities Act of 1933 and Securities Exchange Act of 1934 (as applicable to investment adviser issues)
4. SEC Release No. IA-1092 (applicability of the Investment Advisers Act to financial planners and others)
5. State securities laws (i.e., Blue Sky)
6. NASAA rules prohibiting dishonest and unethical business practices
7. Limitations on permissible practice (i.e., technical licensing requirements)

**B. Demonstrate ability to apply ethical practices**

1. Fiduciary responsibility
2. Conflict of interest
3. Prudent Investor standards
4. Limitations on advice and activities (i.e., when to consult other professionals)"

**10. Financial Services Authority : 'The Regulation of Approved Persons' (July 1999.).**

**11. Some Comments on the first draft of the proposed Bill:**

**"1.1 The provisions of the Bill seek to perpetuate**

- a fragmented supervisory system;
- a system where numerous financial products such as 'standardised' insurance policies will be totally or partially exempted from the provisions of the Act;
- a system which allows untested an unregulated 'representatives' to prey on the public.

This is contrary to modern thought.

## **2. Major Deficiencies**

**2.1** As pointed out, securities legislation should be focused on the protection of investors and the financial markets.

Unfortunately **a large number of the proposed provisions** of the Bill **run counter to such aims and also run counter to the provisions of securities legislation in each and every other jurisdiction researched.**

**2.2** Of **major concern** are the following:

- **it would allow the ‘authorised financial advisers’ to let loose on the public ‘representatives’ who would be completely unregulated and not examined, registered or licensed (section 6);**

**2.3** If a Bill such as the present is enacted, **the supervising authority must be prepared to firmly grasp the twin nettles of proper licensing and adequate supervision.**

**In the absence of proper licensing control by means of written or oral examinations or by other required minimum standards of efficiency, reasonable grounds for licensing intermediaries cannot exist.**

**If reasonable grounds for belief in the ability and efficiency of applicants do not exist, licensing will not only be a farce but, in fact, a fraud on the public.**

**2.4** **Minimum standards** of competency for both the financial advisers and their representatives **assessed by examination or other means and licensing in respect of particular financial products, are the norms in securities legislation in other countries.**

**2.5** **Another major concern is that despite the enormous losses suffered by the public as a result of lapsed or cancelled long-term insurance policies,**

**the Bill seeks to exclude some, if not all, of these products from its more onerous provisions. Thus**

- **‘standardized’ life insurance policies** could be exempted from **all** the provisions of the Bill [Section 1 (2)];
- if the product sold is a **‘standardized’ life or funeral policy** or an **investment in a collective investment scheme**, the provisions relating to **unsolicited calls** and the **cooling-off periods** will not apply [Section 9(ii) & (iv)].

2.6 A further **major concern** is that it is a **hybrid bill which seeks to protect** investors as well as **product suppliers, ‘financial advisers’, unqualified ‘representatives’ and negligent auditors.**

**Instead of seeking to protect ‘big business’, unauthorised advisers should be eradicated, thus**

- **no product supplier should be allowed to enter into an agreement to supply its products if the agreement had been facilitated by an unauthorised financial adviser;**
- **no product supplier should be allowed to supply its products without having been placed in possession of the document contemplated by section 10 (which summarises the advice given and the reasons why a product is considered suitable for the needs of the client) and without being satisfied that the contents correctly reflect the salient features of its product.**
- **no product supplier should be allowed to directly or indirectly reward any unauthorised financial adviser in any manner whatsoever or be allowed to be a party to any such reward by any other person.**

2.7 **Other striking examples of the attempt to protect vested interests at the expense of the investor are the rights reserved to the Executive Chairperson to exempt financial products, financial advisers and product suppliers from the provisions of the Bill.**

**The perpetuation of the system of additional rewards by means of indirect benefits (such as fully paid overseas holidays) without full disclosure to potential investors can never promote the objectivity of authorised financial advisers.**

**2.8** The provisions of **section 10(1)** should be combined with the provisions of **section 203A** of the **Securities Act of Massachusetts**, which reads as follows:

Chapter 110A : **Section 203A. Disclosure content.**

**(a) Each investment adviser registered under this chapter shall disseminate to each client or prospective client a document disclosing material facts. Said document shall include information concerning:**

- (1) compensation arrangements between the client and the investment adviser,**
- (2) the nature of services offered,**
- (3) business practices,**
- (4) methods for obtaining information on disciplinary history and registration of the investment adviser and persons associated with the investment adviser,**

**(b) Each person registered under this section shall disclose to each client before a purchase or sale is effected on behalf of the client:**

- (1) the total amount of sales commissions or other fees that may reasonably be expected to be charged or deducted in connection with the purchase or sale;**
- (2) that the adviser will receive such amount or a portion of such amount, or, in the case of a transaction to be effected through a broker or a dealer that is a person associated or under a common control with the adviser, that the broker or dealer is affiliated with the adviser and will receive such amount or portion of such amount;**

- (3) **the existence of any compensation arrangement with an issuer or other third party with respect to the recommended transaction.**

Such initial disclosure shall be in writing if the purchase or sale was recommended in writing. The secretary may, by rule, permit a client to waive in writing the right to a disclosure”.

The disclosure requirements envisaged by the **Australian Consultation Paper** are as follows:

**“Product issuers will be required to disclose the following information in a financial product information statement (FPIS) where that information is relevant to the particular product being offered:**

1. Information to identify the product issuer;
2. Characteristics, features or nature of the product including the rights, terms, conditions and obligations attaching to the product;
3. **Expected benefits** which a consumer will receive;
4. **The risks** associated with the product;
5. **Details of all amounts payable in respect of the product (including any amounts by way of initial and ongoing fees, commissions or charges) and the point at which the amount is payable;**
6. Internal inquiry and complaints handling mechanisms and external alternative dispute resolution procedures;
7. Taxation considerations;
8. **Cooling off arrangements;**
9. The availability on client request of further information and the nature of the information;
10. The date or version of the FPIS or supplement;
11. Any other material information which is known to the issuer and which is not required to be disclosed under items — 10 above but which may reasonably influence a client’s decision to acquire the product.

- 2.11** To alleviate the enormous problems caused by unscrupulous or incompetent investment advisers, the Commission recommended that any person who gives investment advice for reward without being registered or contrary to the terms of the licence or not in accordance with prescribed rules of conduct, should be guilty of a criminal offence carrying heavy penalties, such as say 10 years imprisonment or a fine of one million rand or both;

In this regard the **Business and Professions Code of California [Section 145(c)]** reads as follows:

“145(c) The **criminal sanction for unlicensed activity should be swift, effective, appropriate, and create a strong incentive to obtain a license**”.

Definition of Cooling-off      The concept of a ‘cooling-off period’ should not form part of a the definition clause. There should be a substantive clause in Period the Bill establishing a right to cancel within, say, 14 days after receipt of the documentation (*cf* section 64 and 64A of the Insurance Contracts Act 1984 of Australia) —

**“SECT 64 ‘Cooling-off period’ period: life insurance**

- (1) **An insured under a contract of life insurance** other than a blanket superannuation contract, or an RSA, **has a right, exercisable at any time before the expiration of 14 days after the insured receives the policy document, to cancel the contract.**
- (2) Subject to subsection (6) and section 64B, **where an insured cancels the contract, the insurer is liable to repay an amount equal to the sum of all the amounts that have been paid to the insurer under the contract.**
- (3) A reference in this section to a policy document does not include a reference to a replacement policy document issued as mentioned in subsection 221(3) of the *Life Insurance Act 1995*.

- (4) If the policy document in relation to a contract of life insurance is sent to the insured by post, that policy document shall be deemed, for the purposes of subsection (1), to have been received by the insured at the time of which it would have been delivered in the ordinary course of post unless the insured proves that, through no fault of the insured, the insured did not received it.
- (5) A reference in this section to a contract of life insurance does not include a reference to a contract of consumer credit insurance even though that contract extends to cover in the case of the death of the insured.

**SECT 64A ‘Cooling-off’ period: consumer credit insurance**

- (1) **An insured under a contract of consumer credit insurance may cancel this contract at any time within 14 days after the insured receives a notice referred to in subsection 71A(5) in respect of the contract.**
- (2) **If an insured cancels a contract, the insurer must repay to the insured an amount equal to the sum of all the amounts that have been paid to the insurer under the contract.**
- (3) A notice referred to in subsection 71A(5) in relation to a contract of consumer credit insurance that is sent to the insured by post is to be taken, for the purposes of subsection (1), to have been received by the insured at the time at which it would have been delivered in the ordinary course of post unless the insured proves that, through no fault on the part of the insured, it was not so received”.

13. The two major deficiencies in this section are —

- that **the auditor is not compelled** to report **irregularities such as fraud or theft immediately**, and
- that the auditor is only required to report irregularities which **in the opinion of the auditor** are **material**.

**This means a subjective approach by the auditor.**

In its **First Report**, the **Commission** pointed to the ineffectual provisions of the Public Accountants' and Auditors' Act as follows:

**“Section 20(5) of the Public Accountants' and Auditors' Act, No 80 of 1991**, requires the auditor of an undertaking to take certain steps —

*'if he is satisfied' or 'has reason to believe'*

that in the conduct of the affairs of the undertaking

*'a material irregularity' has taken place or is taking place which 'has caused' or 'is likely to cause' financial loss to the undertaking or any of its members or creditors.*

**These provisions are lacking in clarity, are difficult to police, and the steps which the auditor has to take are time-consuming.**

The phrases *'material irregularity'*, *'is satisfied'*, *'likely to cause loss'*, *'has been satisfied'*, *'adequate steps'*, mean that in a given situation a particular auditor is required to form an opinion which might differ from the opinion of another auditor, given the same facts.

Thus one auditor might be satisfied that a 'material' irregularity has taken place which is likely to cause financial loss, while another auditor might not share his view.

One auditor might be satisfied that adequate steps have been taken for the prevention of loss likely to be caused and another auditor might not agree.

**If, say, serious theft or fraud is discovered, the auditor is first obliged to despatch a report in writing to the person in charge of the undertaking. If he does not receive a satisfactory reply within 30 days thereafter, then only is the matter reported to the Board which may then, in its discretion, report it to other authorities or interested persons.**

**The inevitable delay means that all the assets of a company could disappear before the relevant authority is eventually notified by the Board.**

16.2 **An auditor should be required to report all irregularities whether they are, in his opinion, material or immaterial.**

The materiality of a particular irregularity, or the frequent occurrence of what normally would be regarded as immaterial irregularities, should be known to the particular supervisor, or shareholders or creditors of the entity concerned.

**If all irregularities are required to be reported it would remove the element of subjectivity created by the undefined concept of 'materiality'".**

In Germany if the auditor discovers shortcomings which are relevant or shortcomings in respect of which uncertainty exist whether they are relevant or irrelevant, the Federal Supervisory Officer has to be informed immediately (section 3(2) of the Ordinance ).

In addition, **after the conclusion of the examination the auditor is required to file the report immediately.** This is a detailed report on the activities of the enterprise. A copy of the requirements is annexed.

In Singapore section 70 of the Securities Act reads as follows:

- “70.— (1) Where in the performance of his duties as an auditor for a relevant person, an auditor becomes aware —
- (a) of any matter which in his opinion may adversely affect the financial position of a relevant person to a material extent;
  - (b) **of any matter which in his opinion may constitute a breach of any provision of this Act or a criminal offence involving a fraud or dishonesty;**
  - (c) that irregularities that have a material effect upon the accounts have occurred, including irregularities that jeopardise the funds or property of the clients of a relevant person.

**he shall immediately report the matter to the securities exchange** where the relevant person is a member of that securities exchange **and the Authority** and in any other case to the Authority.

- (2) An auditor shall not in the absence of malice on his part be liable to any action for defamation at the suit of any person in respect of any statements made in his report pursuant to subsection (1).
- (3) The relevant authority may impose all or any of the following duties on an auditor in addition to those provided under this Part:
  - (a) a duty to submit such additional information in relation to his audit as the relevant authority consider necessary;
  - (b) a duty to enlarge or extend the scope of his audit of the business and affairs of the relevant person;

- (c) a duty to carry out any other examination or establish any procedure in any particular case; and
- (d) a duty to submit a report on any of the matters referred to in paragraphs (b) and (c).

and the relevant person shall remunerate the auditor in respect of the discharge by him of all or any of these additional duties.

**Malaysia.** Similarly in respect of other institutions, **the auditor is required to report irregularities immediately.** Section 39(1) reads as follows:

**“39.(1)** If an auditor, in the course of the performance of duties as an auditor of an exchange company, clearing house, a futures broker or a futures fund manager, is satisfied that —

- (a) there has been a contravention of this Act;**
- (b) an offence in connection with the business** of the exchange company, clearing house, futures broker or futures fund manager, as the case may be, **has been committed;**
- (c) in the case of a futures broker or a futures fund managers, there has been **a contravention of the business rules of an exchange company or a clearing house** of which the futures broker or futures fund manager is an affiliate;
- (d) an irregularity has occurred** in the conduct of the business of an exchange company, clearing house, futures broker or futures fund manager in relation to futures contracts, **including any irregularity that jeopardises the funds, securities or property of any client of a futures broker or futures fund manager;** or

**(e) the auditor is unable to confirm whether the assets of a futures broker or futures fund manager are sufficient to meet the claims of creditor of the broker or fund manager,**

**the auditor shall immediately report the matter to the Commission”.**

**Subsection 1(d)** relates to cooling-off periods, the ‘unenforceability [or] otherwise’ of agreements concluded as a result of unsolicited calls and the powers of the Court to enforce such agreements if

- the client was not materially influenced by the call (whatever that might mean);
- the call was made by a person unconnected with the person seeking to enforce the agreement (whatever that might mean); and
- the client was fully aware of the agreement (whatever that might mean); and
- of any risks connected therewith.

The presumed aim of this Bill is to protect investors and to ensure as far as possible that they invest wisely. Risk is only one of the factors, but a virtually risk free 32 day bank deposit would probably be totally unsuitable for the majority of investors.

Once again the investor is left to the time consuming and costly procedures of the Courts.

— Unsolicited calls should either be completely restricted as the hawking of securities is restricted in Australia, or if not, all agreements following upon unsolicited calls should be subject to cooling-off periods.

**Sections 1077, 1078 (1) and (2) and 1081 of the Corporations Law of Australia** read as follows:

**”Sect 1077 - Division 6 – Hawking of Securities Interpretation**

In this Division:

- (a) a reference to a person going from place to place includes a reference to a person communicating with other persons at different places by the use of an eligible communications service; and
- (b) a reference to the buying or purchase of securities includes a reference to acquiring securities by barter or exchange”.

**Sect. 1078 -**

- (1) A person shall not, whether by appointment or otherwise, go from place to place:
  - (a) issuing invitations to subscribe for or buy securities of a corporation;  
or
  - (b) offering securities of a corporation for subscription or purchase.
- (2) Subsection (1) does not apply in relation to securities of a corporation where the Commission has on the application of the corporation, by writing published in the *Gazette*, exempted the corporation from the operation of that subsection.

**Sect 1081 -**

**Prohibition on hawking securities of proposed corporation**

A person shall not, whether by appointment or otherwise, go from place to place:

- (a) issuing invitations to subscribe for or buy securities of a corporation that is proposed to be formed; or
- (b) offering securities of a corporation that is proposed to be formed for subscription or purchase”.

12. **See also "Financial watchdogs are failing to bark"** - Bruce Cameron Saturday Argus 9.12.2000.

"When the Life Offices' Association (LOA) criticises the Financial Services Board (FSB) for toning down legislation that is meant to protect consumers, then it is time to become concerned about the activities of the board.

As can be expected, the criticisms by the life assurance companies are motivated mainly by a desire to protect their own interests rather than those of the consumer.

The LOA is objecting to banks' financial advisers being excluded from the ambit of the long-awaited Financial Advisory and Intermediary Services Bill (FAIS), which is intended to regulate financial advisers.

Although the LOA's criticisms are probably based on unfair competition rather [than] consumer interest, their complaints are entirely justified as there has been some gross mis-selling by bank brokers in order to meet sales targets. There is no reason why banks should be excluded from the legislation.

The LOA is also concerned about the implementation of the Life Assurance Policyholder Protection Rules, which fall under the Long and Short Term Insurance Acts. Considering that it took some 12 years to write those Acts into law, it is more than perturbing that these rules are not yet in place.

These two factors are of serious concern, particularly as the FAIS has been watered-down as it has passed through various revisions.

But the LOA's criticisms are only the tip of the iceberg.

Of greater concern is that the FSB is showing insufficient commitment to providing proper protection for consumers.

Our front page lead today is but one example of how financial institutions flout laws that are intended to protect South Africans.

While I have little sympathy with investors (and advisers) who, despite ample warning, persist in investing in financial products and through companies that are not registered in South Africa, the FSB has demonstrated that it is either inept or incapable of dealing with companies that play semantics with the law.

The FSB is not the only party to blame. South Africa's financial services industry has a bad reputation for non-compliance. Rather than follow the spirit of the law, many

companies — including some of the largest in the land — find ways to side-step regulations.

But the temptation to side-step the rules is exacerbated by the failure of the FSB to lay down equitable regulations for all participants in the financial services market, and to ensure that those regulations are taken seriously".

.....

# **CHAPTER 11 - THE RECORDS OF CORPORATIONS — ACCESS BY SHAREHOLDERS**

**11.1** Section 242 of the South African Companies Act. No. 61 of 1973, requires the keeping of minutes of the meetings of directors and managers of companies.

"(1) The directors of a company shall cause minutes in one of the official languages of the Republic of all proceedings of meetings of directors or managers to be entered in one or more books to be kept for that purpose at the registered office of the company or at the office where such minutes are made up.

(2) Any resolution of directors or managers of a company in the form of a written resolution signed by the directors or managers shall be deemed to be a minute of a meeting and shall be entered in the book or books provided for in subsection (1) and be noted by the next following meeting of directors or managers."

**11.2** Section 284 of the Act requires the keeping of accounting records.

"(1) Every company shall keep such accounting records as are necessary fairly to present the state of affairs and business of the company and to explain the transactions and financial position of the trade or business of the company....."

**11.3** In terms of section 284(3) directors have access to the books and accounting records.

"(3) The accounting records shall be kept at the registered office of the company or at such other place as the directors think fit and shall at all times be open to inspection by the directors and if such records are kept at a place outside the Republic, there shall be sent to and kept at a place in the Republic, and be at all times open to inspection by the directors, such financial statements and returns with respect to the business dealt with in those records as will disclose with reasonable accuracy the financial position of that business at intervals not exceeding twelve months, subject to section 285, and will enable the company's annual financial statements to be prepared in accordance with this Act."

**11.4** In terms of section 281 the external auditor similarly has a right of access to the books and accounting records.

"An auditor of a company shall —

- (a) have the right of access at all times to the accounting records and all books and documents of the company, and be entitled to require from the directors or officers of the company such information and explanations as he thinks necessary for the performance of his duties as auditor;
- (b) in the case of an auditor of a holding company, have the right of access to all current and former financial statements of any subsidiary of such holding company and be entitled to require from the directors or officers of such holding company or subsidiary all such information and explanations in connection with any such statements and in connection with the accounting records, books and documents of the subsidiary as he may consider necessary; and
- (c) be entitled to attend any general meeting of the company and to receive all notices of and other communications relating to any general meeting which any member of the company is entitled to receive and to be heard at any general meeting which he attends on any part of the business of the meeting which concerns him as auditor."

**11.5** In contrast thereto, the rights of access to and inspection of the books and accounting records of the company by its shareholders are basically restricted to

- the minutes of meetings of the company (meetings of shareholders) — section 206
- the register of members — section 113
- the register of directors and officers — section 215
- the register of interests in contracts of directors and officers — section 240
- the annual financial statement — section 302
- the half-yearly interim report — section 303
- the provisional annual financial statement — section 304
- whilst the company is in the process of being wound up, with the leave of the Court — section 360

"360 (1) Any member or creditor of any company unable to pay its debts and being wound up by the Court or by a creditors' voluntary winding-up may apply to the Court for an order authorizing him to inspect any or all of the books and papers of that company, whether in possession of the company or the liquidator, and the Court may impose any condition it thinks fit in granting that authority".

**11.6** Other stakeholders, such as holders of debentures, employees, creditors and the like, have even less access to its records.<sup>(1)</sup>

Shareholders and other stakeholders thus have no right to inspect the minutes of the meetings of directors and managers or the accounting records of the company.<sup>(1)</sup>

**11.7** Behind this virtually impenetrable statutory veil of secrecy which exists in South Africa and in many other jurisdictions, dishonest, incompetent or astute directors, managers and controlling shareholders, sometimes aided and abetted by auditors and by imprecise accounting and auditing standards, play fast and loose with the fortunes of corporations, enrich themselves and mislead investors and other stakeholders by publishing false, misleading or inadequate financial statements.

**11.8** Any proposed lifting of this veil is usually fiercely resisted by controlling shareholders and by directors and management on the grounds of

- privacy
- protection against competitors
- the impracticality of allowing numerous parties to have access to the records of the company.

**11.9** In the **United Kingdom** the statutory veil of secrecy was drawn over the affairs of companies more than a century ago.

As pointed out , the Davey Committee recommended in 1896 that

"(the) true financial position of the company should be honestly disclosed to shareholders not less than once a year but not for public use".<sup>(2)</sup>

**11.10** The arguments in favour of secrecy were

- that competitors could benefit by the information disclosed;
- that the labour force would present pay demands to the management of highly profitable companies.

**11.11** It was also stated that if information had to be made public, profit should be understated (potentially overstated in unprofitable companies) so that the disclosure would not harm the company.<sup>(3)</sup>

**11.12** The recommendation by the Davey Committee that the true financial position should be honestly disclosed to shareholders but not to the public was adhered to in part only in that shareholders soon suffered the same fate.

**11.13** In contrast hereto, in the **United States** and in countries such as **Anguilla, Belize, the British Virgin Islands** and the **Philippines**, it is accepted that shareholders have the right to inspect corporate books and records.

**11.14** As will be shown, the right of shareholders to inspect the records of corporations incorporated in the **United States** are based on the factual assumptions

- that they are the owners of the corporation;
- that those in charge of the corporation are regarded as the shareholders' agents;
- that the shareholders have an interest and a right to be informed as to whether their agents discharge their duties competently and in good faith;
- that business prudence demands it.

**11.15** In addition, it will be shown that the right to inspect is not limited or restricted by

- the size of the individual shareholding;
- the fact that the shareholder might be a business competitor.

**11.16** In the **United States** at the beginning of the 20<sup>th</sup> century, the right of shareholders to have access to all the records of the corporation was stated to be as follows:

"At common law any shareholder has a right to inspect any corporate records or papers whenever such inspection is reasonably necessary to protect his interests or guide his action as a member of the corporation. His right does not extend to inspection for other purposes. Nor does it extend beyond what is necessary to accomplish a definite and specific purpose.

For the protection of his interests as a member of the corporation against a reasonable suspicion of fraud or mismanagement on the part of the corporate officials, he may demand access to such account books of the corporation and records of its corporate actions as bear upon the particular matter under Inquiry. For guidance in his conduct he is entitled to inspect also the articles and the by-laws of the corporation, the minutes of its general meetings, and the lists of its officers and members. He must exercise the right in a reasonable way, so as not to interfere unduly with business, or endanger the

safe-keeping of the records. He is entitled to employ accountants or attorneys to act with or for him in making the inspection.

The right of inspection is frequently regulated by by-laws, and in most states statutes require the keeping of certain corporate records and prescribe conditions to govern the right to inspect them. In most instances the statutory right of inspection expressly given is more extensive than the right at common law. But it is strictly interpreted by the courts, and unless expressly permitted for any purpose whatever, it is usually held to be impliedly restricted so as not to extend to examination for the purpose of injuring the corporate business or building up a rival."<sup>(4)</sup>

**11.17** The present state of the law in the United States is summarized by **Fletcher** as follows:

"Inspection of corporate books and records, as that phrase is commonly used and understood, refers primarily to inspection by shareholders. Except as otherwise indicated, it is that inspection which this chapter treats.

The existence of a right, either under the common law or by virtue of constitutional or statutory provisions, in every shareholder to inspect the books and records of the corporation seems to be accepted without question throughout the states. A shareholder has a fundamental right to be intelligently informed about corporate affairs. However, the United States Supreme Court has held that inspection of corporate books and records is not a right which universally attaches to corporate shares.

The courts seem to agree that the basis for the shareholder's right is to be found in the ownership of shares in the corporation and the necessity of self protection. Thus, although the corporation and the shareholders are separate and distinct legal entities and legal title to the corporate property is vested in the corporation and not in the shareholders, the shareholders' right of inspection of the corporation's books and records rests upon the underlying ownership of the corporation's assets and property. The right to inspection is an incident of ownership of the corporate property, whether this ownership or interest is termed an equitable ownership, a beneficial interest, or a quasi-ownership.

In a sense, the right to inspection arises out of the fact that those in charge of the corporation are merely the shareholders' agents, concerning whose good faith in discharging their duties the shareholders have an interest and right to be informed.

While the books and papers of the corporation are necessarily in the hands of the corporate officers and agents, they are the common property of the shareholders who have the right to know what the corporation is doing. Shareholders have the same right as the members of an ordinary partnership to examine the books and records of the organization in order that they may protect their own interests.

Managers of some corporations deliberately keep the shareholders in ignorance or under misapprehension as to the true condition of affairs. Business prudence demands that the investor keep a watchful eye on the management and the condition of the business. Those in charge of the company may be guilty of gross incompetence or dishonesty for years and escape liability if the shareholders cannot inspect the records and obtain information.

The right of inspection is not ascribable to any supposed public status of the corporate books and records since, in the absence of special statutory provisions, they are not, in the strict sense, public records which are open as such to inspection by the public generally.

This basis of underlying ownership which characterizes the right of inspection by shareholders also distinguishes it from inspection by: directors; creditors or other persons to whom the right is given by statute or otherwise; or the state or federal governments under their supervisory and visitorial powers and authority, which is discussed elsewhere in this work.

Inspection by a shareholder is not necessarily sought in aid of pending or contemplated litigation or to obtain evidence, although it may be sought for that purpose. It is distinguished from discovery and the various statutory proceedings to compel production and inspection of documentary evidence and the compulsory production of books and papers in court on subpoena *duces tecum*, all of which are ancillary or incidental to pending or contemplated litigation and have as their principal object the obtaining of evidence, as pointed out elsewhere.

The shareholder's statutory right of inspection is distinguishable from the right of discovery pursuant to a lawsuit against the corporation. Thus, even though the same corporate records may be discoverable in accordance with court procedural rules, the effect is not the same. There is authority for the principle that the purpose of statutory shareholder examination provisions is to provide an expeditious and ready means of inspection. Since discovery under rules of procedure may be delayed before the opposing party is required to respond, discovery of corporate records is not nearly as

speedy as inspection. Also, a failure to comply with discovery is not subject to the same sanctions as refusing an inspection demand. Accordingly, shareholders who demand inspection are not precluded from seeking judicial enforcement of their inspection rights merely because they have another suit pending against the corporation and could obtain the same records through the discovery process".<sup>(5)</sup>

**11.18** The American **Corpus Juris Secundum** states it as follows:

"A stockholder has a right at common law to inspect and examine the books and records of the corporation at a proper time and place and for a proper purpose; and in many jurisdictions this right is further secured by statutory or constitutional provisions. Such statutes are salutary.

They are not intended to abridge the stockholder's common-law rights, but rather to enlarge and extend them by removing some of the common-law limitations. Accordingly, they should be liberally construed in favour of the stockholders, unless they are penal in nature; but even the rule of strict construction then applied does not compel courts to take an unreasonable view so as to defeat the object of the statute".<sup>(6)</sup>

**11.19** In the vast majority of the States in the United States, in addition to their common law rights, individual State laws also entitle shareholders for a proper purpose (or for a proper purpose and in good faith, or for a purpose reasonably related to his interests as a shareholder), to inspect and copy the records of the corporation, including the minutes of the meetings of its board of directors and its committees, the records of actions taken by its board of directors and its financial records.<sup>(7)</sup>

**11.20** A typical example of such a State law is **Title 13-A: Maine Business Corporation Act -**

§625. Books and records required to be kept by corporation

Each corporation shall keep accurate books and records of account, which shall be in written form or in any other form capable of being converted into written form within a reasonable time; and shall keep written minutes of the proceedings of its shareholders, board of directors.

§626. Right of shareholders to inspect corporate records

1. Except as otherwise indicated in this section, a 'shareholder', entitled to inspect the books of and records of a corporation as provided by this section shall mean:
  - A. Any person who shall have been a holder of record of shares of any class, or of voting trust certificates representing such shares, for at least 6 months immediately preceding his demand for inspection; or
  - B. Any person who shall be the holder of record of, or any person whose aggregate holdings of record shall equal, at least 10% of the outstanding shares of any class regardless of when they were acquired; or
  - C. Any person or persons who hold voting trust certificates representing shares aggregating at least 10% of the outstanding shares of that class; or
  - D. An attorney, accountant or other agent of any of the foregoing persons.
2. Any such shareholder shall have the right to inspect during normal business hours, for any proper purpose, the corporation's books and records of account, minutes of meetings, and a list or record of shareholders, and to copy them or make extracts therefrom".

**11.21 Section 1601 of the Corporations Code of California** (reputedly the fifth largest economy in the world) reads as follows-

"1601. (a) The accounting books and records and minutes of proceedings of the shareholders and the board and committees of the board of any domestic corporation, and of any foreign corporation keeping any such records in this state or having its principal executive office in this state, shall be open to inspection upon the written demand on the corporation of any shareholder or holder of a voting trust certificate at any reasonable time during usual business hours, for a purpose reasonably related to such holder's interests as a shareholder or as the holder of such voting trust certificate. The right of inspection created by this subdivision shall extend to the records of each subsidiary of a corporation subject to this subdivision.

(b) Such inspection by a shareholder or holder of a voting trust certificate may be made in person or by agent or attorney, and the right of inspection includes the right to copy and make extracts.

The right of the shareholders to inspect the corporate records may not be limited by the articles or bylaws."

**11.22** The **Delaware Corporation Code** (the State most favoured for the registration of corporations) reads as follows (section 220)

"(a) As used in this section, 'stockholder' means a stockholder of record of stock in a stock corporation and also a member of a nonstock corporation as reflected on the records of the nonstock corporation. As used in this section, the term 'list of stockholders' includes lists of members in a nonstock corporation.

(b) Any stockholder, in person or by attorney or other agent, shall, upon written demand under oath stating the purpose thereof, have the right during the usual hours for business to inspect for any proper purpose the corporation's stock ledger, a list of its stockholders, and its other books and records, and to make copies of extracts therefrom. A proper purpose shall mean a purpose reasonably related to such person's interest as a stockholder. In every instance where an attorney or other agent shall be the person who seeks the right to inspection, the demand under oath shall be accompanied by a power of attorney or such other writing which authorizes the attorney or other agent to so act on behalf of the stockholder. The demand under oath shall be directed to the corporation at its registered office in this State or at its principal place of business.

(c) If the corporation, or an officer or agent thereof, refuses to permit an inspection sought by a stockholder or attorney or other agent acting for the stockholder pursuant to subsection (b) of this section or does not reply to the demand within 5 business days after the demand has been made, the stockholder may apply to the Court of Chancery for an order to compel such inspection. The Court of Chancery is hereby vested with exclusive jurisdiction to determine whether or not the person seeking inspection is entitled to the inspection sought. The Court may summarily order the corporation to permit the stockholder to inspect the corporation's stock ledger, an existing list of stockholders, and its other books and records, and to

make copies or extracts therefrom; or the Court may order the corporation to furnish to the stockholder a list of its stockholders as of a specific date on condition that the stockholder first pay to the corporation the reasonable cost of obtaining and furnishing such list and on such other conditions as the Court deems appropriate. Where the stockholder seeks to inspect the corporation's books and records, other than its stock ledger or list of stockholders, such stockholder shall first establish (1) that such stockholder has complied with this section respecting the form and manner of making demand for inspection of such documents; and (2) that the inspection such stockholder seeks is for a proper purpose. Where the stockholder seeks to inspect the corporation's stock ledger or list of stockholders and such stockholder has complied with this section respecting the form and manner of making demand for inspection of such documents, the burden of proof shall be upon the corporation to establish that the inspection such stockholders seeks is for an improper purpose. The Court may, in its discretion, prescribe any limitations or conditions with reference to the inspection, or award such other or further relief as the Court may deem just and proper. The Court may order books, documents and records, pertinent extracts therefrom, or duly authenticated copies thereof, to be brought within this State and kept on this State upon such terms and conditions as the order may prescribe".

**11.23** In the **Philippines**, a similar provision was incorporated in its Corporation Act in 1906 by the then American occupational force.

Section 51 provided that

'The record of all business transactions of the corporation and the minutes of any meeting (referring to all meetings of directors, members or stockholders) should be open to the inspection of any director, member of stockholder of the corporation at reasonable hours'.

**11.24** This provision has been retained in the present **Corporations Act of the Philippines** (section 74) whereby, acting in good faith and for a legitimate purpose -

".....The records of all business transactions of the corporation and the minutes of any meeting shall be open to inspection by any director, trustee, stockholder or member of

the corporation at reasonable hours on business days and he may demand, in writing, for a copy of excerpts from said records or minutes, at his expense".

**11.25** Sections 66 and 67 of the **International Business Companies Ordinance of the British Virgin Islands** read as follows

"66(1) A company incorporated under this Ordinance shall keep such accounts and records as the directors consider necessary or desirable in order to reflect the financial position of the company.

(2) A company incorporated under this Ordinance shall keep:

(a) minutes of all meetings of:

- (i) directors,
- (ii) members,
- (iii) committees of directors,
- (iv) committees of officer, and
- (v) committees of members; and

(b) copies of all resolutions consented to by:

- (i) directors,
- (ii) members
- (iii) committees of directors,
- (iv) committees of officer, and
- (v) committees of members.

(3) The books, records and minutes required by this section shall be kept at the registered office of the company or at such other place as the directors determine.

67 (1) A member of a company incorporated under this Ordinance may, in person or by attorney and in furtherance of a proper purpose, request in writing specifying the purpose to inspect during normal business hours the share register of the company or the books, records, minutes and consents kept by the company and to make copies or extracts therefrom.

- (2) For purposes of subsection (1), a proper purpose is a purpose reasonably related to the member's interest as a member.
- (3) If a request under subsection (1) is submitted by an attorney for a member, the request must be accompanied by a power of attorney authorizing the attorney to act for the member.
- (4) If a company, by a resolution of directors, determines that it is not in the best interest of the company or of any other member of the company to comply with a request under subsection (1), the company may refuse the request.
- (5) Upon refusal by the company of a request under subsection (1), the member may before the expiration of a period of 90 days of his receiving notice of the refusal, apply to the court for an order to allow the inspection".<sup>(8)</sup>

**11.26** In **Australia**, a member of a company may apply to a Court for an order authorizing an auditor or legal practitioner to inspect its records on the member's behalf (sections 319 and 320 of the Corporation Law).

