

Executive compensation

According to the King III report, which was released at the end of February 2009, companies' boards are responsible for the development of remuneration policies. However, companies' boards are now required to present the proposed remuneration policies to the companies' shareholders for approval at a general meeting, which is in line with international best practice. As with King II, a Remuneration Committee is required to make recommendations to the board regarding remuneration policies.

Internationally, the need to revisit executive compensation practices was highlighted by the collapse of the United States (US) housing market in 2007 and the ensuing credit crisis, which wreaked havoc on global markets. The crisis manifested in, amongst other things, the erosion of shareholder value, high levels of market volatility and a lack of confidence among market participants. A very specific point of contention is the role that executive compensation played in incentivising risk-taking by executives, who jockeyed the creation and marketing of complex financial instruments, as was the case with the American International Group (AIG) in the US.

These incentive structures rewarded short-term risk taking without taking into account the potential long-term effects on the company, which may have contributed to the financial crisis. The root of the problem can be traced to greed. This is a sentiment that is shared by Charlie McGreevy, Internal Market Commissioner of the European Commission (EC): "Up to now there have been too many perverse incentives in place in the financial services industry. It is neither sensible nor sane that pay incentives encourage excessive risk-taking for short-term gain."

The subsequent public outcry regarding executive compensation without due performance has highlighted serious concerns from various stakeholders in the international community. Shareholders, regulators, the media and the general public are now focusing closely on executive compensation. The challenge with executive compensation is to achieve goal congruence, i.e. aligning executive incentives with shareholder value creation, amidst the executive labour market's war for talent. As Timothy Geithner, US treasury secretary,

rightly pointed out: "Companies should seek to pay top executives in ways that are tightly aligned with the long-term value and soundness of the firm".

However, no such alignment was visible within the AIG, whose executives, despite the company's near collapse and subsequent bailout by the US government, even within the divisions responsible for the collapse, earned millions of dollars in bonuses. Although a confiscatory tax of 90% was subsequently imposed after a public outcry, many executives within the financial products division maintained that these bonuses were completely deserved.

In our own backyard, executives at Eskom were awarded bonuses to the amount of R10 million in March 2008, based on a year in which Eskom's financial bottom line dropped by 85% to R974 million, down from R6.5 billion in 2006/2007, and the South African economy was brought to its knees by relentless power outages, hardly measures that to the educated mind warrant rewards for due performance. After a public outcry, Eskom CEO, Jacob Maroga, issued a statement saying that he would not be taking a bonus. The other executives, however, accepted 50% of their allotted bonuses.

"COMPANIES SHOULD SEEK TO PAY TOP EXECUTIVES IN WAYS THAT ARE TIGHTLY ALIGNED WITH THE LONG-TERM VALUE AND SOUNDNESS OF THE FIRM."

As is often the case, the latitude of freedom needs to be reeled in after it has been abused. In business, this normally entails the re-examining of corporate governance. The purpose of this article is to explore which measures are currently in place or have been implemented internationally and locally to address these issues; and whether a framework exists that constitutes best practice?

Corporate governance measures European Union

Following the collapse of the US housing market and the subsequent collapse of global stock markets, the EC released two recommendations on executive compensation in May 2009. This followed

conclusions that were drawn from the Ecofin (Economic and Financial Affairs) Council meeting among the economic and finance ministers of the 27 member states of the European Union in December 2008.

Although existing initiatives focus on pay for performance through disclosure of remuneration policies, the EC now seeks to address structural flaws in remuneration policies. The first recommendation provides guidance to facilitate the structuring of executive compensation in line with performance by:

- focusing on the variable components of pay;
- suggesting that variable components of executive compensation should:
 - be capped;
 - be based on predetermined and measurable performance criteria;
- suggesting that severance payments should:
 - not exceed two years' fixed salary;
 - not be paid if termination of employment is due to inadequate performance;
- focusing on a company's long-term sustainability;
- advocating a minimum three-year vesting period for share options;
- requiring that a fixed number of shares are held until the end of employment;

- promoting the deferment of a major part of the variable component of pay; and by
- suggesting that claw back provisions should be included in contracts.

The recommendation, as with the King III report, also elaborates on the governance of remuneration policies with a specific focus on:

- strengthening the remuneration committee;
- ensuring the impartiality of remuneration consultants;
- the mitigation of conflicts of interest; and
- encouraging shareholders to use their votes at general meetings regarding director remuneration.



IMAGE: ISTOCKPHOTO

The second recommendation focuses on remuneration policies of companies in the financial services industry. The four major areas of concern are:

- remuneration policies of risk-taking staff should be consistent with, and foster, sound and effective risk management;
- remuneration policies should be transparent, clear and properly documented;
- remuneration policies and their features should be adequately disclosed to shareholders in a clear and understandable way that explains the main components of the policies, their design and operation; and
- the importance of supervision.

Although proper disclosure remains key to remuneration policies, these two new recommendations emphasise the importance of maintaining a balance between fixed and variable pay, identifying measurable performance criteria and the presence of sound supervision.

United States

In a similar vein in the US, Geithner released a statement in June 2009, outlining five broad principles regarding executive compensation. According to his statement, remuneration policies should:

- properly measure and reward performance;
- be structured to account for the time horizon of risks;

- be aligned with sound risk management;
- be re-examined to establish whether golden parachutes and supplemental retirement packages align the interests of executives and shareholders; and should
- promote transparency and accountability in the process of setting compensation.

In a further effort to protect shareholder interests, the US Treasury Department released the "Say on Pay" bill in June 2009. Although the effective date is, as of yet, unknown, the bill gives shareholders the right to vote on the annual compensation for a company's top five executives. The "Say on Pay" vote, which is already required or encouraged in the UK, Australia, Sweden and the Netherlands, was first piloted in England and demonstrated that it is an effective tool for shareholders to voice their discontent. The vote will be based on the pay as described in the Compensation Disclosure and Analysis sections of companies' proxy statements, including salary, bonus, share awards, option awards, non-equity incentives, change in pension value, deferred compensation earnings, all other compensation and total compensation amount. Similarly, the King III report in South Africa requires shareholders to approve a company's remuneration policy.

The US Securities Exchange Council (SEC) chair, Mary Schapiro, issued a statement in June 2009, outlining new disclosure rules that it plans to propose in the coming

months for, amongst others, a company's overall compensation approach and the potential conflicts of interest between compensation consultants and the company and its affiliates.

