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SPECIAL ISSUE: DISCIPLINARY HEARING

1. INTRODUCTION

The Disciplinary Committee of the Public Accountants' and Auditors' Board (PAAB) has completed its investigation and hearing into the conduct of three partners of Ernst & Young, the auditors of the Regal Treasury Bank Holdings Limited.

There has been much media comment concerning these proceedings and the events which gave rise to them. We feel it is necessary to correct certain misunderstandings surrounding the proceedings, to set the record straight and to contextualise the hearing.

We also take this opportunity to remind people (or inform those who are unaware) of the disciplinary powers and duties of the PAAB and the environment in which these are exercised.

The matter was referred to the PAAB for further investigation and review in March 2002 by Adv John Myburgh in the report of the Myburgh Commission, which had been appointed to investigate the collapse of the bank.

In accordance with its role as independent regulator of the profession charged with protecting the public interest the PAAB commenced a thorough investigation of the conduct of Ernst & Young on the Regal Bank engagement in the context of the application of audit standards and the code of professional conduct. The PAAB investigation included a review by a senior independent expert of the extensive documentation presented to the Myburgh Commission.

Arising out of the investigation a disciplinary charge sheet was drawn up at the end of 2003 in terms of the Public Accountants' & Auditors' Act and the disciplinary rules

published in terms of the Act. The charges concerned the audit of Regal Bank for the 2000 and 2001 financial years. Following the issue of the charge sheet 'pleadings' were exchanged and the case was ultimately set down to be heard by the PAAB Disciplinary Committee on 4-7 July 2005.

At the conclusion of the disciplinary hearing the Committee found the partners of Ernst & Young who had been charged with unprofessional conduct, not guilty on all charges.

2. THE DISCIPLINARY PROCESS IN GENERAL

The PAAB is committed to maintaining and enhancing professional standards, both ethical and technical, in the auditing profession. To this end it is committed to identifying, prosecuting and punishing registered accountants and auditors (RAAs) who are guilty of unprofessional conduct.

Many complaints are resolved informally by the staff of the PAAB. Frequently the complainant is less concerned about the RAA being punished, than about having his problem resolved. We believe it is part of our function to render assistance to the public in a practical and helpful manner, whenever this is possible and appropriate.

If a matter is complex, or has a high profile, or is bulky, an expert is engaged at the outset to undertake a detailed investigation. This expert will usually be the PAAB's witness should the matter prove incapable of resolution by the Investigation Committee and proceed to a disciplinary hearing.

The Investigation Committee may, in terms of the Disciplinary Rules, discharge a matter if it is satisfied that:

- the accused practitioner has given a reasonable expla-



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- nation with regard to the conduct; or
- the conduct does not constitute improper conduct; or
- there is no reasonable prospect of proving that the accused practitioner has been guilty of the conduct.

If, after investigation, the matter cannot be discharged by the Investigation Committee in terms of the Disciplinary Rules as described above, or has not been finalised because the accused practitioner has pleaded guilty and the matter has been resolved by means of a consent order, and the appropriate punishment is within the limits of the jurisdiction of the Investigation Committee, the matter must proceed to a hearing before the Disciplinary Committee.

A disciplinary hearing is a formal procedure and the Board appoints a senior lawyer to act as *pro forma* complainant. The accused is entitled to legal representation, but this is not essential and many RAAs present their own cases.

The question also arises as to what punishment can be imposed on auditors who *are* found guilty of unprofessional conduct. The PAAB has the power to impose the following penalties:

- a caution
- a reprimand
- a fine
- suspension from practice
- removal from the register – permanently, temporarily or conditionally

The PAAB does not have the power to order the auditors to repay monies lost by, for example, creditors of a company. This falls within the realm of our courts.

3. THE DISCIPLINARY PROCESS IN THE REGAL MATTER

Criticism is regularly levelled against auditors where there are company failures, but very few business failures are as a result of an audit failure. In this instance, the Commission of Enquiry found that the main culprit was the CEO. It found that the secondary culprits were the directors. Only after these did it rank the possible negligence of the auditors and of the Reserve Bank. The failure of the Bank was linked to a failure of corporate

governance rather than actions attributable to the auditors or the Reserve Bank.

South Africa is a constitutional democracy. A fundamental principle of the constitutional structure is that everyone is presumed innocent until *proven* guilty, and everyone has the right to a fair hearing at which the question of guilt is determined. This includes auditors. The fact that a company fails does not automatically mean that the auditors are guilty of misconduct; misconduct must be proved by appropriate evidence before an appropriate tribunal.

The Board cannot assume guilt based purely on allegations made by a third party. The function of the Board is to investigate allegations of misconduct and to place evidence before the Disciplinary Committee so that the Committee can judge whether the practitioners concerned have been guilty of unprofessional conduct.

Contrary to what has been said in the media, the Myburgh Commission did not state that the auditors of the Regal Bank matter had been guilty of anything. It stated that *'prima facie the auditors failed to perform their duties with care and skill or acted negligently with misconduct'* and *'accordingly it is recommended that the Registrar refer this report to the PAAB with the request to hold an inquiry'* in terms of the Public Accountants' and Auditors' Act.

Before the Commissioner, Adv J F Myburgh SC, had published his report, but after the evidence had indicated that the conduct of the auditors might be criticised, the PAAB wrote to the Commissioner requesting information. The report of the Commissioner was published on the Commission's website on 28 February 2002. We obtained and read a copy immediately and in March 2002 we received a letter from the Reserve Bank concluding:

"Therefore, the Registrar of Banks hereby requests the Public Accountants' and Auditors' Board to hold an enquiry as envisaged in section 20(8) of the PAAB Act ..."