"319(1) Where:

- (a) a member of a company applies to the Court for an order authorizing a registered company auditor, or a duly qualified legal practitioner, acting on behalf of the member to inspect books of the company; and
- (b) the Court is satisfied that the member is acting in good faith and that the inspection is to be made for a proper purpose:

the Court may:

- (c) make an order authorizing a registered company auditor, or a duly qualified legal practitioner, acting on behalf of the member, at such time as is specified in the order, to inspect, and to make copies of, or take extracts from, specified books of the company; and
- (d) make such order or orders (if any) as it thinks fit including without limiting the generality of the foregoing, an order relating to the use that may be made of the information disclosed to the member by the

registered company auditor or the duly qualified legal practitioner as a result of the inspection.

- (2) The right of a member of a company to apply for an order under subsection (1) is in addition to and not in derogation of any right in relation to the inspection of books of a company that a member of a company has under any other law.

s320. Disclosure of Information. (Corporations Law)

A registered company auditor, or a duly qualified legal practitioner, who inspects books of a company pursuant to an order of the Court under section 319 shall not disclose information acquired in the course of the inspection to a person other than:

- (a) the member of the company on whose application the order was made; or
- (b) a staff member, or a member or acting member, of the Commission".<sup>(9)</sup>

**11.27** While the South African shareholders are denied access to the records of companies of which they are the owners, in a number of jurisdictions, the trustees of holders of debentures have full access to such records.

Examples are **Australia, Argentina, India, Malaysia, Nauru, Papua New Guinea, Paraguay** and **Singapore**.

In these jurisdictions holders of debentures, who are nothing more than creditors of the issuing companies, have all information at their disposal while the owners of South African companies have to rely upon information made available to them by both honest and dishonest directors, officers and auditors.

**11.28** The Commission issued a Consultation Paper entitled 'The Role of the Auditor – The Elimination of the Expectation Gap and the Appointment of Auditors by all Significant Interest Groups' in which the appointment of auditors by each significant stakeholder group of a company was proposed. Stakeholders were identified as shareholders, holders of debentures, other creditors, employees (trade unions) when conducting wage negotiations or when

disputing the necessity to retrench, participation bond investors, depositors in banks and members of pension funds.<sup>(10)</sup>

A predictable outcry followed.<sup>(11)</sup>

**11.29** The Commission is of the view that corporate fraud would be significantly curtailed if shareholders have access to the records of their companies.

It is beyond dispute that dishonesty or negligence of external auditors of companies would virtually be eliminated if the records of the companies are subject to inspection by other experts at any time.

**11.30** Deposit-taking institutions such as banks require some measure of secrecy to protect the interests of their clients.

The Commission is of the view that shareholders of such institutions should only be allowed to exercise their rights of access to the records by using the services of auditors.

**11.31** To allay the fears of administrative mayhem which is often expressed by antagonists of access to corporate records, it is recommended that access by shareholders be restricted to

- **shareholders who individually or in the aggregate hold 5% or more of the issued share capital; and**
- **shareholders who wish to institute derivative or dissenter actions, or whose rights could be affected by mergers, sale of assets or take-overs.**

**11.32 It is also recommended that in the event of a public company**

- not issuing its financial statements by due date; or**
- issuing a financial statement without an unqualified auditor's report;**

**all shareholders should have access to the records of the company.**

**11.33 It is further recommended that**

- (a) such shareholders may in person or by means of a legal representative, an accountant or an auditor have access to all the books and records of the company, including those of any subsidiaries;**
- (b) such access shall only be for a proper purpose reasonably related to such shareholder's interest as a shareholder;**
- (c) access to the books and records shall be at any reasonable time during usual business hours after a written request stating the purpose of such inspection;**
- (d) access to the books and records of banks should only be by means of an auditor.**

.....

## NOTES

1. **During the 19<sup>th</sup> century** in England and in South Africa the records of companies were available for inspection by shareholders appointed by the general body of shareholders.

In addition, special interest groups such as the assured of assurance companies, holders of debentures and holders of preference shares could sometimes appoint their own auditors. Towards the end of the 19<sup>th</sup> century these rights were lost.

2. See Chapter 3.
3. **Troberg, Pastus and Ekholm, Bo-Gorän** : 'Objectives of Financial Reporting and Equity Theories. Are User Needs Different?' (Swedish School of Economics and Business Administration, Series C. Working Paper [1995]).
4. **Scrutton, T.E. and Bowstead, William**. 'The Commercial Laws of the World'. Vol. VIII. p. 40 (British Edition. Sweet and Maxwell Ltd.).
5. **Fletcher** : 'Cyclopedia of the Law of Private Corporations' Vol. 5A, par. 2213. (Clark, Boardman, Callaghan, New York.).
6. **Corpus Juris Secundum**. 'A Contemporary Statement of American Law' Vol. 18 p. 658 – 659 (West Publishing Co., St Paul, Minn.).

**Also see par. 331 – 334.**

"§331. In General

Stockholders are entitled to information as to the business and affairs of the corporation.

The stockholders of a corporation, including minority as well as majority holders, have a right to be informed as to the business and affairs of the company. However, this right is not unlimited.

A stockholder has a right to visit and inspect the corporate property.

§332. Inspection of Corporate Books and Records

At common law, as well as under statutory and constitutional provisions, stockholders ordinarily are entitled to inspect corporate books and records at a proper time and place and for a proper purpose.

A stockholder has a right at common law to inspect and examine the books and records of the corporation at a proper time and place and for a proper purpose; and in many jurisdictions this right is further secured by statutory or constitutional provisions. Such statutes are salutary.

They are not intended to abridge the stockholder's common-law rights, but rather to enlarge and extend them by removing some of the common-law limitations. Accordingly, they should be liberally construed in favour of the stockholders, unless they are penal in nature; but even the rule of strict construction then applied does not compel courts to take an unreasonable view so as to defeat the object of the statute.

The statutes permit multiple examinations of the same corporate books and records.

A statute authorizing a corporation to define, limit, and regulate the powers of its stockholders does not authorize it to deprive them of their right to inspect the company's books.

§333 Absolute or Qualified Right

a. In General

A shareholder's right to inspect corporate books and records is not absolute but is qualified, and the shareholder may exercise inspection rights only for proper purposes.

A shareholder's right to inspect corporate books and records is not absolute but is qualified. The paramount factor in determining whether a stockholder

is entitled to inspection of corporate books and records is the propriety of the stockholder's purpose in seeking such inspection; a stockholder may exercise inspection rights only for the proper purposes.

While the term 'proper purpose' has been held to mean that which is germane or reasonably related to a person's interest as a stockholder, the term is one which seeks to protect the interests of the corporation as well as the interests of the shareholder seeking the information, and it includes honest motive and good faith. It is not sufficient merely to allege a proper purpose. Rather, in each case, the facts must be examined.

Once a proper purpose has been established, any secondary purpose or ulterior motive of the stockholder becomes irrelevant. While the court may discount a secondary or ulterior purpose, at least where the stockholder-related purpose predominates over the ulterior purpose, the primary purpose must not be adverse to the best interests of the corporation. Moreover, the court may deny inspection where the shareholder is shown to have possession of all the information that is requested, or where the request is made out of sheer curiosity, unrelated to any legitimate interest of the stockholder, or where the sole purpose of the inspection is to harass the corporation.

Generally, stockholders are entitled to inspect books and records of the corporation to investigate the conduct of management, to determine the financial condition of the corporation, and to seek an account of the stewardship of the officers and directors. In particular, the valuation of one's shares, solicitation of proxies, election of directors, and a desire to learn the reasons for lack of dividends or insubstantial dividends have been held to be proper purposes for the inspection of corporate books and records.

A mere statement of purpose to investigate possible general mismanagement, without evidence of any possible corporate mismanagement or waste, does not entitle the shareholder to inspection, and an improper purpose exists where the demanding shareholder seeks to further his own interest in the corporation not as a shareholder but as a stockbroker. Also, a court may deny a shareholder the right to inspect corporate books if the shareholder has improperly used information secured through any prior examination of books and records of account.

b. Insufficient Grounds for Denial of Right

In general, adverseness to management and a desire to gain control of the corporation for economic benefit does not indicate an improper purpose for inspecting corporate books and records.

An unqualified statutory right of inspection cannot properly be denied on the ground that the stockholder is on unfriendly terms with the officers of the company or that he hopes to find something alarming which he intends to communicate to other stockholders, or that an inspection would cause inconvenience to the corporation or might involve it in difficulties.

Also, the stockholder's right of inspection is not affected by the fact that he manufactures articles similar to those manufactured by the corporation.

The right of a stockholder to inspect the books and records of the corporation may not be taken away by the substitution of some other method of informing him of the matters of which he desires to learn, and may not be denied to him merely because he has been given the privilege on other occasions, or because the corporation is willing to purchase his shares.

The absence of the custodian from the state cannot ordinarily defeat the right of inspection, if the records can be procured from the corporation itself.

c. Where Corporation Insolvent or in Liquidation

Generally, a stockholder's right to examine the corporate books and records is not extinguished because the corporation is in receivership or bankruptcy.

In such case, the question whether or not an inspection of its books shall be accorded to its stockholders is one resting in the discretion of the court, unhampered by any decisions touching such right of inspection while the corporation was still a going concern in the hands of its officers and directors, and ordinarily such discretion should be exercised by the court most liberally toward every individual stockholder who shows some reason other than mere idle curiosity which induces him to ask for the inspection.

The court will grant an inspection to a stockholder who in good faith asks therefor to enable him to determine whether or not a proposed plan of reorganization is desirable, with proper regulations as to time and circumstances, so as not to interfere with the exercise of the receiver's duties or the inspection of other stockholders; and it is not a sufficient answer that the proposed plan meets with the approval of the majority of the stockholders who have not received such information as asked for, or that it is commended by the receiver and promises to afford means for an early liquidation of the debts of the company.

However, an inspection will not be granted to a person who purchased stock in the corporation, for mere speculative purposes, after the appointment of a receiver.

#### §334 Books and Records Subject to Inspection

##### a. In General.

At common law, the right of inspection covers all the books and records of the corporation, and the term 'books and records of account', as used in the statutes pertaining to the right of a shareholder to inspect corporate records, includes all records to which the common law right of inspection might properly apply. Such statutes are not limited to 'relevant' books and records; the right of a stockholder extends to all books, papers, contracts, minutes or other instruments from which he can derive any information that will enable him to protect his interest, and which are necessary to make an intelligent and searching investigation. The fact that the information sought is of a confidential nature is not enough, in itself, to deny the right of examination.

##### *Books of other corporations.*

A stockholder is not entitled to inspect the books and papers of other corporations not shown to be in the possession of the corporation of which he is a stockholder.

However, the stockholders of one company have a right to inspect the books and records of subsidiary companies where the latter are so organized and controlled, and their affairs so conducted, as to make them adjuncts or instrumentalities of the parent company, and it has been held that

stockholders of a dissolved corporation seeking a proper share of its assets are entitled to examine the books of a successor corporation.

*Small stockholders.*

A holder of a small amount of stock has as much right to examine the books of a corporation as has the owner of a large amount. Indeed one of the purposes of the statutes is to protect small or minority stockholders and to facilitate the exercise of their right of access to the books of the corporation".

7. **Eg.** Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kentucky, Maine, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, Wyoming. (Exceptions are, eg. Hawaii, the District of Columbia and New York State).

8. **See also**

**Anguilla** Sections 60 and 61 of the International Business Companies Ordinance, 1994.

**Belize** Sections 66 and 67 of the International Business Companies Act, 1990.

9. **See also New Jersey Title 14A : 5 - 28 (4) -**

"Nothing herein contained shall impair the power of any court, upon proof by a shareholder of proper purpose, irrespective of the period of time during which the shareholder shall have been a shareholder of record, and irrespective of the number of shares held by him, to compel the production for examination by such shareholder of the books and records of account, minutes, and record of shareholders of a corporation. The court may, in its discretion prescribe any limitations or conditions with reference to the

inspection, or award any other or further relief as the court may deem just and proper. The court may order books, documents and records, pertinent extracts therefrom, or duly authenticated copies thereof, to be brought within this State and kept in this State upon whatever terms and conditions as the order may prescribe. In any action for inspection the court may proceed summarily"

**10. The Consultation Paper** stated that

"1.7 The Commission has come to the conclusion that in addition to the proposed changes set out in paragraph 1.4 above, more effective steps could and should be taken to protect all the stakeholders in the modern corporation.

Stakeholders are persons such as shareholders, holders of debentures, employees (trade unions), suppliers and other trade creditors, members of pension funds, provident funds and a myriad of investment funds, lenders, bank depositors and the assured by insurance companies.

1.8 It is clear that the methods of financial accounting which have evolved into 'generally accepted accounting practice (principles or standards)' and the traditional audit and audit reports in respect thereof, often no longer serve the purpose of adequately informing and thus protecting the stakeholders in the modern corporations.

1.9 The shortcomings in the present methods of accounting and auditing are expounded upon in Chapter 2 hereof.

1.10 To achieve adequate protection for the stakeholders a fundamental and structural change to the audit function is required.

The change envisaged is the empowerment of all significant stakeholder interest groups by granting them the right to appoint their

own auditors to investigate and report on matters which particularly affect them.

- 1.11 The purpose of this Paper is to ensure the widest possible consultation with all interested parties regarding the views expressed herein and the practicality of achieving the proposed changes in the role of the auditor";

and proposed as follows –

- "3.1 Many of the problems created by unfair or fraudulent conduct by market participants, by inadequate disclosure of information upon which users can make informed choices and by dishonest or inefficient auditors, could be eradicated by the appointment of auditors for and by each significant interest stakeholder group.
- 3.2 Significant interest groups would be groups such as No-vote shareholders, minority shareholders in a take-over bid situation, debenture holders, suppliers and other trade creditors, persons assured by insurance companies, members of pension and provident funds, employees, trade unions, bank depositors, etc.
- 3.3 Their auditors would also have access to the audit files of the main auditor of the entity. This would obviate duplication of work and fees and should also have a salutary effect on the main audit.
- 3.4 The value of such auditors for interest groups is obvious. Some examples are —
- employees (trade unions) will not be dependent upon financial information prepared by management when conducting wage negotiations or disputing the necessity to retrench;
  - the debenture holders in the failed Masterbond companies such as Mykonos, Fancourt, Marina Martinique and a host of smaller companies will not have lost hundreds of millions of rand. Their auditors would have raised early warnings that monies were being used for other purposes and that the securities were inadequate;

- similarly, the investors in the failed Owen Wiggins companies would have received early warnings;
- participation bond investors in the Masterbond, Owen Wiggins and Supreme Bond schemes would not have lost their investments;
- **SA Rail Commuters Corporation** would not have lost R247 million deposited in Cape Investment Bank. The auditor of the depositors would have warned them that the insolvent bank was being propped up by the Reserve Bank;
- the depositors in Pretoria Bank would have been warned of its imminent liquidation and that it was riddled with maladministration, theft and fraud. This could have saved the taxpayer millions;
- members of pension funds which fail to produce the required annual returns could take steps to prevent or reduce the extent of the losses or the theft of their monies;
- the reports which emanate from the Registrar of Pension Funds regarding failure to produce annual returns could only be described as frightening;
- minority shareholders would not have to be left to the mercy of the majority shareholder in a take-over situation.

Recently a typical dispute such as between IBM SA and its minority shareholders was reported in the press as follows:

'The dispute between IBM SA and disgruntled minority shareholders has escalated with the shareholders launching a last-ditch bid to force the US-controlled company to disclose more about its financial condition.

The shareholders, who are former IBM employees, have lodged a complaint with the Securities Regulation Panel claiming the company is worth more than it admits.

The minorities are hoping to thwart the computer company's efforts to buy back the 46% of shares it does not already own at R12 each.

The ex-employees are concerned that IBM SA's figures may have been manipulated to keep its share price in the doldrums. They allege the US parent overcharged its SA subsidiary for the secondment of foreign managers, and bumped up the wholesale price of its hardware and software to reduce the subsidiary's profit margin.

The complaint to the panel accuses IBM of withholding information crucial to determine the true value of the shares. A key request is that the panel instruct IBM SA to disclose its figures for the half-year to June 30 1998. These accounts are being prepared but are unlikely to be published before a vote on the buyback offer on August 5.

.....

IBM SA said yesterday it was not aware of any formal complaint. 'In terms of the offer made to minority shareholders and in terms of the scheme of arrangement, we believe we have conformed to all JSE requirements by making available all information that is appropriate and available', said a spokesman'.

An auditor, appointed by the minority shareholders, would have been able to report on the adequacy of the offer.

— Investors, such as the investors in '**Proplace**', would probably have not lost their investments.

The plight of these investors was reported in the **Saturday Argus, August 29, 1998** under the heading —

**'Elderly the hardest hit in R187-m debacle.**

Investors depending on their investments, stand to lose up to 95c in the rand when the R187 million Proplace scam is wound up, fund managers say.

Robert Cameron-Ellis of Deloitte & Touche, who has been appointed by the Registrar of Banks to wind up the scheme and pay out investors, says investors are owed R187 million but only R57 million is available to be paid

out to the more than 1 050 people who invested in the scheme.

Criminal charges are to be laid against the man who headed Proplace, Tony Maniachi, who has skipped the country and is thought to be living in the Lebanon.

Proplace lured investors with promises of guaranteed returns of up to 16 percent with tax advantages through investments in endowment policies with the big assurance houses such as Old Mutual, Sanlam, Southern Life, Fedlife, and Norwich.

Investors, mostly elderly people, handed over money and Proplace promised to buy endowment policies on their behalf. But the Deloitte & Touche accountants have found, the promised policies were not always bought; some were used to cover several investments and those who invested small amounts were not issued with policies in their own name.

Cameron Ellis who broke the bad news to investors at a packed meeting in Johannesburg this week, says these smaller investors, whose investments were not secured by policies, will be hardest hit.

Policies worth only R2 million were issued and they stand to recover only 5c for each rand they put into Proplace.

‘Many people put their life savings into this scheme.’ Says Cameron-Ellis who has described the Proplace scam as the ‘biggest debacle since Masterbond’ “.

- 3.5 If auditors are appointed by each significant interest group, some of the most pressing problems which confront the auditing profession and which are demonstrated by the ‘expectation gap’, could also be alleviated.

Problems such as

- the extent and scope of the main audit which often cannot cater for the particular needs of all significant interest groups;

- the non-independence or perceived non-independence of the main auditor who renders other services for the client;
- the liability for damages caused to a particular interest group by the dishonesty, negligence or lack of insight of the main auditor;
- the interpretation and application of generally accepted accounting standards to the accounts or the account items of an entity.

3.6 In addition, if auditors are appointed for each significant interest group, it would result in

- increased specialization in the profession;
- the employment of specialists by smaller firms;
- from a globalization point of view, the overall audit function could be fulfilled on a modular basis, especially where use is made of specialist correspondent auditors;
- the use of specialist auditors should lead to more uniformity in the presentation of account items, in the auditing thereof and in the auditors' reports thereon;
- specialist auditors would keep abreast with dynamic developments in their fields.

3.7 The Commission is of the view that if stakeholders are empowered by

- the right to appoint their own auditors; and
- appropriate class actions,

corporate fraud would be prevented to a large extent and, if not prevented, significantly curtailed".

11. See Chapter 13.

.....

# CHAPTER 12 - DEBENTURES AND THE PROTECTION OF HOLDERS OF DEBENTURES

**12.1** Section 116 of the South African Companies Act provides that a company if so authorised by its memorandum or by its articles, may create and issue secured or unsecured debentures.<sup>(1)</sup>

**12.2** The South African Companies Act (section 1) defines a debenture as:

" 'debenture' includes debenture stock, debenture bonds and any other securities of a company, whether constituting a charge on the assets of the company or not".<sup>(2)</sup>

**12.3** An issue of debentures may be subject to a trust deed appointing a trustee for the debenture-holders. The trustee may not be a director or officer of the company issuing the debentures.<sup>(3)</sup>

**12.4** In terms of subsections 302 (1) and (2) and section 303, debenture-holders are entitled to receive copies of the company's financial statements.<sup>(4)</sup>

**12.5** No other noteworthy protection is afforded to debenture holders. No limit is placed on the value of debentures which may be issued and, if appointed, the trustee of the debenture holders has no independent right of access to the books and records of the borrowing company.

**12.6** This enabled companies in the Masterbond Group such as Marina Martinique and Fancourt, each with an issued share capital of only R100, with no reserves and without adequate security, to issue debentures for amounts totalling more than R50 million each.

Weskus, another Masterbond company, also with an issued share capital of R100, with no reserves and virtually no security, issued debentures in an amount of R30 million.

**12.7** A debenture is usually a document which creates, acknowledges or evidences the indebtedness of a company in respect of money accepted by it as a deposit or as a loan.

**12.8** Although defined, the word 'debenture' has no precise meaning, it is the name of a genus, not of a species.<sup>(5)</sup>

**12.9** The history of 'debentures' is sketched by Pennington as follows:

"Companies have always been able to create legal and equitable mortgages of their property in the same form and with the same effect as mortgages by individuals. The distinctive security given by companies, however, is the debenture.

Debentures are creatures of fairly recent growth. They appeared first during the 1860's in a form closely resembling the bonds which companies had previously issued in order to raise loans. Their principal difference from bonds was that, in addition to containing a covenant by the company to repay the loan, they charged the company's property or undertaking with the repayment, thus creating a security which later became identified as a floating charge. Gradually the form of debentures changed from that of the bond, but like bonds they were still arranged in two parts. The main part contained the company's covenant for payment of principal and interest and a legal mortgage of its fixed assets and a floating charge over its other property; the other part comprised the endorsed conditions which dealt with the detailed terms of the loan and conferred remedies on the lender for its recovery. The form of debenture is still used when a company borrows from one or a few lenders, in particular for securing short term bank loans and overdrafts.

By the end of the last century public companies found that their issues of debentures were subscribed for by so great a number of investors that it was inconvenient to employ the form of debenture currently in use. If the company mortgaged its assets to a thousand persons, it had to get a thousand consents when it wished to sell an asset which was specifically mortgaged, or to depart in the smallest degree from the terms of its debentures. The problem was solved by the introduction of the trust deed by which trustees were appointed to represent the interests of the debenture holders. The trustees were given a legal mortgage of the company's fixed assets and a floating charge over its other property, were empowered to consent on the debenture holders' behalf to minor departures by the company from the terms of the debentures, and were authorised to call meetings of debenture holders to decide whether the trustees should enforce the security given by the trust deed when a case arose for doing so, or whether the debenture holders should agree to a modification of their rights when the company was unable to meet its obligations in full. Debentures in the old form were still issued to the debenture holders, but they were always expressed to be subject to the provisions of the trust deed, and although they contained a covenant by the company with the holder to repay his loan, they often omitted to give him any security individually and left him to rely on the security given to the trustees by the trust deed.

Soon the trust deed underwent a change and assumed its present form. In a modern trust deed the company covenants with the trustees to repay the debenture loan to the subscribers. They, in turn, are given debenture stock certificates which evidence their right to a share in the total debenture debt equal to the amount they have individually subscribed, but there is no covenant by the company with them to repay the amounts they have advanced. Debenture stockholders, unlike debenture holders, are not creditors of the company. The trustees are the creditors for the whole debenture debt, and the stockholder is an equitable beneficiary of the trust on which they hold that debt. Consequently, his remedies are primarily against the trustees, but by suing them to compel them to exercise their remedies against the company, he can indirectly enforce the same remedies against it as a debenture holder can enforce directly.

The most recent development in debenture issues by the larger and some of the medium sized public companies has been the diminution of the security given by the trust deed. Legal mortgages are now rarely given except by property companies, and sometimes there is not even a floating charge. If no security at all is given and the debentures are to be dealt in on a stock exchange, they must be denominated "unsecured", and they are commonly known as unsecured loan stock or notes. It is usual for trust deeds covering such stock or notes to contain a "negative pledge" clause by which the company undertakes not to mortgage its property, or not to mortgage it for more than a specified

sum. This clause ensures that if the company becomes insolvent and has adhered to its undertaking, the loan stockholders will not find its assets consumed in paying secured creditors. The clause does not give the loan stockholders any priority over the company's other unsecured creditors, however, and so if the company does become insolvent, stockholders and other unsecured creditors alike will be paid an equal proportion of their debts".<sup>(6)</sup>

**12.10** The meagre protection afforded to holders of debentures in South Africa is in stark contrast to the protection which their counterparts enjoy in many other jurisdictions.

**12.11** A worldwide survey of companies and securities laws of other jurisdictions revealed seven basic measures to protect investors when corporations seek to borrow money from the public, namely:

- A merit review of the proposed issue by a regulator.
- The appointment of a reputable trustee to protect the holders of debentures.
- The right of access to the books and records of the issuer by the trustee.
- The obligation of the trustee to ensure the existence of sufficient security for the repayment of the debentures.
- The obligation of the external auditor of the issuer to report irregularities to the trustee.
- A periodical report of the affairs of the issuer by its directors.
- Capping the amount which may be borrowed.

**12.12** The jurisdictions enumerated in the text and in the notes are not intended to be exhaustive lists. They are cited to illustrate that measures to protect holders of debentures are taken worldwide.<sup>(7)</sup>

**12.13** A merit review by a regulator of the proposed issue of debentures including an assessment of the ability of the borrower to repay the loans, is required in many jurisdictions.<sup>(8)</sup>

A prime example is the disclosure requirements set by **India** in its 'Guidelines for Issue of Debt Instruments'.<sup>(9)</sup>

"10.1.1. No public or rights issue of debt instruments (including convertible instruments) in respect of their maturity or conversion period shall be made unless credit rating from a credit rating agency has been obtained and disclosed in the offer document.

10.8. The existing and future equity and long-term debt ratio.  
[and the] Servicing behaviour on existing debentures, payment of due interest on due dates on term loans and debentures".

**12.14** Access to all the records of the borrowing corporation by the trustee for the holders of debentures is a requirement in some countries, such as **Australia**.

"Section 1054. Contents of trust deed (Corporations Law)

(1) A corporation shall not, in this jurisdiction, invite subscriptions for or the purchase of debentures or offer debentures for subscription or purchase unless the relevant trust deed

(a) .....

(b) contains covenants by the borrowing corporation as mentioned in subsection (3)

(2) .....

(3) The covenants referred to in paragraphs (1)(b) and (2)(b) are:

(a) .....

(b) a covenant that the borrowing corporation will:

(i) make available for inspection by the trustee for the holders of debentures or any registered company auditor appointed by that trustee the whole of the financial or other records of the borrowing corporation; and

- (ii) give to that trustee such information as that trustee requires with respect to all matters relating to the financial or other records of the borrowing corporation".<sup>(10)</sup>

**12.15** The appointment of a reputable trustee for the holders of debentures is required in many countries. In **Australia** (section 1052) a trustee must be a body corporate being

- "(c) a person constituted as the Public Trustee in any State or Territory;
- (d) a body corporate authorised by law of a State or Territory to take in its own name a grant of probate of the will, or of letters of administration of the estate, of a dead person;
- (e) a body corporate registered under the Life Insurance Act 1995;
- (f) an Australian ADI;
- (g) a body corporate (in this paragraph called the 'subsidiary') the whole of the issued shares of which are held beneficially by a body corporate or bodies corporate of a kind referred to in paragraph (d), (e) or (f) (in this paragraph called the 'holding company') if:
  - (i) the holding company is liable for all liabilities incurred or to be incurred by the subsidiary as trustee for the holders of the debentures; or
  - (ii) the holding company has subscribed for and beneficially holds shares in the subsidiary, being shares in respect of which there is a liability of not less than \$500,000 that has not been called up and which, because of a special resolution of the members of the subsidiary, is not capable of being called

up except in the event, and for the purposes, of the winding up of the subsidiary; or

- (h) a body corporate approved by the Commission for the purposes of this subsection".<sup>(11)</sup>

**12.16** Restrictions on the total value of debentures are common. In **Korea** (section 470)

- "(1) The total amount of debentures shall not exceed that of twice the stated capital and the reserve fund.
- (2) If the net amount of the existing property of the company as shown by the last balance sheet does not reach to the total amount of the stated capital and the reserve fund, the total amount of debentures shall not exceed twice the net amount of such property".<sup>(12)</sup>

**12.17** Some countries require the trustee to ensure that the assets of the borrower are sufficient to discharge the principal debt when it becomes due. The **Singapore** Companies Act provides as follows (section 101):

"s.101 Duties of trustees (Companies Act)

- (1) A trustee for the holders of debentures:
  - (a) shall exercise reasonable diligence to ascertain whether or not the assets of the borrowing corporation and of each of its guarantor corporations which are or may be available whether by way of security or otherwise are sufficient or are likely to be or become sufficient to discharge the principal debt as and when it becomes due".<sup>(13)</sup>

**12.18** The Companies Act of **Mauritius** requires the auditor of the borrowing company to assist the trustee for the holders of debentures.

"173. Duties of Auditors Towards Debenture Holders' Representatives

- (1) The auditor of a borrowing company shall, within 7 days after furnishing the company with any balance sheet or profit and loss account or any report, certificate, or other document which he is required by this Act or by the agency deed to give to the company, send a copy by post to every debenture holder's representative.
- (2) Where in the performance of his duties as auditor or borrowing company the auditor becomes aware of any matter which is in his opinion relevant to the exercise and performance of the powers and duties imposed by this Act or by any agency deed on any debenture holder's representative, he shall within 7 days after becoming aware of the matter send by post a report in writing on such matter to the borrowing company and a copy to the representative.
- (3) The auditor of a borrowing company shall at the request of the debenture holders' representative, furnish to him such information or particulars relating to the borrowing company as are within his knowledge and which are in his opinion relevant to the exercise of performance of the powers or duties conferred or imposed on the representative by this Act or by the agency deed".

**12.19** The Companies Act of **Singapore** (section 103(1)) requires a borrowing corporation to furnish a quarterly report of the state of its financial affairs to the trustee for the holders of debentures and to the Registrar.

"The report referred to in subsection (1) shall be signed by not less than 2 of the directors on behalf of all of them and shall set out in detail any matters adversely affecting the security or the interests of the holders of the debentures and, without affecting the generality of subsection (1), shall state:

- (a) whether or not the limitations on the amount that the corporation may borrow have been exceeded;
- (b) whether or not the borrowing corporation and each of its guarantor corporations have observed and performed all the covenants and provisions binding them respectively by or pursuant to the debentures or any trust deed;
- (c) whether or not any event has happened which has caused or could cause the debentures or any provision of the relevant trust deed to become enforceable and, if so, particulars of that event;
- (d) whether or not any circumstances affecting the borrowing corporation, its subsidiaries or its guarantor corporations or any of them have occurred which materially affect any security or charge included in or created by the debentures or any trust deed and, if so, particulars of those circumstances;
- (e) whether or not there has been any substantial change in the nature of the business of the borrowing corporation or any of its subsidiaries or any of its guarantor corporations since the debentures were first issued to the public which has not previously been reported upon as required by this section and, if so, particulars of that change; and
- (f) where the borrowing corporation has deposited money with or lent money to or assumed any liability of a corporation which pursuant to section 6 is deemed to be related to the borrowing corporation, particulars of

- (i) the total amounts so deposited or loaned and the extent of any liability so assumed during the period covered by the report; and
- (ii) the total amounts owing to the borrowing corporation in respect of money so deposited or loaned and the extent of any liability so assumed as at the end of the period covered by the report,

distinguishing between deposits loans and assumptions of liabilities which are secured and those which are unsecured, but not including any deposit with or loan to or any liability assumed on behalf of a corporation if that corporation has guaranteed the repayment of the debentures of the borrowing corporation and has secured the guarantee by a charge over its assets in favor of the trustee for the holders of the debentures of the borrowing corporation".<sup>(14)</sup>

**12.20** These measures to protect investors from unscrupulous borrowers are fair and practical and should be incorporated into the South African Companies Act.

**12.21** It is recommended that no company should be allowed to borrow money from the public, whether as loans or as deposits of whatever nature and whether as an agent or a principal unless

- (a) it has satisfied the regulator that it would be able to repay such monies and any interest thereon, on due date;
- (b) in terms of a trust deed a registered South African financial institution has been appointed as trustee for the investors;
- (c) the trustee is required to exercise reasonable diligence to ascertain from time to time whether or not the assets of the borrowing company which are or may become available whether by way of security or otherwise are sufficient or are likely to be or become sufficient to discharge the principal debt as and when it becomes due;

- (d) the trustee has at all times access to all accounting and other records of the borrowing company and to all information held by its directors, officers and employees;
- (e) it quarterly prepares and lodges with the trustee and the regulator a report signed by not less than two of the directors on behalf of all of them and which shall set out in detail any matters adversely affecting the security or the interests of the holders of the debentures and, without affecting the generality, which shall state:

  - (i) whether or not the limitations on the amount that the company may borrow have been exceeded;
  - (ii) whether or not the borrowing company and each of its guarantor companies have observed and performed all the covenants and provisions binding them respectively by or pursuant to the debentures or any trust deed;
  - (iii) whether or not any event has happened which has caused or could cause the debentures or any provision of the relevant trust deed to become enforceable and, if so, particulars of that event;
  - (iv) whether or not any circumstances affecting the borrowing company, its subsidiaries or its guarantor companies or any of them have occurred which materially affect any security or charge included in or created by the debentures or any trust deed and, if so, particulars of those circumstances;
  - (v) whether or not there has been any substantial change in the nature of the business of the borrowing company or

any of its subsidiaries or any of its guarantor companies since the debentures were first issued to the public which has not previously been reported upon as required and, if so, particulars of that change; and

(vi) where the borrowing company has deposited money with or lent money to or assumed any liability of another entity or person, full particulars thereof, including

(aa) the total amounts so deposited or loaned and the extent of any liability so assumed during the period covered by the report; and

(bb) the total amounts owing to the borrowing company in respect of money so deposited or loaned and the extent of any liability so assumed as at the end of the period covered by the report,

distinguishing between deposits, loans and assumptions of liabilities which are secured and those which are unsecured, and the reasons for making such deposits or loans or the assumption of liability;

(f) the auditor of the borrowing company, or such other entity referred to in 12.21(e) above, is required

(i) to forthwith report to the trustee any matter of which he becomes aware and which could be relevant to the exercise and performance of the powers and duties imposed upon the trustee by the Companies Act or the trust deed;

(ii) to furnish on request to the trustee copies of all working papers and such information or particulars relating to the borrowing company as are within his knowledge or which he can obtain

**and which could be relevant to the exercise and performance of the powers and duties imposed upon the trustee by the Companies Act or the trust deed;**

- (g) the amount which may be borrowed is restricted.**

.....