It seems that companies in general are rather reluctant to disclose their actual goals for executives on which bonuses are based. A Watson Wyatt-study in 2007 indicated that only 46% of public by traded American companies disclose the goals on which they base rewards, and only 55% disclose the goals for long-term incentive plans.

The SEC adopted new rules in 2006 in an attempt to furnish investors with enough information to enable them to understand how executives are compensated. According to SEC rules, companies must disclose such information in their proxy statements, unless it could result in "competitive harm". Despite the fact that only half of the companies disclosed the information, even those that did failed to disclose specifics such as attaining earnings per share of US\$4, for example.

According to Ira Kay, director of compensating consulting at Watson Wyatt, companies are experiencing increasing pressure from investors to be accountable for their executive pay programmes. Companies, however, should not do so grudgingly, but rather use this as an

opportunity to demonstrate how their pay programmes are performance-based, which is the key requirement for executive compensation.

South Africa

According to the King III report, which was released in February 2009, the board, assisted by the Remuneration Committee, should present a remuneration policy to the shareholders for their approval at a general meeting. The remuneration policy should reflect fair and responsible compensation, and focus on enhancing shareholder value in the longer term. Remuneration policies, the company's strategic objectives and how they were implemented, the base fee policy, benchmarks, annual bonuses for targets achieved and pay above the median should be disclosed in the annual remuneration report. In order to avoid the manipulation of results, King III recommends that multiple performance incentive measures are used, including share incentives, and recommends that the vesting of share options and conditions of performance achievement should be linked to shareholder value.

revolutionary competing businesses, chronic underperformance;

- Overall economic context – boom, bust, cost of capital; and
- Specific executive duties – scope, complexity, multiple versus single areas of responsibility.

Fairness is probably the most difficult of the three principles. According to Randy Jayne, managing partner at Heidrick & Struggles, the market will correct under- and over-paid executives. An executive whose pay is excessive when compared to poor company results will not be able to move to a similar position at another company with the same level of compensation. The executive's compensation will either be adjusted downward or he/she will be dismissed. On the other hand, as executives become aware of the fact that their compensation does not offer a fair reward for their performance, they will move elsewhere.

The underlying principle that anchors effectiveness is pay-for-performance. The base pay should be set at a moderate level and topped up with variable performance bonus plans for both the short-term (current year) and the long-term (three to five years).

being drawn to buy more shares in order to maintain the 70% share portion. If the share price increases, the CEO has the option of selling shares to increase his cash position. However, these gains cannot be cashed in immediately, but will vest gradually.

Apart from the fact that the escrow accounts manage to marry executive and shareholder goals, they also introduce a mechanism to avoid the short-term manipulation of the share price. Although companies such as Goldman Sachs and Morgan Stanley have implemented clawbacks for bonuses, Alex Edmans, finance professor at the University of Pennsylvania, holds that they are not as effective as escrow accounts: "If you have paid out bonuses and the company then tanks, trying to claw back the bonus seems like shutting the barn door after the horse has bolted".

Final remarks

It is important to bear in mind that no single compensation model will suit all companies. The responsibility for implementing new executive compensation schemes resides with companies' boards of directors. The board has the responsibility to ensure that executive compensation schemes are in the long-term interest of companies. How long "long-term" should be is up to a company's board of directors, but one could argue that such a time frame should at least equate to the time it takes for the executive's key actions to manifest in operations and the share price. In any event, a time frame of shorter than five years may carry with it an increased risk of actions taken to realise short-term earnings and share price spikes, but could hurt the company in the long run. Enron and Countrywide Financial are but two examples of the latter.

In terms of remuneration policies, the right mix of remuneration will ensure that the desired executives are attracted, retained and motivated. To this end, remuneration policies should embody three basic principles, i.e. appropriateness, fairness and effectiveness. The golden thread to the success of any remuneration policy is that it is appropriately linked to performance and ultimately enhances shareholder value over the long-term. To this end, the application of the concept of escrow accounts may be worth exploring.

Bibliography

- Jayne, R. 2005. Leading practices in executive compensation. Working paper. Heidrick & Struggles Knowledge Management Centre. pp 1-9.
- Riskmetrics. 2009. EC issues new pay guidelines. Published on Riskmetrics Group.: pp 1-3.
- Riskmetrics. 2009. Treasury calls for annual advisory votes. Published on Riskmetrics Group.: pp 1-5.
- Edmans, A., Gabaix, X., Sadzik, T. and Sannikov, Y. 2009. Dynamic incentive accounts. Working paper. Wharton School: University of Pennsylvania. pp1-46. [asa](#)

Jacobus van Zyl Smit CA(SA), BCom, LLB, is a non-Executive Director at PSG. Soon Nel CA(SA), MCom, HDE, is a lecturer in the Department of Accounting at the University of Stellenbosch.

THE BASE PAY SHOULD BE SET AT A MODERATE LEVEL AND TOPPED UP WITH VARIABLE PERFORMANCE BONUS PLANS.

14

The Remuneration Committee should, amongst other requirements, recommend a remuneration policy for executives, align the mix of fixed and variable pay with company needs, ensure that recorded performance measures are accurate, and regularly review incentive schemes such as share-based and long-term schemes for their contribution to the enhancement of shareholder value. Shareholder approval is required, in advance, for all new long-term share-based and other incentive schemes or major changes to the existing schemes.

A value framework for executive compensation

World-renowned leaders in the executive search industry, Heidrick & Struggles, emphasise three key principles of executive compensation: appropriateness, fairness and effectiveness. A strong strategic and operational skill set is required to run a business successfully, i.e. to sustain and increase shareholder wealth. Executive skills are applied in a certain corporate setting, of which certain generic parameters will render the executive compensation appropriate or not. According to Heidrick & Struggles, the appropriateness of executive compensation levels can be judged against the following parameters:

- Size – revenues, number of businesses, employees, etc;
- Complexity – number of products and services, technological content, extent of international, multicultural scope;
- Nature of the specific market – expanding, contracting, threatened by radical/

The important link is how to connect improved company performance with a particular element of executive compensation.