In May 2002 the Reserve Bank agreed that we might have access to the numerous boxes of documents and evidence in its possession relating to this matter. In October 2002 our expert delivered his preliminary draft report, dealing with the conduct of three partners at Ernst & Young. From this a first draft charge sheet was drawn up. The charge



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sheet was reviewed and redrafted by the Investigation Committee and the finalised charge sheet was despatched to the respondents in December 2003. An exchange of correspondence and 'pleadings' with the respondents' attorneys took place and in October 2004 the matter was set down for hearing during the week 4 – 8 July 2005.

The Disciplinary Committee hearing the matter considered voluminous evidence, including evidence which had not been placed before the Myburgh Commission.

4. INDEPENDENCE OF THE DISCIPLINARY COMMITTEE

The Disciplinary committee consists of five senior RAAs drawn from a panel of 20. The committee has the power of co-option where this would be appropriate. In addition, the Committee is chaired by a senior lawyer.

The Disciplinary Committee in this particular instance comprised four senior RAAs in public practice in small and medium firms, most of the large firms being excluded because of conflicts of interest. The fifth member was the Chief Executive Officer of the Financial Services Board. The committee was under the chairmanship of retired High Court Judge Eloff.

5. JUDGEMENT

The judgement of the Committee was delivered after the *pro forma* complainant (a senior advocate) and the legal representatives of Ernst & Young had been afforded the opportunity to present and argue the issues. It fairly reflects the outcome of these presentations. It also recognises the subjective and judgemental aspects of auditing, which will always be present.

In the interests of transparency, the full judgement of the Disciplinary Committee is reproduced hereunder. Unfortunately, as it was an extemporary judgement on the same day, it is of necessity short and does not explain in full the arguments advanced, or the full reasoning of the committee in coming to its decision.

Accordingly, in view of the complexity of the issues involved, and in order to place the judgement in context, we also reproduce a transcription of the closing arguments of both the *pro forma* complainant and the respondents' counsel.

Address in argument by *pro forma* complainant

What remains before the committee at this stage is a charge of improper conduct against all three of the respondents on various grounds. In respect of the third respondent, the only remaining charge relates to the manner in which the branding model was dealt with, and particularly in three respects. We have heard about them.

They are firstly the recognition of the branding asset. Secondly, the recognition of the income earned from branding, and thirdly, the deferral of R6 million worth of the expenditure on the branding model. That is the only count which presently implicates the third respondent. The first and second respondents are also implicated in that count, and over and above that, the first respondent faces two other counts.

The first is that he acted improperly in failing to comply with SAAS 500 in that he failed to obtain sufficient audit evidence relating to the security pledged for and the recoverability of various discretionary loans, namely loans totalling R19 million to the shareholders trust and the client trust. I might pause there to refer to the fact that you will be aware that in the charge sheet the charge was originally formulated on the basis of a loan of R19 million to the shareholders trust. However, my submission in that regard is that it became clear during the course of the evidence that was given, in fact it was as I recall the first respondent who made the point that the amount which was being referred to in the charge in fact related to what I will call the client trust, and I submit that the issues in relation to that charge have properly been identified and the charge should be read as relating to the shareholders trust and the client trust. That is a charge as I have said in relation to SAAS 500.

A competent verdict, if I could call it that, would be a failure to comply with SAAS 230, which relates to the failure to document the investigations carried out.

The second further count which faces the first respondent is that relating to his failure to comply with SAAS 320 in that he failed to reconsider the materiality level applicable to the audit despite an increase in audit risk.

The second respondent for his part, faces, apart from the



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branding model count, a count relating to the failure to ensure that certain remuneration paid to Mr Levenstein was not disclosed in the financial statements, which non-disclosure amounted to a contravention of Section 297 of the Companies Act and certain auditing standards.

If I might turn then to the branding model. The prosecution, as was indicated during the application for discharge, no longer presses for conviction on the count relating to the recognition of the branding asset. It has further become apparent that a proper application of GAAP to the particular circumstances of this branding model would permit recognition in the income statement of income measured on the basis of the valuation of that asset, and accordingly, subject to the expert views of the committee, I submit that the income was properly recognised and accordingly the prosecution will not press for conviction on that count either.

What remains of the branding model counts then is the count relating to the deferral of the branding expenditure. In that regard it is my submission that it has become common cause that no audit work was done in respect of that entry. Mr Wilmot [the expert called by the respondents] in his evidence suggested that a reasonability test as he called it, was done on the R6 million deferral. He accepted in evidence in cross-examination that it was a crude test.

My submission is that it was not even that and in fact all that happened, as you have heard in evidence, was that a member of the audit team, on request for information, was told what Regal had done. It does not amount in my submission to a reasonability test and my submission is the totality of the evidence indicates that there was no audit test done in relation to that.

The audit work, such as it might be described, was limited to a consideration of the fact that there had been some work done by Regal on its branding model and therefore that some expenditure could be attributed to that work and there should be some future economic benefit flowing from it to Regal, and therefore that some expenditure could legitimately be deferred, and that really is the totality of what might be described as the audit work. It is also clear I submit that a clear inference can be drawn as to

what was actually happening in the background. We know that Regal had been forced to accept a significant decrease in the income attributable to the branding model as a result of the recognition of the asset and the income at R5.5 million rather than R55 million.