## NOTES

1. **Section 116. "Creation and issue of debentures.**—A company, if so authorized by its memorandum or by its articles, may create and issue secured or unsecured debentures".
2. The 'other securities of a company' is not defined. It is in fact illogical and contradictory. 'Securities' of a company are normally assets of the company. Debentures are liabilities. The definition was copied from an English Act and probably inserted without further thought.
3. **Section 122. "Director or officer not to be trustee for debenture-holders. —** No director or officer of a company shall be capable of being a trustee for the holders of debentures of that company".
4. **Section 302. "Duty of company to send annual financial statements to members and Registrar.**—(1) A copy of the annual financial statements of a company and the group annual financial statements, if any, shall not less than twenty-one days before the date of the annual general meeting of the company be sent to every member of the company and every holder of debentures of the company (whether or not such member or holder of debentures is entitled to receive notices of general meetings of the company) and to all persons other than members or holders of debentures of the company who are entitled to receive such notices.
  - (2) The provisions of subsection (1) shall not be construed as requiring a copy of the said statements to be sent —
    - (a) in the case of a company not having a share capital, to any member or holder of debentures of the company who is not entitled to receive notices of general meetings of the company;
    - (b) to any member or holder of debentures of a company who is entitled to receive such notices and whose address is not known to the company;
    - (c) to more than one of the joint holders of any shares or debentures of a company none of whom is entitled to receive such notices;

- (d) in the case of joint holders of any such shares or debentures of whom some are and others are not entitled to receive such notices, to any such joint holder who is not so entitled.

**Section 303. Half-yearly interim reports.**—Every public company having a share capital, other than a wholly owned subsidiary, shall not later than three months after the expiration of the first period of six months of its financial year send to every member and holder of debentures of the company an interim report fairly presenting the business and operations of the company or, in the case of a holding company, of the company and its subsidiaries, during the said period of six months, and the results thereof".

5. **Pennington, Robert R.** : 'Company Law' 3<sup>rd</sup> Ed. p. 367. (Butterworths, London. 1973.)

"It is apparent that the commercial meaning of the term debenture covers many different forms of investment. The legal definition of a debenture is even wider. In one case, Chitty, J., said (*r*) :-

"In my opinion a debenture means a document which either creates a debt or acknowledges it, and any document which fulfils either of these conditions is a 'debenture'. I cannot find any precise legal definition of the term, it is not either in law or commerce a strictly technical term, or what is called a term of art'."

6. **Ibid** : p. 365 – 366.
7. **Translations** of companies laws are translations published in 'Commercial Laws of the World". (Foreign Tax Law Publishers, Inc., Florida.).
8. **See generally Chapter 8** : "Securities Regulation – The Primary Market – Disclosure and the Merit Review".
9. **The Gazette of India Extraordinary** : 29.12.93. (Guidelines)

10.0 "A company offering Convertible/Non Convertible debt instruments through an offer document, shall comply with the following provisions in addition to the relevant provisions contained in other chapters of these guidelines.

### 10.1 Requirement of credit rating

10.1.1 No public or rights issue of debt instruments (including convertible instruments) in respect of their maturity or conversion period shall be made unless credit rating from a credit rating agency has been obtained and disclosed in the offer document.

10.1.2 For a public / rights issue of debt security of issue greater than or equal to Rs. 100 crores two ratings from two different credit rating agencies shall be obtained.

10.1.3 Where credit rating is obtained from more than one credit rating agency, all the credit rating/s, including the unaccepted credit ratings, shall be disclosed.

10.1.4 All the credit ratings obtained during the three (3) years preceding the public or rights issue of debt instrument (including convertible instruments) for any listed security of the issuer company shall be disclosed in the offer document.

## **10.2 Requirement in respect of Debenture Trustee**

10.2.1 In case of issue of debenture with maturity of more than 18 months, the issuer shall appoint a Debenture Trustee.

10.2.2 The names of the debenture trustees must be stated in the offer document.

10.2.3 A trust deed shall be executed by the issuer company in favour of the debenture trustees within six months of the closure of the issue.

10.2.4 Trustees to the debenture issue shall be vested with the requisite powers for protecting the interest of debenture holders including a right to appoint a nominee director on the Board of the company in consultation with institutional debenture holders.

10.2.5 The merchant banker shall, along with draft offer document, file with Board, certificates from their bankers that the assets on which security is to be created are free from any encumbrances and the necessary permissions to mortgage the assets have been obtained or a No Objection Certificate from the financial institutions or banks for a second or pari passu charge in cases where assets are encumbered.

10.2.6 The debenture trustee shall ensure compliance of the following:

- a. Lead financial institution / investment institution shall monitor the progress in respect of debentures raised for project finance / modernisation / expansion / diversification / normal capital expenditure.
- b. The lead bank for the Company shall monitor debentures raised for working capital funds.
- c. Trustees shall obtain a certificate from the company's auditors:
  - i. In respect of utilization of funds during the implementation period of projects.
  - ii. In the case of debentures for working capital, certificate shall be obtained at the end of each accounting year.
    - a. Debenture issues by companies belonging to the groups for financing replenishing funds or acquiring share holding in other companies shall not be permitted.

**Explanation:**

The expression 'replenishing of funds or acquiring shares in other companies' shall mean replenishment of funds or acquiring share holdings of other companies in the same group. In other words, the company shall not issue debentures for acquisition of shares / providing loan to any company belonging to the same group. However, the company may issue equity shares for purposes of repayment of loan to or investment in companies belonging to the same group.

- a. The debenture trustees shall supervise the implementation of the conditions regarding creation of security for the debentures and debenture redemption reserve.

**10.3 Creation of Debenture redemption reserves (DRR)**

10.3.1 A company has to create DRR in case of issue of debenture with maturity of more than 18 months.

10.3.2 The issuer shall create DRR in accordance with the provisions given below,

(a) If debentures are issued for project finance for DRR can be created up to the date of commercial production.

(b) The DRR in respect of debentures issued for project finance may be created either in equal instalments or higher amounts if profits so permit.

a. In the case of partly convertible debentures, DRR shall be created in respect of non-convertible portion of debenture issue on the same lines as applicable for fully non-convertible issue.

b. In respect of convertible issues by new companies, the creation of DRR shall commence from the year the company earns profits for the remaining debentures.

(c) DRR shall be treated as a part of General Reserve for consideration of bonus issue proposals and for price fixation related to post tax return.

a. Company shall create DRR equivalent to 50% of the amount of debenture issue before debenture redemption commences.

b. Withdrawal from DRR is permissible only after 10% of the debenture liability has actually been redeemed by the company.

c. The requirement of creation of a DRR shall not be applicable in case of issue of debt instruments by infrastructure companies.

#### **10.4 Distribution of Dividends**

(a) In case of new companies, distribution of dividend shall require approval of the trustees to the issue and the lead institution, if any.

(b) In the case of existing companies prior permission of the lead institution for declaring dividend exceeding 20% or as per the loan covenants is necessary if the company does not comply with institutional condition regarding interest and debt service coverage ratio.

(c)(i) Dividends may be distributed out of profit of particular years only after transfer of requisite amount in DRR.

- (ii) If residual profits after transfer to DRR are inadequate to distribute reasonable dividends, company may distribute dividend out of general reserve.

## **10.5 Redemption**

10.5.1. The issuer company shall redeem the debentures as per the offer document.

## **10.6 Creation of Charge**

10.6.1 The security shall be created within six months from the date of issue of debentures.

Provided that if for any reasons the company fails to create security within 12 months from the date of issue of debentures the company shall be liable to pay 2% penal interest to debenture holders.

Provided further that if security is not created even after 18 months, a meeting of the debenture holders shall be called within 21 days to explain the reasons thereof and the date by which the security shall be created.

10.6.2 If the issuing company proposes to create a charge for debentures of maturity of less than 18 months, it shall file with Registrar of Companies particulars of charge under the Companies Act.

Provided that, where no charge is to be created on such debentures, the issuer company shall ensure compliance with the provisions of the Companies (Acceptance of Deposits) Rules, 1975, as, unsecured debentures / bonds are treated as "deposits" for purposes of these rules.

10.6.3 The proposal to create a charge or otherwise in respect of such debentures, may be disclosed in the offer document along with its implications.

## **10.7 Requirement of letter of option**

10.7.1 Filing of letter of option

A letter of option containing disclosures with regard to credit rating, debenture holder resolution, option for conversion, justification for conversion price and such other terms which the Board may prescribe from time to time shall be filed with the Board through an eligible Merchant Banker, in the following cases:

10.7.1.1. In case of Roll over of Non Convertible portions of Partly Convertible Debentures (PCDs)/Non Convertible Debentures (NCDs)

- i. In case, the non-convertible portions of PCD/NCD issued by a listed company, value of which exceeds Rs. 50 lacs, can be rolled over without change in the interest rate subject to the following conditions:
  - a. An option shall be compulsorily given to debenture holders to redeem the debentures as per the terms of the offer document.
  - b. Roll over shall be done only in cases where debenture holders have sent their positive consent and not on the basis of the non-receipt of their negative reply.
  - c. Before roll over of any NCDs or non-convertible portion of the PCDs, a fresh credit rating shall be obtained with a period of six months prior to the due date of redemption and communicated to debenture holders before roll over.
  - d. Fresh trust deed shall be executed at the time of such roll over.
  - e. Fresh security shall be created in respect of such debentures to be rolled over.

Provided that if the existing trust deed or the security documents provide for continuance of the security till redemption of debentures fresh security may not be created.

10.7.1.2 In case of conversion of instruments (PCDs/FCDs, etc.) into equity capital

- i. In case, the convertible portion of any instrument such as PCDs, FCDs etc. issued by a listed company, value of which exceeds Rs. 50 Lacs and whose conversion price was not fixed at the time of issue, holders of such instruments shall be given a compulsory option of not converting into equity capital.
- ii. Conversion shall be done only in cases where instrument holders have sent their positive consent and not on the basis of the non-receipt of their negative reply.

**Provided** that where issues are made and cap price with justification thereon, is fixed beforehand in respect of any instruments by the issuer and disclosed to the investors before issue, it will not be necessary to give option to the instrument holder for converting the instruments into equity capital within the cap price.

- iii. In cases where an option is to be given to such instrument holders and if any instrument holder does not exercise the option to convert the debentures into equity at a price determined in the general meeting of the shareholders, the company shall redeem that part of debenture at a price which shall not be less than its face value, within one month from the last date by which option is to be exercised.
- iv. The provision of sub-clause (iii) above shall not apply if such redemption is to be made in accordance with the terms of the issue originally stated.

#### 10.7.1.3 In case of Conversion of Debentures Issued under Consent of Controller of Capital Issues (CCI)

- A. In case, the value of convertible portion of any instrument such as PCDs, FCDs, etc. issued by a listed company exceeds Rs 50 Lacs and;
  - i. where in terms of the consent issued by the Controller of Capital Issues, the price of conversion of PCDs / FCDs is to be determined at a later date by the Controller, such price and the timing of conversion shall be determined at a general meeting of the shareholders subject to -

the consent of the holders of PCDs / FCDs for the conversion terms shall be obtained individually and conversion will be given effect to only if the concerned debentureholders send their positive consent and not on the basis of non- receipt of their negative reply; and

such holders of debentures, who do not give such consent, shall be given an option to get the convertible portion of debentures redeemed or repurchased by the company at a price, which shall not be less than face value of the debentures.

- C. Where the consent from the Controller of Capital Issues stipulates cap price for conversion of FCDs / PCDs, the board of the Company may determine the price at which the debentures may be converted.

**Provided** that options to debentures / other instrument holders for conversion into equity not required where the consent from the Controller of Capital Issues stipulates cap price for conversion of FCDs and PCDs and the cap price has been disclosed to the investors before subscription is made.

- i. In case of issue of debentures fully or partly convertible made in the past, where the conversion was to be made at a price to be determined by the CCI at a later date, the price of conversion and time of conversion shall be determined by the issuer company in a meeting of the debenture holders, subject to the following:

The decision in the said meeting of debentureholders may be ratified by the shareholders in their meeting.

Such conversions shall be optional for acceptance on the part of individuals debenture holders.

The dissenting debenture holders shall have the right to continue as debenture holders if the terms of conversions are not acceptable to them.

- (iii) Where issue of PCDs and FCDs is made pursuant to the consent given by the Controller of Capital Issues and the consent specifies the timing of conversion but the price of conversion of PCDs / FCDs is to be determined at a later date, the following shall be complied with:-

- A. the consent of the shareholders is to be obtained only for the purposes of fixing the price of conversion and not for the pre-poning and postponing the timing of the conversion approved by CCI.
  - a. The conversion price shall be reasonable (in comparison with previous conversion price where the terms of the issue provide for more than one conversion) and the conversion price shall not exceed the face value of that part of the convertible debenture which is sought to be converted.
  - b. In cases where an option is to be given to the debentureholders and, if any debentureholder does not exercise the option to convert the debentures into equity at a price determined in the general meeting of the shareholders, the company shall redeem that part of debenture at a price which shall not be less than its face value within one month from the last date by which option is to be exercised.
  - c. The provision in sub-clause (c) above shall not be applicable in case such redemption is to be made in accordance with the original terms of the offer.
- B. In cases of issues of debentures fully or partly convertible, irrespective of value made in the past, where conversion was to be made at a price to be determined by CCI and the consent order does not provide for a specific premium or a cap price for conversion, the draft letter of option to the debenture holders filed with the Board shall contain justification for the conversion price.

## **10.8 Other requirements**

10.8.1 No company shall issue of FCDs having a conversion period of more than 36 months, unless conversion is made optional with "put" and "call" option.

- 2. If the conversion takes place at or after 18 months from the date of allotment, but before 36 months, any conversion in part or whole of the debenture shall be optional at the hands of the debenture holder.

3. (a) No issue of debentures by an issuer company shall be made for acquisition of shares or providing loan to any company belonging to the same group.

Sub-clause (a) shall not apply to the issue of fully convertible debentures providing conversion within a period of eighteen months.

4. Premium amount and time of conversion shall be determined by the issuer company and disclosed.

10.8.5 The interest rate for debentures can be freely determined by the issuer company.

#### **10.9 Additional Disclosures in respect of debentures**

The offer document shall contain:-

- a. Premium amount on conversion, time of conversion.
- b. In case of PCDs/NCDs, redemption amount, period of maturity, yield on redemption of the PCDs/NCDs.
- c. Full information relating to the terms of offer or purchase including the name(s) of the party offering to purchase the khokhas (non-convertible portion of PCDs).
- d. The discount at which such offer is made and the effective price for the investor as a result of such discount.
- e. The existing and future equity and long term debt ratio.
- f. Servicing behaviour on existing debentures, payment of due interest on due dates on term loans and debentures.
- g. That the certificate from a financial institution or bankers about their no objection for a second or pari passu charge being created in favour of the trustees to the proposed debenture issues has been obtained.

13. Obligation before appointment as debenture trustees

13.(1) No debenture trustee who has been granted a certificate under regulation 8 shall act as such in respect of each issue of debenture unless -

- (a) he gives consent in writing to a body corporate to act as debenture trustee under trust deed for securing any issue of debentures by each such body corporate;

consent under clause (a) is given before the issue of debentures for subscription.

Obligation of the debenture trustees

14. Every debenture trustee shall amongst other matters accept the trust deed which contain the matters specified in Schedule IV to the regulations.

Duties of the debenture trustees

15.(1) It shall be the duty of every debenture trustee to -

call for periodical reports from the body corporate;

inspect books of accounts, records, registers of the body corporate and the trust property to the extent necessary for discharging his obligations;

- (a) take possession of trust property in accordance with the provisions of the trust deed;
- (b) enforce security in the interest of the debenture holders;
- (c) do such acts as are necessary in the event the security becomes enforceable;
- (d) carry out such acts as are necessary for the protection of the debenture holders and to do all things necessary in order to resolve the grievances of the debenture holders;

- (e) ensure that the -
  - (i) refund monies due to the applicants applying for the debentures have been paid in accordance with the Companies Act and the listing agreement of the stock exchange on which the debentures of the company are listed;
  - (ii) debenture certificates have been despatched to the debenture holders in accordance with the provisions of the Companies Act;
  - (iii) interest warrants for interest due on the debentures have been despatched to the debenture holders on or before the due dates;
  - (iv) debenture holders have been paid the monies due to them on the date of redemption of the debentures;
- (h) exercise due diligence to ascertain whether or not the assets of the body corporate which are available by way of security or otherwise are sufficient or are likely to be or become sufficient to discharge the claims of debenture holders as and when they become due;  
  
exercise due diligence to ensure compliance by the body corporate, with the provisions of the Companies Act, the listing agreement of the stock-exchange or the trust deed;  
  
to make appropriate measures for protecting the interest of the debenture holders as soon as any breach of the trust deed or law comes to his notice;
- (i) to ascertain that the debentures have been converted or redeemed in accordance with the provisions and conditions under which they are offered to the debenture holders;
- (j) inform the Board immediately of any breach of trust deed or provision of any law.

[15](2) A debenture trustee shall call or cause to be called by the body corporate a meeting of all the debenture holders on -

- (a) a requisition in writing signed by at least one tenth of the debenture holders in value for the time being outstanding; or
- (c) the happening of any event, which constitutes a default or which in the opinion of the debenture trustees affects the interests of the debenture holders.

#### Code of Conduct

16. Every debenture trustee shall abide by the Code of Conduct as specified in Schedule III.

#### Maintenance of books of accounts, records, documents etc.

17. (1) Subject to the provisions of any law every debenture trustee shall keep and maintain proper books of accounts, records and documents relating to the trusteeship functions for a period of not less than five financial years preceding the current financial year.

(2) Every debenture trustee shall intimate to the Board, the place where the books of accounts, records and documents are maintained.

#### Information to the Board

(1) Every debenture trustee shall as and when required by the Board submit the following information and documents namely:-

- (a) the number and nature of the grievances of the debenture holders received and resolved;
- (b) copies of the trust deed;
- (c) non-payment or delayed payment of interest to debenture holders in any in respect of each issue of debentures of a body corporate;

- (d) details of despatch and transfer of debenture certificates giving therein the dates, mode, etc;
- (e) any other particular or document which is relevant to debenture trustee.

Where any information is called for under sub-regulation (1) it shall be the duty of the debenture trustees to furnish such information".

**10. See also**

**Argentina** Section 345

".....the trustee shall have the following authority:

To examine the documentation and accounting of the debtor company".

**India** Section 15 of the Guidelines

"It shall be the duty of every debenture trustee to call for periodical reports from the body corporate [and to] inspect books of accounts, records, registers of the body corporate and the trust property to the extent necessary for discharging his obligations".

**Malaysia** Sections 76 and 78

**Nauru** Sections 74 and 75

**Papua New Guinea** Securities Regulation 1999 – Section 37

"(3) The issuer shall on regular basis –

- (a) at the request in writing of the trustee, make available for its inspection the whole of the accounting and other records of the issuer; and
- (b) give to the trustee such information as it requires with respect to all matters relating to such records".

**Paraguay** Section 1145

**Singapore**      Section 99

"(1)      Where a corporation offers debentures to the public for subscription in Singapore, the debentures or the relevant trust deed .....shall contain covenants by the borrowing corporation, or if the debentures do not or the trust deed does not expressly contain those covenants they or it shall be deemed to contain covenants by the borrowing corporation, to the following effect:

(a)      .....

(b)      that, to the same extent as if the trustee for the holders of the debentures or any approved company auditor appointed by the trustee were a director of the corporation, the borrowing corporation will:

(i)      make available for its or his inspection the whole of the accounting or other records of the borrowing corporation; and

(ii)     give to it or him such information as it or he requires with respect to all matters relating to the accounting or other records of the borrowing corporation".

**11.      See also**

**Bangladesh**      Securities and Exchange Commission Public Issue Rules, 1998  
- Rule 16(2)

"(2)      The debentures trustee shall be a bank, a financial institution or an insurance company".

**Canada**          Section 84

"A trustee, or at least one of the trustees if more than one is appointed, shall be a body corporate incorporated under the laws of Canada or a province and authorised to carry on the business of a trust company".

**Malaysia**        Section 1

"Trustee Corporation means

- (a) a company registered as a trust company under the Trust Companies Act 1949; or
- (b) a corporation that is a public company under this Act or under the laws of any other country, which has been declared by the Minister to be a trustee corporation for the purposes of this Act".

**Nauru** Section 2

**Singapore** Section 4

**United States** Section 77jjj (Trust Indenture Act of 1939)

"(a) Persons eligible for appointment as trustee

- (1) There shall at all times be one or more trustees under every indenture qualified or to be qualified pursuant to this subchapter, at least one of whom shall at all times be a corporation organized and doing business under the laws of the United States or of any State or Territory or of the district of Columbia or a corporation or other person permitted to act as trustee by the Commission (referred to in this subchapter as the institutional trustee), which (A) is authorized under such laws to exercise corporate trust powers, and (B) is subject to supervision or examination by Federal, State, Territorial, or District of Columbia authority. The Commission may, pursuant to such rules and regulations as it may prescribe, or by order on application, permit a corporation or other person organized and doing business under the laws of a foreign government to act as sole trustee under an indenture qualified or to be qualified pursuant to this subchapter, if such corporation or other person (i) is authorized under such laws to exercise corporate trust powers, and (ii) is subject to supervision or examination by authority of such foreign government or a political subdivision thereof substantially equivalent to supervision or examination applicable to United States institutional trustees. In prescribing such rules and regulations or making such order, the Commission shall consider whether under such laws, a United States institutional trustee is eligible to act as sole trustee

under an indenture relating to securities sold within the jurisdiction of such foreign government".

**12. See also**

**Australia**           Section 1054

"A corporation shall not, in this jurisdictions, invite subscriptions for or the purchase of debentures or offer debentures for subscription or purchase unless the relevant trust deed

- (a)       contains a limitation of the amount that the borrowing corporation may borrow under that deed or those debentures";

**Brazil**               Section 60

"Except as provided for by special legislation, the total amount of debenture issues may not exceed corporate capital".

**Egypt**               Section 162

"A company shall not issue debentures unless the total of the issued capital shall be paid-up in full and provided that the total value of previously issued added to the new debentures to be issued shall not exceed the net value of the company assets as stated by the accounts auditor in his report to the general meeting considering the issue of the new debentures and on basis of the information contained in the last balance sheet approved by the general meeting".

**Japan**               Section 297

"The amount of debentures for which subscriptions are to be invited shall not exceed the net amount of the existing assets of the company as shown by the last balance sheet".

**Malaysia**           Section 76

- "(1)       Where a corporation offers debentures to the public for subscription in Malaysia the debentures or the relevant trust deed shall contain a

limitation on the amount that the borrowing corporation may pursuant to those debentures or that deed borrow".

**Romania** Section 118

"The joint-stock company may issue bearer or nominal bonds, for an amount not exceeding three quarters of the deposited and existing capital, according to the latest approved annual report".

**Singapore** Section 99

**Thailand** Section 1230

"The total amount of debentures may not exceed the amount which has been paid up on the capital.

If the latest balance sheet shows the amount of the assets to be less than the amount which has been paid up on the capital, the total amount of debentures may not exceed the amount represented by the assets".

**Turkey** Section 422

"The amount of debentures to be issued by companies limited by shares may not exceed the amount of the basic capital which has been paid up, as ascertained by the last balance sheet that has been approved".

**Venezuela** Section 305

".....in amounts that exceed the capital contributed and still subsisting, in accordance with the last approved balance sheet".

**13. See also**

**Malaysia** Section 78

**Nauru** Section 75

**India** Section 15(1)(h)

".....exercise due diligence to ascertain whether or not the assets of the body corporate which are available by way of security or

otherwise are sufficient or are likely to be or become sufficient to discharge the claims of the debenture holders as and when they become due".

14. See also

**Malaysia** Section 80

**Nauru** Section 77

**St Lucia**Section 274

"At least once in every 12 month period beginning on the date of the trust deed and at any other time upon the demand of a trustee, the issuer or guarantor of debentures issued under the trust deed shall furnish the trustee with a certificate that the issuer or guarantor has complied with all requirements contained in the trust deed that, if not complied with, would, with the giving of notice, lapse of time or otherwise, constitute an event of default, or, if there has been failure to comply giving particulars of that failure".

.....

# **CHAPTER 13 - FINANCIAL STATEMENTS -THE AUDITOR AND THE EXPECTATION GAP – ACCESS TO RECORDS BY INTEREST GROUPS**

**13.1** At the beginning of the 20<sup>th</sup> century it was thought that corporations should only disclose financial information to its members. It was believed that public disclosure would benefit competitors and if the information was positive, that the disclosure could lead to increased wage demands by labour.<sup>(1)</sup>

**13.2** Today it is widely accepted that public disclosure of the financial affairs of corporations is vital to the wellbeing of economies, not only for the reason

"that the price of limited liability ought to be the maximum possible disclosure of information regarding the company's financial position"

but because the users of the information represent all sections of the economy.

**13.3** Leading entities in the field of accounting, such as

- the International Accounting Standards Committee (IASC) which represents 140 accountants organizations;
- the Financial Accounting Standards Board (FASB) of the United States;
- the Accounting Standards Board of the UK;

agree that the objective of financial statements is to provide useful information about the the performance of an enterprise, its financial position and any changes therein.

**13.4** The FASB regards 'useful information' as information useful to users in making rational investment, credit and similar decisions and useful for purposes of predicting, comparing and evaluating potential cash flows in terms of amount, timing and related uncertainty.

**13.5** The members of corporations are no longer regarded as the only potential users of the financial statements. The Accounting Standards Steering Committee (now the Accounting Standards Board) identified seven user groups, namely —

- the equity investor group;
- the loan creditor group;
- the employee group;
- the analyst – adviser group;
- the business contact group;
- the government;
- the public.<sup>(2)</sup>

**13.6** Factors such as the growth in size of modern corporations, the growth in the volume of their transactions, the advent and growth of institutional investors, the shift away from the detection of fraud as a primary audit objective and the diversity of the needs of the users of the financial statements, have resulted in a situation where the auditing profession as presently employed cannot fulfil the expectations of the diverse users of the financial statements who each want to be able to make meaningful investment decisions based on the contents thereof.

**13.7** Unfortunately the diversity of the needs of the users of financial statements is not the only stumbling block to the publication of reliable information because the contents of financial statements are often coloured by management to suit their own purposes. Professor MacGregor stated it as follows:

"Although many of the items requiring disclosure by statute are couched in general terms, there is an overriding requirement that financial statements in accordance with generally accepted accounting practice fairly present the state of affairs of the company (the so-called 'true and fair' view) and the directors are obliged by statute to ensure that this is so.

This is a legal requirement and directors have found that it is possible to show the 'true and fair' view by adopting one of the many bases of, for example, depreciation, valuation of stock and work-in-progress, providing for deferred taxation, valuations of uncompleted construction contracts, all of which bases have been categorized as

generally acceptable accounting practice by accountants and auditors. It is understandable that the preparers of financial statements will choose the alternative that best suits their purpose, be it increasing disclosed profits or suppressing profits, and provided that the 'true and fair' requirement has not been disregarded, they are not contravening any part of the statute".<sup>(3)</sup>

**13.8** In addition, the often unexpected liquidations of entities soon after having been reported as profitable and the often perceived non-independence of their auditors, have led to a distrust of the auditing profession and the generation of the well documented '**expectation gap**'. This is a worldwide phenomenon as proven by studies conducted in countries such as the **United States** (1978), **Australia** (1993), **New Zealand** (1993) and **South Africa** (1993).<sup>(4)</sup>

**13.9** The Commission became convinced that as a result of

- the flexibility inherent in the interpretation and in the application of the rules pertaining to Generally Accepted Accounting Practice (Principles);
- the diverse needs of the users and potential users of financial statements;
- the inevitable time lag before interim reports and financial statements are issued;
- the dishonesty or ineptitude of some managers and some auditors;

access to the records of corporations should no longer be the exclusive domain of directors, management, auditors and sometimes the majority shareholders.

**13.10** Comments were invited from interested persons by means of the dissemination of a Consultation Paper – '**The Role of the Auditor – The Elimination of the Expectation Gap and the Appointment of Auditors by all Significant Interest Groups**'.

**13.11** The contents of the Consultation Paper were designed to convey the reasons why the Commission regards

- the contents of financial statements;
- the traditional audit thereof;

- the required audit report thereon

as inadequate for the needs of the users thereof and why a structural shift towards transparency is regarded as a necessity.

**13.12** To avoid needless repetition and to better understand the criticisms and the emotions evoked when it is suggested that the statutory veil of secrecy which surrounds the affairs of South African companies be lifted, the text of the Consultation Paper is reproduced in full.

## "CONSULTATION PAPER

### 1. INTRODUCTION

**1.1** During the late eighties and early nineties the systems designed to protect investors in South Africa failed and hundreds of millions were lost by small investors, many of them pensioners. The systems are still failing with disastrous effects for the victims, many of whom can never recover financially.

**1.2** One of the failures during the early nineties, was the Masterbond Group of Companies which over a number of years attracted approximately a billion rand by promising secured and thus seemingly safe investments. More than 90 percent of the money borrowed on short-term was used within the group and associated companies for highly speculative long-term projects, which generated little or no return. It soon degenerated into a 'Ponzi' scheme. The Group collapsed and thousands of investors were left destitute, many of them pensioners who specifically had been targeted and tempted with the carrot of security and higher than normal interest rates.

**1.4 A public outcry led to the appointment of the Commission of Inquiry. Its First Report reads –**

**“The investigation into the Masterbond Group and its associated companies revealed serious deficiencies in the South African supervisory system and in those sections of the Companies Act which were designed to protect investors. It also revealed an astonishing degree of dishonesty, inefficiency, lack of professional integrity and lack of independence on the part of some of the auditors involved with these companies.”**

**and**

**“It became apparent that with a few notable exceptions the auditors involved seemed to believe that in addition to auditing the books of a company, their function was to assist and protect the management of such company as far as possible. They also seemed to believe that the end justifies the means.**

**Examples thereof are the following**

- issuing of false certificates in respect of participation bond schemes;**
- signing of unqualified reports relating to blatantly false financial statements;**
- failure to comply with the requirements of section 20(5) of the Public Accountants’ and Auditors’ Act on the discovery of material irregularities;**
- drafting and signing financial statements which departed so fundamentally from GAAP (Generally Accepted Accounting Practice) that no reliance could be placed thereon;**
- without proper disclosure changing accounting policies to convert loss situations into profit situations;**

- failure to perform procedures designed to identify all relevant material events occurring after the balance sheet date and up to the date of the auditor's report;
- failure to report relevant after balance sheet date events;
- backdating auditors' reports, financial statements and letters of representation;
- failure to scrutinise minutes of relevant directors' meetings;
- failure to comply with the disclosure requirements in respect of debentures issued;
- failure to establish whether a company had issued debentures when the contrary was recorded in the notes to the financial statements;
- assisting in misleading the Receiver of Revenue".<sup>(1)</sup>

**1.4** The Commission also reported that it was investigating a number of aspects regarding the auditing profession, including

- the introduction of legal backing for accounting and auditing standards;
- the creation of a public oversight board which would be charged with public oversight over the profession's discharge of its regulatory, disciplinary and standard-setting responsibilities;
- the preservation of auditor independence;
- the compulsory duty to report all irregularities discovered during an audit to the proper authorities and to the shareholders of the entity;

- the creation of avenues of communication between auditors and shareholders or holders of debentures.

1.5 The response by the auditing and accounting professions represented by the Public Accountants' and Auditors' Board, the South African Institute of Chartered Accountants (SAICA), the Institute of Commercial and Financial Accountants of South Africa (CFA) and the Association of Chartered Certified Accountants (ACCA) was extremely positive.

1.6 The Executive Summary of the submission by SAICA concludes with the following paragraph:

“Even if all the above mentioned changes can be achieved, SAICA is not convinced that public protection can be achieved. It is the view of SAICA that underlying all of these problems is an unhealthy attitude of mind that exists in this country. Many South Africans have a view that it is acceptable to cheat the system, not pay taxes, or to avoid complying with laws and regulations. SAICA believes that for effective investor protection to take place, the regulators need the co-operation of the people involved, the entities and the government. How this mental attitude is changed is a challenge facing this country, but it is a very important one. Government and community organisations will have to take the lead in helping to forge a greater spirit of morality in South Africa”.

Total protection of the public cannot be achieved by the proposed changes referred to in paragraph 1.4 above, but if implemented, should significantly improve protection. The unhealthy attitude of mind to which SAICA refers, applies to not only South Africa but to each and every country in the world.

The First Report of the Commission stated –

“The investigations, enquiries and research revealed that the circumstances which had led to the losses suffered by the Masterbond investors were not unique to the Masterbond group in particular or even in South Africa in general.

In one form or another these circumstances prevail elsewhere in the world but in many countries legislative measures have been taken to minimise losses caused by fraud and bad management”.

1.7 The Commission has come to the conclusion that in addition to the proposed changes set out in paragraph 1.4 above, more effective steps could and should be taken to protect all the stakeholders in the modern corporation.

Stakeholders are persons such as shareholders, holders of debentures, employees (trade unions), suppliers and other trade creditors, members of pension funds, provident funds and a myriad of investment funds, lenders, bank depositors and the assured by insurance companies.

1.8 It is clear that the methods of financial accounting which have evolved into ‘generally accepted accounting practice (principles or standards)’ and the traditional audit and audit reports in respect thereof, often no longer serve the purpose of adequately informing and thus protecting the stakeholders in the modern corporations.

1.9 The shortcomings in the present methods of accounting and auditing are expounded upon in Chapter 2 hereof.

1.10 To achieve adequate protection for the stakeholders a fundamental and structural change to the audit function is required.

The change envisaged is the empowerment of all significant stakeholder interest groups by granting them the right to appoint their own auditors to investigate and report on matters which particularly affect them.

1.11 The purpose of this Paper is to ensure the widest possible consultation with all interested parties regarding the views expressed herein and the practicality of achieving the proposed changes in the role of the auditor.

Matters to be considered include

- the additional cost to the entity;
- confidentiality;
- defining a significant stakeholder interest group;
- whether entities such as potential investors (when offers to the public are made), the government and the public (in environmental disputes) should also be included;
- the method of appointment of the additional auditors;
- the possible effect on the auditing profession;
- the qualifications of the additional auditors.

## 2. BACKGROUND

2.1.1 In modern economies, all members of society are actively encouraged to save some portion of their earnings by investing in pension funds, unit trusts, insurance policies, listed companies and the like. They are encouraged to do so to

achieve capital growth and to enable them to provide for their old age. Usually unable to rely upon their own skills, they entrust their future in the hands of persons such as professional advisers, managers of investment schemes, trustees of pension funds and the like.