Escrow accounts

An interesting alternative, which focuses on aligning executive's efforts with the long-term performance of the company, is escrow accounts. According to research conducted at the University of Pennsylvania in the US, compensation structures based on long-term escrow accounts are a better alternative to cater for a company's long-term future than the traditional method of rewarding short-term changes in the share price. The research indicates that linking executive compensation to the performance of the company over a number of years will prevent executives from taking short-term decisions that may enrich them *vis-à-vis* the company's future profits.

The basic principle underlying this approach to executive compensation is that executives be allocated escrow accounts wherein a constant balance between cash and equity is maintained. These accounts are rebalanced on a monthly basis to maintain a "constant percentage" of shares and cash in each account. Applying this concept to a South African company where the percentage was set at a 70:30 share-to-cash ratio, for example, would mean that a CEO that earns R10 million, would have R7 million in the form of shares and R3 million in the form of cash. Should the share price fall, this would result in cash in the account

If you could

manage **third party funds**,
with **enhanced returns** for
you and your client,
why wouldn't you?

As an intermediary, the Investec Corporate Cash Manager offers you an efficient online management system that improves your offering to clients. Deposit into a high interest-earning cash facility, administer clients' accounts and process transactions on their behalf, all without set-up or maintenance costs. Making it the best way to maximise returns.

For enhanced management of your clients' funds, call
Johannesburg on **0860 MONEY5** (0860 666 395), Pretoria on **0860 MONEY6** (0860 666 396),
Cape Town on **0860 MONEY7** (0860 666 397), Durban on **0860 MONEY8** (0860 666 398)
or Port Elizabeth on **0860 MONEY4** (0860 666 394).

Visit www.investecmoney.co.za



Out of the Ordinary®

 **Investec**
Money

Engagement quality control review

I consider myself a dab hand in the kitchen – after all I have been doing it for years, own hordes of recipe books and have a mother who has a fix for every flop. Don't get me wrong - I'm not claiming any Michelin stars here, but my husband bears ample (excuse the pun) testimony to my culinary skills. Even so, put another female in my kitchen and I always want a second opinion – is the salt right, have I spiced it too much, does the centre of the crème caramel have enough of a wobble in it? What's my point again (sorry, the thought of crème caramel always sends me on a tangent) – yes – that everyone, no matter how accomplished, can always do with a bit of re-assurance. I suspect it's no different for an audit practitioner. How wonderful it would be if every time you signed an audit report a voice from the heavens above would proclaim "Fear not my child, you have done right". Oh ye of little faith, that voice is now here, only it does not come from the heavens. What, do I hear you say, am I on about? ISQC 1 of course, and its requirement for the performance of an engagement quality control review (EQCR) for appropriate engagements. But I mislead you – it was never the intention of the IAASB for this requirement to provide any kind of comfort or reassurance to the auditor. Rather, the requirement and in fact ISQC 1 itself, arose in response to increasing public demand for improvement in the quality of audits. It is not the intention of this article to examine the origin of ISQC 1 or its merits, instead I want rather to focus on paragraph 35 of ISQC 1, which states the following:

35. *The firm shall establish policies and procedures requiring, for appropriate engagements, an engagement quality control review that provides an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report. Such policies and procedures shall: -evaluate to determine whether an engagement quality control review should be performed; and*
- (c) *Require an engagement quality control review for all engagements, if any, meeting the criteria established in compliance with subparagraph 35(b).*

As is evident from the requirement of paragraph 35 above, the standard makes mandatory the requirements for listed entities to be subject to an EQCR, and requires the firm to establish criteria against which all other engagements are to be assessed for EQCR applicability, for example, engagements of public interest or high risk engagements.

Be aware, however, that an EQCR does not involve a reperformance of the audit. On the contrary, the EQCR process is intended to be performed at a high level with the skeleton of the process laid out in paragraphs 37 and 38 as follows:

37. *The firm shall establish policies and procedures to require the engagement quality control review to include:*

- (a) *Discussion of significant matters with the engagement partner;*
- (b) *Review of the financial statements or other subject matter information and the proposed report;*
- (c) *Review of selected engagement documentation relating to significant judgments the engagement team made and the conclusions it reached; and*
- (d) *Evaluation of the conclusions reached in formulating the report and consideration of whether the proposed report is appropriate.*

38. *For audits of financial statements of listed entities, the firm shall establish policies and procedures to require the engagement quality control review to also include consideration of the following:*
- (a) *The engagement team's evaluation of the firm's independence in relation to the specific engagement;*
- (b) *Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations; and*
- (c) *Whether documentation selected for review reflects the work performed in relation to the significant judgments and supports the conclusions reached.*

Use of the word "include" leaves little doubt that the procedures listed comprise the bare minimum in terms of an EQCR. Other procedures to be performed will be dictated by the firm's quality control policies and procedures as embodied in its quality control manual.

I ALWAYS WANT A SECOND OPINION – IS THE SALT RIGHT, HAVE I SPICED IT TOO MUCH, DOES THE CENTRE OF THE CRÈME CARAMEL HAVE ENOUGH OF A WOBBLE IN IT? WHAT'S MY POINT – THAT EVERYONE, NO MATTER HOW ACCOMPLISHED, CAN ALWAYS DO WITH A BIT OF RE-ASSURANCE.



pain or gain?

The type of EQCR as envisaged by paragraph 35 is what is commonly known as a pre-issuance review. In other words, the review needs to be performed in conjunction with the performance of the audit with a prohibition on the signing of the audit report prior to completion of the pre-issuance review. The pre-issuance review is of course not the only type of EQCR. Paragraph 48 further requires an inspection, on a cyclical basis, of at least one completed engagement per engagement partner as part of the firm's ongoing monitoring process. Such a review is commonly known as a post-issuance review and is performed after the audit report has been issued.

The benefits of an EQCR (whether it be pre-issuance or post-issuance) have long been recognised by the IFAC Code of Ethics, and indeed even in our very own Code of Professional Conduct, both of which acknowledge an EQCR as an effective safeguard against certain types of threats, such as self review threats. EQCRs have gained even more prominence with the recent revision of section 290 of the IFAC Code, which now requires the performance of an EQCR (whether pre-issuance or post-issuance is up to the auditor's professional judgement) in addition to certain disclosures, when a significant self review threat arises.