We know that Mr Levenstein felt passionately about that. He put up a very spirited fight for his income. He was a man who was particularly in the circumstances of the market perceptions and expectations at the time, chasing earnings. There had been up to that time no suggestion whatsoever about the deferral of income.

In fact if anything the attention of management as conveyed to Ernst & Young at the time, was precisely the opposite. It was expressed in the preliminary results and the intention was that the full amount of expenditure at that time, thumb-sucked, and I can call it that because there seems to be no more than that, at R80 million, would be expensed in the current year, so that the future economic benefits would be enjoyed without any reduction for expenditure. So if anything there was precisely the opposite approach taken to the deferral.

The bottom line in my submission, the proper inference that can be drawn, the only inference that can be drawn, is that Levenstein was clawing back some profit. He did it for one reason and one reason only, and that was to present a better picture to the investing public. Put another way one might say he manipulated the accounts to misrepresent Regal's performance to the investing public. Why did he do that? My submission is that he did it to preserve the share price certainly, but more importantly he did it to preserve Regal's image and to preserve its business and to ensure that the public continued to invest in it. These are not emotional statements with respect.

When one examines the background to this charge and one examines what actually happened, as I say with respect, it is a fair inference to draw that that is what was happening and that is how it should have been seen by the auditors.

In the circumstances, I submit it is not an exaggeration to say that here was exactly the kind of situation in which the public is entitled to seek the protection of a system that requires a company's financial results to be scrutinised by an auditor. And this is not a situation where the auditor



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missed something, this was something that was right in front of its face and which it was confronted with. All three of the respondents knew the score. They knew, in my submission, that the deferral of the expenditure could not be accepted on the application of auditing standards.

Their defence is, and really their sole defence is, that they were faced with an extremely difficult situation, and it is my submission that it is precisely when the auditors are faced with that type of difficult situation, that the public needs the protection of the auditor, because if the protection is not provided by the auditor, where does the protection come from?

It is true that it is only with hindsight that we can now say look what happened to Regal and we can recognise that at the time that the 2000 audit was completed, Regal was at the top of a steep and slippery slope. But what was known then to the auditors when they made their decision about the materiality of this entry in the financial statements, was certainly that it was not, if I can use an expression that perhaps Mr Levenstein might use, it was not kosher.

It is suggested that it was not material, and my submission is that that suggestion cannot stand in light of the evidence. It is so, and it is conceded because it is obvious on the face of the financial statements, that the inclusion of the R6 million deferred expenditure improved the income before profit figure and it did not just improve it, it improved so that instead of being worse than the previous year, it was better than the previous year.

It is a matter of perception, an important matter of perception in my submission. It also improved the earnings per share figure, another important message to the investing public. And it did not improve it by a small amount, R6 million in the context of total profit before tax of R50 million, is a substantial portion of the profit. And the reality is that it was simply plucked out of the air. It was plucked out of the air to the extent that it demonstrated – or was symptomatic of a complete change in approach from management, from this vaunting of the fact that all expenditure was being expensed in the current year, to a deferral for, as I have submitted already, one reason and one reason only, and that was to enhance the image which was projected to the public.

And my submission is that, as I have said, that is when the public needs protection, that is when professional standards become most critical, and it is that time when an auditor must stand up and stand up to his professional responsibilities.

A different decision by the auditors at that time, if it had had the effect that was suggested by them in evidence, would have been perhaps that the collapse of the bank was precipitated. That would have made a substantial difference with respect, to all the investors of Regal who continued to invest in Regal between May 2000 and June 2001 when the collapse in fact came. And that must with respect, be taken into account in judging that decision as to whether the reflection was material or not.

In the circumstances it is submitted that there can be no doubt that the conduct of the respondents in this regard constituted improper conduct. The fact that the decision was taken under extremely difficult circumstances, and that is recognised, there is no question but that the circumstances were of the most difficult perhaps that face an auditor, is relevant but relevant only with respect to sentence. It is relevant to the decision as to what price the respondents should pay for their breach of auditing standards. It is not relevant to the question of whether there was a breach of those auditing standards.

My submission in the circumstances is that all three of the respondents must be found guilty of improper conduct in this regard.

In relation to the count against the first respondent in relation to the security for advances on the discretionary loans, with respect the committee now knows the facts. The facts are that there was a total of discretionary loans amounting to some R90 million, and of that three of the larger loans related to related party trusts – the incentive trust, the shareholders trust and the client trust. The prosecution presses for conviction only in relation to the facts surrounding the manner in which the client trust was dealt with.

Although the prosecution originally understood the relevant facts to relate to the shareholders trust, you will recall that it was understood when regard was had to the schedule of the discretionary loans, because it is somewhat



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confusingly represented on that page, that the shareholders trust had two amounts loaned to it. One of R4.6 million odd, the other of R15 million, a total of R19.1 million which is reflected on the charge sheet.

In fact it turns out through the evidence I think of the first respondent himself, who faces the count, that that in fact related to two separate share trusts and the point is made about the shareholders trust, which is the R4.6 million, that that was not tested and the point is made that it is not incumbent of course on the auditors to test every loan, and the prosecution accepts that point and therefore persists in this charge only in so far as it relates to the R15 million loan to the client trust.

The test which was done in relation to that loan is reflected at the defence bundle D9 on page 14, and you will recall the words which are the only reflection of the tests which were done, and the words are the actual agreements were not signed, but a ceding of shares was. The charge then now is based on the assertion that the security should properly have been investigated and, in breach of SAAS 500, insufficient audit evidence was obtained.