**2.2 The AICPA (American Institute of Certified Public Accountants) Special Committee on Financial Reporting (the Jenkins Committee Report), described the sources of information of the users of business reports as follows:**

**“Users need and use information from multiple sources for two reasons. First, users need information from the best sources, which differ depending on the type of information and other factors. For example, users obtain information about the economy from economic studies and reports by economists and other sources. They obtain information about industry conditions from industry trade publications, government statistics, and others. Although a company’s management is often the best source for a large portion of company specific information, it is not the only source, nor always the best source. For example, users learn about a company’s stock price and trading volume from a stock exchange. Second, obtaining the same type of information from multiple sources allows users to compare views and assess the relative reliability of the information. For example, users may learn about a company’s strengths and weaknesses from its management, competitors, customers, and other users, each of which may offer a different perspective. Users can judge for themselves about which view is the most reliable. Despite its usefulness, users do not want business reporting to become the only source for their information”.**

**The ‘users’ referred to were defined as**

**“investors and creditors, including potential investors and creditors, and their advisers that use business reporting as a basis for their capital allocation decisions”.**

**(professional investors and creditors and their advisers)**

**Although business reporting is not the only source of information, the Committee described it as the ‘cornerstone’.**

**”People in every walk of life are affected by business reporting, the cornerstone on which our process of capital allocation is built. An effective allocation process is critical to a healthy economy that promotes productivity, encourages innovation, and provides an efficient and liquid market for buying and selling securities and obtaining and granting credit.**

**Conversely, a flawed allocation process supports unproductive practices, denies cost-effective capital to companies that may offer innovative products and services that add value, and undermines the securities market. Without adequate information, users of business reporting cannot judge properly the opportunities and risks of investment opportunities. To make informed decisions, they need a variety of information, including data about the economy, industries, companies, and securities. Complete information provided by the best sources enhances the probability that the best decisions will be made. And for company-specific information; which is a key because companies are the sources of cash flows that ultimately result in the return on securities or the repayment of loans; management often is the best source. Business reporting packages management’s company-specific information and delivers it to users in a meaningful way. Few areas are more central to the national economic interests than the role of business reporting in promoting an effective process of capital allocation. It simply must be made to work as well as possible.”<sup>(2)</sup>**

### **2.3 History teaches that it is often dangerous to rely upon pronouncements of management.**

**The Commission reported as follows on this aspect:**

**“The lack of severe penalties for the making of false statements, the virtual collapse of the Office of the Registrar of Companies, and the inefficiency of prosecuting authorities allow some chairmen of boards in South Africa to deceive their shareholders, creditors and other interested parties with relative impunity.**

**Pretoria Bank : The Chairman’s Report dated 31 October 1990:**

**“The past Twelve Months have been a period of strong performance by Pretoria Bank with Strong Growth in both Assets and Income.**

**In the year under review.....net income after tax increased by 192,2% from R292 439 to R861 381.**

**As Chairman, I wish to thank my co-directors for their loyalty and support.....**

**.....my appreciation is extended to the management and personnel of Pretoria Bank for the diligent and competent way in which they fulfilled their duties.”**

**In fact —**

- Pretoria Bank was insolvent;**
- the managing director had been dismissed as a result of massive fraud;**
- the general manager had also been dismissed;**
- during the financial year approximately R700 000, more than 15% of the capital of the bank, had been stolen.**

**Cape Investment Bank : Chairman’s Review also dated 31 October 1990 —**

**“This is the 3<sup>rd</sup> annual review of the Group. It was a difficult but gratifying year characterised by achieving forecasted results, rapid expansion both in terms of organic and acquired growth, uncertain environments and the resultant strain on people and the organisation.”**

**In fact —**

- the bank was insolvent;**
- numerous offences had been committed by directors;**
- but for hand-outs of approximately R50 million by the Reserve Bank, the auditors would not have signed unqualified reports to the annual financial statements.**

**Masterbond : Press Announcement published by the Board on 3 September 1991 and signed by Jonker and Brits —**

**“Prospects: The Masterbond Trust Group has achieved excellent profits during the year under review. Despite the expected downturn in the economy we believe the Group will maintain its profit growth.**

**In fact**

— **the probability of liquidation was being foreseen and eventuated within 30 days thereafter”.**

**2.4 The problems associated with reliance on the contents of financial statements compiled in accordance with generally accepted accounting practice and audited in accordance with generally accepted auditing standards are briefly sketched hereinafter.**

**2.5 At the end of the 17<sup>th</sup> and the beginning of the 18<sup>th</sup> centuries, companies, incorporated an unincorporated, proliferated in England. There were no regulating authorities and fraud, corruption, insider trading and manipulation of stock prices were not uncommon.**

**2.6 As from the 24<sup>th</sup> June 1720 virtually all unincorporated companies were outlawed by the British Parliament and brokers ('stockjobbers') were prohibited from dealing in their securities. The effects of this act (VI George I. Cap. 18) were so disastrous that it became known as the 'Bubble Act' (the Act which burst the bubbles).<sup>(3)</sup>**

**2.7 The losses suffered by the public and the effects of the 'Bubble' Act retarded the development of companies in England for decades. Eventually, from the latter part of the 18<sup>th</sup> century and partly as a result of the industrial revolution, numerous associations, some with hundreds of members, were again formed for purposes such as banking and insurance.**

**2.8 The rise in numbers and importance of the unincorporated companies led to the repeal of the Bubble Act in 1825. This led to the evolvement of the modern company in the English-speaking world.<sup>(4)</sup>**

**2.9 In 1844 a Select Committee under the chairmanship of Gladstone and**

**appointed by the House of Commons**

*'to inquire into the State of Laws respecting Joint Stock Companies  
.....with a view to greater security of the public'*

**reported that it believed that disclosure and transparency in corporate affairs  
could prevent fraud and that —**

*'Periodical accounts, if honestly made and fairly audited, cannot fail to excite  
the attention to the real state of a concern.....'* <sup>(5)</sup>

**2.10 The Gladstone Report was followed by the first general companies act, the  
Joint Stock Companies Act 1844, which provided for —**

- the preparation and delivery of 'full and fair' audited balance sheets and  
auditors' reports to all shareholders and the reading thereof at the annual  
meetings of companies;**
- the right of shareholders to inspect the books of accounts of  
companies.**

**This heralded the beginning of never-ending attempts to enforce proper  
disclosure of the affairs of corporations, the birth of the modern auditing  
profession and eventually led to the development of supervisors such as Stock  
Exchanges, Central Banks, the SEC in the United States, the FSA in the United  
Kingdom and the Financial Services Board in South Africa.**

**2.11 This first attempt to enforce a 'full and fair' disclosure of the affairs of  
companies is described by Chatfield as —**

**"Though ambitious in intent, the first effort at audit legislation was weak  
procedurally and far ahead of its time in the sense that means to implement it did  
not yet exist. Moreover, audit attention was fixed on the traditional issues of  
company solvency and managerial integrity, ignoring questions of profit  
measurement and dividend policy which the shareholders of most companies  
would have found more relevant.**

The acts assumed that stockholders themselves would form a committee, check the books and report back to their colleagues. And at midcentury one might actually find teams of investors making periodic visits to corporations in which they held shares, ticking off ledger balances against their printed balance sheets and seeing that each cash payment was covered by a voucher.

It soon became evident that only an examination by professionals could provide the meaningful check on directors intended by the law. The 1844-1845 statutes provided for the employment of skilled accountants as ‘assistants’ to the stockholder-auditors. Finally these assistants took over the whole audit examination.”<sup>(6)</sup>

**2.12 The compulsory audit of balance sheets of companies was abolished in 1856 but reintroduced by the Companies Act of 1900.**

**2.13 According to H W Robinson (quoted by Chatfield p.147) the British accounting profession**

‘was born through bankruptcies, fed on failures and frauds, grew on liquidations and graduated through audits’.

**Chatfield describes the development of the profession during the latter part of the 19<sup>th</sup> century as follows:**

“The Companies Act of 1862 soon became known as ‘the accountant’s friend’. By requiring that dividends could be paid only from income, it made the service of skilled accountants absolutely necessary. Auditors no longer had to be stockholders, and their precise duties for examination and reporting were set forth. The 1862 Act also created the position of official liquidator for the purpose of winding up insolvent companies, and this job was usually given to a professional accountant. The first important liquidation under the act followed the collapse of Overend, Gurney and Company, Ltd., together with four large banks, during the crisis of 1866. The failure of the City of Glasgow Bank in 1878 directed attention to public accountants when leading Glasgow practitioners took charge of the liquidation while others testified for the prosecution or the defense.

**A law passed in the following year required annual audits of financial institutions in return for the privilege of incorporation with limited liability.**

**H A Shannon<sup>(7)</sup> estimates that just over 30 percent of all English corporations formed between 1856 and 1883 ended in insolvency, and that a majority of these were liquidated within six years of their inception. Business depressions followed one another with machinelike regularity.**

**The British government responded to these crises, with their attendant upsurge of business failures, by passing a series of bankruptcy acts. It is likely that no other law enacted during the nineteenth century, not even the companies acts, provided so much work for accountants. The stewardship provisions of these statutes varied, but all required the appointment of administrators to take control of the bankrupt's property, both in his interests and to protect his creditors from asset concealment and conversion”.**

**2.14 In the United States the development of accounting principles was largely activated by banks who required audited balance sheets when approached for credit. The bankers were interested in the relationship between current assets and current liabilities, favoured the writedown of inventories to the lower of cost or market price and encouraged the use of depreciation reserves and bad debt allowances.**

**2.15 The crash of the stock market in 1929 and the depression of the thirties led to the acceptance by the New York Stock Exchange of the proposal by the American Institute of Accountants that accounting methods should be within the framework of ‘accepted accounting principles’. Later it became ‘generally accepted accounting principles (standards)’ and was also followed by ‘generally accepted auditing standards’.<sup>(8)</sup>**

**2.16 Prior to the 1920's the detection of fraud was regarded as a primary audit objective. This is stated by Professor Brenda Porter of Massey University in her comparative historical and international study ‘Auditors’ Responsibility to Detect and Report Corporate Fraud’ (1994) —**

**“This is clearly evidenced by the auditing texts of the time : for example, Dicksee (1898) stated that the objective of an audit was made up of three parts, the detection of fraud, the detection of technical errors, and the detection of errors in principle; similarly, Montgomery (1912) referred to the prevention and detection of fraud and error as the ‘chief objects’ of an audit (p 2).”**

**The term ‘fraud’ as used by Porter includes –**

**“the use of deception, such as manipulation, falsification, or alteration of accounting records or supporting documents, so as to obtain an unjust or illegal financial advantage;**

**intentional misstatements in, or omissions of amounts or disclosures from, accounting records or financial statements;**

**intentional false accounting or misapplication of accounting principles relating to amounts, classification, manner of presentation or disclosure;**

**misappropriation of assets”.**

**2.17 During the period from the 1920’s to the 1960’s, a fundamental change occurred. It is described by Porter as follows:**

**“.....largely as a result of changes in the socio-economic environment, the auditing profession acknowledged progressively less responsibility for detecting fraud. During this period, companies grew in size and their management’s established systems of internal control designed, inter alia, to prevent and detect fraud and error. As companies increased in size, so did the number of their transactions and it soon became infeasible for auditors to verify all of a company’s transactions and accounting entries. Auditing techniques changed in response to the new environment and detailed checking of accounting records gave way to examining the company’s internal controls and testing a sample of accounting entries.**

**Additionally, as company ownership became more widespread and diverse, investors grew less interested in the fortunes of ‘their’ company per se, and more**

interested in the returns it generated. If they perceived that better returns could be earned elsewhere, they rapidly switched their allegiance to another company. This changed attitude of investors stimulated a change in focus with respect to financial statements. Instead of being seen as documents which reflected the stewardship of company managers entrusted with the financial resources of shareholders, they came to be regarded as a basis for investment decisions. As a consequence, attention focused on the fairness with which financial statements portrayed the financial affairs of the reporting entity. Reflecting these changes in the socio-economic environment, audit objectives shifted away from detecting fraud and error towards assessing the truth and fairness of information contained in financial statements.

Towards the end of the 1920s-1960s phase, the auditing profession was, in general, denying all but an incidental responsibility to detect corporate fraud. This is reflected in Montgomery's (1957) auditing text which referred to the detection of fraud as 'a responsibility not assumed' (reported in CAR, 1978, p.34). It is also reflected in the professional promulgations of the time. For example, in 1951, the American Institute of Certified Public Accountants (AICPA) stated in its Codification of Statements on Auditing Procedure:

*'The ordinary examination incident to the issuance of an opinion respecting financial statements is not designed and cannot be relied upon to disclose defalcations and other similar irregularities, although their discovery frequently results. In a well-organised concern reliance for the detection of such irregularities is placed principally upon the maintenance of an adequate system of accounting records with appropriate internal control. If an auditor were to discover defalcations and similar irregularities he would have to extend his work to a point where its cost would be prohibitive.'*  
(pp. 12-13)<sup>(9)</sup>

**2.18** As pointed out, the Joint Stock Companies Act 1844 provided for the preparation of 'full and fair' audited balance sheets and the right of shareholders to inspect the books of account of companies.

During the ensuing years shareholders lost their right to inspect the books of account of their companies. The rights which some other stakeholders had to appoint their own auditors, also disappeared.

**In 1891 Pixley in his Treatise on the Duties and Responsibilities of Auditors stated**

—

**“For instance, some Assurance Companies have Auditors for the Assured as well as for the Assurers or shareholders. Occasionally the Debenture Holders of a Company have their own Auditor, as also have the Preference Shareholders.**

**Within the last few years, Companies have been formed with ‘Founders’ Shares’, the holders of which are entitled to a proportion of the profits after the other shareholders have received a minimum dividend. In all these cases their specially appointed Auditors have to ascertain their clients receive their full privileges, and that the reserves for depreciation, for loss on realisation of debts, and general reserve, are not unduly high”.**

**As pointed out, the shareholders and other stakeholders in the modern corporation are largely dependent on its published financial statements and the pronouncements of management.**

**Other ‘stakeholders’ are often more dependent upon the welfare of the corporation than the original contributors of its capital. For instance such persons as**

- **holders of debentures;**
- **employees;**
- **members of its pension fund;**
- **suppliers and other trade creditors;**
- **lenders;**
- **assured;**
- **depositors;**
- **the large numbers who are members of institutional investors who invest in the corporation.**

**2.20 The International Accounting Standards Committee (IASC) accepts that in addition, the users of the audited financial statements of corporations also include**

- potential investors;
- customers;
- governments;
- the public.<sup>(10)</sup>

To this list should be added the multitude of financial analysts and financial advisers, the editorial staff of financial magazines and newspapers, supervisors, stock exchanges and trade unions.

2.21 The FEE also accepts the obvious, namely that the auditor's opinion enhances the credibility of the financial statements and assists in the making of decisions such as for the provision of finance, for the granting of credit, for employment and for taxation or the grant of subsidies.<sup>(11)</sup>

2.22 It is also accepted that in addition to unfair or fraudulent conduct by market participants, inadequate disclosure of information upon which users can make informed choices about financial products and their providers could lead to market failure.<sup>(12)</sup>

In a recent speech (28 September 1998) Arthur Levitt, the chairman of the SEC, remarked as follows:

“The significance of transparent, timely and reliable financial statements and its importance to investor protection has never been more apparent. The current financial situations in Asia and Russia are stark examples of this new reality. These markets are learning a painful lessons taught many times before : investors panic as a result of unexpected or unquantifiable bad news.

If a company fails to provide meaningful disclosure to investors about where it has been, where it is and where it is going, a damaging pattern ensues. The bond between shareholders and the company is shaken; investors grow anxious; prices fluctuate for no discernible reasons; and the trust that is the bedrock of our capital markets is severely tested”.<sup>(13)</sup>

The disclosure requirements prescribed by the corporate laws, by the stock

exchanges and by supervisors are thus in place not only to protect investors but also to protect financial systems.

**2.23** Factors such as the growth in size of modern corporations, the growth in the volume of their transactions, the advent and growth of institutional investors, the shift away from the detection of fraud as a primary audit objective and the diversity of the needs of the users of the financial statements, have resulted in a situation where the auditing profession as presently employed cannot fulfil the expectations of the diverse users of the financial statements who each want to be able to make meaningful investment decisions based on the contents thereof.

**2.24** Investment decisions regarding a particular entity could include

- to invest or disinvest in its shares or debentures;
- to seek or terminate employment;
- to accept or reject wage proposals;
- to join or terminate membership of pension schemes, provident funds and other investment schemes;
- to supply or refuse to supply goods;
- to extend or refuse credit;
- to supply finance;
- to deposit or withdraw money;
- to enter into or to terminate insurance agreements.

**2.25** In addition, the often unexpected liquidations of entities soon after having been reported as profitable and the often perceived non-independence of their auditors, have led to a distrust of the auditing profession and the generation of the well documented 'expectations gap'. This is a worldwide phenomenon as proven by studies conducted in countries such as the United States (1978), Australia (1993), New Zealand (1993) and South Africa (1993).<sup>(14)</sup>

**2.26 In the United States the Cohen Commission reported as follows:**

**“Users of financial statements expect auditors to penetrate into company affairs, to exert surveillance over management, and to take an active part in improving the quality and extent of financial disclosure. In all of these areas, users seem to expect more than they believe they are receiving from auditors.**

**Despite efforts by many auditors to downgrade the importance of detection of fraud as an audit objective, all segments of the Public — including the most knowledgeable users of financial statements — appear to consider the detection of fraud as a necessary and important objective of an audit. Users expect the auditor to be concerned with the possibility of both fraud and illegal behaviour by management. They expect him to protect the interests of shareholders and be independent of management in doing so.**

**Some segments of the public have an erroneous impression of the auditor’s role. Several expectations are neither feasible to meet nor practical from a cost-effectiveness viewpoint. For example, some users believe that a ‘clean’ opinion by an auditor necessarily means that the company is financially sound. Some investors feel that the auditor should not only express an opinion on the financial statements but should also interpret them in such a way that the investor can judge whether he should invest in the company. These misunderstandings cause the auditor serious difficulties, and their existence emphasizes the importance of clarifying his role. The profession has tried in the past to improve users’ understanding of the role and function of auditors. While the Commission has refrained from specific recommendations for such educational activities, it believes that they are useful and should be continued”.**

**2.27 In 1998, Sikka, Puxty, Willmott and Cooper published an article ‘The Impossibility of Eliminating The Expectations Gap: Some Theory and Evidence’ in which they examined the ‘expectation gap’ and the response of the auditing profession thereto.**

**The introduction reads as follows:**

**“The expectation gap’, signifying the differences between what the public expects from an audit and what the auditing profession prefers the audit**

objectives to be, has been a recurring issue in the audit literature (Chandler & Edwards, 1996). It is an issue for auditors since the greater gap of expectations, the lower is the credibility, earning potential and prestige associated with their work. It is an issue for the public, investors and politicians because, in a capitalist economy, the process of wealth creation and political stability depends heavily upon confidence in processes of accountability, of which an external audit of financial statements is considered to be an important part. Not surprisingly, 'the expectation gap' has attracted considerable institutional interest (for example, American Institute of Certified Public accountants, 1978; Chartered Association of Certified Accountants, 1986a, 1986b; Canadian Institute of Chartered Accountants, 1988) as it is considered to be a threat to effective corporate governance (The Committee on the Financial Aspects of Corporate Governance, 1992) and legitimacy of the institutions of auditing (Auditing Practices Board, 1992, 1994a).

In general, the academic literature on the expectations gap is quite fragmented (see Gwilliam, 1987; Holt & Moizer, 1990; Gaa, 1991) and is relatively uninformed by any sustained appreciation of the broader historical and political context in which expectations are formed, frustrated and transformed (Willmott, 1991). One major element of this body of literature relies upon questionnaires and opinion surveys to draw attention to the gap between the profession's preferred meanings of audit and the public's expectations (see for example Lee, 1970; Beck, 1973; Arthur Andersen, 1974; Purewal & Sikka, 1977; Steen, 1990; Humphrey et al., 1992b, 1993a; Porter, 1993). Another major element assumes that the meaning of audit is uncontested and fixed and that this can be deduced (or is self-evident) from a study of the contents of audit reports (see Baskin, 1872; Estes & Reimer, 1977; Firth, 1978, 1979; Alderman, 1979; Ball et al., 1979; Libby, 1979; Chow & Rice, 1982; Davis, 1982; Elliott, 1982; Estes, 1982; Houghton, 1983; Dodd et al., 1984; Crasswell, 1985; Gul, 1987). Such studies are founded upon the assumption that there is only one correct reading of the audit report and that this correct reading is identical to the values preferred by the profession. Associated with this assumption is the belief that the expectations gap would be substantially reduced, if not entirely eliminated, if only auditors' intentions could be accurately transmitted to the users and regulators (Auditing Practices Board, 1991; Hatherly & Skuse, 1991).

Of the remaining research and scholarship in this field, a few studies offer valuable contemporary commentary which shed light on the part played by the

profession in sustaining and perpetuating the expectations gap (e.g. Humphrey et al., 1993b), but provide little conceptual guidance for understanding its persistence. A number of commentators have attributed the gap to users' confusion (Lange, 1987; Marra & Radig, 1987), widespread misunderstanding (Baron et al., 1977; Campbell & Michenzi, 1987; Krasnoff, 1987; Ellis & Selley, 1988: Auditing Practices Board, 1991), ignorance (Singleton-Green, 1990a) and/or lack of education (Cockburn, 1986; Amhowitz, 1987; Kirk, 1987; Singleton-Green, 1990b). Many more have uncritically accepted the definition of, and solution to, the problem favoured by the profession. Namely, that a deficient understanding of auditing objectives amongst users that can, and must, be remedied by educating users and other non-accountants (Goldwasser, 1987; Miller et al., 1990). Despite raising numerous questions about the agenda, definitions, meanings, interests and values which the profession wishes to advance or marginalise, this orientation to the issue reflects and legitimises a string of initiatives and publications intended to 'educate' non-accountants (see for example, Buckley, 1980; Shaw, 1980; Calpin, 1984; Auditing Practices Board, 1992, 1993). It tends to confirm the profession's conception of, and response to, the expectations gap, formulated in terms of others' ignorance coupled with the right and responsibility of the profession to take care of 'the problem'. In effect, the profession is absolved from responsibility for its involvement in creating and sustaining the conditions in which the expectations gap has developed, except perhaps for its limited grasp of, and responsiveness to, the scale of the public's ignorance. Although not blameless, the profession is placed in a 'positive space' where its responsibility is defined primarily in terms of educating a confused and ignorant public. By representing the expectations gap in this way, the systemic nature of the gap is obfuscated and the profession strives to silence, or at least draw private boundaries around, discussion of issues that could unsettle its authority, such as the status of auditor independence, the unwillingness or inability of auditors to detect fraud, report actively on going concern issues, the social function of audits and so on (Willmott, 1986, 1989). In responding to widespread criticism from politicians, regulators and the media, the favoured strategy for the profession has been to equate the expectations gap with audit failures and to ascribe such failures to the incompetence of some individuals or special circumstances. The way to deal with errant auditors, it is argued, is to strengthen the disciplinary and related apparatuses even though many previous attempts to strengthen self-regulation have been ineffective (Mitchell et al., 1994). A related strategy has been for the profession to acknowledge that, due to public expectations, auditor responsibilities in areas such as 'fraud' and 'going concern' need to be revised. However, the outcome

has been a move to require more exacting audits without requiring auditors to fulfil social expectations or exert additional audit effort (Fogarty et al., 1991; Hooks, 1992; Sikka, 1992; Power 1993b). This response is accompanied by obfuscation and denial of responsibilities for matters such as detection and reporting of fraud and arguing that they are the responsibility of directors (APC, 1984, 1985, 1990a). However, this strategy has done little more than repeatedly paper over its cracks and contradictions as it slides away from the common sense of the public and politicians who expect the auditor to discover frauds. As Singleton-Green (1990a, p. 34, cited by Humphrey et al., 1993a, p. 57), the Editor of Accountancy has commented, 'the layman expects the auditor to discover all serious frauds', adding that a denial of this responsibility 'will do nothing to diminish the auditor's duties, but will help to discredit the profession'.

As we shall argue later in this paper, contemporary moves to diminish or limit their responsibilities for fraud detection depart markedly from the discourses advanced by the profession when, during the nineteenth century, it often directly associated auditing expertise with the detection and reduction of fraud (Chandler et al., 1993). At that time, members of the profession sought to raise the material and symbolic value of their labour by presenting themselves as specialist authorities capable of reducing the risks associated with investment in general, and the liability of joint stock ownership, in particular. As these claims have become accepted and institutionalised, the performance expected of auditors has also been raised. Not surprisingly, the profession has subsequently sought to exercise its (limited) powers of self-regulation to reduce expectations by shifting the meaning of the audit. As Humphrey et al, (1993b, p. 55) have observed

'In general, the position adopted by the profession in Britain during the twentieth century has been to downplay the suggestion that auditors have any responsibility connected with fraud other than that derived from the need to confirm the truth and fairness of financial statements'.

At the heart of the expectations gap, we argue, is a clash of preferred meanings about the nature, practice and/or outcomes of auditing. As sellers of auditing services, members of the auditing profession have a stake in securing the material and symbolic value of their labour. Historically, this they have done by successfully petitioning the state for monopoly control over the supply of external auditing labour and by minimising the formal obligations (and associated liabilities) placed upon them. In contrast, the buyers and regulators of auditing labour have a stake in ensuring that audits deliver whatever quality of practice is deemed to be necessary to secure the confidence of the public, and investors in particular, in the operation of capital markets. This uneasy relationship between buyers and sellers of audit services, mediated by complex and obscure (self) regulatory mechanisms, is compounded by auditors' relationship to management upon whom they depend to sell-on more profitable services. As Humphrey et al. (1993b, p. 56) have concluded:

‘Greater professional priority would appear to have been placed on the need to maintain the auditors’ relationship with management than on satisfying the demands of the public’.

Although the respective stakes of the parties are subject to change and redefinition, it is this fundamental difference in orientation between the buyer and seller of auditing labour, we suggest, that accounts for the continuation of an expectations gap which flourished in earlier times (Brief, 1975; Humphrey et al., 1992b) and continues to exist despite the numerous institutional attempts to reduce or eliminate it (AICPA, 1978; ICAE, 1986; CICA, 1988; APB, 1992). From this perspective, understanding the expectations gap is a matter of identifying and applying conceptual tools capable of explaining the relationship between the negotiation of the meaning of social practices (e.g. audits) and the organization of power (Fogarty et al., 1991; Hooks, 1992; Humphrey et al., 1992a; Lee, 1994)<sup>(15)</sup>.

**2.28** In the foreword to the publication ‘Modern Company Law For a Competitive Economy’ published by the British Department of Trade and Industry (March 1998), the President of the Board of Trade stated:

“Our current framework of company law is essentially constructed on foundations which were put in place by the Victorians in the middle of the

last century. There have been numerous additions, amendments and consolidations since then, but they have created a patchwork of regulations that is immensely complex and seriously out of date”.<sup>(16)</sup>

**2.29 Similar thoughts about auditing are being expressed from within the auditing profession. Addressing a meeting of accountants Harvey Kapnick, the then Chairman of Arthur Andersen & Co, said that the accounting (auditing) profession**

“should be the link between responsible business and the public in providing adequate financial data in an understandable manner for use in arriving at sound, unbiased conclusions about the effectiveness of business enterprises in managing our economic wealth for the overall benefit of society. Unfortunately, however, the accounting profession has been subject to the same regulatory pressures and the same failures to tell all the facts as business. The result has been public skepticism of the accounting profession to the point that it, too, is faced with a potential loss of credibility”.

**One of the problems singled out by him was —**

“.....the accounting profession treats business today in large measure as business existed in the early part of the century. When organized business activity consisted largely of personal ownership and interests, together with a limited number of creditors, the accounting needs of those owners and creditors could be easily served. There was little need for or interest in accounting information by outsiders. The interests of owners and creditors were satisfactorily served by a relatively simple determination that there was no overstatement of net worth or profits. The emphasis was to make certain that those elements were at least as great as represented.

Now, however, the existence of large numbers of public stockholders removed from the day-to-day activities of the business in which they have an investment requires an entirely different concept of financial reporting. Yet, in large measure, the accounting profession has failed to recognize the importance of the changes in business activity and has persisted in applying the outmoded concepts acceptable to an earlier era.”<sup>(17)</sup>

The views of some commentators as reported by the Jenkins Committee are —

“The American Accounting Association Committee on Accounting and Auditing Measurement, 1989-1990, concluded that ‘.....the most general criticism to be leveled at financial statements in their present form is that they are seriously *incomplete*’.

Alter P. Schuetze, a past chair of AcSEC and now chief accountant of the SEC, said that ‘We need an .....inquiry into the met and unmet needs of users of financial statements’.

Meanwhile similar events were occurring in other countries. U.K. accountancy bodies issued several documents challenging current business reporting.

*Making Corporate Reports Valuable* (1988). ‘The present model for corporate reporting is not satisfactory.....Presentday financial statement packages seldom give any indication of the overall objectives of the entity; and even crucial information about its management and ownership is provided only on a limited scale’.

*Financial Reporting. The Way Forward* (1990): ‘What is principally wrong with present financial statements is that they do not reflect the economic reality of a company’s progress and position .....Present day financial statements are deficient in that they concentrate on .....past events rather than the future’.

*The Future of Financial Reports* (1991): ‘There is increasing support for the view that the existing financial reporting package is not adequate to meet the needs of users. The balance sheet and profit and loss account have evolved from the limited requirements of reporting in the developing industrial economy of the nineteenth century, and extensive tinkering has not been sufficient to bring them in line with the requirements of the late twentieth century market economy.....The contents of financial reports should be user driven.....’ “<sup>(18)</sup>

2.30 Mr John Whitney, the Executive Director of the Columbian Business School’s Deming Centre (at the 1997 World Congress of Accountants) summarised the problems associated with the traditional audit as —

## **Timeliness**

**“We are all painfully aware of the time it takes to complete an audit. By the time the audit is finished and the financial statements are printed, two things will have happened: people will have lost interest and the world will have changed. Moreover, financial statements are lagging indicators”.**

## **Trustworthiness**

**“Trustworthiness is a much more complicated issue. It deals with both reliability and scope of the audit. Let’s deal first with reliability. We are all tired of hearing about the number of companies that have filed for bankruptcy following the receipt of ‘clean’ opinion from their auditors. We are tired of it, but we cannot escape its implications. It impugns the credibility of the profession and exposes it to litigation. In this same vein, it is foolish to blame the auditors because someone made an investment in or extended credit to a company that goes bankrupt. Rather, these constituencies should use the audit as just one piece of information. Under present accounting practices, companies have to rely on other resources to learn whether the company’s technologies, knowledge capital, systems, and procedures are pertinent to the markets they are serving.**

**Last but not least, trustworthiness is called to question because the auditor serves two masters: the company, which pays the bill, and the external constituents, who wish to rely on the information. An inherent conflict exists and it does no good to say it doesn’t”.**

**Trajectory, in that users are interested in the future of the entity and not in its financial history.**

“Traditional accounting provides an historical look at financial data. But the people who read financial statements are interested in the future. Bankers and suppliers want to know if obligations will be met. Investors want to know if their expectations will be fulfilled. Managers and the board of directors of the company that pays for accounting services want to know if their business systems and control procedures are adequate. We know, of course, that no one can predict the future with certainty.. But we also know that traditional accounting statements are, as I said before, a fuzzy approximation of a distant past.

Accountants have been mired in financial history while their constituencies have been asking for a look at the future”.<sup>(19)</sup>

2.31 A number of these problems were raised by Professor I H MacGregor, professor of accountancy at the University of Witwatersrand, during his inaugural lecture (1982) —

“In dealing with published annual financial statements the law prescribes the matters which must be disclosed in somewhat broad terms, setting out a basic and minimum framework of objectives and content. The extent of disclosure has increased steadily over the years, largely as a result of changes in the economic and social environment, but also as a result of the increasing separation between ownership and management of large companies which has changed the pattern of share ownership over the past decades. Governments are concerned with the protection afforded creditors and investors as one consequence of the change in the pattern of share ownership has been a concentration of shareholdings in the hands of institutions. These institutions are pension funds, long-term insurers and mutual funds in which the man in the street (and never let it be forgotten that he is a voter) has an indirect stake.

We can now see that it is no longer merely a matter of disclosure for the peace of mind of creditors and shareholders. Today such disclosure is of great relevance to wider groups such as potential investors and lenders, employees, government departments, trade unions and the public at large.

Although many of the items requiring disclosure by statute are couched in general terms, there is an overriding requirement that financial statements in accordance with generally accepted accounting practice fairly present the state of affairs of the company (the so-called ‘true and fair’ view) and the directors are

obliged by statute to ensure that this is so.

This is a legal requirement and directors have found that it is possible to show the 'true and fair' view by adopting one of the many bases of, for example, depreciation, valuation of stock and work-in-progress, providing for deferred taxation, valuations of uncompleted construction contracts, all of which bases have been categorized as generally acceptable accounting practice by accountants and auditors. It is understandable that the preparers of financial statements will choose the alternative that best suits their purpose, be it increasing disclosed profits or suppressing profits, and provided that the 'true and fair' requirement has not been disregarded, they are not contravening any part of the statute.

The potential users are likely to include owners, lenders, suppliers of goods and services, potential investors, lenders and creditors, bankers, employees, management, customers, financial analysts, stockbrokers, underwriters, financial journalists, taxation authorities, trade unions and the general public. A formidable list of people all of whom are expected to get all their answers from this one set of financial reports — for this is the assumption underlying current company legislation, requiring as it does annual financial statements to be prepared for the members of the company.

It must be noted, however, that these financial statements are generally issued 3 to 5 months after the end of the company's financial year and this is too late for most users to act on the information they contain. Annual financial statements should not contain any real surprises in the case of a listed company as the preliminary results are announced some 4 to 6 weeks after the financial year-end and most investment decisions will have already been taken by the time the annual report appears".<sup>(20)</sup>

**2.32** In 1997 a book titled 'Corporate Collapse, Regulatory, Accounting and Ethical Failure' was published. Its authors were Professor F L Clarke of the University of Newcastle, Professor G W Dean of the University of Sydney and Mr K G Oliver. They examined the role of accounting in corporate collapses in Australia during the last three decades and the repeated inadequate professional responses thereto.