Not only the IFAC Code, but even the Sarbanes Oxley Act of 2002, details a requirement for the Public Company Accounting Oversight Board (PCAOB) to include in its standards that each registered public accounting firm "provide a concurring or second partner review and approval of such audit report (and other related information), and concurring approval in its issue, by a qualified person (as prescribed by the Board) associated with the public accounting firm, other than the person in charge of the audit, or by an independent reviewer (as prescribed by the Board). In response, the PCAOB earlier this year approved Auditing Standard 7 Engagement Quality Review, the purpose of which, according to PCAOB Chairman Mark W Olsen, is to "focus on the engagement quality control reviewer's attention on the areas that are most likely to contain a significant engagement deficiency and increases the likelihood of identifying and correcting those deficiencies before the audit report is issued". The need for an entire auditing standard on the matter surely bears witness to the role of the EQCR in ensuring a quality audit.

In the South African context, we of course have the Practice Review department of the Independent Regulatory Board for Auditors, which in terms of Section 47 of the Auditing Profession Act No. 26 of 2005, performs engagement reviews on a cyclical basis. The engagement to be selected by the practice reviewer is anyone's guess but an established EQCR process at a firm level can assist in identifying general quality deficiencies in an engagement, which can then be applied to all engagements undertaken by the firm and fixed going forward.

EQCRs however require a certain degree of technical expertise, skill and experience, which may not necessarily be available in-house, more so in the case of sole practitioners and smaller firms. In such situations, practitioners should look to paragraph A50, which recommends that such firms seek suitably qualified external



17

IMAGE: ISTOCKPHOTO

persons to perform such reviews. It goes without saying that this option comes with a price tag.

It may even be argued, particularly in the case of pre-issuance reviews, that such a process could cause significant delays in the audit process, thus hampering the firm's ability to meet its deadline. Proponents of this argument have obviously not read paragraph A43, which requires that the EQCR be concluded in a timely manner at appropriate stages during the engagement, thus allowing for significant issues to be resolved before the date of the audit report. Thus, all it takes, is a little planning!

There is no doubt that public confidence in the auditing profession has waned over the last decade or so. More so, then, the need for self-regulation tools such as EQCRs, which serve as meaningful contributors to regaining that trust. Coming back to the question in my title, it seems to me that that EQCR is here to stay and rightfully so, as the odds are firmly stacked in favour of Gain. **asa**

Taskeen Abdool Majid CA(SA), BSc, has a postgraduate certificate in advanced taxation and is a Quality Reviewer at Protect a Partner.



IMAGE: ISTOCKPHOTO

Consumer Protection Act

Overview of the main features of the Act¹

Background

The Act sets out the minimum requirements to ensure adequate consumer protection in South Africa. This Act constitutes an overarching framework for consumer protection, and all other laws which provide for consumer protection (usually within a particular sector) will need to be read with this Act to ensure a common standard of protection.

All suppliers of goods and services will need to take note of the new measures and ensure that they are able to comply once the Act becomes effective. It is foreseen that the Act will become effective towards the end of 2010.

Application of the Act

The Consumer Protection Act affects a wide range of consumers and transactions. The definition of a “consumer” includes

not only the person (either a natural or juristic person) to whom goods or services are promoted or supplied, but also the actual user of the goods or the recipients or beneficiary of the services. In other words, a consumer may be a person other than the person who entered into an agreement with a supplier and paid for the goods or services. In practice this would mean that if you are given a spa treatment as a birthday present, you will be entitled to the consumer protection measures set out in the Act, even though you never entered into an agreement with the spa.

With regard to juristic persons, the Act will only provide protection to small businesses (in other words, where the consumer is a juristic persons with an asset value or annual turnover below a threshold determined by the Minister). This approach is in line with the approach in the National Credit Act. In terms of the National Credit

Act the threshold is set at R1000 000. However, we’ll have to wait and see exactly what the threshold will be for purposes of the Consumer Protection Act.

In terms of section five of the Act, certain transactions will be excluded from the application of the Act. Exempted transactions include those where:

- goods or services are supplied to the State (transactions where the State will be the consumer); or
- where the transaction constitutes a credit agreement under the National Credit Act (the goods or services that are the subject of the credit agreement are not excluded from the ambit of the Act); or
- a transaction pertaining to services under an employment contract; or
- a transaction which gives effect to a collective bargaining agreement within the meaning of section 23 of the Constitution and the Labour Relations Act.



The Act further provides for a mechanism in terms of which a regulatory authority may apply to the Minister of Trade and Industry (the Minister) for an industry wide exemption from certain provisions of the Act. The application for such an exemption must be based on the fact that there is an overlap between the provisions of the Act and the regulatory scheme administered by the relevant regulatory authority. The Minister may only grant an exemption if the applicable regulatory scheme provides better, or at least similar, consumer protection than the protection provided for in the Act.

The provisions in the Act regarding safety monitoring and recall (section 60), and liability for damages caused by goods (section 61) apply to ALL transactions, even those transactions exempted from the application of the Act. Thus, in our example above, the distributor will be entitled to protection where she suffered damage as a result of defective goods – even where the transaction was exempted.

The Act will not apply to services which constitute advice or an intermediary service that is subject to regulation in terms of the Financial Advisory and Intermediary Services Act, 2002 (FAIS), or services in terms of the Long-term Insurance Act, 1998 or the Short-term Insurance Act, 1998. However, it should be noted that the Act prescribes that the Long-term Insurance Act and the Short-term Insurance Act must be aligned with the consumer protection measures in this Act within 18 months from the commencement of this Act. If this is not done, the provisions of this Act will apply to all services rendered in terms of the two insurance Acts.

Threshold

The Act will not apply to transactions where the consumer is a juristic person with an asset value or annual turnover of more than a threshold value determined by the Minister (section 6).

Direct marketing

The provisions in the Act which regulate direct marketing extend to *all* communication for the purposes of direct marketing (not only direct marketing via electronic communication). In terms of section 11, a consumer may either refuse to accept, pre-emptively block, or require another person to discontinue any communication which may be seen as direct marketing. This may include telephone calls, e-mails, brochures or

letters in the mail, etc. The National Consumer Commission will facilitate the establishment of a registry where a consumer may register their particular preferences (for example, that a consumer wishes not to receive any direct marketing (a pre-emptive block) or, where he previously agreed to receive marketing material, he now wishes to change his mind and requires the marketer to stop marketing to him directly). Businesses will have to ensure that they have measures in place to receive and record consumers' specific preferences (at no cost to the consumer), and abide by these expressed preferences. In addition, the Minister may prescribe certain times when consumers may not be contacted, for example, on public holidays or after a certain time at night.