The prosecution says that a proper investigation should have been done in respect of this particular loan for four reasons.

The first is that it is a related party.

The second is that not only is it a related party, but it is what might be described as a shadowy related party and I would refer the committee in that regard to the document at the defence bundle 6, which is the summary review memorandum which has been looked at during the course of evidence, and page 14 of that where the following is said about the Regal Treasury Client Trust.

“Difficult to establish exact nature of this. Would seem to be a trust set up to hold shares in bank as some form of loss control protection, but has also paid some donations into community and been allocated windfall trading income earned by the bank. Would appear to be under the personal control of Jeff Levenstein.”

It is so, as was pointed out in evidence, that there is no indication of at what stage this comment was made, but

nothing has been shown of any advance in that view of the client trust, no evidence was given that there was any advance in that view by the auditors of that trust, and the submission is that in those circumstances it is precisely that – when tests were being done on the discretionary loans, that particular trust stood out like the proverbial sore thumb.

The third reason why there should have been a proper investigation is that that trust reflects a significant percentage of the total of discretionary loans, it reflects some R15 million out of the R19 million odd total.

And fourthly, that it is secured by a cession of shares in Regal itself, and those facts taken together would commit it to the auditor as a transaction which required full investigation, or required investigation, proper investigation, during the course of testing.

The prosecution also points out to the committee that the security should have been reconsidered in light of the fact that any auditor would have regard to the substantial loss of value in the security which would have resulted from the dramatic 40% drop in the value of the share price which happened between May 16th and the end of May 2000. That of course was after the initial testing was done. The point which is made by prosecution is that that should have formed the subject matter of the subsequent events review, and it is not an answer to that to say it is impossible to test all security again in a subsequent events review. That point is taken. The point that is made by the prosecution is this is something which comes up very specifically and is something which can hardly be missed by a reasonable auditor. And in the circumstances it is submitted that a reconsideration should have taken place at that time.

It also cannot be said glibly that this did not amount to a permanent impairment. My submissions in that regard are firstly that Regal itself had only been listed for a year, so the question of permanent impairment must take that into account, and the fact of the matter is that the drop was of such a nature that it called, as I have said, for further investigation, and the point really is that it is not as if it was considered and considered not to be permanent impairment.

There was no consideration whatsoever done of the security held for this loan. In that regard it is my submission



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that the evidence of – I forget now, I think it was the first respondent who said that the annotation to cell H27 – it was indeed the first respondent. He said the annotation to H27, that is the annotation which read:

“The actual agreements were not signed, but a ceding of shares was.”

He said that reflects to him an analysis of the security. He says when you look at the context of that entry, it is quite clear that that is what was being done in the course of these tests.

My submission in that regard is that is precisely what it is, a reflection of what was not done. Because if one has regard to the context and the first respondent pointed this out very fairly, where the security was tested, that was noted. So where one does not see the note, one can accept that that testing was not done, and it should have been, and it is the prosecution’s submission therefore in those circumstances that the failure to conduct that test amounts to improper conduct for want of compliance with SAAS 500.

At the very least of course, if that conviction is not upheld, then there is a contravention of SAAS 230 for the failure to reflect the evidence of the auditing work done.

Turning then to the charge against the second respondent relating to the reflection in the financial statements of the R2 million emolument to Mr Levenstein. The bottom line here submitted is that it is admitted that an error was made. Ernst & Young as an amorphous body, and I mean no disrespect to it in those terms, realised that the payment should have been dealt with and realised how it should have been dealt with and realised that disclosure was required.

The fact of the matter is, and it is conceded to be an error, disclosure was not made. Mr Wilmot indicated that really in the context this should be ignored, it is a very small point. He makes that point.

My submission is that it is an important disclosure. It is specifically required by Section 297 of the Companies Act in unequivocal terms, and while the seriousness of the breach might be taken into account in considering what punishment should be levied, the point is it is a breach, and the

question then is whose responsibility is that breach?

The second respondent is somewhat dismissive of his role towards the end of the audit for the 2000 year. He says that he agreed out of the goodness of his heart to see to the finalisation of the glossies. In my submission in taking on that responsibility, he took on the responsibility for the financial statements, including the responsibility to ensure that they accurately reflected the facts and complied with the law. He chose the manner in which he would discharge that responsibility.

Mr Wilmot says look, it is a matter of the auditor making a decision, it is a subjective decision. Well, the point is that decision must be judged by the panel. It is my submission he made the wrong choice and that the choice he made is not justifiable in the circumstances. The second respondent knew that he had no background knowledge of the audit.

The first respondent may have been able to come before the committee and say look, I was involved in this audit, I knew the issues which had arisen, I knew how they had been dealt with, it was enough for me to say to my subordinates what has been done, has the checking been done, let me see the checklist, all right, everything looks fine. That was not the situation in which the second respondent found himself at all. He came in, he says he had nothing to do with the audit after he was involved in the branding income scenario. He went off, he did the audit I think of ABSA, he then went on holiday and he came back and he took on that responsibility. He knew that he had no background knowledge of the audit.

It is my submission that he owed a professional duty to familiarise himself with the issues that had arisen and had in this particular case expressly arisen as an issue being one among not very many in the audit issues document. The error cannot simply be dismissed as an anonymous error that lies somewhere within the firm and comes to rest on the shoulders of no responsible person. That in my submission is precisely the responsibility that the audit partner takes on, and the second respondent must accept that responsibility and it must be accepted that it was not discharged.