The authors state —

**“There is no disputing that these leading companies had another common factor. They all collapsed, many suddenly, seemingly unexpectedly. For many, collapse followed news releases of reportedly successful operations. Only occasionally, in advance of collapse, were those companies identified to be ailing over a period of years. Certainly they were not failing according to many in the press and some of those in the market claiming to be in-the-know. Understandably so, for those companies’ financial reports failed to indicate unambiguously their impending failure. Despite claims by the ‘punters’ (the uninformed investors) that they are denied information apparently available to others in the market, the published financial statements are the primary source of financial information to virtually all in-the-know punters (e.g. the institutional investors) too. History demonstrates that corporate failure does not appear to have had a lengthy public incubation period. Whilst symptoms are there and some ferret them out, the financial reporting system masks them. Therein lies a major problem — matters of unquestionable public interest are able to be kept private.**

**Public complaint, criticism, and questioning of the role of accountants and auditors were features of the highly publicised bankruptcies and liquidations in the 1980s and early 1990s. Complaint and criticism of that kind were international phenomena. Comments on the crumbled empires of Asil Nadir, Aghan Abedi and Robert Maxwell in the United Kingdom indicate that ‘the crumbling of firms like Polly Peck, BCCI, and, most recently, Maxwell Communication, [occurred] all within months of getting a clean bill of health from their auditors, has raised serious questions about the usefulness of company accounts’. Likewise in this assessment on the US Savings and Loans affair: ‘[Democratic Congressman] Wyden and others lay a large part of the blame for the S&L crisis at the door of the accounting profession. ‘Accountants didn’t cause the S&L crisis’, says Wyden. ‘But they could have saved taxpayers a lot of money if they did their jobs properly and set off enough warning alarms for regulators’. And the similar lament in a 1993 United States Public Oversight Board Report:**

**'The accounting profession has suffered a serious erosion of confidence:....in its standards, in the relevance of its work and the financial reporting process....[because] in some cases, not long before an entity failed, it**

received an auditor's report giving no indication that the entity was in its latter days'."

"Mostly, however, the comments have evoked a flurry of attention by the professional accountancy bodies to search out someone, or more commonly 'something', they might blame – bad management, declining business ethics and inadequate educational resources have each had their turn. Indicative of the search for causes is the 1994 Australian study by Greatorex et al., *Corporate Collapses: Lessons for the future*, which surveyed Australian liquidators of 162 cases of corporate collapse and recorded their observations on the causes of corporate failure. They identified lack of CEO management skills, overreliance on debt, and the failure to have sufficient capital for ongoing development or survival. An equally pertinent question might have been why those who failed had shortly earlier been reported as profitable, sometimes as highly successful".<sup>(21)</sup>

**2.33 In a letter from the SEC dated October 9, 1998, addressed to the Director, Audit and Attest Standards of AICPA, the following warning was sounded:**

**"Our financial reporting system generally has served our markets well and has minimized the premium charged for capital. However, the staff has noticed recently some trends in financial reporting that, if left unaddressed, may threaten the pre-eminent position of US markets because they cause investors to question the reliability and transparency of the financial statements of US registrants. These trends range from an inappropriate management of earnings to fraud, and encompass inappropriate application of generally accepted accounting principles ('GAAP'), and aggressive applications of GAAP. These trends have been manifested in a rash of recent highly publicized cases of alleged financial accounting fraud in which corporate financial results may have been misrepresented.**

**The Commission cannot tolerate an erosion of investor confidence, which will inevitably occur if investors believe that the information they receive is a product of manipulation or gimmickry. Manipulated, incomplete, or unreliable information generally is cited as a common problem in weaker financial reporting systems and has contributed to economic problems in other areas of the world, such as Asia and Russia".**

**2.34 In the Cape Times Business Report, October 23, 1998, the following appeared under the heading —**

**“Undervalued’ Sappi to list in New York next month.**

**In terms of the listing, Sappi will have to comply with the US’s generally accepted accounting principles. Under these rules, the restated earnings were less than a quarter of those reported under local rules for the past financial year.**

**Analysts, however, said this information was already known by institutional investors and should not negatively affect the share price.**

**Sappi told shareholders in a letter that full-year earnings for 1996 would have come in at 113c a share, and not the 230c a share as reported by Sappi. Last year’s earnings would have come in at 41c a share, less than a quarter of Sappi’s reported 172c a share. First-half earnings for the current year would, however, have been 1c higher at 162c a share.**

**Van As told shareholders that the changes related largely to the timing of when income was recognised for accounting purposes”.**

**2.35 In the Saturday Business Report (Saturday Argus), October 24, 1998, the following appeared under the heading —**

**“Better off reading tea leaves than financial results.**

**Of the many shadowy professions proliferating in the world, few show any less commitment to truth and reality than accountants. Just recently, we have heard how Sappi’s profits would be much lower if they used American standards. AngloGold, using South African accounting methods, earned R810 million in the most recent quarter; by American standards, it earned \$37 million. We know the rand-dollar exchange rate has depreciated, but clearly not by that much.**

**It is not just South African companies that have problems. When Daimler-Benz listed in the US and started using their accounting standards, their profit fell by 75 percent. Some might say that American accountants are just more stringent and honest than their foreign counterparts. Dream on. When US companies**

make acquisitions, they frequently write off the whole goodwill and the value of all R&D in process and yet to come, allowing the company to take a one-time exceptional loss and then huge profits in the years to come, which is jiggery-pokery of the highest order.

Arthur Levitt, the chairman of the SEC, is trying to change this. Accounting rules exist, after all, so that companies can be compared on the same basis. But as long as so much leeway exists to do what you like with numbers, an observer would be better off reading tea leaves than financial results”.

**2.36** These newspaper reports illustrate the deficiencies inherent in financial statements compiled in accordance with GAAP and the utter contempt in which the auditing profession is held in some circles.

**2.37** As pointed out by Sikka *et al*, the auditing profession describes the expectation of the users of financial statements as unreasonable and attributes the ‘expectation gap’ to confusion, ignorance and a deficient understanding of auditing objectives.

The profession considers the solution to these problems to be better corporate governance and the education of the confused and ignorant users of financial statements.

**2.38** The authors of ‘Corporate Collapse’ have little faith in ‘corporate governance’ to which they refer as the ‘Buzz phrase’ of the nineties.—

“ ‘Corporate governance’ is one of the buzz phrases of the 1990s, fertile ground for producing reports and codes of practice. Following the 1960s failures, the Australian accountancy profession sheeted most of the blame to poor management in its white paper, *Accounting Principles and Practices Discussed in Reports on Company Failures*. Analysis of the 1980s collapses has contained more of the same, blaming bad management and declining ethics. It is the same the world over. Pratten’s 1991 inquiry into UK failures commissioned by The Institute of Chartered Accountants in England and Wales trots out the same rhetoric, despite recent evidence in the affairs of Polly Peck, Maxwell and BCCI of more fundamental problems in corporate governance. There has been little effective introspection despite a disturbing repetition of past behaviour.

**One might have expected increased promulgation of Accounting and Auditing Standards to have been accompanied by decreased complaint and criticism. But just the opposite is the case — increased specification of accounting and auditing practices by the profession is positively correlated with increased litigation. Understandably so, we would argue, for compliance with Standards then in vogue was as likely to have contributed to creative accounting as deviation from them. Perversely, corporate regulators and the accounting profession are calling for even more Accounting and Auditing Standards.**

**One product of the ‘better corporate governance’ movement is the 1992 wisdom of the Cadbury Committee in the United Kingdom, in particular its ‘Code of Best Practice’. Ultimately, however, the code amounts to little more than a series of motherhood statements regarding the virtues directors must display and be seen to display, plus the recommendation for audit committees to be mandatory for all public companies. Overall, the inevitable impression to be gained is that bad, dishonest or unethical conduct by managers, directors and the like, are the major causes of corporate failure – and that the code will set that right. At best, that is a pious hope.**

**Commonly suggested remedies take little heed of lessons of the past. The UK’s ‘Cadbury Code’ is typical. Significantly, nowhere does the code explain how the appointment of audit committees will ensure that the financial information disclosed by companies will be indicative of their wealth and progress”.**

**2.39 The proposed education of the so-called confused and ignorant users of financial statements cannot solve the problem. The users want financial statements and auditors’ reports which would enable them to make informed investment decisions.**

**The auditing profession as presently employed is not able or not willing to provide such a service. Hence the need for the structural changes set out in Chapter 3.**

### **3. PROPOSALS FOR THE EMPOWERMENT OF INVESTORS AND OTHER STAKEHOLDERS**

**3.1 Many of the problems created by unfair or fraudulent conduct by market participants, inadequate disclosure of information upon which users can make informed choices and dishonest or inefficient auditors, could be eradicated by the appointment of auditors for and by each significant interest stakeholder group.**

**3.2 Significant interest groups would be groups such as No-vote shareholders, minority shareholders in a take-over bid situation, debenture holders, suppliers and other trade creditors, persons assured by insurance companies, members of pension and provident funds, employees, trade unions, bank depositors, etc.**

**3.3 Their auditors would have access to the audit files of the main auditor of the entity. This would obviate duplication of work and fees and should also have a salutary effect on the main audit.**

**3.4 The value of such auditors for interest groups is obvious. Some examples are —**

- employees (trade unions) will not be dependent upon financial information prepared by management when conducting wage negotiations or disputing the necessity to retrench;**
- the debenture holders in the failed Masterbond companies such as Mykonos, Fancourt, Marina Martinique and a host of smaller companies will not have lost hundreds of millions of rand. Their auditors would have raised early warnings that monies were being used for other purposes and that the securities were inadequate;**
- similarly, the investors in the failed Owen Wiggins companies would have received early warnings;**
- participation bond investors in the Masterbond, Owen Wiggins and Supreme Bond schemes would not have lost their investments;**

- SA Rail Commuters Corporation would not have lost R247 million deposited in Cape Investment Bank. The auditor of the depositors would have warned them that the insolvent bank was being propped up by the Reserve Bank;
- the depositors in Pretoria Bank would have been warned of its imminent liquidation and that it was riddled with maladministration, theft and fraud. This could have saved the taxpayer millions;
- members of pension funds which fail to produce the required annual returns could take steps to prevent or reduce the extent of the losses or the theft of their monies.

In this regard the reports which emanate from the Registrar of Pension Funds could only be described as frightening;

- minority shareholders would not have to be left to the mercy of the majority shareholder in a take-over situation.

Recently a typical dispute such as between IBM SA and its minority shareholders was reported in the press as follows:

”The dispute between IBM SA and disgruntled minority shareholders has escalated with the shareholders launching a last-ditch bid to force the US-controlled company to disclose more about its financial condition.

The shareholders, who are former IBM employees, have lodged a complaint with the Securities Regulation Panel claiming the company is worth more than it admits.

The minorities are hoping to thwart the computer company’s efforts to buy back the 46% of shares it does not already own at R12 each.

The ex-employees are concerned that IBM SA’s figures may have been manipulated to keep its share price in the doldrums. They allege the US parent overcharged its SA subsidiary for the secondment of foreign managers, and bumped up the wholesale price of its hardware and software to reduce the

subsidiary's profit margin.

The complaint to the panel accuses IBM of withholding information crucial to determine the true value of the shares. A key request is that the panel instruct IBM SA to disclose its figures for the half-year to June 30 1998. These accounts are being prepared but are unlikely to be published before a vote on the buyback offer on August 5.

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IBM SA said yesterday it was not aware of any formal complaint. 'In terms of the offer made to minority shareholders and in terms of the scheme of arrangement, we believe we have conformed to all JSE requirements by making available all information that is appropriate and available', said a spokesman".

An auditor, appointed by the minority shareholders, would have been able to report on the adequacy of the offer.

Investors, such as the investors in 'Proplace', would probably have not lost their investments.

The plight of these investors was reported in the Saturday Argus, August 29, 1998 under the heading —

"Elderly the hardest hit in R187-m debacle.

Investors depending on their investments, stand to lose up to 95c in the rand when the R187 million Proplace scam is wound up, fund managers say.

Robert Cameron-Ellis of Deloitte & Touche, who has been appointed by the Registrar of Banks to wind up the scheme and pay out investors, says investors are owed R187 million but only R57 million is available to be paid out to the more than 1 050 people who invested in the scheme.

Criminal charges are to be laid against the man who headed Proplace, Tony Maniachi, who has skipped the country and is thought to be living in the Lebanon.

**Proplace lured investors with promises of guaranteed returns of up to 16 percent with tax advantages through investments in endowment policies with the big assurance houses such as Old Mutual, Sanlam, Southern Life, Fedlife, and Norwich.**

**Investors, mostly elderly people, handed over money and Proplace promised to buy endowment policies on their behalf. But the Deloitte & Touche accountants have found, the promised policies were not always bought; some were used to cover several investments and those who invested small amounts were not issued with policies in their own name.**

**Cameron Ellis who, broke the bad news to investors at a packed meeting in Johannesburg this week, says these smaller investors, whose investments were not secured by policies, will be hardest hit.**

**Policies worth only R2 million were issued and they stand to recover only 5c for each rand they put into Proplace.**

**‘Many people put their life savings into this scheme.’ Says Cameron-Ellis who has described the Proplace scam as the ‘biggest debacle since Masterbond’ “.**

**3.5 If auditors are appointed by each significant interest group, some of the most pressing problems which confront the auditing profession and which are demonstrated by the ‘expectation gap’, could also be alleviated.**

**Problems such as**

- the extent and scope of the main audit which often cannot cater for the particular needs of all significant interest groups;**
- the non-independence or perceived non-independence of the main auditor who renders other services for the client.**
- the liability for damages caused to a particular interest group by the dishonesty, negligence or lack of insight of the main auditor;**
- the interpretation and application of generally accepted accounting standards to the accounts or the account items of an entity;**

**3.6 In addition, if auditors are appointed for each significant interest group, it would result in**

- increased specialisation in the profession;**
- the employment of specialists by smaller firms;**
- from a globalization point of view, the overall audit function could be fulfilled on a modular basis, especially where use is made of specialist correspondent auditors;**
- the use of specialist auditors should lead to more uniformity in the presentation of account items, in the auditing thereof and in the auditors' reports thereon;**
- specialist auditors would keep abreast with dynamic developments in their fields.**

**3.7 The Commission is of the view that if stakeholders are empowered by**

- the right to appoint their own auditors; and**
- appropriate class actions,**

**corporate fraud would be prevented to a large extent and, if not prevented, significantly curtailed.**

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#### *NOTES*

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3. *Scott W R. Constitution and Finance of English, Scottish and Irish Joint Stock Companies to 1720. 1912.*
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8. *Chatfield. Chapter 10.*
9. *Brenda Porter. Auditors' Responsibility to Detect and Report Corporate Fraud. A Comparative Historical and International Study. 1994.*
10. *International Accounting Standards Committee. International Accounting Standards. 1998, par. 9.*  
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12. *Australia. Financial Systems Inquiry. Final Report (Wallis Report). 1997.*
13. *Arthur Levitt. "The Numbers Game". NYU Center for Law and Business, New York, N.Y. September 28, 1998.*
14. *United States. American Institute of Certified Public Accountants. The Commission on Auditors' Responsibilities: Report. Conclusions and Recommendations (Cohen). 1978.*  
*Australia. Society of Certified Practising Accountants and The Institute of Chartered Accountants in Australia – A Research Study on Financial Reporting and Auditing – Bridging the Expectation Gap. 1994.*  
*New Zealand. Brenda Porter. An Emperical Study of the Audit Expectation Performance Gap. 1993.*  
*Republic of South Africa. J D Gloeck – The Expectation Gap with Regard to the Auditing Profession in the Republic of South Africa. 1993.*
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*Critical Perspectives on Accounting (1998) 9. 299 - 330.*

16. *Margaret Beckett. Foreword to the Company Law Reform Consultation Paper. March 1998.*
17. *Arthur Andersen & Co. In the Public Interest. Vol. 1 p. 46.*
18. *Jenkins Committee Report.*
19. *John Whitney. "There's a Rhinoceros in the Room". IFAC World Congress. 1997.*
20. *McGregor I H. Corporate Financial Reporting : Past, Present and Future. 1982.*
21. *Clarke, Dean & Oliver. Corporate Collapse – Regulating, Accounting and Ethical Failure. 1997.*

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**13.13** A fairly predictable outcry followed the dissemination of the Consultation Paper. In jurisdictions such as South Africa where company law remained under the influence of the Victorian view as expounded by the Davey Committee in 1896, that

"(the) true financial position of the company should be honestly disclosed to shareholders not less than once a year but not for public use",

the idea that any outsider should have access to the records of a company is viewed with horror. After all, in South Africa even members who are the owners of the company

- are not allowed to inspect its financial records;
- need a special order by the court to have access to the books and papers of the company when it is unable to pay its debts and is being wound up (section 360(1));

- need a special order by the court or the Master to attend the examination of directors, officers or other persons regarding the affairs of a company after a winding-up order has been made (section 417(7)).

**13.14** The negative comments were welcomed in that they crystallized the views of those who wish to preserve the *status quo*, and enables the Commission to clarify some aspects of its proposals and to endeavour to allay some of the concerns expressed.

**13.15** Some extremely scholarly comments were also received and in particular the paper by Professors **Chambers, Clarke** and **Dean**, the authors of 'Corporate Collapse'. It is reported in full.<sup>(5)</sup>

**13.16** Generally, the auditing profession and the academics were not in favour of more transparency and more access to the records of corporations.

Their objections related to

- the fear of administrative mayhem if a number of persons should have access to the records;
- problems relating to confidentiality and secrecy;
- the additional cost which will be incurred;
- problems which might arise if auditors differ.

**13.17** Unfortunately no attempt was made to justify their objections with reference to practical experience elsewhere in the world.

Jurisdictions where all members of corporations have access to the books and records, and jurisdictions where a special interest group, namely the holders of debentures, have full access by means of trustees, or jurisdictions where employees have access by means of representation on boards, have simply been ignored.

The rights to access to the books and records by members of corporations or by trustees of holders of debentures have been extensively dealt with in Chapters 10 and 11, but for the sake of convenience the names of these jurisdictions are repeated.

**13.18** Jurisdictions in which members of companies have access to the records of corporations, are

**Anquila**

**Belize**

**British Virgin Islands**

**Philippines**

**United States of America**

**Alabama**

**Alaska**

**Arizona**

**Arkansas**

**California**

**Colorado**

**Connecticut**

**Delaware**

**Mississippi**

**Missouri**

**Montana**

**Nevada**

**New Hampshire**

**New Jersey**

**New Mexico**

**North Carolina**

<b>Florida</b>	<b>North Dakota</b>
<b>Ohio</b>	<b>Texas</b>
<b>Oklahoma</b>	<b>Utah</b>
<b>Oregon</b>	<b>Vermont</b>
<b>Pennsylvania</b>	<b>Virginia</b>
<b>Rhode Island</b>	<b>Washington</b>
<b>South Carolina</b>	<b>West Virginia</b>
<b>South Dakota</b>	<b>Wisconsin</b>
<b>Tennessee</b>	<b>Wyoming</b>

**13.19** Jurisdictions in which trustees of holders of debentures have access to the records, include

**Australia**  
**Argentina**  
**India**  
**Malaysia**  
**Nahru**  
**Papua New Guinea**  
**Paraguay**  
**Singapore**

**13.20** The comments submitted by the South African Institute of Chartered Accountants (SAICA) reflect the attitude of those who wish to preserve the *status quo* and who wish to preserve the cloak of secrecy which protects fraudulent and incompetent directors, managers and auditors.

They propound the idea that adequate protection for the public can be achieved by

- the raising of the standards of financial reporting and auditing;
- improving the standards of corporate governance;
- relying upon the supervisory activities of entities such as the Securities Exchange, the Reserve Bank and the Financial Services Board.

**13.21** According to SAICA the comments were compiled after the views of its members in the various SAICA constituencies had been sought, namely members in commerce and industry, practising auditors in both small and large firms and members in the academic field. For purposes of convenience, the full text is reproduced, interspersed with some comments by the Commission.

**"THE ROLE OF THE AUDITOR - ELIMINATION OF THE EXPECTATION GAP AND APPOINTMENT OF AUDITORS BY ALL SIGNIFICANT INTEREST GROUPS**

*Set out below are the comments of The South African Institute of Chartered Accountants (SAICA) on the above-mentioned consultation paper. In compiling these comments we sought the views of members in the various SAICA constituencies, namely members in commerce and industry, practising auditors, including small and large firms, and members in academia.*

*Before commenting on the detailed proposals contained in the paper, we believe it is necessary to reiterate that SAICA acknowledges that the investigation into the affairs of the Masterbond group of companies highlighted deficiencies in the audit process applied and a lack of independence on the part of certain of the auditors involved. However, we feel it is important to make the point that this only related to a limited number of auditors involved in a limited number of transactions and therefore should not be regarded as reflecting on the entire audit arm of the profession, as was implied in recent press articles.*

**The criticism expressed in the First Report of the Commission was not restricted to the activities of the auditors of the Masterbond Group.**

**The criticism extended to, inter alia, the auditors of the Owen Wiggins Group, the Supreme Bond Group, Pretoria Bank, Cape Investment Bank, Prima Bank, Bankorp and the Reserve Bank.**

**The 'limited number of transactions' referred to by SAICA included the following: (Vol. 1 p. 50-52)**

- issuing of false certificates in respect of participation bond schemes;**
- signing of unqualified reports relating to blatantly false financial statements;**
- failure to comply with the requirements of section 20(5) of the Public Accountants' and Auditors' Act on the discovery of material irregularities;**
- drafting and signing financial statements which departed so fundamentally from GAAP (Generally Accepted Accounting Practice) that no reliance could be placed thereon;**
- changing accounting policies to convert loss situations into profit situations without proper disclosure;**
- failure to perform procedures designed to identify all relevant material events occurring after the balance sheet date and up to the date of the auditor's report;**
- failure to report relevant after balance sheet date events;**
- backdating auditors' reports, financial statements and letters of representation;**
- failure to scrutinize minutes of relevant directors' meetings;**
- failure to comply with the disclosure requirements in respect of debentures issued;**
- failure to establish whether a company had issued debentures when the contrary was recorded in the notes to the financial statements;**

— assisting in misleading the Receiver of Revenue."

As pointed out above, the 'limited' number of auditors referred to by SAICA were not limited to the auditors of the Masterbond Group.

With reference to the secret donations by the Reserve Bank to Bankorp, Prima Bank and Cape Investment Bank, the Commission reported as follows (Vol.1, p. 68-69):

*"The auditors were members some of the most prestigious internationally affiliated auditing firms whose members are amongst the leaders in their profession. Leaders who are also perceived to be responsible for the setting and maintaining of ethical standards and generally accepted accounting practice".*

Unfortunately deficiencies in the audit process and the lack of independence on the part of some auditors are not restricted to South Africa. Similar problems occur in jurisdictions where much better regulation and supervision are in place. An example is the report 'Fraudulent Financial Reporting : 1987-1997. An Analysis of US Public Companies'.

The research was commissioned by the Committee of Sponsoring Organization of the Treadway Commission and provides a comprehensive analysis of fraudulent financial reporting occurrences investigated by the SEC since the issuance of the 1987 'Report of the National Commission on Fraudulent Financial Reporting (The Treadway Report)'.

"We analyzed instances of fraudulent financial reporting alleged by the SEC in AAERs issued during the 11 year period between January 1987 and December 1997. The AAERs, which contain summaries of enforcement actions by the SEC against public companies, represent one of the most comprehensive sources of alleged cases of financial statement fraud in the United States. We focused on AAERs that involved an alleged violation of Rule 10(b)-5 of the 1934 Securities Exchange Act or Section 17(a) of the 1933 Securities Act given that these represent the primary antifraud provisions related to financial statement reporting. Our focus was on cases clearly involving financial statement fraud. We excluded from our analysis restatements of financial statements due to errors or earnings management activities that did not result in a violation of the federal antifraud statutes.

**Our search identified nearly 300 companies involved in alleged instances of fraudulent financial reporting during the 11 year period. From this list of companies, we randomly selected approximately 200 companies to serve as the final sample that we examined in detail. Findings reported in this study are based on information we obtained from our reading of (a) AAERs related to each of the sample fraud companies, (b) selected Form 10-Ks filed before and during the period the alleged financial statement fraud occurred, (c) proxy statements issued during the alleged fraud period, and (d) business press articles about the sample companies after the fraud was disclosed.**

**Several key findings can be generalized from this detailed analysis of our sample of approximately 200 financial statement fraud cases. We have grouped these findings into five categories describing the nature of the companies involved, the nature of the control environment, the nature of the frauds, issues related to the external auditor, and the consequences to the company and the individuals allegedly involved.**

#### **Nature of Companies Involved**

- Relative to public registrants, companies committing financial statement fraud were relatively small. The typical size of most of the sample companies ranged well below \$100 million in total assets in the year preceding the fraud period. Most companies (78 percent of the sample) were not listed on the New York or American Stock Exchanges.**
  
- Some companies committing the fraud were experiencing net losses or were in close to break-even positions in periods before the fraud. Pressures of financial strain or distress may have provided incentives for fraudulent activities for some fraud companies. The lowest quartile of companies indicate that they were in a net loss position, and the median company had net income of only \$175,000 in the year preceding the first year of the fraud period. Some companies were experiencing downward trends in net income in periods preceding the first fraud period, while other companies were experiencing upward trends in net income. Thus, the subsequent frauds may have been designed to reverse downward spirals for some companies and to preserve upward trends for other companies.**

### **Nature of the Control Environment (Top Management and the Board)**

- **Top senior executives were frequently involved. In 72 percent of the cases, the AAERs named the chief executive officer (CEO), and in 43 percent the chief financial officer (CFO) was associated with the financial statement fraud. When considered together, in 83 percent of the cases, the AAERs named either or both the CEO or CFO as being associated with the financial statement fraud. Other individuals named in several AAERs include controllers, chief operating officers, other senior vice presidents, and board members.**
  
- **Most audit committees only met about once a year or the company had no audit committee. Audit committees of the fraud companies generally met only once per year. Twenty-five percent of the companies did not have an audit committee. Most audit committee members (65 percent) did not appear to be certified in accounting or have current or prior work experience in key accounting or finance positions.**
  
- **Boards of directors were nominated by insiders and 'grey' directors with significant equity ownership and apparently little experience serving as directors of other companies. Approximately 60 percent of the directors were insiders or 'grey' directors (i.e., outsiders with special ties to the company or management). Collectively, the directors and officers owned nearly 1/3 of the companies' stock, with the CEO/President personally owning about 17 percent. Nearly 40 percent of the boards had not one director who served as an outside or grey director on another company's board.**
  
- **Family Relationships among directors and / or officers were fairly common, as were individuals who apparently had significant power. In nearly 40 percent of the companies, the proxy provided evidence of family relationships among the directors and / or officers. The founder and current CEO were the same person or the original CEO / President was still in place in nearly half of the companies. In over 20 percent of the companies, there was evidence of officers holding incompatible job functions (e.g., CEO and CFO).**

### **Nature of the Frauds**

- Cumulative amounts of frauds were relatively large in light of the relatively small sizes of the companies involved. The average financial statement misstatement or misappropriation of assets was \$25 million and the median was \$4.1 million. While the average company had assets totaling \$533 million, the median company had total assets of only \$16 million.
- Most frauds were not isolated to a single fiscal period. Most frauds overlapped at least two fiscal periods, frequently involving both quarterly and annual financial statements. The average fraud period extended over 23.7 months, with the median fraud period extending 21 months. Only 14 percent of the sample companies engaged in a fraud involving fewer than twelve months.
- Typical financial statement fraud techniques involved the overstatement of revenues and assets. Over half the frauds involved overstating revenues by recording revenues prematurely or fictitiously. Many of those revenue frauds only affected transactions recorded right at period end (i.e., quarter end or year end). About half the frauds also involved overstating assets by understating allowances for receivables, overstating the value of inventory, property, plant and equipment and other tangible assets, and recording assets that did not exist.

#### **Issues Related to the External Auditor**

- All sizes of audit firms were associated with companies committing financial statement frauds. Fifty-six percent of the sample fraud companies were audited by a Big Eight/Six auditor during the fraud period, and 44 percent were audited by non-Big Eight/Six auditors.
- All types of audit reports were issued during the fraud period. A majority of the audit reports (55 percent) issued in the last year of the fraud period contained unqualified opinions. The remaining 45 percent of the audit reports issued in the last year of the fraud departed from the standard unqualified auditor's report because they addressed issues related to the auditor's substantial doubt about going concern, litigation and other uncertainties, changes in accounting principles, and changes in auditors between fiscal years comparatively reported. Three percent

of the audit reports were qualified due to a GAAP departure during the fraud period.

- Financial statement fraud occasionally implicated the external auditor. Auditors were explicitly named in the AAERs for 56 of the 195 fraud cases (29 percent) where AAERs explicitly named individuals. They were named for either alleged involvement in the fraud (30 of 56 cases) or for negligent auditing (26 of 56 cases). Most of the auditors explicitly named in an AAER (46 of 56) were non-Big Eight/Six auditors.
  
- Some companies changed auditors during the fraud period. Just over 25 percent of the companies changed auditors during the time-frame beginning with the last clean financial statement period and ending with the last fraud financial statement period. A majority of the auditor changes occurred during the fraud period (e.g., two auditors were associated with the fraud period) and a majority involved changes from one non-Big Eight/Six auditor to another non-Big Eight/Six auditor".

Another example is the contents of the "Report of the Internal Investigation of Independence Issues at PriceWaterhouseCoopers LLP". The investigation was conducted at the request of the SEC to ascertain to what extent the professional accountants employed by PwC LLP violated the rules and guidelines issued by the SEC and by AICPA regarding the independence of accountants and more specifically the rules that relate to financial interests in an audit client.

"The Internal Investigation revealed that substantial numbers of PwC professionals, particularly partners, had violations of the independence rules, and that many had multiple violations. While many PwC professionals reported violations in the firmwide March 1999 Confirmation Process, the full numerical magnitude of independence non-compliance was evident only from the Random Sample Study, which demonstrated that the overwhelming majority of partners selected for audit failed to report at least one violation in the March 1999 Confirmation Process.

Violations and the failure to report violations appear to have resulted, for the most part, from a range of reasons that included excusable mistake, various forms of laxity, and an insensitivity to the importance of the

independence rules or reporting requirements, although at least one individual acknowledged intentional non-compliance.

.....

Nonetheless, the numbers alone, as PwC acknowledges, disclose that there was widespread independence non-compliance at PwC that reflected serious structural and cultural problems rooted in both its 'legacy' predecessors."

*In the years since the Masterbond failure, there has been significant improvement in relevant legislation, corporate governance practices and auditing standards. These include compulsory protection of minority shareholders required by the Securities Regulation Panel and the Johannesburg Stock Exchange, as well as various enhancements to financial services legislation. In addition, the issue of the King Report on Corporate Governance in 1994 has significantly increased awareness of the need for good corporate governance and the acknowledgement of the corporation's duty to other stakeholders. It is internationally acknowledged that the King Code is one of the finest in the World. Adherence to the Code is encouraged and is growing.*

*In the case of listed companies, the Johannesburg Stock Exchange requires directors to state the extent to which they adhere to the principles of the Code.*

**It is not correct to refer to improvements as 'significant'. During the last three years, the South African business world has become littered with corporate failures. Examples can be found in the notes to Chapter 1, and include the Islamic Bank, Amalia, Proplace, New Republic Bank, pension funds, Refcorp, MacMed, LeisureNet and Business Bank to name a few.**

**The perception of a 'significant' improvement is certainly also not shared by others.**

## **"Business is living in the wild, wild west**

**Johannesburg – The business community in South Africa was like the wild west, where financial cowboys reigned supreme and auditing and law enforcement was woefully inadequate, Clive Robertson, the general manager of Credit Guarantee, the domestic and foreign credit insurance firm, said this week.**

**He has been involved in a number of recent liquidations, and has just broken his silence to warn of the rotten underbelly of business life.**

**'We are paying out millions and millions of rands a month, and we have to warn credit granters to be very careful,' he said.**

**Robertson protested that blatant dishonesty and inept management were evident in virtually every one of the recent spate of high-profile company failures to hit the business community, and he highlighted Macmed, Beige, Oranje Sewing Thread and Infinity as cases.**

**'Dishonesty is evident in between 70 percent and 85 percent of all liquidations taking place in South Africa,' he said.**

**'This compares with a figure of 60 percent in the UK. However, the proportion of businesses failing in South Africa is far greater than in the UK.'**

**Robertson questioned why the danger signs were not apparent until too late in recent liquidations, and suggested that auditors had not been sufficiently rigorous.**

**'What is most disconcerting about the recent spate of failures is that the latest audited financial results of the listed companies gave little indication of impending financial collapse,' he said.**

**'You look at a company's accounts after liquidation, and compare this to the situation before liquidation, and assets have just disappeared, or stock has**

gone,' he said. To steal and hide assets away was the easiest thing in South Africa he said.

'This gives cold comfort to shareholders and creditors as to the effectiveness of current auditing procedures.' Robertson suggested that this situation reflected an alarming decline in both business integrity and acumen.

Robertson argued that the patent inability of the policing and justice systems to deal effectively with what he described as 'rampant' white collar crime was encouraging a wild west syndrome amongst potentially dishonest businessmen, for whom the rewards of unlawful business practise far outweighed the risks".

**A year later, Clive Robertson said the following**

**SA business failures raise questions of morality (Business Report : Cape Times - 25,10,2000.)**

"Every time Clive Robertson, the general manager of Credit Guarantee South Africa, reads about loss-making companies in the newspaper the alarm bells ring. For him, the recent spate of listed company failures poses the question whether South African business is morally bankrupt. Often we complain about the levels of criminal activity on the streets, but perhaps eyebrows need to be raised at what happens - or does not happen - at board level.

Credit Guarantee covers the risk of almost every company listed on the JSE. For a premium it will cover costs of the companies offshore and locally should things go awry, and it will ensure payment of suppliers and clients.

The number of listed companies is on the decrease. Of the total number of listed companies, 16 have failed over the past two years including household names such as the Hyundai Group and Kelvinator. Medical supplies business Macmed is involved in a closed inquiry and there has been the recent high-profile liquidation (albeit provisional) of LeisureNet.

'In a nutshell, creditors and other stakeholders take an enormous gamble when affording credit today as the possibility of corporate failure is so high that it is safer to play roulette at a local casino than investing in a business,' says Robertson.

He says this makes any grantor or underwriter of credit fearful of what lies ahead. One thing's for sure - in case no one's noticed - a listing on the JSE is no longer any indication of financial health".

#### **Business Day : 11 February 2000 – "When the ducks quack**

Cynical stockbrokers coined a phrase during the boom of the late 1960s to describe investors' indiscriminate and insatiable appetite for new listings: 'When the ducks quack', went the saying, 'feed them'. Judging by a string of unpleasant surprises recently sprung by JSE-listed companies – most of them newcomers – one can be forgiven for wondering whether the same philosophy has taken hold three decades later.

But the growing frequency of the surprises should set alarm bells ringing. Judging by the cases that have recently come to light, some of the entrepreneurs at the helm of venture capital and IT start-ups have scant knowledge, and perhaps even scant regard, for the niceties of corporate governance. There is also the question of how thoroughly auditors and the JSE's listings committee are doing their jobs."

#### **Business Day 16 November 2000—"A case of imaginative accounting - Greta Steyn**

A joke doing the rounds might be applied to Specialised Outsourcing. An accountant and a mathematician are asked to add two and two. The mathematician does not hesitate to answer 'four'. The accountant replies: 'Tell me what you want the answer to be, and I'll see what I can do'."