Cooling off

The Act provides for a 5 business day cooling off period in instances where transactions resulted from direct marketing, in other words, transactions which were not initiated by the consumer (section 16). The five business day period will commence on the latter of the day on which the transaction or agreement was concluded, or the day on which the goods or services were delivered to the consumer. This section does not apply to transactions which are governed by section 44 of the Electronic Communications and Transactions Act, 2002 (in terms of which consumers have a seven day cooling off period (normal days, not business days)).

goods. This provision determines that producers, importers, distributors and retailers of goods will be liable for any harm caused as a result of the supply of unsafe goods, a product failure, a defect or hazard in the product, or interestingly, inadequate instructions for the use of the goods or warnings related to any possible hazard that might be associated with the product. (Although the Act determines that labelling of products and trade descriptions are optional, it might be necessary for producers, importers, distributors and retailers of goods to ensure that proper instructions for use, and warnings of potential danger or hazard are provided, as this may prevent a claim for damages by consumers.)

Probably the biggest change to the current legal position is the fact that the Act determines that producers, importers, distributors and retailers of goods will be liable for damage caused by unsafe or defective goods whether or not the harm resulted from their negligence. This means that the consumer will no longer have to prove that the damages suffered as a result of defected goods was due to the fault (negligence or otherwise) of the producer, importer, distributor or retailer (this is referred to as strict liability). Rather, the shoe is now on the other foot: where a consumer claims for damages, the producer, importer, distributor or retailer will have to prove that they are not

THE ACT PROVIDES FOR A NUMBER OF DEFENCES WHICH THE PRODUCER, IMPORTER, DISTRIBUTOR AND RETAILER MAY USE WHEN A CLAIM FOR DAMAGES IS INSTITUTED AGAINST THEM BY A CONSUMER.

It should be noted that it is not a requirement for the transaction to be concluded at the home of the consumer for the cooling off period to apply (as is the case in the National Credit Act). The cooling off period will apply to all transactions that resulted from direct marketing.

Product liability

Section 61 of the Act effects a major change with regard to the position of the consumer in cases where he suffers damages as a result of unsafe or defective

responsible, and thus not accountable, for the resulting damages.

The Act determines that a consumer may hold the producer, importer, distributor and retailer jointly or severally liable, and a consumer may claim for damages related to death, injury, illness, loss or damage to property, or economic loss as a result of death, injury, illness or, loss or damage to property. The Act provides for a number of defences which the producer, importer, distributor and retailer may use when a

Consumer Protection Act

claim for damages is instituted against them by a consumer.

Term, renewal and cancellation of contracts

The Act regulates the term, renewal and cancellation of fixed term contracts. In terms of section 14, there can be no automatic renewal of the fixed term contract. The consumer (this section applies to natural persons only) is entitled to cancel the contract when the contract term expires, or at any other time, given that he gave the supplier 20 business days notice in writing. Where the consumer cancels the contract before the expiry date, the supplier will be entitled to any outstanding amounts, as well as a reasonable cancellation fee.

At the expiry of the term of a fixed term agreement, the contract will automatically continue on a month to month basis, until the consumer either cancels the contract or renews the agreement for another fixed term. The Act requires the supplier to remind the consumer of the expiry date at least forty business days prior to the expiry date of the fixed term. The Act also allows the Minister to prescribe the maximum duration of fixed terms agreements in general or for specific categories of agreements.

Language

The Act does not contain a provision for information to be in an official language. However, section 22 requires that all information should be in plain language. The Act further requires that the language used should be appropriate to the class of persons the goods or services are aimed at, and as understandable to someone of that class with average literacy skills and experience. Where technical specifications are set out in any agreement or on a product label, this requirement might prove difficult to comply with.

Written agreements

There is no general requirement for agreements to be in writing. However, the Act allows the Minister to require certain categories of agreements to be in writing. It is foreseen that the Minister

may require fixed term contracts to be in writing. Section 50 requires that where an agreement is set out in writing (whether this is required in terms of this Act or voluntary) the supplier must provide the consumer with one free copy (or access to an electronic copy) of the terms and conditions, that the agreement must be in plain and understandable language, and that it should contain a breakdown of the consumer's financial obligations under the agreement. However, if a consumer agreement between a supplier and a consumer is not in writing, the supplier is obliged to keep a record of the transactions entered into over the telephone or any other recordable form.

Customer loyalty programmes

Section 35 of the Act determines that a supplier who sponsors a consumer loyalty programme, or accepts loyalty credits in exchange for goods or services (for example frequent flyer miles), may impose a partial or complete restriction on the availability of the goods or services during specific periods of the year. However, the restriction may not exceed 90 days in a calendar year. In addition, the Act requires that certain information be made available to the consumer when an offer to participate in the loyalty programme is made.

The information should include the nature of the programme, the goods or services to which it applies, the steps required to receive benefits, and the time, venue and persons from which consumers may obtain access to either the programme or benefits in terms of the programme. This means that a supplier that has a loyalty programme, such as an airline, may restrict the use of frequent flyer miles during certain periods of the year (not exceeding 90 days). However, at any other time of the year, the airline must accept loyalty credits in return for a service as if the consumer offered any other form of consideration (such as cash). The supplier may not benefit consumers who offer to pay cash over consumers who use loyalty credits. The Act provides for possible defences that a supplier may use when a consumer

alleges that the supplier did not have sufficient goods or services available in return for loyalty credits. In essence, it will be a defence where the supplier offers to supply comparable goods or services to the consumer, and the consumer either accepts the offer, or unreasonably refuses the offer.

Overselling and overbooking

The Act provides for the reasonableness test for overselling and overbooking. In terms of this test a supplier may not accept payment for goods or services where it has no reasonable intention to supply the goods or services, or where it intends to supply goods or services that are materially different to the goods or services for which the consumer has paid.

With regard to damages suffered as a result of a supplier's inability to supply goods or services due to overbooking or overselling the Act provides for a refund of the amount paid plus interest (usually, this would be the deposit plus interest), as well as any consequential damages which directly resulted from the breach of contract.