In regard then finally...

Chairman: Just before you leave this aspect. I take it that



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in the ordinary common law doctrine of vicarious responsibility, is questionable in this type of prosecution, but what do we make of the Code of Professional Conduct which at paragraph 3 says – 3.1 :

“A practitioner may be held responsible for breach of or failure to comply with this Code on the part of all persons who are his employees, under his supervision, or under his partners.”

Can it be said that the person who made the error was under the supervision of the second respondent?

Pro forma complainant: There is no question of that with respect Chair, and that is as in my submission – your co-panellists would be aware of, that is the position of the audit partner. The audit partner takes responsibility for the audit and he cannot be heard to say the error lies somewhere with my subordinates. And that is reflected in the very passage to which you refer with respect Chair, and that is why the responsibility must rest on the second respondent and why I say to Mr Wilmot, that ultimately it is a question of risk taking.

He took a risk. He took a risk. He says I think – and it was not entirely without justification, he said most of the work has been done, most of the issues have been dealt with, I am prepared to speak to my subordinates and gain their impression. As was put by a member of the panel:

“Did you simply sit around a table and discuss this, or did you sit there surrounded by the working papers, looking at the issues which had come up?”

And the answer was no, we just sat across the table and I asked for their opinion. That is not sufficient. If he had investigated the issues properly and had missed it, that is a different point. He took a risk. He took the risk not to investigate and the risk came back to bite him. That is with respect ultimately what must be found.

In relation then to materiality. There my submission is simply that the facts are clearly before you. The submission that is made by the prosecution is that when it became apparent that the profit figure in terms of which the materiality level had been calculated became drastically reduced, coupled with the circumstances which had arisen

at that precise time which demonstrated not just the dominance displayed by Mr Levenstein, which had been there presumably throughout, but particularly his pursuit of earnings, which is recognised in auditing practice as a risk factor, that necessarily threw up the materiality level as something which required reconsideration.

Chairman: Which of the respondents do you contend should be saddled with responsibility for this?

Pro forma complainant: The first respondent, and that is the only evidence that was put up by the prosecution. It was the prosecution’s case that the first respondent should bear responsibility for that.

It is so, as has been pointed out during the course of the evidence that has been given during the hearing, that nothing concrete can be shown to have resulted from that, and with respect that is correct in relation particularly to the R6 million deferred expenditure. The point that is made there, in my submission is correct. The materiality that was relied on at that point, was not the materiality level so much as the effect that this would have on the investing public, and I have made submissions in that regard. So I do not rely on that as being something that would have necessarily changed because the materiality level changed.

So in the end I place the facts before the committee. I make the submission that there should have been a reconsideration. The committee knows as a panel of experts, the importance of the setting of a materiality level and the committee is in the best position to judge whether the failure to reconsider that in the circumstances, amounts to improper conduct. Thank you.

Address in argument by respondents’ counsel

I should perhaps deal at the outset, because it may be a factor in more than one charge – with the question of whether there can in this enquiry be a finding of vicarious liability under Clause 3.1 of the Code.

We submit not, for two fundamental reasons. The first is a matter of interpretation of Clause 3.1. It says :

“A practitioner may be – *may* be held responsible for a breach of or a failure to comply with this Code on the part



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of persons who are his employees or under his supervision or his partners.”

I suppose ‘may be held responsible’ may mean different things. It may mean may be held criminally responsible, it may mean may be held civilly liable, and it may conceivably also mean may be held to have been guilty of improper conduct, that is, may be held responsible in the context of such enquiry as this.

But it does not say ‘must’, it says ‘may’, and we submit that to make sense of such a provision if it is capable of interpretation to mean may be held to have been guilty of improper conduct for failure to comply with this Code on behalf of others, then it must be interpreted to mean may be held responsible if he was remiss in his duty to ensure that those under his supervision or his partners or whatever, observed the Code. It cannot mean may be held to have been guilty of improper conduct despite the fact that he might be wholly innocent of any impropriety. That would be to give an absurd interpretation of the two rules read together, and the rule cannot be interpreted to mean that people wholly innocent of any misconduct may nonetheless be branded to have been guilty of improper conduct. That is our first submission.

Our second submission is that it is a matter that must be pleaded. You cannot fail to plead it and after the event contend that whereas the case that I have run against is one that you personally have been guilty of improper conduct. I acknowledge that I have failed to establish that case. It is not you but someone else in your firm that has been guilty of this improper conduct, but I now nonetheless seek a conviction under Rule 3.1 without ever putting you on your defence on the question whether that other person has been guilty of improper conduct and whether you should be held responsible for that other person’s conduct. That would be fundamentally unfair and would be in violation of the most fundamental requirement that the accused be given an opportunity to be heard on the charge against him. So that we submit that although in theory we accept that there may be a conviction of improper conduct under Rule 3.1, it is simply not – this is not such a case.

May I turn then to the three charges.

Firstly, the branding charges. My learned friend does not

seek a conviction under the first two aspects of it, the recognition of the asset or the income, and we also submit with respect that there is absolutely nothing in the evidence that would justify a conviction.

And I turn then to the third aspect and that is the deferral of the branding expenses of R6 million, and I start off by stressing how important it is that one should remind yourself of the circumstances in which this decision was taken. It was not a decision, a materiality judgement call, that was made in the circumstances in which those calls are normally made, that is, before publication of the accounts and before they have become final.