**Another example that others certainly do not share the views of SAICA that an improvement in corporate governance is perceptible,**

let alone 'significant', is the view expressed by Mr Hutton-Wilson (director of the Institute of Directors' Centre for Directorship and Corporate Governance) as reported in the Cape Times Business Report of 13 March 2001:

" 'Why corporate governance is so important to companies, public corporations and even the national economy, is because South Africa is under scrutiny by major lenders of money and unless we run a clean economy we will not attract foreign capital.'

The result is that whenever international risk-aversion is running high - as it did last year - the global electronic herd instinct is to ditch emerging countries which have poor corporate governance score cards.

For instance, says Hutton-Wilson, last year net foreign investment in the JSE Securities Exchange plummeted to R17,4 billion from R40,3 billion in 1999.

'It is vital that we be perceived to run a clean economy, which the world right now doesn't seem to think we do. For instance, we're generally seen as one of the worst offenders in the world for insider trading,' he says.

'Despite a large number of cases of insider trading investigated, each has been settled by the Financial Services Board out of court and not a single case has been prosecuted or individual imprisoned. South Africa is seen as too soft.

The position of director is the only position in any company which does not require qualifications - other than the disqualifications contained in the Companies Act. Yet the King Report on Corporate Governance published in 1994 concludes: 'Directors have awesome responsibilities and must be properly prepared to carry out their duties.'

There are no less than 43 clauses in the Companies Act relating to the responsibilities of directors. Yet few directors would even know where to locate these duties in the act notwithstanding the fact that transgressors can

face individual penalties of up to a R2 million fine and imprisonment of 10 years.

'So it is surprising that most directors accept their appointment with little induction or training in their new role. In the UK the IoD, which is 40 000 strong, carried out a survey of 1 000 companies and found that less than 6 percent of directors of those companies had had any formal training for their responsibilities,' says Hutton-Wilson.

'A recent McKinsey Investor Opinion Survey reported on the views of 200 institutional investors representing \$3 trillion in assets, found that board practices are as important as financial disciplines when they come to evaluate companies for investment.

The report found that 80 percent of investors would be willing to pay more for the shares of a well-governed company'."

*Further, we refer you again to our previous submissions where we made certain recommendations relating to the audit process. We believe that these recommendations would significantly strengthen the audit process and therefore overcome the type of difficulties experienced with the Masterbond group of companies.*

#### COMMENT ON PROPOSAL

- 1. On reading the paper it appears that the objective of the proposal is to provide protection for all parties having a relationship with a corporation from business failure and consequent financial loss.*
- 2. To achieve this objective, the paper proposes that every significant stakeholder group should be given the opportunity to appoint its own auditor to investigate and provide assurance on various matters of interest to that particular stakeholder group. SAICA does not support the proposal and believes that it is unworkable.*

**SAICA states that the proposal that every significant stakeholder group should be given the opportunity to appoint its own auditor to provide assurance on matters of interest would be unworkable. No reasons are stated for this view, and their own statement on South African Auditing Standards, SAAS 800 'The Auditor's Report on Special Purpose Audit Engagements', seems to have been ignored.**

*Practical problems*

3. *Identified practical problems relating to the proposal are summarised below.*

*Affected corporations*

4. *It is not clear from the paper which corporations would be affected by the proposal, i.e. will it apply, to listed companies only or to all companies falling within the ambit. of the Companies Act? Or will affected corporations be identified based on quantitative measures? If the intention is to apply it to listed companies only, we would question the appropriateness of this, as there is already in place a significant amount of regulation through the Johannesburg Stock Exchange and, in appropriate cases, other regulatory bodies such as the Financial Services Board and the Registrar of Banks. Furthermore, as was the case with the Masterbond group of companies, business failures often occur within unlisted companies. However, we believe that to impose the proposal on all corporations would be unduly burdensome and could result in the cost becoming prohibitive for most corporations. This could discourage entrepreneurship and the development of small and medium size enterprises in South Africa.*

**All public companies will be affected by the proposal.**

**Regulation and supervision by the Stock Exchange is virtually non-existent. It is a toothless organization which plays little if any part in the protection of investors.**

**Despite the supervision by the Registrar of Banks (which is the most effective supervisor in SA) banks such as the Business Bank, the Islamic Bank and the New Republic Bank have recently collapsed.**

**The Financial Services Board does its utmost with limited resources.**

**However, nobody could realistically rely on the Registrar of Banks and the Financial Services Board to provide the protection envisaged by the Commission's proposals to provide more access to the records of companies. In addition, the Registrar of Banks and the Financial Services Board have no jurisdiction over ordinary companies and could also have an interest which differs from that of other stakeholders. An example is the role played by the Bank of England in the BCCI affair, alluded to later.**

**There is no basis for the fear that costs might become prohibitive. A well regulated business world should encourage and not discourage entrepreneurship.**

**If a company seeks funds from the public, it should be prepared to pay for a system which protects the public.**

*Identification of stakeholders*

5. *The paper lists a number of stakeholder groups. However, the wording used implies that there could be more stakeholder groups than those listed. Is it intended that the categories of stakeholder will be listed somewhere and each or them will have an automatic right to appoint an auditor, or can any stakeholder group of a company apply for recognition as a stakeholder group with the right to appoint an auditor? In addition, to whom would a stakeholder group apply for recognition? Where, for example, more than one trade union is represented, does every union have the right to appoint an auditor?*

6. *Once a stakeholder group has been identified, how will the group's representative be identified? How will it be ensured that the views of all the members of that particular stakeholder group are adequately represented?*

**The Commission reconsidered the practical possibility of identifying creditor and supplier stakeholder groups. It came to the conclusion that in normal business and trading situations there are too many groups or sub-groups to be able to identify**

particular creditors or suppliers for the purposes of the appointment or election of representatives.

The Commission is of the view that the groups be limited to

- shareholders who individually or in the aggregate hold 5 per cent or more of the issued ordinary shares of a company save in special circumstances. See Chapter 11;
- holders of debentures. See Chapter 12;
- depositors in banks and other financial institutions;
- contributors to pension/provident funds;
- the assured of long-term insurance companies;
- all recognized trade unions;
- owners of time-share;
- members of medical aid societies;
- investors in participation bond schemes;
- holders of non-voting shares;
- holders of preferent shares.

It is envisaged that the interests of holders of debentures, depositors, contributors to pension funds and the assured of insurance companies and the owners of time-share etc. will be represented by trustees

**appointed in the same manner as trustees for holders of debentures should be appointed (see Chapter 11), and who would have access to the records and to the working papers of the external auditor.**

**Auditors on behalf of trade unions would have access at times of wage negotiations or retrenchment.**

*Cost implications*

7. *The paper does not make it clear who will bear the additional cost of the proposed stakeholder audits. The paper seems to imply that the additional cost will be borne by the corporation. We do not believe that this is equitable, as it will burden the corporation with expenses over which it has no control. At the end of the day it will be the shareholders who will bear the cost in the form of reduced earnings and dividends. In addition, there will be loss to the corporation in the form of distraction and loss of time of senior management and key staff. These increased cost structures and inefficiencies will negatively impact on South African corporations ability to compete in a global market. We believe that this could be harmful to the economy particularly at a time when South Africa is competing with other emerging markets for foreign investment.*

**It is difficult to believe that SAICA could seriously consider that any additional cost and the so-called distraction of senior management could have an adverse impact on foreign investment.**

**As pointed out above, the reality of the situation in other jurisdictions is ignored, or worse, is not known.**

**When a company issues debentures, it carries the costs of the trustee of the holders of the debentures. It has never been suggested in any jurisdiction that such costs are prohibitive.**

**Similarly, costs which will be incurred by banks, insurance companies, pension funds, time-share companies, etc. in respect of trustees for their particular interest groups need not be prohibitive.**

**It is envisaged that minority shareholders (save in mergers, sale of assets or in a take-over situation) and trade unions should pay the costs themselves.**

**In addition, to suggest by implication that the distraction of the attention of the directors or other senior management and key staff of corporations such as Masterbond, Supreme Bond, Owen Wiggins, MacMed, Prima Bank, Cape Investment Bank, etc. by the investigations of stakeholder auditors could have led to an increase in losses for the entities, can only be described as preposterous. In any event, any such loss caused to these entities would have been insignificant compared to the losses actually suffered by the investors.**

*Interaction amongst auditors*

8. *The paper proposes that the stakeholder auditors should have a right of access to the audit files of the main auditor. The practicality of such a proposal needs to be considered including the following: What are the time constraints? What are the cost implications for the main auditor? Who has priority access to the main auditor's files? What is the status of working papers, and how much reliance can be placed on them by a stakeholder auditor?*

**In group companies' audits a similar situation can occur. It is for the stakeholder auditors to decide how much reliance can be placed on the working papers. See also SAAS 600 (South African Auditing Standards):**

**"The principal auditor should perform procedures to obtain sufficient appropriate audit evidence that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment".**

9. *The proposal inevitably will create a relationship between the main auditor and the stakeholder auditors, as the stakeholder auditors will be reliant on the main auditor for certain information. This in itself raises a number of questions.*

10. *What are the liability, implications for the stakeholder auditors who misinterpret the main auditor's files or rely on them without obtaining evidence that the work of the main auditor is adequate for the stakeholder auditors' purposes?*

11. *Worldwide there are currently problems around the issue of auditor liability and we believe that the proposal will exacerbate those problems in South Africa.*

**Why the proposals should exacerbate auditor liability is not stated. In fact, it should alleviate auditing problems in that independent peer professional opinions will be heard. The stakeholder auditor will not be reliant on the external auditor for information, the information will be at his disposal.**

12. *An auditor is required to exercise judgement during the course of an audit. The type of audit being performed and stakeholder group being represented would affect an auditor's judgement. However, the paper does not address the issue of disagreement between auditors. What if there is disagreement between the main auditor and a stakeholder auditor on the treatment of an item in the financial statements? Or if there is a disagreement between one stakeholder auditor and another stakeholder auditor on such treatment? How would disagreements be reported to the various stakeholders?*

**Objectivity is required from auditors, whoever might employ them or whoever might pay them.**

**Bona fide disagreement is not unique. If additional evidence cannot resolve the disagreement, the disagreement should be disclosed.**

13. *What about the confidentiality aspects? The main auditor has a duty of confidentiality to his/her client. To whom will the stakeholder auditors report and what duty of confidentiality and care will they have to the company in question? Could their clients ask them to disclose all sorts of information that in any other situation would have remained*

*confidential/proprietary, such as information relevant to the company's competitors or creditors?*

**The stakeholder auditors will report to whoever employed them. Information irrelevant to the needs of the group should not be disclosed by the auditor concerned.**

**The issue of confidentiality is often over-emphasised. In jurisdictions where there is extremely limited confidentiality, problems do not seem to arise. See Chapter 11.**

*Class actions*

14. *The Commission also recommends, apart from the right on the part of stakeholders to appoint their own auditors, that class actions should be permitted. Much has been written about class actions, which are a fairly common occurrence in the United States but not, as far as SAICA is aware, in any other jurisdiction. It is SAICA's opinion that the South African legal system, as is the case with the United Kingdom's legal system, does not lend itself to class action. If and when class actions are permitted they will have a far-reaching effect on the liability of professional persons and on the incidence of claims against them, and are likely to give rise to demands for these persons to be allowed to practise in a form, which will give them limited liability. Furthermore, there may be other undesirable consequences of class actions, which cannot now be foreseen.*

**A class action does not mean the creation of new or additional legal liabilities.**

**It is difficult to believe that SAICA with all its international contacts and experience, is unaware of the existence of class actions in the legal systems of the United Kingdom, Canada, Australia and Israel and the proposed introduction thereof in Sweden. In addition, it is a right enshrined in section 38 of the South African Constitution which reads as follows:**

**"(38) Anyone listed in this section has the right to approach a competent court, alleging that a right in the Bill of Rights has been infringed or threatened, and the court may grant appropriate relief, including a declaration of rights. The persons who may approach a court are –**

- (a) anyone acting in their own interest;**
- (b) anyone acting on behalf of another person who cannot act in their own name;**

- (c) anyone acting as a member of, or in the interest of, a group or class of persons;
- (d) anyone acting in the public interest;
- (e) an association acting in the interest of its members".

**In the United Kingdom the history of class actions has been sketched as follows:**

"The modern era of class actions began with the passage of the Supreme Court of Judicature Act, 1873 in England, and the fusion of law and equity. As indicated, prior to this time the class action device could be employed only in the court of Chancery and, therefore, only equitable remedies, such as an accounting, a declaration, and an injunction, could be claimed in a representative action. Damages, being a common law remedy, were not available in an action brought in class form in the Court of Chancery. In other words, the nineteenth century forms of action determined when and how the class action device could be employed, despite the functional similarity of a claim for an accounting, for example, and a suit asserting a right to damages.

The merger of the common law courts and the courts of equity resulted in the adoption of a single set of procedural rules applicable to all civil proceedings. Included in these rules was a Rule for representative or class actions. Rule 10 of the Rules of Procedure scheduled to the Supreme Court of Judicature Act, 1873 provided as follows:

'Where there are numerous parties having the same interests in one action, one or more of such parties may sue or be sued or may be authorised by the court to defend in such action on behalf of or for the benefit of all parties so interested' ".

#### *Corporations in temporary difficulty*

15. *In many instances corporations may be experiencing short-term difficulties. However, in the long-term they may be able to work through the problems and operate as a viable going concern.*

16. *The paper does not address the difficult problem of how to ensure that failure is not precipitated by the auditor's indication that the corporation is in difficulty, where in fact it could have been avoided. In the case of a bank, even the smallest indication by the auditor of possible difficulties may itself result in certain failure of the bank, due to the heavy reliance of banks on confidence to attract and retain depositors.*

17. *Should a corporation fail as a result of the report of a stakeholder auditor, the effect on other stakeholder groups could be disastrous. Therefore, protection of one stakeholder group could be achieved to the detriment of all other stakeholder groups.*

**These comments serve to illustrate the difficulties which some members of the auditing profession seem to have with an honest and objective approach. If a corporation is experiencing difficulties, the auditor should report it, whatever the consequences. The auditor should not try to deceive by suppressing facts.**

*Other arguments against the proposal*

*Director's responsibilities and corporate governance*

18. *It is important to distinguish between business and audit failure. When corporations fail, the blame for failure is often laid at the door of the auditor when in fact the real problems rested with management. Corporations function in a free market environment and; as a result, there will always be business failures. It needs to be remembered that the auditor is but one of the cogs in the regulatory framework. If the other important regulatory functions do not operate effectively, the problems which arise will not timeously be addressed and gaps in the framework will continue to be exploited.*

**The Commission does not lay the blame for business failures at the door of the auditor; the blame for not timeously warning of impending failure is often, and with just cause, laid at the door of the auditor.**

19. *The statutory audit cannot be utilised to provide protection for all stakeholders. However, stakeholder protection, and empowerment, is provided for in the King Report, as well as other applicable legislation and by the relevant regulators. The compulsory appointment of employees to management boards of pension funds is one such example.*

**The statutory audit cannot be utilized to provide protection for all stakeholders. That is why the Commission proposed the introduction of stakeholder auditors. The Commission does not believe that other entities provide the necessary protection.**

20. *If irregularities occur in large public corporations, they should be detected by one or more of the screening processes of the governance structure (e.g. non-executive directors, internal audit function, audit committee) before the auditor becomes aware of them. These screening processes are integral to the King Report. However, as noted before, the King Report was issued in 1994. As a result, these processes in many instances did not exist in the companies investigated by the Commission. Indeed there was very little evidence of any form of governance in the companies investigated.*

**As pointed out above, no discernable improvement has occurred since 1994. Arguably, the situation has become worse.**

*Dishonesty by management*

21. *A management team that is determined to commit fraud will almost certainly be able to mislead any number of audit teams. The proposal will afford protection only in those few situations where the audit firm/partner colludes with the management team.*

**The stakeholder auditor will have access to the records at all times. While such an auditor could be misled, it does not mean that the stakeholder should not have the right to attempt to satisfy himself that the investment is safe or that internal controls are in place.**

22. *An example of the above was noted in a consultation paper, 'Fraud and Audit: Choices for Society', issued by the Auditing Practices Board in the United Kingdom in November 1998 (copy attached). According to this paper, at its headquarters BCCI had a separate "Special Duties Department" dedicated to deceiving its auditors by fabricating thousands of documents to support the lending to sham companies secretly controlled by the Gulf Group, including letters of introduction, loan documentation, financial statements, credit reviews, Board minutes and resolutions, and audit confirmations.*

23. *The aim was to create the impression that there was real and substantial commercial activity with genuine third parties and that the Gulf Group companies were keeping up interest payments on their loans, when in reality vast sums of money were simply going round in a circle every day between BCCI and the Gulf Group laundered through special conduit accounts at two New York banks.*

The reference to the activities of the BCCI Bank is unfortunate in this context. Two of the so-called 'big five' in the auditing world, Ernst & Young and PriceWaterhouseCoopers, agreed to pay \$30 million and \$95 million respectively to the liquidators of the bank as damages for their roles as external auditors of the bank.

Findings of Lord Bingham who had conducted an inquiry into the supervision of BCCI and findings by the US Congressional Investigation are reported by Arnold and Sikka as follows:

"Throughout the 1980s, BCCI's auditors continued to issue unqualified reports on the Bank's financial statements despite several warning signs of potential problems in the bank's accounts (USS Senate, 1992b, Chapter 10). In 1987, the Bank of England received reports of fraudulent activity by BCCI (Bingham, 1992, p. 56), but no decisive action was taken, in part, because auditors did not suspect BCCI management of fraud (Bingham, 1992, p. 57). In May 1988, Price Waterhouse prepared a substantial report for the College of Regulators (originally formed in 1987). The report drew attention to the heavy concentration of BCCI loans to certain customers, several of whom were shareholders. The report also included information concerning BCCI nominee companies and possible illicit investments in the United States. The information provided to regulators, however, was minimal because auditors 'faced the dilemma of seeking to reconcile their duty to make appropriate disclosure to the (bank) supervisors with the need to retain confidence of their client' (Bingham, 1992, p. 59).

Price Waterhouse's relationship with BCCI changed dramatically in April of 1990 when the auditors, acting under the authority of the 1987 Banking Act, notified the Bank of England of lending problems and possible fraud at BCCI without informing BCCI of their action (US Senate, 1992b, p. [2]71-173). However, despite notifying the Bank of England of possible fraud at BCCI, the auditors (in May 1990) issued an unqualified report on BCCI's 1989 financial statements. Possibly fearing that a qualified opinion would prompt a run on BCCI and undermine confidence in the banking system, UK regulators wanted the 1989 BCCI accounts [to] be published with an unqualified audit opinion and the Abu Dhabi guarantees made this possible (Bingham, 1992, p. 82). In fielding public criticisms, Price

Waterhouse continued to defend their decision to sign the accounts by arguing that the Bank of England and Luxembourg regulators had been informed and wanted BCCI to continue operations, the auditors believed the extent of fraud was limited, the royal house of Abu Dhabi had agreed to recapitalize the bank, and the audit report disclosed that the auditor's opinion was based on guarantees provided by Abu Dhabi (US Senate, 1992b, p. 275).

The US Congressional investigators, however, were severely critical of Price Waterhouse's decision to sign the accounts and accused the auditors of collaborating with bank regulators to deceive the public. According to the Congressional report (US Senate, 1992b, p. 276) on the BCCI affair:

'By agreement, Price Waterhouse, Abu Dhabi, BCCI and the Bank of England had in effect agreed upon a plan in which they would each keep the true state of affairs at BCCI secret in return for cooperation with one another in trying to restructure the bank to avoid a catastrophic multi-billion dollar collapse. Thus to some extent, from April 1990 forward, BCCI's British auditors, Abu Dhabi owners, and British regulators, had now become BCCI's partners, not in crime, but in cover up.'

The resulting report (hereafter the Bingham Report) was based on written and oral evidence from over 200 witnesses, including the Institute of Chartered Accountants in England & Wales (ICAEW). In the course of the inquiry, the issue of whether auditors should have a 'duty' as opposed to a 'right' to report to regulators was revisited (also see Mitchell, 1991). In its evidence (written and oral), the ICAEW defended the status-quo and opposed the need for auditors to have a statutory 'duty' to report fraud and irregularities to the regulators. But, Lord Justice Bingham rejected the ICAEW's case and recommended that a statutory duty to report fraud to regulators be imposed upon auditors. Subsequently, the government legislated (Hansard, 6 November 1992, cols. 523-594) and a 'duty' to report fraud and irregularities was imposed on auditors of all financial sectors, including banks, insurance companies, financial services, pension funds. (Hansard, 15 February 1994, cols. 852-875; Auditing Practices Board, 1994; Sikka et al, 1998)".

*International standardisation*

24. *Rapid globalisation of world markets has changed the way in which corporations worldwide do business and has created a greater degree of interdependence amongst countries. This process has resulted in the need for countries to harmonise laws, regulations and standards, which South Africa has actively been pursuing since its reintroduction to world markets.*

25. *The audit of financial statements is well defined and understood by knowledgeable users or financial statements, and follows the same process in all Anglo Saxon countries.*

*Implementation of the proposal would cause the audit function and its incumbent risks in South Africa to be different from that which is well understood and already defined in international auditing standards.*

**The Commission's proposal does not impact on the normal audit function. The proposal relates to special purpose audits. The only impact it could have would be to enhance an honest and efficient main audit. This, surely, should be an aim of SAICA.**

*Conclusions drawn in the paper*

26. *Paragraph 3.4 makes statements as to how certain collapses could have been prevented. Although we are not in a position to comment on the detail of the examples cited, we do believe that they are speculative and one cannot say with any certainty that if the proposal had been implemented, loss to the various stakeholder groups would have been prevented.*

**There can be no doubt at all that if the holders of the debentures in the Masterbond companies had been represented by honest trustees with access to the records, no debentures would have been issued. The statement that this is mere speculation flies in the face of the factual situation, well known to the auditors at the time and subsequently to SAICA, that short-term funds were being utilized to fund long-term projects of extremely dubious value.**

**The examples which were cited are those of corporate failures which were well publicised, in which millions were lost, in which members of SAICA were involved and many of which had occurred almost ten years ago. The examples include Masterbond companies, Mykonos, Fancourt, Marina Martinique, Owen Wiggins, Cape Investment Bank and Pretoria Bank.**

**The fact that SAICA can assert that it is unaware of the details of the examples is an indication of the need for a Public Oversight Board for the profession. The Public Oversight Board will set ethical standards and discipline members of the profession when necessary.**

*Conclusion and recommendations*

*27. Although SAICA supports the objective of protecting stakeholders, we believe that it would be unrealistic and undesirable to try and achieve this solely through the audit function. However, we do believe that the presentation of reliable financial information and the statutory audit play a fundamental part in achieving this objective.*

**The Commission agrees that it would be unrealistic and undesirable to achieve the protection of stakeholders solely through the audit function. This is certainly not the intention of the proposals.**

**The intention is to create an opportunity for interest groups to satisfy themselves whether their investments are safe or at risk, and not to have to rely on the statutory audit or on the protection of regulatory authorities who might have agendas of their own or who might not have the resources or the necessary will to fulfil their functions.**

*28. In this regard we believe that the focus should be on improving the quality of financial reporting and the audit thereof in its current format. As mentioned above, we have in our previous submissions to you made recommendations on how to achieve this; however, we would like to reiterate some of the more important points here.*

**The obvious fact that improved quality of financial reporting and auditing cannot be equated with transparency, is ignored.**

**It seems to be clear that SAICA believes that the services of additional auditors conducting special purpose audits would not be of any assistance to investors.**

**The Commission has not suggested that investor protection could be achieved 'solely through the audit function'. The Commission believes that investor protection would be significantly enhanced by the appointment of interest group auditors.**

**It is not clear why SAICA takes the opposite view.**

*Legal backing for accounting standards*

29. SAICA believes that the lack of legal backing for accounting standards seriously affects the quality and consistency of information presented to shareholders and other stakeholders in corporations.

30. The status quo also inhibits the carrying out of an effective audit as auditors often have weak ground on which to qualify their audit report for non-achievement of fair presentation. Clients are able in the current framework to demonstrate that their chosen accounting policy is "generally accepted" even though it is often misleading and not supported by reputable accounting standards.

31. Steps taken by SAICA with regard to legal backing for accounting standards were covered in our previous submissions to the Commission. However, SAICA is concerned at the length of time it is taking to implement these proposals because many of the other building blocks in the system rely on this foundation stone to be effective.

**Legal backing for accounting standards is recommended by the Commission.**

*Improved standards*

32. To adapt to changing market demands, SAICA has promoted and driven a programme of harmonisation to enable South African businesses to compete on an equal footing with their competitors in other countries. The key areas of harmonisation have been accounting standards, auditing standards, the code of professional conduct and education and training standards.

33. SAICA has not only been involved in harmonising South African standards; it has also played a very effective and important role in the setting of standards in the international community. It has done this through its representation on the Council of the International Federation of Accountants and its technical committees as well as through its representation on the International Accounting Standards Committee and the International Auditing Practices Committee.

*The profession in South Africa has reached an advanced stage in harmonising its accounting and auditing standards with international standards. Being part of the international accountancy profession, the profession in South Africa has to monitor international developments and adapt its own requirements accordingly. This process of internationalisation has been operating for some years, but the main effect has been felt over the past five years. It is likely that South African auditing standards will be fully harmonised with international standards by the end of 1999 and accounting standards by the end of 2000.*

35. *Internationally, developments are taking place on further clarifying the auditor's responsibility for the detection and prevention of fraud. Once international guidance or standards have been issued on the subject, equivalent standards will be issued in South Africa.*

36. *SAICA believes that compliance with these internationally harmonised auditing standards will address many of the audit related problems highlighted in the Commission's report and paper prepared by Justice Nel.*

#### *Monitoring*

37. *To ensure that the abovementioned standards are being complied with, an appropriate monitoring mechanism needs to be in place. The practice review process, which takes place under the auspices of the Public Accountants' and Auditors' Board, was instituted to carry out this monitoring function. It is now in its fifth year and every practitioner has been reviewed at least once. Remedial actions in the form of disciplinary proceedings have followed in cases where the required standards have not been met.*

38. *SAICA believes that practice reviews have resulted and continue to result in a raising or practice standards. It has also had the effect of making practitioners who cannot meet the required standards give up attest function work.*

*Over the years SAICA has made many changes to its own requirements and it has issued guidance to its members and the public on many topics. It has worked with its members, the regulatory authorities, government and non-government organisations to find solutions. As was the case with its previous submissions to the Commission, SAICA is willing to work with the Commission to find a workable solution to the problems identified in the paper."*

.....

**13.22** The **Association for the Advancement of Black Accountants (ABASA)** listed what they regard as the positive aspects of the proposals by the Commission -

- improved regulation and levels of morality in a country beset with white-collar crime;
- an opportunity to develop new lines of business for the auditing profession;
- more opportunity to develop financial skills and thus from ABASA's point of view, black accountants in South Africa;
- improved credibility of South African financial reporting within the international business community.

**13.23** **ABASA** also expressed concern about possible cost implications, confidentiality and the definition of stakeholder groups.

These concerns have been dealt with in the comments on the SAICA document.

**13.24** **ABASA** is also of the view that a number of other matters should be considered, namely

"Regulation of additional auditors. How will, *inter alia*, required skill levels be ensured?

Resolving conflicts of interest between various stakeholders and defining the criteria and circumstances for appointment of additional auditors (differentiating between genuine concern vs witch-hunts and frivolous actions).

Relationship between the statutory auditor and additional auditor. For example, how will conflicting findings be dealt with? When will the 'responsibility' to report pass from the auditor to the additional auditor? Who will be liable when there is supposed failure by both auditors and there is a business failure that was not reported on in time?

Affordability to South Africa in terms of time requirements of skilled individuals which could be used elsewhere for the overall good of the country. Are current avenues of reporting, with a few modifications, not sufficient? As a developing nation, can we afford this additional regulation, which developed nations do not have?

Will the proposal address the current concerns regarding investor protection and will responsibility for investor protection now rest with various stakeholders themselves? Or if in the case of business failure and losses in the future, will responsibility now rest with additional auditors, which does not really address the issue?"

**The necessary skill levels must be ensured by the profession. The trustees for the various interest groups will be financial institutions and should not have any reason to institute witch-hunts or frivolous actions.**

**The possibility of conflicting views between auditors is not something new and in fact could only result in a more objective auditing and reporting process (current avenues of reporting are demonstrably not successful) and additional costs will be more than off-set by the saving of the enormous losses which are suffered under the present system.**

**Protection will not be the responsibility of the various stakeholders themselves. The proposals envisage an opportunity to enhance their protection.**

**13.25 ABASA concluded as follows:**

"Based on the above, we believe that:

1. The responsibility for fair presentation of financial statements is and should continue to be management's responsibility. However, the auditor has a specific duty to ensure that financial statements are fairly presented.
2. The responsibility for investor protection and for the detection of possible business failure cannot and should not be the responsibility of the financial auditor. Investors themselves should show more vigilance when appointing and evaluating their appointed officers. Directors should also not be allowed to hire, fire and pay auditors - this should be the responsibility of a shareholders committee. The effectiveness of audit committees in South Africa can be questioned. The current shortcomings need to be addressed through improved corporate governance in South Africa and the role and responsibility of directors need to be reconsidered. The South African investing public also needs to be educated.
3. The King code addresses many of the requirements of good corporate governance. We believe that consideration should be given to possibly regulating the King code.
4. We believe that the current South African Companies Act is out of date and requires some serious attention in order to get it up to date and in line with internationally accepted standards. For example, it is a criminal offence to lie to the external auditors in the UK and Malaysia, which it is not in South Africa. The profession has for a long time been

asking for legal backing but this process has been delayed, for a number of reasons.

5. We recognise that the regulatory framework for accountants and auditors needs to be improved and our suggestions to this effect are contained in our submission to the NACF.
6. We are in principle in agreement with the appointment of additional auditors, however, there are certain practicalities listed above, which has to be addressed, some of which are fairly fundamental to making the recommendations contained in the Nel submission workable.
7. Finally, we believe that in a free market, there can never be 100% assurance and it is a matter of balance being achieved between risk and cost".

**The Commission agrees that the South African Companies Act is out of date and that a major revision should be undertaken. Such a revision could include some of the matters raised by ABASA, namely, shareholders committees, improved governance, improved audit committees and the like.**

**13.26** In addition to the reasons stated why particular interest groups should have access to the records of corporations, the provisions of the 'Promotion of Access to Information Act' No. 2 of 2000 must also be taken into account.

These provisions enable anyone who wants to exercise a right or protect a right to have access to records of the corporation.

**13.27** Section 50(1) of the Act reads as follows:

- "50. (1) A requester must be given access to any record of a private body if –
- (a) that record is required for the exercise or protection of any rights;
  - (b) that person complies with the procedural requirements in this Act relating to a request for access to that record; and
  - (c) access to that record is not refused in terms of any ground for refusal contemplated in Chapter 4 of this Part".

**13.28** Section 68(1) which lists some grounds for refusing access to commercial information reads as follows:

- "68.(1) Subject to subsection (2), the head of a private body may refuse a request for access to a record of the body if the record –
- (a) contains trade secrets of the private body;
  - (b) contains financial, commercial, scientific or technical information, other than trade secrets, of the private body, the disclosure of which would be likely to cause harm to the commercial or financial interests of the body;
  - (c) contains information, the disclosure of which could reasonably be expected –
    - (i) to put the private body at a disadvantage in contractual or other negotiations; or
    - (ii) to prejudice the body in commercial competition;or

- (d) is a computer program, as defined in section 1(1) of the Copyright Act, 1978 (Act No.98 of 1978), owned by the private body, except insofar as it is required to give access to a record to which access is granted in terms of this Act".

**13.29** Structural access to the records as recommended by the Commission, would be far superior to the random access envisaged by the Act.

**13.30** It is recommended that the following interest groups should have access to the records of corporations

- minority ordinary shareholders, see Chapter 11;
- holders of debentures, see Chapter 12;
- depositors in banks and other financial institutions;
- contributors to pension and provident funds;
- the assured of long-term insurance companies;
- owners of time-share;
- members of medical societies;
- investors in participation bond schemes;
- holders of non-voting shares;
- holders of preferent shares.

**13.31 It is recommended that the access should be exercised by means of trustees to be appointed with the powers and in accordance with the procedure set out in Chapter 12.**

**13.32 It is also recommended that at times of wage negotiations or retrenchments, auditors appointed by recognised trade unions should have access to the records of the corporations.**

.....

## NOTES

1. **See Chapter 3.**
2. **Professor I H Mac Gregor** : 'Corporate Financial Reporting : Past, Present and Future' (University of the Witwatersrand 1982) identified the potential users of published annual financial statements as likely to include
  - owners;
  - lenders;
  - suppliers of goods and services;;
  - potential investors;
  - lenders and creditors;
  - bankers;
  - employees;
  - management;
  - customers;
  - financial analysts;
  - stock brokers;
  - underwriters;
  - financial journalists;
  - taxation authorities;
  - trade unions;
  - the general public.
3. **Ibid.**
4. **United States.** American Institute of Certified Public Accountants.  
The Commission on Auditors' Responsibilities: Report. Conclusions and Recommendations (Cohen). 1978.  
**Australia.** Society of Certified Practising Accountants and The Institute of Chartered Accountants in Australia - A Research study on financial Reporting and Auditing - Bridging the Expectation Gap. 1994.  
**New Zealand.** Brenda Porter. An Empirical Study of the Audit Expectation Performance Gap. 1993.  
**Republic of South Africa.** J.D. Gloeck - The Expectation Gap with Regard to the Auditing Profession in the Republic of South Africa. 1993.

**5. Raymond J Chambers**

**Frank L Clarke**

**Graeme W Dean**

"SUBMISSION TO THE NEL COMMISSION OF INQUIRY INTO INVESTOR PROTECTION AND EMPOWERMENT

SUMMARY

This submission responds to the Consultation Paper addressing the above issue. It should be read in conjunction with the supplementary material referred to in it, particularly *Corporate Collapse: Regulatory, Accounting and Ethical Failure*, (Clarke, Dean and Oliver, CUP, 1997) to which reference is made in the Consultation Paper, and the additional material attached, namely:

*Securities and Obscurities*; R. J. Chambers, Gower Press Australia, 1973.

*Photocopies:*

*Accounting Standards Review Committee, Company Accounting Standards*, under the Chairmanship of R. J Chambers, NSW Government Printer, Sydney, 1978.

"Chaos in the Counting-House: Accounting under Scrutiny", F. L. Clarke and G. W. Dean; *Australian Journal of Corporate Law*, Vol 2 No 2 1992, pp.177-201.

"Creative Accounting, Compliance and Financial Commonsense", G. W. Dean and F. L. Clarke; *Australian Journal of Corporate Law*, 378 7 (1997), pp.366-386.

References in parentheses of the kind (CP2.21, p.20) are to the relevant paragraphs and pages of the Consultation Paper.