In practical terms, this would mean that where you -

- booked a flight from Cape Town to Durban for which you paid a deposit of RX,
- booked and paid for a rental car in Durban in the amount of RY, and
- set up a meeting with a business associate in Durban to sign a contract valued at RZ, after which the business associate will leave for India, and you are bumped from the flight as a result of overbooking, you will be entitled to claim
 - RX plus interest for the deposit you paid for the flight, and
 - RY plus interest for the rental car, which amounts to a consequential loss that is *directly* resulting from the overbooking.

However, the fact that you suffered a loss because you were not able to sign the contract before your business associate left for India amounts to loss of anticipated use

or enjoyment, for which the Act does not provide.

Implied warranty of quality

The Act provides for an implied warranty of quality. In terms of this warranty the producer or importer, the distributor and the retailer each warrant that the goods comply with the requirements and standards contemplated in the Act. However, the implied warranty will not apply where goods have been altered contrary to the instructions of the producer, importer, distributor or the retailer, or altered after leaving the control of the producer, importer, distributor or the retailer.

or condition stipulated by the producer or importer, distributor or retailer.

Warranty on repaired goods

The Act provides for a three month warranty on repaired goods. This warranty includes all new or reconditioned parts installed during the repair or maintenance work, as well as the labour to install such parts. However, where a consumer subjected goods to abuse or misuse, the warranty will be void. Also, the warranty does not extend to ordinary wear and tear.

Safety monitoring and recall

The Act introduces a streamlined approach to safety monitoring in that it obliges

Industry codes

The Act provides for procedures to be followed before the Minister approves and publishes an industry code in the Government gazette. The Act requires the National Consumer Commission to consult the public and relevant stakeholders before it recommends a proposed industry code to the Minister for his approval. In turn, the Minister is provided with the authority to prescribe, approve or withdraw a previously approved industry code. The Minister may withdraw an industry code on the recommendation of the Commission, who has the authority to review the effectiveness of a code at intervals of five years.

THE ACT PROVIDES FOR POSSIBLE DEFENCES THAT A SUPPLIER MAY USE WHEN A CONSUMER ALLEGES THAT THE SUPPLIER DID NOT HAVE SUFFICIENT GOODS OR SERVICES AVAILABLE IN RETURN FOR LOYALTY CREDITS.

Failed, unsafe or defective goods may be returned to the supplier within six months after the delivery of the goods to a consumer. In such a case the supplier has to either repair or replace the goods, or refund to the consumer the price paid by the consumer. It is important to remember that the Act allows the consumer to choose whether to be refunded, or to have the goods replaced or repaired.

In instances where the supplier repairs the failed or defective goods (or any component of the goods) and within three months after that repair, the failure or defect was not fixed and it recurs, or another failure or defect is discovered, the supplier must replace the goods, or refund the price to the consumer. It should be kept in mind that the Act specifically determines that an implied warranty, as provided for in the Act, is in addition to any other implied warranty or condition imposed by the common law, any other legislation, and any express warranty

the National Consumer Commission to promote the development and adoption of industry wide codes of practice in terms of which industries will monitor safety of their products. This includes the introduction of systems to receive and investigate complaints, recall goods, and reporting on certain matters to the National Consumer Commission.

However, the National Consumer Commission may require the importer or producer of particular goods to carry out a recall of the product where the National Consumer Commission has reasonable grounds to believe that goods are unsafe, and the producer or importer of the goods has not taken the necessary steps in terms of the applicable industry code to ensure public safety.

Prepaid certificates, credits and vouchers

The Act determines that gift or similar vouchers expire either upon redemption or after three years.

Also, where an industry code provides for an alternative dispute resolution scheme, the Act allows the Minister to accredit such a scheme as an "ombud with jurisdiction". This means that the scheme will be officially recognised in the whole scheme of redress as provided for in the Act. For example, where a consumer has a dispute with a supplier within the particular industry, the consumer may lodge a complaint with the industry ombud, before he approaches the National Consumer Commission for assistance.

1. *Purpose of this document: This document provides insight into the Consumer Protection Act, 2008. asa*

Dr Johan Erasmus, BLC, LLB, LLD is a Regulatory Analyst at Deloitte and also chairman of the SAICA Legal Compliance Committee.

Coming to terms with ISA 265

Communicating deficiencies in internal controls to those charged with governance and management (ISA 265) is a new International Standard on Auditing (ISA) that comes into effect, together with all the other clarified ISAs, for all audits of financial statements beginning on or after 15 December 2009.

ISA 265 consists of a number of requirements that the auditor shall perform in order to have complied with this standard.

The table contains the requirements placed on the auditor in terms of ISA 265 together with assistance on how practically to apply the requirements, together with some explanatory notes on interpreting the requirements. [asa](#)

Theashen Vandiar CA(SA), is Project Director: Auditing and members Advice, SAICA.

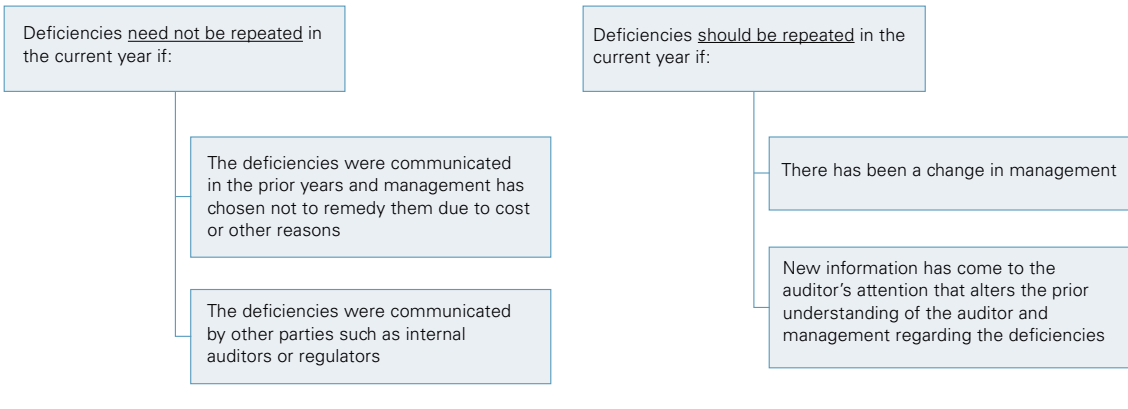
ISA 265 CONSISTS OF A NUMBER OF REQUIREMENTS THAT THE AUDITOR SHALL PERFORM IN ORDER TO HAVE COMPLIED WITH THIS STANDARD.