This judgement call was made after the client had gone off and without consultation or consent of the auditors, published accounts which they called audited, in which they deferred expenses – well, in which they did two things.

Firstly, to concede the auditors’ demand that the branding income be slashed from R55 to R5.5 million, and secondly, without authority and without the blessing of the auditors, to defer R6 million worth of branding expenses.

My learned friend has taken the liberty of making a series of emotive statements about that deferral and the motive with which it was made. We submit with respect that you should resist the invitation to approach the issue on that basis, which is both emotive and which impermissibly employs the benefit of hindsight. What you need to do in determining whether these auditors acted properly or not, is to place yourself back into their shoes, without the emotive issues raised by my learned friend and the benefit of the knowledge of hindsight that we have today.

The evidence tells us that – firstly, that it was not surprising as my learned friend suggested, that the client would want to defer some of the branding expenses despite the fact that they had not previously done so, because they had up to that point recognised the income in full, so that there was no cause for deferral of expenses.

It was on the big issue where the auditors had stood up to the client and the client had finally capitulated, that the income was slashed from R55 to R5.5, and it was as a result of that reduction that the issue of deferral of expenses legitimately arose.



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And the evidence is, and it is uncontradicted and it is unchallenged, that the deferral was at least in part justifiable so that one proceeds from the premise that what one is dealing with is not a departure from GAAP of R6 million before tax and R4.2 after tax, but an untested item of which it is clear that it is at least in part justifiable, which may be wholly justifiable.

The prosecution made no attempt to demonstrate that that item was not justifiable, and the auditors when they made their judgement call, had to take into account that the whole item might be justifiable. All they knew was that there had been substantial branding expenses, the client said it was 18 or 9 or in any event more than 6 and that the deferral of 6 is justified.

I am not suggesting for a moment that it was demonstrated that the deferral was justified, but they had to contend with the possibility that it might be, that they might pull the plug on the bank and then be confronted with the accusation that they had done so despite the fact that the deferral might have been perfectly justified. But they told you at the end of the day that they realised under those circumstances that they did not have the luxury of making the determination as to whether the deferral was justified or not and that they made it instead on the basis of materiality.

Well, as far as the materiality is concerned, it is true as my learned friend says one has to take into account that no substantive work had been done to quantify the expenses justifiably deferred, so they had to cater for the possibility that it was a substantial amount. Less than R6 million before tax, R4.2 million after tax, but one did not know how much less than that. They had to ask themselves in the circumstances in which they found themselves and in the light that they had in those circumstances, would users of these statements likely be influenced in their decisions if the deferral had not been made. Those users, it is also common cause, had expected a profit of the order of R80 million after tax, and in fact had been told that the after tax profit was only R50 million.

The question is, and this is the question that the auditors ultimately thought was decisive, was that that investor whose expectations had already been so dramatically disappointed, would not have made any different decision

if he had been told that the profit was not R50 million, but was in fact R45 million after tax, R45 or R46 million.

It was a judgement call fundamentally made by the third respondent, and I am going to ask you to take that into account when you consider this issue, that his two junior partners were entitled ultimately to rely on his leadership in taking that decision, so that if anybody is responsible for it, it was the third respondent.

You then have to ask yourself with respect, two questions, and they are two separate questions and I will address you on them separately.

The first question is was he right? If he was, then that is the end of the enquiry.

The second question arises only if you were to conclude that he was in fact wrong. The second question then is well, was he negligent? Because to make a mistake is not necessarily to be negligent, and it is only for negligence that you will punish him and not for making a mistake. We all make mistakes and it does not amount to professional misconduct to make one.

But may I deal with those two issues separately, those two questions. Firstly, was he right or was he wrong? We submit that he was right. There are five witnesses who gave evidence on the issue. Mr Patterson [the expert for the *pro forma* complainant], the first respondent, the second respondent, the third respondent and Mr Wilmot. Every one of the five told you that that materiality judgement call was a fair call. There is no evidence before you to the contrary.

When that is so, when there is no witness who contended that the judgement call was not a fair one, that the judgement call was wrong, it would be fundamentally unfair to make such a finding against the respondent when it is not supported by any evidence before you and when the respondent has never had an opportunity to test any contention to that effect in cross-examination. The only witness who was called to contend that that was an incorrect judgement call conceded the contrary, and in those circumstances it would be unfair of you for reasons of your own, unsupported by any of the evidence, to come to an opposite conclusion.



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You may hold different views, and I am not submitting if you do that you are wrong and that the third respondent is right, and that is because this issue as to whether that item was a material one or not, is a classical example of an issue of professional judgement, an issue on which professional people, responsible professional people, skilful professional people may legitimately hold different views, and it does not make one view right and the other one wrong that they hold different views about that same issue. It is classically an issue which arises in your profession in many different spheres, but in relation to the materiality judgement call perhaps more than in others.

But in any other profession judgement calls that professional people have to make, where there is a range of legitimate difference of opinion and as long as one is within the range it cannot be said that any judgement call is right and another one wrong. They are all right in the sense that they are judgement calls that professional people of reasonable competence, exercising with reasonable care, may legitimately make. So that even if you disagree with the judgement call that the third respondent made, it does not make you right and him wrong. It just means that there is a legitimate difference of opinion in a domain in which professional people legitimately differ from one another. The witnesses who gave evidence before you all accepted that it was a correct call that he had made, a fair call.