The general themes of this submission are that:

- (i) investors in general and creditors in particular, can be afforded little protection so long as published the Financial Statements contain data which are not serviceable for determining the wealth and financial progress of companies and other business entities;
- (ii) the data generally emerging from the use of conventional GAAP are not serviceable;

(iii) the perception of misleading (*creative*) accounting being primarily the consequence of deviations from the prescribed Standards is in error;

(iv) the Financial statements of companies that have complied with the prescribed Standards are almost certainly equally misleading as those that have deviated from the Standards;

(v) the labeling of the variation between what the investing public expect of the products of accountants and auditors and what they receive as an *Expectation Gap* is a misnomer, it is a *Performance Gap*; and,

(vi) the general principles underlying the quality- control effected upon, and the protection of consumers in respect of, ordinary goods and services ought apply equally to the products of accounting and auditing services.

Accordingly, whereas this submission addresses the overall thrust of the Consultation Paper and the impact of the matters addressed in it, from our perspective these coalesce into issues that might be described broadly as: the function of financial statements; creative and feral accounting; the functions of auditors - the *Expectation v. the performance gap*; and, the need to reconstruct accounting practice. These are addressed below, seriatim.

#### COMMENT

##### 1. Function of financial statements

An all-pervading emphasis in the accounting literature is that accounting data are for the purposes of informing interested parties in the context of making economic decisions. This appears to have been spawned by the conceptual framework exercises in the United States, the United Kingdom and the English speaking countries whose accounting is influenced by them. A focus on decision usefulness may not be as justified as appears to be implied, nor as backed by tradition as might be presumed.

A feature of the promotion of the decision usefulness theme has been the manner in which the functions of general purpose financial statements have been considered in the context of the interests, the potential specific decisions by (an ever -increasing list of) potentially interested parties. A fuzzy logic has been employed to translate *general purpose* into a *specific purpose*, without justification. One might have expected the listing of the separate categories of parties likely to be interested in the contents of general-purpose financial statements to have sprung from evidence that general-purpose

statements do not have any function in the domain of contemporary commerce. Instead, the focus on potential individual *users* has emerged from a contestable affiliation forged between a legitimate function of general purpose statements and the unknown potential decisions by myriad potential users.

No evidence exists to the effect that the function intended by the UK 1844 Act for dated financial statements was other than to inform of the overall wealth and progress of companies. As such, the data might well have been expected to be generally relevant to the investment and other similarly financial decisions of all associated with the company or contemplating an association. Indeed, it is fair to suggest that until Geo. O May (*Financial Accounting- A Distillation of Experience*, The Macmillan Company, 1943) produced a tentative list of likely users of published financial data, it was not presumed that the specific decisions of individuals were ever intended to be serviced, except in the broadest of terms, by the contents of published financial statements. Since May (1943) the specific interests of individual categories of investors and others has increased with successive publications. The decision usefulness theme has itself been transformed from *general purpose decision usefulness to specific decision usefulness*, and implied characteristic of *generally* relevant to *specifically* relevant.

Of course, the data in general purpose financial statements cannot be expected to be specifically- relevant to the particular and idiosyncratic interests of all associated or contemplating an association with a company. To that end, the overall objective underlying the accounting provisions and financial statement requirements of the 1844 Act were promulgated on the understanding that data in a dated balance sheet ,which disclosed the wealth and progress of a company were generally relevant to virtually every financial assessment, evaluation or decision. that an interested party might make. Those data may, of course, be insufficient to satisfy all the needs of an individual interested party. Nor should they be expected to be, or it follow that published financial data could ever be so crafted.

Underlying the specific relevance push is a curious (though unstated) denial of what we know and do not know about decision making. Whereas only some parties of interest are entitled to receive a public company's financial statements directly from it, those data almost universally are in the public domain. As such it is impossible to even sensibly contemplate the myriad different specific interests of the parties or the specific decisions they might wish to make regarding their relationship or contemplated relationship with the company in question, other in the most general and broadest of terms. *Broadly*, that is, to show a company's wealth and financial progress, the nature, composition and contemporary worth of its assets; the nature, composition and amount

of its liabilities; the consequential amount and composition of the equity of its shareholders, as at the date of the statement; and the changes in those items and amounts during the period under review and the causes of those changes. Such are unequivocally of general relevance to virtually every financial decision - to invest, disinvest, lend, borrow, seek or contemplate terminating or continuing employment in, extending or contracting credit to, purchasing or otherwise doing business with - the company, though in no case might it be sufficient information.

A considerable part of the discussion (CP2.1 - 2.25) in the Consultation Paper is consistent with the general theme that the individual decisions of the specific users of financial statements ought to be serviced by published financial statements in more than a generally relevant manner. The focus on specific interest groups (CP2.1, 2.2, 2.19, 2.24) and their specific decisions are illustrative of the pervading attempts to have general purpose financial statements do what they cannot do, provide other than generally relevant information. Yet elsewhere the notion of general relevance underlies the validity of comment and exposes the futility of imagining that it would ever be possible to identify the specific information needs of every specific category of user. Jenkins (CP 2.2), for example, is noted to refer to "*People in every walk of life* are affected by business reporting, the cornerstone . . ." (emphasis added); the Gladstone Committee is noted (CP2.10) to have referred to " . . . greater security of the *public*" (emphasis added); Arthur Levitt (1998) is quoted in what we might take to be a generic reference to the panic of " . . . *investors*"; and, for example, the Cohen Commission referred to the generic "users" (CP 2.26). Point is, when it comes to discussing the failure of published financial statements to provide adequate information, in one way or another, reference is made to generic deficiencies or omissions that amount to a failure to disclose what we have labeled the wealth and financial progress of companies, and it is made in reference to the public at large. And, it ought to be noted that Jenkins somewhat acknowledged this in his Report by ultimately canvassing the possibility that different categories of users with the leverage to exercise pressure might contract or demand *negotiated disclosures* for their particular use. Of course, banks and financial institutions already do this.

A focus on specific, rather than, general relevance as the goal of published financial data draws upon the idea that individuals who make decisions regarding their association with companies can be categorised according to their common information needs. Clearly Jenkins was of that view. That necessitates subscribing to the idea that individuals or categories of them understand the process by which they make their decisions. It is as if there is a belief that decision models exist in real life, and as if the exact manner in which published financial information meshes with other information is

known. We suggest that decision-making is by far more complicated than suggested in the accounting or management literature sympathetic to accounting. Indeed, it is doubtful if anyone actually *knows* how all the information they gather meshes to prompt a particular course of action. Reflection in respect to one's own decision-making almost certainly reveals that whilst some information may take on greater significance than other information, how it meshes to move us in one direction rather than the alternatives is a mystery. Even when a particular factor is deemed to be the *decider*, why it is so deemed is problematic.

Many in commerce have been drilled in the mysteries of decision-making through recourse to illustrative decision models. Accountants' drilling in the use of NPV's to discriminate between possible alternative courses of action, is a case in point. But nobody in commerce would contemplate the use of such a process other than as a rough-and-ready tool. Nobody would deny the influence of other deliberate inputs and, more importantly, the influence of known and (we suspect) unknown subliminal inputs. How they all mesh is a mystery. That is what "gut feeling" is intended to describe! Decision-making is a mystery. Decision models are just that - mere models. No more! If it is impossible to know the decision models of user categories, and certainly not of the individuals comprising them, it is humbug to contemplate a search for financial information which might be other than generally relevant to the broad scope of decisions made in everyday commerce regarding relationships between corporations with other corporations and with individuals.

Financial statements are an *instrument* for disclosing the wealth and progress of corporations. As with other forms of instrumentation it is critical that the readings accounting gives are reasonably accurate quantitative representations of the characteristics of which they are held-out to be indicative. As such, if they are to be a general guide to commercial action and the means by which to derive reliable indications of other features of companies, the data they contain must be indicative of the financial characteristics and consequences of the items, actions or circumstances they are held-out to represent. Data which emerge from the use of conventional accounting practices drawing primarily upon input data from transactions supplemented with hypothetical data relating to physical asset amortisation, cost capitalisation, periodic amortisation of costs, consolidation of the data in the context of a presumed economic *group*, tax effect accounting, and the like, aggregated in published financial statements, cannot function as reliable financial instrumentation.

Arguably, not only- is the focus on specific relevance misguided, the data which emerge from the use of conventional accounting practices are, for the most part. not serviceable

for providing the necessary generally relevant information on the wealth and progress of companies generally- relevant to the interests of the public at large.

Conventional accounting processes are not geared to disclosing the wealth and progress of business entities. So many of the data produced through complying with GAAP (in most of its varied manifestations) are not indicative of actual amounts of money in the possession of or accessible to the entity; so many are indicative of money the entity once had in the past and has since spent on the physical assets and the like it currently has; many represent money spent for which nothing currently exists except the record of the expenditure carried forward; some are not representative of anything that currently exists, existed in the past or is likely to exist in the future - mere artifacts of the system; and still others are indicative of a balance of money spent in the past arbitrarily amortized.

It is no wonder that nobody can gain much insight of the wealth and progress of companies from the contents of published financial statements. No wonder that there is a public outcry (CP1.3). But arguably the problem arises not so much from companies' failure to comply with (deviating from) GAAP as from complying with GAAP, and not so much as from failing to disclose conventionally prepared accounting data in the published financial statements as disclosing those data that do not have any legitimate part in the representation of wealth or the assessment of financial progress.

Corporate history is replete with examples of misleading accounting data arising from compliance with the conventional rules and entrenched practices of accounting. Our enquiry in corporate failures in *Corporate Collapse . . .* (Clarke, Dean and Oliver, CUP 1997) disclosed that most of the accounting of most of the companies involved in the most celebrated of Australian failures complied with the Accounting Standards current at the time. That is, by far more of their accounting complied with the Standards than in force than deviated from them. Of course, some instances of more than questionable conduct existed. But we would argue that those companies' published financial statements would have been misleading without the impact of any deliberate intentions to mislead. And more to the point, the statements of companies that did not fail, companies whose performance has received adulation, arguably have been equally misleading entirely by virtue of compliance with the Accounting Standards in force.

A confounding issue in the discussion of creditor protection has been the literature which identifies *creative accounting* as the consequence of departure from the prescribed practices, rules or Standards. That has tended to divert attention from the inevitably misleading nature of many of the data arising from compliance. Creditors are

not protected by data which do not disclose the wealth and progress of those with whom they do business. If they do not know a company's wealth and progress, they are not in any position to decide whether to do business with it! A distinction between accounting practices undertaken with the intention to mislead and those without such an intention is more fruitful. The evidence upon which we draw suggests to us that the misleading (*creative*) data which emerge from complying with the Standards without the intention to mislead might better be labeled *creative accounting*, and the misleading data from practices with the intent to mislead are better labeled *feral accounting*.

## 2. *Creative and feral accounting*

We draw your attention to the matters discussed under this head in Chapter Two of *Corporate Collapse . . .* Attention is drawn also to the similar matters coursing through *Securities and Obscurities*. Juxtaposed, these are indicative of the persistence of misleading data arising through the prosecution over time of the conventional rules of accounting of the day. A point we would emphasise is that the creative character of conventional accounting has been a longstanding problem. As such, it is reasonable to claim that the problem of *creative accounting* is a much greater problem than the products of deliberate intent to mislead - what we have labeled *feral accounting*. In that context your attention is drawn to the matters addressed "Chaos in the Counting House . . .", (Clarke and Dean, 1992) and "Creative Accounting, . . ." (Dean and Clarke, 1998).

What we have argued is consistent with Levitt's observation (CP2.22, p.21). How can data be *meaningful disclosure* unless (as Levitt puts it ) it show *where it has been, where it is?* And how can data show *where [a company]* is financially, unless the data are indicative of the money's worth of the assets it has and the actual money's worth of its liabilities. There is no room for data that do not relate to actual amounts of money, or its equivalent to which the company has access or the actual amounts it owes. There is no place for data indicating the prices paid for assets acquired in the past - money long gone, no place for imputed data for goodwill arising as the balance between the amounts attributed to net assets acquired and the price paid for them, no place for imputed tax-effect accounting debits or credits, no place for capitalised expenses, no place for accruals based upon time rather than upon recoverable or payable amounts, no place for arbitrary amortisation charge unrelated to the actual *de pretium*, no place for the artifacts of consolidation accounting, and the like. Yet all of those are the everyday fare of the application of conventional forms of GAAP.

It is worth contemplating whether the creditors, shareholders and other stakeholders aggrieved when companies fail would ever calculate their own financial position, *where*

*they are*, with many, of the data of the kind found in conventional marine statements and balance sheets. Nobody would assess their financial position by recourse to amounts of money they once had, but have no more. Nor would they bring into calculation numbers that they know are not indicative of money to which they have access directly, or by virtue of what they know of the prices for which items could be sold. It is inconceivable that anybody would count as an amount owing by them, something they knew not to be. Must GAAP imply that they would! And certainly require accountants to do so in respect of the affairs of public companies.

We would question Levitt's implied plea that published financial statements might reasonably show *where [a company] is going*. Nobody knows the future. It cannot be presented in dated financial statements. But prediction depends upon an accurate knowledge of the past and of the present position. Balance Sheets certainly could and should be constructed to reveal a good representation of the latter. Indeed, the future cannot be predicted unless the present position is known, for every future position is a departure from the present.

We suspect that a considerable part of the mythical nature of accounting data arises from the focus on the unknown processes of decision-making. Apart from the commonsense proposition that accurate data might be expected to be more useful than the inaccurate, for most purposes no real mapping is possible. That is partly why many supporters of the *status quo* are able to claim that conventional accounting *works* and draw upon the success of companies over very long periods using it.

In contrast, it is unequivocal that many of the data emerging from compliance with the conventional GAAP in most countries are not serviceable for deriving most of the indicators (solvency, rate of return, debt to equity, asset backing, earnings per share, return on total assets, capacity to pledge assets as security, for borrowing, conformity with borrowing covenants), that are the salient financial characteristics of companies. We return to this below.

### 3. Function of auditors

Whereas the function of auditing may have changed as Porter (CP2.17) points out and notwithstanding the confusion as to the extent to which auditors ought to detect fraud, it is unequivocal that a clean auditors' report is taken (and expected to be taken) to add credibility- to the contents of published financial statements. Various semantical rules and other tactics have been employed to soften the auditor's role. But, unless the

auditor's role is to check the accuracy and declare the credibility, or otherwise of the financial statements, audit fees are money wasted.

It has to be acknowledged, however, that auditors are placed in an invidious position. In most settings they are now required to form their opinion regarding the veracity of the financial statements within a framework implying that compliance with GAAP will, *prime facie*, lead to *true and fair* accounts (or something of equivalent meaning). Auditors are thus in a no win situation. The inherent defects addressed in the previous section in most GAAP specifications mean that auditors are *damned if they do, and damned if they don't* ! Reporting GAAP compliant accounts to be true and fair entails them engaging in declaring what is almost certainly false, and permitting departure from GAAP without qualification exposes them to the risks attaching to deviating from the rules of their profession and, in Australia for example, the dictates of the Corporations Law. We discuss this situation in *Corporate Collapse . . .* (1997, pp232-260) in respect to the uncomfortable position of accountants in general.

Not much written about the supposed *Expectations Gap* points to remedying the situation in a manner that promotes the dissemination of financial information more serviceable than currently exists. From our perspective the Sikka, Puxty, Willmott and Cooper discussion (CP2.27, pp23-27) of the underlying reasons for the Gap misses the messenger more than the message. True, a considerable part of the literature has addressed the Gap *in terms of others' ignorance* (CP2.27, p.25). Education of the *laity* has been the preferred remedy. The Australian profession, for example, suggested that the position would be resolved by educating the general public to understand that what they expected was not what they would get (Australian Society of Certified Practising Accountants and The Institute of Chartered Accountants in Australia, *A Research Study on Financial Reporting and Auditing - Bridging the Expectation Gap*. ASCPA and ICAA, Melbourne 1993). Sikka, Puxty, Willmott and Cooper identify a *systematic nature of the gap*, presumably as a social problem. Possibly it is. But analyses of the manner in which the Gap survives does nothing to expose the major cause of it.

In reality the public is neither ignorant nor confused in their understanding of the role of auditors according to the history of their craft. The general public is absolutely correct in their understanding of what it is reasonable to expect from auditors. It may, be more to the point to declare that the auditing profession is ignorant of what their historical professional responsibilities are and the continuing relevance of them in today's commercial environment. Most commentators do not see it that way (as the Porter, and the Sikka, Puxty., Willmott and Cooper discussions expose). In many respects the

failure to grasp the underlying essence of the problem means that most commentaries on the Expectation Gap do more to perpetuate than remove it.

At the heart of the problem is that the public at large expects that auditors are able to form reliable opinions on the truth and fairness of the financial statements - and the truth is that auditors cannot do so within the framework in which auditors are required to work. The public in general is entitled to its expectation. The history and tradition framing the development of auditing supports the public's expectation. The recent history of auditors' performance, does not. The legislature' and the profession's obligation is to create the circumstances in which auditors can do what is reasonably expected of them and what is their rightful role and function. Only then can creditors' rights be protected as part of everyday commercial intercourse.

That necessitates that the accounting produces data that are serviceable for showing the wealth and progress of companies and from which their salient financial characteristics can be derived.

With that in place little would be served by having different auditors appointed by different stakeholder groups. In contrast, appointment of special auditors to serve the needs of particular stakeholder groups would achieve little were the general serviceability of the content of published financial to remain as it is.

#### 4. A reconstruction of accounting?

A primary thrust of our argument here, and in the materials attached to this submission and our *Corporate Collapse* . . . (cited in the Consultation Paper), is that accounting needs to be reconstructed with a view to the data emerging being serviceable for determining the wealth and progress of companies and for deriving their various financial characteristics.

Whereas neither the actual decisions made by myriad stakeholders in companies can be known (except in the broadest generic sense of *invest* and *disinvest*), nor how they are made, there is considerable evidence regarding particular habitual uses made of published financial data. It is incontestable also that data are extracted from the published income statements and balance sheets of companies to derive assessments of solvency, rate of return, asset backing, earnings per share, return on total assets, debt to equity, and the like. How those indicators are meshed with the other information that impacts decision-making is the mystery discussed earlier. But it is beyond dispute that such assessments and calculations are made habitually, widely published and, indeed, the outcomes traded commercially. Of what each is to be taken to be indicative is also

beyond dispute - clearly, defined financial characteristics of the company. Whilst how best to assess solvency is debatable, no informed person would deny that the notion refers to the capacity to pay debts; no such person would deny that rate-of-return refers to the rate of increase in the entity's net wealth, that asset backing refers to the proportional money's worth of asset cover for each voting share, that earnings per share refers to the proportion of income attributable to each ordinary share, and the like. Nor would an informed person dispute that each of those indicators refers unequivocally to a *financial* characteristic incapable of meaningful assessment or calculation unless the data are indicative of either actual money or money's worth possessed by the entity or actually owing by it. There is no place, no role, and no serviceable function for data that are mere artifacts of the double entry system.

Above we argued that a focus on users in the decision-usefulness framework tended to misdirect attention from the inherent generic defects of conventional accounting and encouraged suggestions that the needs of individual user groups be considered. In many respects those misdirections have tended to imply that general-purpose financial statements of the kind envisaged in the 1844 Act and pursued since in corporate laws framed in the British tradition currently serve little purpose. A change in focus from users to *uses* places general-purpose financial statements in a setting in which the necessary characteristics of the data they contain are unequivocal. Unequivocal also is the role of auditors, one they reasonably can fulfill and accord with what is expected of them. The Expectations Gap would not exist. There would not be any excuse for a Performance Gap.

There is no good reason why accounting data ought not satisfy the same general serviceability criterion commonly applied to all other goods and services. In the general run of consumer law there is no argument that goods and services are to be of merchantable quality, fit for use, *serviceable* in the ordinary uses habitually made of them. Whilst this argument is put elsewhere in our work (it underpins the general thrust of the Report of the Committee of Enquiry in Accounting Standards [Chambers, et al. 1978]; the argument in "Chaos in the Counting-house, . . .", [Clarke and Dean, 1993]; "Creative Accounting. . . . .", [Dean and Clarke, 1998]; Chapters 2, 15, 16, 17 and 18 of *Corporate Collapse* . . . [Clarke, Dean and Oliver, 1997]), it is worth highlighting some of the general points upon which it rests.

No serious dispute can be put to the claim that the data from published financial statements are extracted habitually to assess the wealth and progress of companies and are subjected to mathematical manipulation to derive critical indicators of various financial characteristics of those companies. We have already argued that there also can

be little serious dispute as to what those indicators are held-out to be indicative, that each refers to a financial characteristic that can be indicated only with numbers representing actual money or its equivalent possessed or accessible by a company or owing by it. Such conditions invoke the generic characteristic of financial data *serviceability* that must be satisfied.

It is significant that the only balance sheet data from conventional accounting practice that unequivocally satisfy the serviceability criterion are the liquid items. Were accounting to be on a cash basis only, except for deliberate intent to deceive or absolute incompetence, all the data would be serviceable in the uses specified above. All the usual inter and intra-firm comparisons could be made on both static and inter-temporal bases, all the data would be homogeneous contemporary measurements of current general purchasing power, mathematical procedures could be applied to all and yield valid and interpretable products. Accounting procedures need to simulate the cash-to-cash basis as best they can. That requires only two deviations from the general framework of conventional accounting. At each period's end all the balance sheet data have to be either representing actual cash or its equivalent - cash amounts stated at their then current balances, accounts receivable and payable by the entity stated at their respective contractual amounts, and vendible physical assets stated at the prices for which they might be sold at that time in the ordinary course of business. Non-vendible physical assets make no contribution to the current financial wealth of the company at that date, though through their use they may contribute to it in the future.

Balance sheets and income statements are dated statements. The discipline imposed by being dated is that what they disclose is indicative of the present position and the changes in it since the last set of dated statements, providing a basis for diagnosis, plans for future action, and prognosis. Nobody would expect anything other than that from other than dated position statements; a dated bank statement for example does not deny, that the balance shown may well be different from what it was in the past and what it might be at some future date. Nor does a ticket from a weighing machine deny that the weight of the user might be differ at some future time, or a reading from a sphygmometer declare other than what the blood pressure is at that time. No good reason exists for published income statements and balance sheets to function in any different way - to tell it other than *how it is*.

In passing it is worth noting that the usual criticism that non-vendible physical assets must *be valuable to the firm*, and be shown in the balance sheet as such, completely misses the point of preparing dated financial statements - to assess the financial characteristics of the company *at that time*, to assess its progress *up to that time* and,

amongst other things, determine what might be possible in the future, evaluate the financial feasibility of the alternatives available to it, and the like. It also completely misses the distinction between the past and the present - capable of being *accounted* for and capable of being *audited*, and the future of which only *predictions* are possible and at that time are incapable of corroboration.

Simulation of the *cash -to-cash basis* period by period also meshes with the ultimate overall financial outcome of business activity. No matter for how long corporations operate, they commence with cash and ultimately end up with cash. Periodic financial statements are meaningfully viewed as attempts to simulate the company's successive positions at selected points in time to depict its progress through that continuum. One would imagine it commonsense to best structure accounting to best reflect the progress at the end of each period towards the ultimate outcome. That does not entail any prediction as to when the ultimate outcome will arise or what it might be.

Such a specification could presage harsh treatment for many of the rules and practices underpinning conventional GAAP. This implication is spelled out in respect to the Australian Accounting Standards in *Corporate Collapse...* and in the other papers. Most of the Standards could be scrapped and be replaced with a *general serviceability criterion* embedded in a General Quality Standard of the kind that underpins the general consumer protection movement. The 1978 Report of the Chambers Committee recommended such an approach though it did not specify it in terms of applying the general rules applicable in the consumer protection domain.

There promises to be considerable benefits for company stakeholders, accountants in general and auditors in particular, and also for regulators, from such a radical approach. The stakeholders would receive serviceable data indicative of the wealth and progress of companies. Accountants would not be at risk in the manner they are currently. Auditors could proceed to meet their traditional role without the expectations and performance gaps currently eroding their professional image and status. Regulators would have a simpler set of rules by which to effect governance over the financial affairs of corporations (see the general arguments in respect of accountants and auditors in Chapters 17 and 18 of *Corporate Collapse...*).

Importantly, appointing auditors for the separate stakeholder groups in the manner suggested in the Discussion paper would be unnecessary. Published financial statement data would be generally relevant to all, serviceable in all the uses ordinarily made of such data, the failure of which to do so in the past has prompted the multiple auditor approach. The combination of a thousand such auditors and the perpetuation of 'the

publication of data of the kind currently emerging from conventional accounting would achieve nothing - the data (many, individually and all collectively) would continue to be unserviceable in the uses ordinarily made of them.

We would argue that the case for reconstructing accounting along the lines suggested here is incontestable.

We trust that this submission assists the Commission in its important deliberations. Should there be any matter which requires elaboration we would be pleased to assist.

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Graeme W Dean - Associate Professor in Accounting, Faculty of Economics, the University of Sydney, Australia."

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# CHAPTER 14 - THE FIDUCIARY

## DUTIES OF DIRECTORS

**14.1** The South African Companies Acts followed fairly faithfully in the footsteps of the English Companies Acts.<sup>(1)</sup> One of the results is that, as in the United Kingdom, the duties of directors of South African companies have never been codified.<sup>(2)</sup> The director is said to stand in a fiduciary relationship to the company and is required to act in accordance therewith. This is a concept of the common law.

**14.2** The lack of codification has resulted in directors often not being aware of or not appreciating the extent of their duties towards the company, its shareholders and other stakeholders, and ultimately it is left to the Courts to decide whether the actions or inactions of the directors have been in accordance with their 'fiduciary' duties.

**14.3** Unfortunately, 'fiduciary duty' is not a precise concept.

"in *Bellairs v Hodnett* 1978 1 SA 1109 (A) 1130 it was said: 'Since principles of equity underlie a fiduciary duty we think that the substance of their relationship and not the form in which it was cast must be looked at in order to ascertain its existence, nature, and extent'. In *Howard v Herrigel* supra 678, Goldstone JA said that while a person who accepts appointments as a director becomes a fiduciary in relation to the company and is obliged to display the utmost good faith towards the company and in his dealings on its behalf, the application of this general rule 'to any particular incumbent of the office of director must necessarily depend on the facts and circumstances of each case'. The precise content of a fiduciary's obligations depends on the powers and opportunities that he has: See *Robinson v Randfontein Estates Gold Mining Co Ltd* supra 445. Thus it has been stressed that to describe someone as a fiduciary, without more, is meaningless without further analysis: *Goldcorp Exchange Ltd* 1994 2 All ER 806 (PC).<sup>(3)</sup>

.....

Fiduciary relationships to others: It has been held that, as such, directors stand in a fiduciary relation to the company alone. Hence, as such, they owe no fiduciary duties to their company's shareholders individually, or to its creditors, or to its holding company, or to its subsidiary (at least where the subsidiary has an independent board of directors), or, where the company is a member of a group of companies, to the

group as a whole. However, the proposition that directors do not stand in a fiduciary relationship to their company's shareholders individually is no longer free from doubt, for it is accepted that this is a developing area of the law.

Certainly, the office of director does not release a person from what would otherwise be a fiduciary duty. Thus directors may place themselves in a fiduciary relationship to the shareholders individually by acting as agents for them. Furthermore, a fiduciary relationship between directors and shareholders may arise in the special circumstances of the case. Thus it may arise where the company is closely held and participation in the company is premised upon a relationship of mutual confidence and trust. Indeed, in the special circumstances of the case, directors may owe fiduciary duties to the shareholders even when existing powers conferred on the board by the company's articles of association. Of course, the duties arising from such fiduciary relationships depend on the circumstances giving rise to them, and they are inevitably of a more limited nature than those imposed on the directors by virtue of their fiduciary relationships to the company. Usually, they do not more than impose a duty on directors to make full disclosure of all relevant facts concerning the company's affairs when negotiating with the shareholders to purchase their shares.

While *Percival v Wright* has long been regarded as authority for the proposition that directors owe fiduciary duties to their company alone, it has been pointed out that the case is in truth very doubtful authority for that proposition: *Coleman v Myers* 1977 2 NZLR 225 CA (NZ); *Sage Holdings Ltd v The Unisec Group Ltd* 1982 1 SA 337 (W) 366; *Re Chez Nico (Restaurants) Ltd* 1992 BCLC 192 208; *Glandon Pty Ltd v Strata Consolidated Pty Ltd* (1993) 11 ACSR 543 CA (NSW). In *Sage Holdings Ltd v The Unisec Group Ltd* supra 366, Goldstone J expressed the view that *Percival v Wright* supra ought not to be interpreted so widely as to absolve directors from all responsibility towards a buyer or seller of shares when directors themselves trade in those shares"<sup>(4)</sup>

**14.4** In England, formulation of the standard of the duty of care owed by a director to the company started to evolve during the latter half of the 19<sup>th</sup> century. Some of the then leading judgments exonerated directors in circumstances where the assets of companies had been plundered and where investors had been defrauded by the most blatant of lies in prospectuses and the like.

**14.5** The meagre standard of care which was required of directors is illustrated by *Re Cardiff Savings Bank* [1892] 2 Ch 100, where an action for damages against the Marquis of

Bute, who was appointed bank president at the age of six months and attended only one meeting of the board in 39 years, was unsuccessful.

**14.6** This so-called 'traditional view' of the required standard of care is slowly being replaced by a stricter view of the duties expected of directors.

"In *Bishopsgate Investment Management Ltd (in liq) v Maxwell Hoffman* LJ suggested, obiter, that the time may now have come for a more objective approach:

[I]n the older cases the duty of a director to participate in the management of a company is stated in very undemanding terms. The law may be evolving in response to changes in public attitudes to corporate governance.... Even so, the existence of a duty to participate must depend upon how the particular business is organised and the part which the director could be reasonably expected to play".<sup>(5)</sup>

**14.7** These 'undemanding terms' referred to by Hoffman LJ are in contrast to the duty of care imposed in other jurisdictions. As an example, the contrast between the standard of care required from directors in the United States and their counterparts in the United Kingdom, is illustrated by **Henn and Alexander**:

"324. Persons who accept directorships as 'accommodation' or 'dummy' directors, or as sinecures for lending their prestige to boards of directors, are liable for any corporate losses resulting from their passive, as well as active, negligence.

(3). The name 'guinea-pig' was applied to English directors under the older practice of their being paid in guineas. Their function was to add an appearance of respectability to the board by lending it their names or titles. L. Gower, *The Principles of Modern Company Law* 139, n. 1 (3d ed. 1969).

See 80 *Time*, No. 14, 96 (Oct. 5, 1962): 'In Britain, where a company's list of directors often reads like a tear sheet from Burke's Peerage, many a titled tycoon sits on more boards than he can count. Lord Boothby, 62, a longtime Tory backbencher who is one of this happy breed himself (he has 'eight or nine' directorships), explained last

week just what directors do in return for adding prestige to corporate letterheads. 'No effort of any kind is called for', he told an audience of Yorkshire club-women. 'You go to a meeting once a month in a car supplied by the company. You look both grave and sage, and on two occasions say 'I agree," say "I don't think so' once, and if all goes well, you get £1,440 a year. If you have five of them, it is total heaven, like having a permanent hot bath' ".<sup>(6)</sup>

#### 14.8 Another example is the standard of the duty of care required from directors in California.

"On its face, the standard of careful conduct is fairly demanding. This is particularly true of the element of prudence or reasonability. For example, in *San Leandro Canning Co. v. Perillo*, the court said that '[the directors] were bound to exercise *that degree of care which men of common prudence take of their own concerns...*' In *Burt v. Irvine Co.*, the court, quoting other authority said:

'The rule exempting officers of corporations from liability for mere mistakes and errors of judgment does not apply where the loss is the result of failure to exercise proper care, skill and diligence. 'Directors are not merely bound to be honest; they must also be diligent and careful in performing the duties they have undertaken. *They cannot excuse imprudence* on the ground of their ignorance or inexperience, or the honesty of their intentions; and, if they commit an error or judgment through mere recklessness, or *want of ordinary prudence* and skill, the corporation may hold them responsible for the consequences". [237 Cal. App. 2d 828, 852, 47 Cal. Rptr. 392, 407-08 (1965)] <sup>(7)</sup>

14.9 Generally speaking, the South African Companies Act is in dire need of modernization. However, it seems that without leadership emanating from UK sources, revision and modernization seldom occur.

14.10 The urgency with which modernization of company law has been approached in jurisdictions such as **Australia, Canada, Hong Kong, New Zealand** and the **United States**, is not discernible in the **United Kingdom** or in **South Africa**.

**14.11** A rather unusual illustration of this sense of urgency is the contents of the 'emergency clause' in the **Business Corporation Act of Texas** (article 11.0.1).

"Art. 11.01. Emergency Clause.

A. The fact that existing laws of the State of Texas have been amended from time to time over a period of some seventy (70) years and more without any adoption meanwhile of a complete Act relating to business corporations generally, the provisions of which are consistent with one another; the fact that with so many amendments of the corporation laws applicable to business corporations generally over so many years there have developed many uncertainties in the corporation laws of this State and with the result that there is now an imperative need for clarification of certain provisions of the existing laws; the fact that all of the other states than Texas in which large and important business is transacted have adopted in recent years modern corporation laws and with the result that Texas citizens are increasingly prone to organize their corporate ventures under the laws of other states than the laws of Texas because Texas does not have such a modern act; and the fact that Texas in such connection is losing a substantial volume of corporate enterprise which it should otherwise gain from and after the time that a modern business corporation Act becomes effective in Texas and is losing tax income from *ad valorem taxes*, filing fees and otherwise meanwhile; all such facts create an emergency and public necessity that the Constitutional Rule requiring bills to be read on three separate days in each House be suspended and said Rule is hereby suspended; and require that this Act take effect and be in force from and after the date of its enactment, and it is so enacted".

**14.12** The late Professor Gower posed the question whether the **United Kingdom** Company Law which had evolved in the 19<sup>th</sup> century had adapted itself adequately to the needs of the 20<sup>th</sup> and the likely challenges of the 21<sup>st</sup>. He suggested that it had not, and stated that

"Our system of Company Law was, until recently, the model widely followed in the Common Law countries. That leading role has now been taken over by the United States and we cannot hope to recover it".<sup>(8)</sup>

**14.13** The lack of urgency to revise company law in the United Kingdom and the lack of adaptation to modern needs are illustrated by the century-long debate in the UK as to whether or not the duties of directors and officers of companies should be codified.

- In **1896** the **Davey Committee** recommended that the Companies Act be amended to provide that a director owed a duty to his company to exercise reasonable care and skill, and proposed the following clause:

"10(2) Every director shall be under an obligation to the company to use reasonable care and prudence in the exercise of his powers, and shall be liable to compensate the company for any damage incurred by reason of neglect to use such care and prudence".

The recommendation was not accepted.

- In **1926** the **Greene Committee** concluded that
  - "to attempt by statute to define the duties of directors would be a hopeless task".
- In **1962** the **Jenkins Committee** recommended a non-exhaustive statement of directors' fiduciary duties.
- In **1973** clause 52 was introduced in the Companies Bill to give effect to the recommendation.