Requirement on Auditor in terms of ISA 265	Application of the requirements of ISA 265	Further Explanatory notes
1. Determine if one or more deficiencies in internal controls have been identified.	1.1 Discuss the relevant facts and circumstances with the appropriate level of management.	1.1 Appropriate level of management is those that are familiar with the internal control area concerned and that have the authority to take remedial action.
	1.2 When discussing the above with management, the auditor may obtain other relevant information for further consideration.	1.2 Other relevant information includes: 1.2.1 management's understanding of the actual or suspected causes of the deficiencies. 1.2.2 exceptions arising from the deficiencies that management may have noted. 1.2.3 a preliminary indication from management of its responses to the findings.
2. Determine if the deficiency(ies) identified constitute significant deficiencies.	2.1 Matters to be considered when determining if a deficiency is significant: 2.1.1 The likelihood of the deficiencies leading to material misstatements in the financial statements in the future. 2.1.2 The susceptibility to loss or fraud of the related asset or liability. 2.1.3 The subjectivity and complexity of determining estimated amounts. 2.1.4 The financial statement amounts exposed to the deficiencies. 2.1.5 The importance of the controls to the financial reporting process. 2.1.6 The cause and frequency of the exceptions detected as a result of the deficiencies in the control.	2.1 Indicators of significant deficiencies include: 2.1.1 Evidence of ineffective aspects of the control environment. 2.1.2 Absence of a risk assessment process within the entity. 2.1.3 Evidence of an ineffective response to identified significant risks. Misstatements detected during substantive testing that were not prevented, detected or corrected by the entity's internal controls. 2.1.4 Restatement of previously issued financial statements to reflect the correction of material misstatement due to error or fraud. 2.1.5 Evidence of management's inability to oversee the preparation of the financial statements.
3. Communicate in writing significant deficiencies in internal controls identified to those charged with governance on a timely basis.	3.1 Communication should be in writing to reflect the importance of the matters. 3.2 In determining "WHEN" to issue the communication, consideration needs to be given as to when communication would be most appropriate in enabling those charged with governance to discharge their oversight responsibilities. 3.3 Professional judgment must be applied in determining the level of detail at which to communicate significant deficiencies.	3.3. In determining appropriate level of detail, the auditor should consider the following factors: 3.3.1 The nature of the entity. 3.3.2 The size and complexity of the entity. 3.3.3 The nature of the significant deficiencies identified. 3.3.4 The entity's governance composition. 3.3.5 Legal or regulatory requirements regarding the communication of specific types of deficiencies in internal controls.
4. Communicate to management : (a) in writing regarding significant deficiencies in internal controls identified.	4. (a)1 This requirement does not apply if it is considered inappropriate to communicate directly to management.	4. (a)1 It is considered inappropriate when: 4.1.1 the integrity and competence of management is called into question. 4.1.2 there are suspected non-compliance with laws and regulations (refer to ISA 250 for guidance). 4.1.3 the auditor has identified fraud or suspected fraud involving management. (Refer to ISA 240 for guidance).
4. Communicate to management : (b) regarding other deficiencies that merit management's attention.	4(b).1 The communication need not be in writing but may be oral.	4(b).1 Determining what merits management's attention is a professional judgment that takes into account the likelihood and potential magnitude of misstatements that may arise in the financial statements as a result of those deficiencies.



IMAGE: ISTOCKPHOTO

Repeating the communication of deficiencies as required in ISA 265:



What must the auditor include in the written communication in terms of ISA 265:

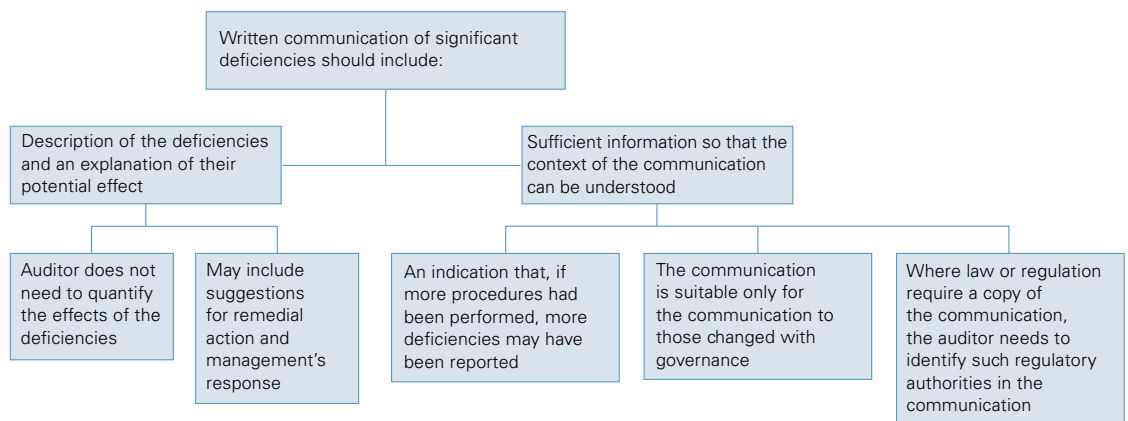




IMAGE: ISTOCKPHOTO

of sixpence in the pound upon all goods exported and imported, except wool, woollfells, leather and wines – which were subject to a special duty.

King Edward I also collected a hereditary customs on wool, skin and leather exported from England. The duties were paid by every merchant. However, foreign merchants paid an additional toll.

Different methods of levying duty

Over time, kings have used different methods of levying customs duty. Today there are two main methods, namely;

1. Specific Duty: these relate to a duty determined per unit of imported good. Specific duties prevent a reduction in revenue when the prices of imported goods fall. This type of duty is also often favoured for goods which have unstable prices.
2. *Ad Valorem* Duty: loosely translated this means ‘in proportion to the value’. This type of duty provides the least protection when imported goods are inexpensive. Conversely, protection is greatest when the imported goods are expensive.

Generally, customs administrations prefer specific duties rather than *ad valorem* duties because of the difficulty in determining the correct value for *ad valorem* duty purposes.

In considering the long history of customs duty, it is evident that it would be exceedingly difficult for any customs administration to abolish the concept of customs duties.

Although the kinds of customs duties have not changed significantly over the years, the role of customs has changed. This role change includes a far greater emphasis on the facilitation of trade. Also, we no longer trade slaves. Although the Harmonized Commodity Description and Coding System (HS) of tariff nomenclature caters for every conceivable living being and type of good, it excludes human beings.