If you disagree, if you were to conclude not only that the third respondent was wrong, but that his judgement call was beyond the range of legitimate difference of opinion, then it does not follow that he was guilty of improper conduct. It would then follow merely that he made a mistake. But we all make mistakes and a mistake does not amount to unprofessional conduct unless it was carelessly made, unless it was negligently made, and it is important that you should make that distinction between a mistake on the one hand, and negligent conduct on the other, because it is negligent conduct that is branded unprofessional and not a mere mistake.

And when you embark on this enquiry into the second question, was this not only a mistake, but one that was negligently made, may I refer you to some law on the question as to when a professional person can be said to have acted negligently.

The first is an extract from the textbook which is the leading English textbook on Professional Negligence of Jackson & Powell. But I use it not for the views of the authors, but merely because it is a handy collection of extracts from English cases on the topic and I will later go to a South African case from which it will appear that our law is substantially the same.

The first extract to which I would like to refer you is on page 611 of the textbook. You will see from page 609 that the section of the book is the section on the standard of skill and care. This happens to be a section in the chapter of the book on medical practitioners, but just because there is such a rich jurisprudence on the question of negligence of medical practitioners. I will later demonstrate to you that the principles to which I am going to refer, are applicable to all professionals and not only to medical practitioners.

The first extract then that I wish to refer to is on page 611. There are two paragraphs (d). It is the second one that I wish to refer to where there is a case of **Hunter & Hanley**. Lord Clyde in **Hunter & Hanley** said :

“But where the conduct of a doctor, or indeed of any professional man, is concerned, the circumstances are not so precise and clear cut as in the normal case [of negligence]. In the realm of diagnosis and treatment...”

and I would add and materiality,

“...there is ample scope for genuine difference of opinion and one man clearly is not negligent merely because his conclusion differs from that of other professional men, nor because he has displayed skill or knowledge that others would have shown. The true test...”

and I emphasise this part

“...The true test for establishing negligence in diagnosis or treatment on the part of a doctor is whether he has been proved to be guilty of such failure as no doctor of ordinary skill would be guilty of if acting with ordinary care...”

In other words, translated to our case, the question is whether the third respondent's judgement call was such as no auditor acting with ordinary skill and care would have made in the circumstances.

Over the page there is reference to the test in English law,



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the Bolam test. It is described on the left-hand side next to that number 6-34 in the middle of the page.

“Despite the variety of formulations which have been offered by appellate courts, probably the best known and most often quoted definition of the standard of care required of medical practitioners is McNair, J’s direction to the jury in **Bolam v Friern Hospital Management Committee**, commonly known as ‘the Bolam test.’ Indeed the Bolam test itself has been the subject of numerous judicial paraphrases and summaries. Lord Scarman in **Sidaway v Governors of Bethlehem Royal Hospital** has reformulated it thus: ‘a doctor is not negligent if he acts in accordance with a practice accepted at the time as proper by a responsible body of medical opinion, even though other doctors adopt a different practice.’”

May I translate that again to our case.

The third respondent is not negligent if he acts in a manner acceptable to Mr Wilmot, Mr Patterson, etcetera, despite the fact that other auditors might adopt a different view.

That is the point I tried to make earlier, that the question is not whether you agree with him, the question is whether his judgement call was such as a reasonable auditor could have made under the circumstances. All of the evidence, including the two experts on both sides, Mr Wilmot and Mr Patterson, agree that it was a proper judgement call in those circumstances.

Over the page, that is page 628, on the left-hand side next to the number 6-51, the same point is again where there is a lack of a single uniform practice.

“In many instances, of course, there is no uniform, general and approved practice... Different schools of thought exist. If a medical practitioner acts in accordance with one respectable school of thought...”

that is, the one supported by Mr Wilmot and Mr Patterson
“... he is unlikely to be held negligent.”

And there is an example of it at the top of the next page, that is at the top of page 629.

“The decision of the Court of Appeal in **Hughes v Waltham Forest Health Authority** affords a recent

illustration of the same principle. The decision of two surgeons not to refer the patient for an ERCP examination was endorsed by an eminent surgeon, practising in the same field, as being in accordance with the practice accepted as proper within the profession. The Court of Appeal reversed the trial judge’s finding of negligence. The fact that two other surgeons were critical of the decision and that it turned out to be mistaken, did not mean that it was negligent.”

Again in this case the third respondent’s judgement call was in accordance with the practice accepted as proper by Mr Wilmot and Mr Patterson and was not contradicted by any expert before you, so that even if you were to hold different views, it would not render his call to have been negligent. Lastly from this textbook, at page 868 in the section on accountants there is a heading “General Practice and Knowledge as Evidence of the Standard.” 8-81. I just want to pick it up six or seven lines down, after footnote 15.

“Reflecting similar statements in other professional negligence cases the Alberta Court of Appeal in dismissing a claim against accountants in **Sceptre Resources v Deloitte Haskins & Sells** proceeded from the premise that ‘the law allows differing opinions among accountants, as it does with the medical and legal professions. Acting in concert with an opinion or practice held by a significant fraction of the profession, is almost always a defence to a suit of malpractice... The only exception arises where the practice of the profession is totally unreasonable.’”

Again the same point. A respectable body of opinion in this case represented by Wilmot and Patterson tells you that it was a fair judgement call. The fact that others may differ does not render the third respondent’s decision negligent.