- "(1) A director of a company shall observe the utmost good faith towards the company in any transaction with it or on its behalf and shall act honestly in the exercise of the powers and the discharge of the duties of his office.
- (2) A director of a company shall not make use of any money or other property of the company, or of any information acquired by him by virtue of his position as a director or other officer of the company, to gain directly or indirectly an improper advantage for himself at the expense of the company.
- (3) A director of a company who, by any breach of subsection (1) and (2) above, makes a profit or inflicts any damage on the company shall be liable to account to the company for the profit or to compensate it for the damage.
- (4) This section is without prejudice to any other provision of the Companies Acts and to any rule of law with respect to the duties or liabilities of directors".

The Bill was not enacted.

- In **1978** codification of directors' duties were once again attempted by the insertion of clauses 44 and 45 in the Companies Bill 1978:

"44. (1) A director of a company shall observe the utmost good faith towards the company in any transaction with it or on its behalf and owes a duty to the company to act honestly in the exercise of the powers and the discharge of the duties of his office.

(2) A director of a company shall not do anything or omit to do anything if the doing of that thing or the omission to do it, as the case may be, gives rise to a conflict, or might reasonably be expected to give rise to a conflict, between his private interests and the duties of his office.

45. (1) In the exercise of the powers and the discharge of the duties of his office in circumstances of any description, a director of a company owes a duty to the company to exercise such care and diligence as could reasonably be expected of a reasonably prudent person in circumstances of that description and to exercise such skill as may reasonably be expected of a person of his knowledge and experience.

(2) Subsection (1) above shall have effect instead of the rules of law stating the duties of care and diligence and of skill owed by a director of a company to the company".

The Bill was not enacted.<sup>(9)</sup>

**14.14** In 1998, in the latest attempt, the **Scottish Law Commission** issued the **Consultation Paper 'Company Directors : Regulating Conflicts of Interests and Formulating a Statement of Duties'**.

**14.15** In paragraph 14.8 of the Paper the Commission stated the main advantages of a statutory statement of the director's duty of care to the company –

- " – it makes the law more consistent;
- it makes the law more certain;
- it makes the law more accessible, particularly to lay people : they have less need to have the law mediated for them through professionals;
- it makes the law more comprehensible".

**14.16** Unfortunately, the Commission was eventually swayed by the fact that most of the respondents had not been in favour of full

codification and the Commission reported as follows in its Report published in September 1999:

"The law governing directors' duties is dynamic. It continues to develop. For example, the courts have recently had to determine the duties of a director who has resigned, but who then uses commercial opportunities connected with the company's business for his own benefit. They have also considered the duties which directors owe when there are groups or classes of shareholders whose interests conflict. We expect that the law will need to continue to evolve incrementally as circumstances require. The commercial context is constantly changing. It is important that the law retains the capacity to develop".

It proceeded to recommend that —

- "(1) there should be a statutory statement of a director's main fiduciary duties and his duty of care and skill, being those duties which are set out in Appendix A;
- (3) the statement should so far as possible be drafted in broad and general language as in Appendix A; and
- (4) it should not be exhaustive i.e. it should state that a director is subject to other duties which have not been codified.

We recommend that Forms 10(2) and 288a should contain the statutory statement of duties and that when a director signs the Forms he should acknowledge that he has read this statement".

Appendix A reads as follows:

**"General**

- (1) The law imposes duties on directors. If a person does not comply with his duties as a director he may be liable to civil or criminal proceedings and he may be disqualified from acting as a director.

- (2) Set out below there is a summary of the main duties of a director to his company. It is not a complete statement of a director's duties, and the law may change anyway. If a person is not clear about his duties as a director in any situation he should seek advice.

### **Loyalty**

- (3) A director must act in good faith in what he considers to be the interests of the company.

### **Obedience**

- (4) A director must act in accordance with the company's constitution (such as the articles of association) and must exercise his powers only for the purposes allowed by law.

### **No secret profits**

- (5) A director must not use the company's property, information or opportunities for his own or anyone else's benefit unless he is allowed to by the company's constitution or the use has been disclosed to the company in general meeting and the company has consented to it.

### **Independence**

- (6) A director must not agree to restrict his power to exercise an independent judgment.. But if he considers in good faith that it is in the interests of the company for a transaction to be entered into and carried into effect, he may restrict his power to exercise an independent judgment by agreeing to act in a particular way to achieve this.

### **Conflict of interest**

- (7) If there is a conflict between an interest or duty of a director and an interest of the company in any transaction, he must account to the company for any benefit he receives from the transaction. This applies

whether or not the company sets aside the transaction. But he does not have to account for the benefit if he is allowed to have the interest or duty by the company's constitution or the interest or duty has been disclosed to and approved by the company in general.

#### **Care, skill and diligence**

- (8) A director owes the company a duty to exercise the care, skill and diligence which would be exercised in the same circumstances by a reasonable person having both –
- (a) the knowledge and experience that may reasonably be expected of a person in the same position as the director, and
  - (b) the knowledge and experience which the director has.

#### **Interests of employees etc.**

- (9) A director must have regard to the interests of the company's employees in general and its members.

#### **Fairness**

- (10) A director must act fairly as between different members.

#### **Effect of this statement**

- (11) The law stating the duties of directors is not affected by this statement or by the fact that, by signing this document, a director acknowledges that he has read the statement".

**14.17** The reasonable and logical response to the Consultation Paper by the international accountants KPMG remained unanswered.

"They asked how directors and others are expected to understand and comply with the law if experts could not reach agreement about it".

**14.18** Whilst the **United Kingdom** has been procrastinating for more than a 100 years, numerous countries and numerous States of the USA have codified or have partly codified the duties of their directors.

**14.19** Some of these countries are –

<b>Antigua</b>	<b>Italy</b>
<b>Argentina</b>	<b>Japan</b>
<b>Australia</b>	<b>Jersey</b>
<b>Austria</b>	<b>Liberia</b>
<b>Bahama Islands</b>	<b>Malaysia</b>
<b>Barbados</b>	<b>Mauritius</b>
<b>Bermuda</b>	<b>Nauru</b>
<b>Bolivia</b>	<b>New Zealand</b>
<b>Brazil</b>	<b>Peru</b>
<b>British Virgin Islands</b>	<b>Puerto Rico</b>
<b>Canada</b>	<b>Seychelles</b>
<b>Chile</b>	<b>Singapore</b>
<b>Costa Rica</b>	<b>Spain</b>
<b>Ethiopia</b>	<b>Switzerland</b>
<b>Germany</b>	<b>St Christopher &amp; Nevis</b>
<b>Grenada</b>	<b>St Lucia</b>
<b>Ghana</b>	<b>St Vincent &amp; Grenadines</b>
<b>Guatemala</b>	<b>Western Samoa</b>
<b>Guyana</b>	<b>Yugoslavia</b>
<b>Honduras</b>	

**14.20** The formulation adopted by thirteen of these countries is that of **Canada**.

<b>Antigua</b> (s. 97)	" <b>Canada</b> s.122(1)
<b>Bahamas</b> (s. 86)	Every director and officer of a
<b>Barbados</b> (s. 95)	corporation in exercising his powers and
<b>Bermuda</b> (s. 97)	discharging his duties shall -
<b>British Virgin Islands</b> (s. 54)	act honestly and in good faith with a
<b>Canada</b> (s. 122)	view to the best interests of the
<b>Grenada</b> (s. 54)	corporation; and
<b>Guyana</b> (s. 96)	exercise the care, diligence and skill that
<b>Jersey</b> (s. 74)	a reasonably prudent person would
<b>Mauritius</b> (s. 112)	exercise in comparable
<b>St Christopher &amp; Nevis</b> (s. 74)	circumstances.
<b>St Lucia</b> (s. 97)	
<b>St Vincent &amp; Grenadines</b> (s. 97)	

**14.21** Following **section 309** of the Companies Act of the **United Kingdom, Antigua, Barbados, Guyana, St Lucia** and **St Vincent & Grenadines**, require directors, in determining what the best interests of the corporation are, to have regard to

"**Antigua** s.97

- (2) ..... the interests of the company's employees in general as well as to the interests of its shareholders;
- (3) The duty imposed by subsection (2) on the directors of a company is owed by them to the company alone; and the duty is enforceable in the same way as any other fiduciary duty owed to a company by its directors"

**St Lucia**, with the additional rider – (section 97(2))

'except that the interests of its shareholders shall in all cases prevail'.

**14.22 Section 309** of the Companies Act of the **United Kingdom** reads as follows:

**"Directors to have regard to interests of employees (Companies Act 1985)**

- (1) The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members.
- (2) Accordingly, the duty imposed by this section on the directors is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors.
- (3) This section applies to shadow directors as it does to directors".

**14.23** Many **States** of the **USA** have chosen expressions such as '**good faith**', '**in the best interests of the corporation**', '**care**' of '**an ordinary prudent person** and '**business judgment**'.

	<b>"General standards for directors.</b>
<b>Alabama</b> (10-2B-1.010)	
<b>Alaska</b> (614)	A director shall discharge his or her
<b>Arizona</b> (10-38-30)	duties as a director, including duties
<b>Arkansas</b> (4-27-30)	as a member of a committee:
<b>California</b> (309)	(1) In good faith;
<b>Colorado</b> (7-108-401)	With the care an ordinarily prudent
<b>Connecticut</b> (33-756)	person in a like position would

**Florida** (607.0830)  
**Georgia** (14.2.8.30)  
**Idaho** (30-1-830)  
**Indiana** (23-1-35-1) <sup>(10)</sup>  
**Iowa** (490.830)  
**Kentucky** (271B.8-300)  
**Maine** (13-A-716)  
**Michigan** (450-1541)  
**Minnesota** (302A.251)  
**Mississippi** (79-4-8-30)  
**Nevada** (78.138)  
**New Hampshire** (293-A18.42)  
**New Jersey** (14A:6-14)  
**New Mexico** (53-11.35)  
**New York State** (717)  
**North Carolina** (55.8.30)  
**Ohio** (1701.59)  
**Oregon** (60.357)  
**Pennsylvania** (15.1712)  
**Rhode Island** (7-1-1-33)  
**South Carolina** (33-9-300)  
**Tennessee** (14-18-30)  
**Utah** (16-10a-840)  
**Vermont** (8.30)  
**Virginia** (13.1.60)  
**Washington** (23B.08.420)  
**Wyoming** (17-16-830)

exercise under similar circumstances;  
and

In a manner the director believes to be in the best interests of the corporation.

In discharging his or her duties, a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

One or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters;

Legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or

A committee of the board of directors of which he or she is not a member if the director reasonably believes the committee merits confidence.

A director is not acting in good faith if he or she has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.

A director is not liable for any action taken as a director, or any failure to take any action, if the director performed the duties of his or her office in compliance with this section. (Alabama)

**14.24** In addition, **Connecticut** requires a director to consider -

"...in determining what (he) reasonably believes to be in the best interests of the corporation,

- (1) the long-term as well as the short-term interests of the corporation,
- (2) the interests of the shareholders, long-term as well as short-term, including the possibility that those interests may be best served by the continued independence of the corporation,
- (3) the interests of the corporation's employees, customers, creditors and suppliers, and
- (4) community and societal considerations including those of any community in which any office or other facility of the corporation is located.

A director may also in his discretion consider any other factors he reasonably considers appropriate in determining what he reasonably believes to be in the best interests of the corporation".

**14.25** In States such as **Florida, Minnesota, Mississippi, New Jersey, New York State, Ohio, Vermont** and **Wisconsin** a director -

".....**may** consider such factors as the director deems relevant, including the long-term prospects and interests of the corporation and its shareholders, and the social, economic, legal, or other effects of any action on the employees, suppliers, customers of the corporation or its subsidiaries, the communities and society in which the corporation or its subsidiaries operate, and the economy of the state and the nation".(**Florida**)

"In taking action, including, without limitation, action which may involve or relate to a change or potential change in the control of the corporation, a director **shall be entitled** to consider, without limitation,

- (1) both the long-term and the short-term interests of the corporation and its shareholders and
- (2) the effects that the corporation's actions may have in the short-term or in the long-term upon any of the following:
  - (i) the prospects for potential growth, development, productivity and profitability of the corporation;
  - (ii) the corporation's current employees;
  - (iii) the corporation's retired employees and other beneficiaries receiving or entitled to receive retirement, welfare or similar benefits from or pursuant to any plan sponsored, or agreement entered into, by the corporation;
  - (iv) the corporation's customers and creditors; and
  - (v) the ability of the corporation to provide, as a going concern, goods, services, employment opportunities and employment benefits and otherwise to contribute to the communities in which it does business.

Nothing in this paragraph shall create any duties owed by any director to any person or entity to consider or afford any particular weight to any of the foregoing or abrogate any duty of the directors, either statutory or recognized by common law or court decisions." (sec. 717) (**New York State**)

#### **14.26 In Indiana**

- "(d) A director may, in considering the best interests of a corporation, consider the effects of any action on shareholders, employees, suppliers. and customers of the corporation, and communities in

which offices or other facilities of the corporation are located, and any other factors the director considers pertinent".<sup>(10)</sup>

**14.27** Some countries use the words '**diligence**', '**loyalty**' and '**prudence**'.

<b>Argentina</b>	(s. 59)	"59. Administrators and representa-
<b>Bolivia</b>	(s. 164)	tives must perform their duties (act
<b>Peru</b>	(s. 171)	with loyalty and with the diligence
<b>Spain</b>	(s. 127)	of good businessmen (diligence, prudence and loyalty)".

**14.28** '**Honesty**' and '**reasonable diligence**' are used in the **Pacific Rim**.

<b>Malaysia</b>	(s. 132)	"132(1) A director shall at all times
<b>Nauru</b>	(s. 109)	act honestly and use reasonable
<b>Singapore</b>	(s. 157)	diligence in the discharge of the duties of his office.

(5) This section is in addition to and not in derogation of any other written law or rule of law relating to the duty or liability of directors or officers of a company".

**14.29** Requirements in some other jurisdictions are

<b>Australia</b>	(s. 180)	'...with the degree of care and diligence that a reasonable person would exercise if they:
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- (a) were a director or officer of a corporation in the corporation's circumstances; and
- (b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer'.

<b>Austria</b>		'skill and care of a conscientious manager'
<b>Brazil</b>	(s. 153)	'the care and diligence which an honest man usually employs in the administration of his own affairs'
<b>Chili</b>	(s. 41)	'care and diligence which men ordinarily employ' (in their own affairs)
<b>Costa Rica</b>	(s. 189)	'with the diligence of a mandate'
<b>Ethiopia</b>	(s. 364)	'care due from an agent', 'due care and diligence'
<b>Germany</b>	(s. 93 & 116)	'sound and conscientious business manager'
<b>Ghana</b>	(s. 203)	'fiduciary relationship, utmost good faith, faithful, diligent, careful and ordinarily skilful director'
<b>Honduras</b>	(s. 222)	'with the care demanded of a regular and prudent mercantile administration'
<b>Italy</b>	(s. 1710 & 2392)	'with the diligence of a bonus pater familias'

<b>Japan</b>	(s. 254 – 2)	'faithfully in the interests of the corporation'
<b>Liberia</b>	(s. 6.14)	'in good faith and with that degree of care which an ordinary person in a like position would use under similar circumstances'
<b>New Zealand</b>	(s. 131 & 133)	'in good faith', 'in what the director believes to be the best interests of the company' and 'for a proper purpose'  "A director of a company that is a wholly-owned subsidiary (or a subsidiary not wholly-owned [subsection 3]) may, when exercising powers or performing duties as a director, if expressly permitted to do so by the constitution of the company, act in a manner which he or she believes is in the best interests of that company's holding company even though it may not be in the best interests of the company".
<b>Puerto Rico</b>	(s. 2.03)	'prudent management'
<b>Seychelles</b>	(s.173)	'in good faith in what they reasonably consider to be the interests of the shareholders of the company as a whole'
<b>Switzerland</b>	(s. 717)	'with all necessary diligence and shall faithfully watch over all the interests of the company'

**Western Samoa** (s. 89)

'for a proper purpose honestly in what he believes are in the best interests of the international company'

**Yugoslavia** (s. 22.8)

'shall exercise a good manager's care'.

**14.30** Section 180 of the Corporations Law of **Australia** reads as follows:

*"Care and diligence – directors and other officers*

- (1) A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they
  - (a) were a director or officer of a corporation in the corporation's circumstances; and
  - (b) occupied the office held by, and had the same responsibilities within the corporation as, the director officer.

*Business judgment rule*

- (2) A director or other officer of a corporation who makes a business judgment is taken to meet the requirements of subsection (1), and their equivalent duties at common law and in equity, in respect of the judgment if they:
  - (a) make the judgment in good faith for a proper purpose; and
  - (b) do not have a material personal interest in the subject matter of the judgment
  - (c) inform themselves about the subject matter of the judgement to the extent they reasonably believe to be appropriate; and
  - (d) rationally believe that the judgment is in the best interests of the corporation.

The director's or officer's belief that the judgment is in the best interests of the corporation is a rational one unless the belief is on that no reasonable person in their position would hold.

- (3) In this section:  
*business judgment* means any decision to take or not to take action in respect of a matter relevant to the business operations of the corporation'.

**14.31** Section 189 reads as follows:

**"Reliance on information or advice provided by others**

- If:
- (a) a director relies on information, or professional or expert advice, given or prepared by:
    - (i) an employee of the corporation whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned; or
    - (ii) a professional adviser or expert in relation to matters that the director believes on reasonable grounds to be within the person's professional or expert competence; or
    - (iii) another director or officer in relation to matters within the director's or officer's authority; or
    - (iv) a committee of directors on which the director did not serve in relation to matters within the committee's authority; and
  - (b) the reliance was made:
    - (i) in good faith; and
    - (ii) after making an independent assessment of the information or advice, having regard to the director's knowledge of the corporation and the complexity of the structure and operations of the corporation; and

- (c) the reasonableness of the director's reliance on the information or advice arises in proceedings brought to determine whether a director has performed a duty under this Part or an equivalent general law duty;

the director's reliance on the information or advice is taken to be reasonable unless the contrary is proved".

**14.32** The Consultancy Report by **Professor Cally Jordan** on the '**Review of the Hong Kong Companies Ordinance**' (March 1997) recommended as follows:

"There should be a statutory statement of directors' duties to act honestly and in the best interests of the company and to exercise the care, diligence and skill that a reasonably prudent person would. These duties should also be made applicable to those corporate officers appointed by the board".

**14.33** The commentary on this recommendation is set out in the notes hereto.<sup>(11)</sup>

**14.34** Codification of the duties of directors will

- bring South African company law in line with modern trends;
- eliminate the imprecise 'fiduciary' concept;
- assist directors to appreciate the responsibilities they have to assume;
- assist investors and other stakeholders when maladministration occurs.

**14.35** It is recommended that the duties of directors should be codified as follows:

- (a) **A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve,**
  - (i) **Honestly and in good faith;**
  - (ii) **With such reasonable skill, diligence and care, including reasonable inquiry, as a reasonably prudent person in a like position would exercise under similar circumstances; and**

- (iii) In a manner the director believes to be in the best interests of the company.
- (b) A director must act fairly as between different members and between different classes of members.
- (c)
  - (i) The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general and the interests of its creditors.
  - (ii) The duties imposed by this subsection on the directors of a company are owed by them to the company alone.
- (d) In discharging his or her duties, a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:
  - (i) One or more officers or employees of the company whom the director reasonably believes to be reliable and competent in such matters;
  - (ii) Professional advisers or other experts as to matters the director reasonably believes are within the person's professional or expert competence;
  - (iii) A committee of the board of directors of which he or she is not a member if the director reasonably believes the committee merits confidence.

- (e) A director is not acting in good faith if he or she has knowledge concerning the matter in question which makes reliance otherwise permitted by subsection (c) unwarranted.**
  
- (f) (i) A former director who has confidential information regarding the business affairs of the company which has come to his knowledge or has been divulged to him during his tenure as director shall not use such information to the detriment of the company.**
  
- (ii) Such former director shall not disclose such information directly or indirectly to another person knowing or having reasonable cause to believe that such other person will use or cause such information to be used to the detriment of the company.**

## NOTES

1. See Chapter 2.
2. **In the South African Banks Act**, No. 94 of 1990, a partial codification of the duties of directors of banks has been attempted. It reads as follows:

**"60. Directors of bank or controlling company. —**

- (1) Each director of a bank or controlling company shall stand in a fiduciary relationship to the bank or controlling company, as the case may be, of which he is a director (date of commencement 9 August, 1991)..
- (2) Without derogating from the generality of the expression 'fiduciary relationship' in subsection (1), the provisions of that subsection imply that a director —
  - (a) shall, in relation to the bank or controlling company of which he is a director, act honestly and in good faith and, in particular, shall exercise such powers as he may have to manage or represent the bank or controlling company, exclusively in the best interests and for the benefit of the bank and its depositors or of the controlling company, as the case may be; and
  - (b) shall, in performance of his functions as director of such bank or controlling company, observe such guide-lines and comply with such requirements as may be prescribed under section 90(1)(b)"

The Close Corporation Act, No. 69 of 1984, reads as follows:

**"42. Fiduciary position of members.—**

- (1) Each member of a corporation shall stand in a fiduciary relationship to the corporation.

(2) Without prejudice to the generality of the expression 'fiduciary relationship', the provisions of subsection (1) imply that a member —

(a) shall in relation to the corporation act honestly and in good faith, and in particular —

(i) shall exercise such powers as he may have to manage or represent the corporation in the interest and for the benefit of the corporation; and

(ii) shall not act without or exceed the powers aforesaid; and

(b) shall avoid any material conflict between his own interests and those of the corporation, and in particular —

(i) shall not derive any personal economic benefit to which he is not entitled by reason of his membership of or service to the corporation, from the corporation or from any other person in circumstances where that benefit is obtained in conflict with the interests of the corporation;

(ii) shall notify every other member, at the earliest opportunity practicable in the circumstances, of the nature and extent of any direct or indirect material interest which he may have in any contract of the corporation; and

(iii) shall not compete in any way with the corporation in its business activities".

3. **Lawsa** First Reissue.Vol. 4. Part 2, par 116, Note 2. (Butterworths Durban 1996).

4. **Ibid.** : par. 119 and Note 7.

5. See also **The Scottish Law Commission**. Consultation Paper : p. 257 – 258.

"In the same vein, a director who failed to attend relevant board meetings, and whose credentials were those of a 'country gentleman not a skilled accountant', was held not

liable for recommending payment of a dividend from capital. In *Re Brazilian Rubber Plantations and Estates Ltd*, Neville J held that a director was

not bound to bring any special qualifications to his office and may undertake the management of a rubber company in complete ignorance of everything connected with rubber without incurring responsibility for the mistakes which may result from such ignorance.

*Re Brazilian Rubber* also laid down that if a director did bring special expertise to his office, he was bound to give the company the advantage of it and would be judged accordingly. The position on general business experience was less clear. Some cases seem to have required that a director exercise his judgment, at such board meetings as he did attend, 'as a man of business'. Others, however, required only that he exercise the skill and care of an ordinary prudent man notwithstanding other business experience.

The traditional line culminated in the case of *Re City Equitable Fire Insurance Co* where Romer J, while recognising that the authorities were not entirely clear, reviewed and summarised them. He held that:

(1) A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person with his knowledge and experience.... It is perhaps only another way of stating the same proposition to say that directors are not liable for mere errors of judgment. (2) A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings...He is not, however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able to do so. (3) In respect of all duties that, having regard to the exigencies of a business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly".

6. **Henn, Harry G. and Alexander, John R.** : 'Laws of Corporations and Other Business Enterprises', 3<sup>rd</sup> ed., p. 621 (West Publishing Co., St Paul Minn. 1983).
7. **California** Law Revision Commission. Recommendation — Business Judgment Rule, p. 39. (January 1998).
8. **Gower's** Principles of Modern Company Law : 5<sup>th</sup> ed., p. 70. (Sweet & Maxwell, London, 1992).

9. The Scottish Law Commission. **Ob. cit.** : p. 265 – 272.

10. Chapter 35 of the Indiana Code reads as follows:

"Sec. 1. (a) A director shall, based on facts then known to the director, discharge the duties as a director, including the director's duties as a member of a committee:

(1) in good faith;

(2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and

(3) in a manner the director reasonably believes to be in the best interests of the corporation.

(b) In discharging the director's duties a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(1) one (1) or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;

(2) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or

....

(4) a committee of the board of directors of which the director is not a member if the director reasonably believes the committee merits confidence.

(c) A director is not acting in good faith if the director has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.

- (d) A director may, in considering the best interests of a corporation, consider the effects of any action on shareholders, employees, suppliers, and customers of the corporation, and communities in which offices or other facilities of the corporation are located, and any other factors the director considers pertinent.
- (e) A director is not liable for any action taken as a director, or any failure to take any action, unless:
  - (1) the director has breached or failed to perform the duties of the director's office in compliance with this section; and
  - (2) the breach or failure to perform constitutes willful misconduct or recklessness.
- (f) In enacting this article, the general assembly established corporate governance rules for Indiana corporations, including in this chapter, the standards of conduct applicable to directors of Indiana corporations, and the corporate constituent groups and interests that a director may take into account in exercising the director's business judgment. The general assembly intends to reaffirm certain of these corporate governance rules to ensure that the directors of Indiana corporations, in exercising their business judgment, are not required to approve a proposed corporate action if the directors in good faith determine, after considering and weighing as they deem appropriate the effects of such action on the corporation's constituents, that such action is not in the best interests of the corporation. In making such determination, directors are not required to consider the effects of a proposed corporate action on any particular corporate constituent group or interest as a dominant or controlling factor. Without limiting the generality of the foregoing, directors are not required to render inapplicable any of the provisions of IC 23-1-43, to redeem any rights

under or to render inapplicable a shareholder rights plan pursuant to IC 23-1-26-5, or to take or decline to take any other action under this article, solely because of the effect such action might have on a proposed acquisition of control of the corporation or the amounts that might be paid to shareholders under such an acquisition. Certain judicial decisions in Delaware and other jurisdictions, which might otherwise be looked to for guidance in interpreting Indiana corporate law, including decisions relating to potential change of control transactions that impose a different or higher degree of scrutiny on actions taken by directors in response to a proposed acquisition of control of the corporation, are inconsistent with the proper application of the business judgment rule under this article. Therefore, the general assembly intends:

- (1) to reaffirm that this section allows directors the full discretion to weigh the factors enumerated in subsection (d) as they deem appropriate; and
  - (2) to protect both directors and the validity of corporate action taken by them in the good faith exercise of their business judgment after reasonable investigation.
- (g) In taking or declining to take any action, or in making or declining to make any recommendation to the shareholders of the corporation with respect to any matter, a board of directors may, in its discretion, consider both the short term and long term best interests of the corporation, taking into account, and weighing as the directors deem appropriate, the effects thereof on the corporation's shareholders and other corporate constituent groups and interests listed or described in subsection (d), as well as any other factors deemed pertinent by the directors under subsection (d). If a determination is made with respect to the foregoing with the approval of a majority of the disinterested directors of the board of directors, that determination shall conclusively be

presumed to be valid unless it can be demonstrated that the determination was not made in good faith after reasonable investigation".

11. "COMMENTARY: A statutory statement of directors' duties would have the beneficial effect of clearly setting out the standard against which actions by directors would be measured. As in other jurisdictions, there is no doubt that the long history in the case law would continue to inform the statutory language, but the statutory standard would prevail. The duties incumbent upon company directors are the product of long evolution at common law; their development was also influenced by certain equitable notions. Directors' duties may be classified into two categories: fiduciary duties and the duty of care and skill. Directors' fiduciary duties represent Equity's most significant contribution to company law; they place the directors under a fiduciary obligation to act in the best interests of the company, not to abuse or fetter their powers, and not to place themselves in situations of conflict of interest.

At common law, the duty of care incumbent upon directors was anything but onerous; in *Re Brazilian Rubber Plantations and Estates Ltd.*, Neville J. said the following:

'A director's duty has been laid down as requiring him to act with such care as is reasonably to be expected from him, having regard to his knowledge and experience. He is, I think, not bound to bring any special qualifications to his office. He may undertake the management of a rubber company in complete ignorance of everything connected with rubber, without incurring responsibility for the mistakes which may result from such ignorance; while if he is acquainted with the rubber business he must give the company the advantage of his knowledge when transacting the company's business. He is not, I think, bound to take any definite part in the conduct of the company's business, but so far as he does undertake it he must use reasonable care in its despatch.

Such reasonable care must, I think, be measured by the care an ordinary man might be expected to take in the same circumstances on his own behalf. He is clearly, I think, not responsible for

damages occasioned by errors in judgment...(Re *Brazilian Rubber Plantations and Estates*, [1911] Ch. 425 (C.A.) at 437)'.

The duty of care as it has evolved in the case law is derived from a gross negligence standard.

In counterbalance to this very low standard of care (and partly due to the historical development of the company where directors were originally seen as true trustees or fiduciaries), fiduciary duties have been imposed on directors. Initially the fiduciary duties imposed by the courts were quite strict, in keeping with the view that directors were in fact trustees. With time, and in the interests of the promotion of commerce and risk-taking enterprises, these strict fiduciary duties were relaxed by the courts. A more modern view of these new fiduciary-like duties would include some or all of the following:

- to act in good faith
- not to fetter their discretion (such as agreeing to vote in a certain way in future)
- to avoid conflicts of interest (such as interested director transactions)
- not to misuse corporate property, information, or opportunities
- not to compete with the company.

There are various statutory formulations of directors' duties but all are derived from the standard of care (essentially a negligence standard) and the fiduciary duty attributed to directors by the courts. Such formulations have become the accepted norm in company statutes. Delaware is a notable exception, relying instead on its highly specialized judiciary to formulate the standards. Until recently, it seemed that the United Kingdom was moving in the direction of statutory standards. According to the U.K. Department of Trade and Industry working group on Directors Duties, there was 'support emerging for the codification of directors' duties similar to the approach adopted in other Commonwealth countries. The DTI favours a reduced Part X coupled with a

'statement of directors' duties' (Great Britain, Department of Trade and Industry, *DTI's Programme for the Reform of Company Laws - Progress Report I* (London: Department of Trade and Industry, 11 June 1996)). A subsequent Progress Report (October 1996) indicates, however, that such an initiative has been again derailed.

The U.K. Jenkins Committee, in 1962, considered that a general statement of the basic principles underlying the fiduciary relationship of directors towards their companies would be useful to directors and others concerned with company management. The Second Report in Hong Kong in 1973 agreed and so recommended. The SCCLR has also so recommended. Efforts were made to develop a statutory formulation of directors' fiduciary duties in Hong Kong, the most recent being the Companies (Amendment) Bill 1991. The Bill was not enacted due to objections expressed in particular by the Law Society. The Law Society was of the view (among other things) that any attempt to draft a statutory formulation of directors' fiduciary duties would be incomplete and that it was better to continue with the present system where a director should consult his professional advisors whenever a question involving his fiduciary duties to the company arose. When the Bill was withdrawn, the Government encouraged the private sector to draft guidelines to better inform directors of their duties. In 1995 the Hong Kong branch of the Institute of Directors published *Guidelines for Directors* which was, in part, intended to be responsive to the need for some private sector guidelines. Of special interest in this area is the SEHK Listing Rules' Formulation of directors' duties, which demonstrates its affinity to modern statutory formulations. This is a measure which is long overdue and upon which there was considerable consensus in the working party.

There are several issues associated with the statutory formulation of directors' duties. Under the 'negligence' branch (the duty to act with care, diligence and skill), the issues are primarily the level of diligence required and the degree of objectivity of the test. There appears to be a fairly general consensus that the 'gross negligence' standard of the common law is too low and that the test should be an objective one, to this extent displacing the case law. On the other hand, setting too high a standard has been resisted on several grounds: commercial expediency and the ability to attract good business people to fill

directorships. So that although serious consideration has been given to setting a 'professional' standard and in fact encouraging the development of a professional class of directors, these efforts have not materialised. The MBCA rejects the notion of raising the standard to that of professional expertise.

The reference to 'ordinarily prudent person' embodies long traditions of the common law, in contrast to suggested standards that might call for some undefined degree of expertise, like 'ordinarily prudent businessman'. The phrase recognizes the need for innovation, essential to profit orientation, and focuses on the basic director attributes of common sense, practical wisdom, and informed judgment (MBCA, Official Comment, s.8.30 (a)).

As for the fiduciary branch of directors' duties, the main issues are the breadth of the duty owed, by whom and to whom it is owed (e.g. does it encompass individual or groups of shareholders). There is little quarrel with requiring directors to act honestly, in good faith and in the best interests of the company. Obvious issues of conflict of interests (which under traditional fiduciary standards are dealt with strictly) or duties to a third person may be addressed separately in the legislation. Although it does appear in the New Zealand legislation, care should be taken not to import the 'proper purpose' test into the standards. The 'proper purpose' test was not recommended by the New Zealand Law Commission but included in the resulting legislation at the behest of Parliament. The Law Commission in New Zealand correctly noted that the 'concept of proper purpose was originally derived from the case law on powers and today arguably there is a lack of underpinning objects against which powers could be assessed. On the other hand, recent cases seem to use 'proper purpose' to impose an objective standard where the good faith of directors is accepted' (NZLRC 9, at 119). A proper purpose test is unnecessary given the statutory statement of directors' duties proposed.

Corporate officers are included in the U.S. and Canadian formulation of both branches of the duties, in recognition of the commercial reality of managerial responsibilities. The MBCA makes the duties applicable to corporate officers with 'discretionary authority'. This recommendation suggests applying the standards to those corporate officers appointed directly by the board of

directors. Where most executive officers are also directors, as is often the case in Hong Kong, there would, in fact, be no extension of duties and liabilities.

In connection with the statutory formulation of directors' duties in the United States, there has been a recent flurry of so-called 'stakeholder' or 'constituency' statutes. These statutes widen the range of factors directors may consider in making decisions to include interests such as those of employees, suppliers, customers, the community in which the corporation is situated, and, in some cases, all other 'pertinent factors'. By 1995, twenty-nine states had enacted such provisions. However, of these, only one, Connecticut, had made these considerations mandatory; the others were worded in a permissive fashion.

The stakeholder statutes were not designed to widen the range of persons to whom directors owe fiduciary duties; none permit any of the mentioned classes to take action if boards fail to consider their interests. Rather than to cause a sea of change in corporate decision-making, these statutes were actually intended, as transcripts from state legislatures reveal, to be anti-takeover defences; in the event that none of the other legislative or corporate anti-takeover defences prevail, directors can always cite constituency concerns as reason for rejecting a hostile bid. They may also have reduced directors' potential fiduciary liability. There has been little litigation over these provisions and their effect on American corporate law has been non-existent for all practical purposes. For these reasons, stakeholder or constituency provisions are not being recommended; they are not relevant or appropriate in the Hong Kong context".