The shaping of future customs administrations will be a challenge as they move from their historic roles of primarily policing trade and collecting revenue to a modern day role of facilitating trade. This change in focus is bound to create tension between the revenue collection, enforcement and trade facilitation roles of customs officials. Clearly, modern day customs administrations will be required to be more adaptable and flexible to fulfil the global demands of businesses and governments.

In our next edition we will turn our focus to Customs and Excise in South Africa, including the role and status of the South African Customs Union. [asa](#)

Ronnie van Rooyen, is Senior Manager of Customs at Deloitte.

Customs simplified

Customs and excise is not a subject that is covered in the Tax syllabus at University in Bachelor of Commerce degrees even less rarely covered in professional journals. Once qualified and working as a Finance Director, Manager or even a Tax Manager, you are now for the first time confronted by customs and excise issues.

24

In the coming months, a series of articles will follow that are intended to provide a simplified overview of Customs and Excise in an easily understood manner. The series is aimed at helping businesses understand both the risks and potential savings opportunities in this often neglected area of taxation.

Going back in time: The history of Customs and Excise

Today, customs duties are taxes levied upon goods imported or exported from a country. Customs duty has, however, always formed one of the most important sources of public revenue in the development of civilisation.

It is assumed that the customs duty is called ‘customs’ in English because the duty was not granted to a king by any statute but passed on from one generation to another and formed part of common law.

In ancient times, customs duties were employed solely for the purposes of raising revenue. During the middle ages, ‘customs officers’ were placed at the gates of a city and controlled and collected duty of goods entering and leaving the city. The customs duties were kept as high as possible, but not so high that they would drive away trade.

It is estimated that the Romans started to collect customs duties as far back as 199 BC. These customs duties or *portoria* were collected on all types of goods, including

THE SHAPING OF FUTURE CUSTOMS ADMINISTRATIONS WILL BE A CHALLENGE AS THEY MOVE FROM THEIR HISTORIC ROLES OF PRIMARILY POLICING TRADE AND COLLECTING REVENUE TO A MODERN DAY ROLE OF FACILITATING TRADE.

slaves, which were imported by merchants for the purpose of selling them again. If goods subject to a duty were concealed and later discovered, the goods were then confiscated.

The rate of customs duty varied but the portorium in, for example, the ports of Sicily and Greece were one-twentieth of the value of any taxable goods. After the collapse of the Roman Empire, feudal lords and barons began collecting customs duty on transit goods passing through their territory. As a consequence, the rivers and highroads were lined with customs houses and tollgates. As the kings gradually overcame the influence of feudalism, the tollgates and customs houses remained thereby enabling the kings to raise national revenue for their kingdoms.

The most ancient customs impost in England consisted of fees paid by merchants for the privilege of using the king’s warehouses, weights and measures. Later on, King Edward I established a duty

Unpaid tax:

for how long are you on the hook?

For many years South Africans were perhaps a bit happy-go-lucky when it came to tax matters. You know the sort of thing; “discount for cash”, nudge, nudge, wink, wink. Or stick a student into your converted garage – now a “garden cottage” – and make a bit on the side. No need to bother the Receiver about that sort of thing.

Even the term “Receiver” has a sort of rosy, nostalgic glow about it, not so? Nowadays we have SARS. Big, scary SARS. Pravin Gordhan is no longer the big, scary public face of SARS. But, as Minister of Finance, he’s still ultimately in charge. And we’re all still scared of SARS. Or we should be.

Just how scared people are of SARS was vividly demonstrated a couple of years ago when some SARS officials went on an evangelistic mission to the Bruma flea market. It was probably to encourage people to take advantage of the small business tax amnesty that was on offer at that time.

Imagine the scene: SARS officials approaching, winning smiles on their faces. “We come in peace, just for a chat,” - that sort of thing.

The traders were having none of it. They screamed, they ran, they hid. Some even leapt into rubbish bins, carefully pulling the lids down on their heads.

Imagine the thoughts of the SARS officials concerned: “How disconcerting to be regarded with such terror when I have come in peace.”

On the other hand...The power!

Of course it could be said that, if you are a compliant taxpayer (and what other kind would be reading this august publication?) then you have nothing to fear. In fact, SARS’ effectiveness is a cause for celebration. It means that your less compliant compatriots have fewer places to hide - and quite right too! Greater compliance means lower tax rates. Well, it has up to now. The government has cut income tax rates in recent years. Of course, that’s not going to be so easy in a recession, when SARS is budgeted to end up R70 billion behind its budgeted tax collection target for the current financial year. But that’s surely all the more reason for everyone to pull their weight.

But what if you still have some skeletons in your tax file? OK, not you. A friend, say. For how long do you need to worry? Well... actually it depends on the nature of the particular skeleton. More specifically, did the object of your anxiety ever appear in your tax return?

If it did, and if you were subsequently assessed, then you may be in the clear if at least three years has elapsed since the date of the assessment. In this situation the assessment may have prescribed. What this means is that SARS cannot issue an additional assessment because it is believed that a mistake was made the first time round.

“May have, may have...” I can hear you mutter. “How does ‘may have’ help me?” I get this reaction from my clients all the time.



25

It all depends on whether SARS believes that the amount that was not taxed first time around is attributable to fraud or misrepresentation on your part. Did you make proper disclosure in your tax return? If you did, then three years from the date of assessment you are free and clear. However, if you left stuff out of your tax return, or put wrong stuff in, then you remain on the hook for any amount of tax that should have been paid.

For how long? The Prescription Act deals with debts and how long they last. Most debts only last for three years. But some debts last a lot longer. For one thing, the state gets favourable treatment. Generally speaking, a debt owed to the state lasts for 15 years. Jolly unfair and probably unconstitutional, I say. Or not. What do I know? (Note to self, stick to the area about which you know.)

But a debt for unpaid tax lasts a lot longer. As in 30 years. Yes, 30 years! By then you could be in Golden Harvest retirement home.

The lesson: do things right the first time round. If you do, then SARS is your friend. No need to jump into the rubbish bin! asa

Billy Joubert, BA LLB, H Dip Tax, H Dip International Tax, an Admitted Attorney of the High Court of South Africa is Tax Director Head: Transfer Pricing at Deloitte.