Lastly then if I may turn to a South African case, that is the case of **Castell v Greef**. It is a judgement of the full bench of the Cape Provincial Division and the passage to which I wish to refer appears on page 416 of the judgement, just below the letter E.

“It has on occasions been suggested that a mere error of judgement on the part of a medical practitioner does not constitute negligence. In **Whitehouse v Jordan** the House of Lords *inter alia* considered the correctness of the statement by Lord Denning in the Court of Appeal that



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'We must say, and we say firmly that in a professional man an error of judgement is not negligence.' The House of Lords held this to be an inaccurate statement of the law. Lord Fraser Tullybelton expressed the view that 'I think Lord Denning must have meant to say that an error of judgement is not *necessarily* negligent'. Lord Fraser further observed as follows."

and it is this passage that I wish to emphasise

"Merely to describe something as an error of judgement tell us nothing about whether it is negligent or not. The true position is that an error of judgement may or may not be negligent; it depends on the nature of the error. If it is one that would not have been made by a reasonably competent professional man professing to have the standard and type of skill that the defendant held himself out as having, and acting with ordinary care, then it is negligent. If on the other hand it is an error that a man, acting with ordinary care might have made, then it is not negligent."

Translated to our case, if the third respondent's judgement call is a judgement call that an auditor acting with ordinary skill and care might have made, then it was not a negligent one, whether we agree with his judgement call or not.

And we submit that once one recognises, as we have submitted, that there are two questions, the first question is whether the third respondent was right or wrong. To recognise that merely because some of us might hold a different view, does not make him wrong. He was correct if his judgement call was within the legitimate range of difference of opinion. All of the evidence before you supports his judgement call. That means that he was correct and not wrong. It was within the range of decisions that were right.

Even if he was without it, the question is whether it is still a judgement call that an auditor acting with reasonable care and skill might have made, despite the fact that it might have been wrong, then we submit it clearly was.

All of the evidence again tells you that it is a judgement call that Mr Patterson would have made, that Mr Wilmot would have made, and that was not challenged. Nobody challenged that evidence, nobody came to contend that it is a judgement call that a reasonable auditor cannot and should not have made under those circumstances. So that

we would submit that not only would it be unfair to the third respondent, but it would be a perverse finding on the evidence before you to conclude that he was wrong, and not only that he was wrong, but that his judgement call was negligent. The evidence before you simply does not begin to warrant such a conclusion.

May I turn then to the R2 million paid to Mr Levenstein and the question whether the second respondent ought to have picked it up. My learned friend is quite correct to say it is clear that somebody in Ernst & Young was mistaken and was negligent, and as a result of that negligence the disclosure that ought to have been made by the client, was not picked up, the error was not picked up.

And we have also identified who it was, it was said that it was either Mr [A] or Mr [F]. There is no attempt to contend that there is some amorphous, unknown, anonymous person who made the mistake. The clerk clearly made the mistake. The person who compiled the disclosure checklist made a mistake. Ticked off the item as having been properly dealt with when in fact that person clearly must have known that it was not. So there clearly was a mistake and it was a negligent mistake.

The question is whether the second respondent is guilty of unprofessional conduct in not picking it up. Now the second respondent's conduct must be judged in the light of what he was asked to do. You are not here sitting in judgement on whether the organisation of Ernst & Young were remiss on this item. They clearly were and we do not even need to debate that. The question is whether the second respondent was guilty of unprofessional conduct.

In answering that question one must have regard to what he was asked to do. Not whether the instruction to him was the correct one, whether there ought to have been a wider instruction to him, whether he ought to have been asked to be more careful in ensuring that there was no gap between himself and his predecessor. That was not what he was asked to do. He was asked merely to complete the glossies.

He was asked to do that against the background of the letter of the 17th May which said to the client that subject to proper disclosure we will issue an unqualified certificate on the figures published on the 16th May, so that he was entitled to accept that his predecessors had finalised the



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figures and his job was one of presentation and disclosure.

Now our learned friend argues that that is tough; he assumed the responsibility for the financial statements by issuing the audit report. That is a beguilingly and deceptively attractive way of putting it, and it would be the relevant one if this were an enquiry into professional negligence. If he was sued for damages he is jointly and severally liable with all the partners of Ernst & Young, and that would be the proper analysis. But that is not our enquiry.

Our enquiry is whether the individual was guilty of unprofessional conduct. When he signed the audit report, he did not sign his name, he signed Ernst & Young. All he did was with the authority of his firm, on behalf of the firm, to subscribe to that audit report. He did not purport either internally or externally, personally to assure the reader of the truth – or the proper audit of every item in the balance sheet and the income statement.

He was entitled to assume that the audit on the numbers had been finalised. His task was to see to proper presentation and disclosure. He was not asked in his evidence here, and the enquiry never was, whether he did that job as a whole, whether that job was then done properly.

You simply do not know what the second respondent did in order to discharge that function. His evidence and his cross-examination and the charge against him was confined to a single item, directors emoluments, and he was asked what did you do in relation to directors emoluments, and he said as far as directors emoluments are concerned, I had firstly the disclosure checklist which told me that the item had been properly disclosed, and I secondly had the directors' signed declaration of his own income.

And the question then is, was it negligent for the second respondent in those circumstances not to have enquired further. In other words, for the sake of that item, not to have gone below the disclosure checklist and below the directors' declaration.

And we submit in the circumstances not. Whether there were other reasons to do so is debatable, but that is not the question before you. The question is whether in relation to this item, directors emoluments, it was incumbent upon him to do more than to look at the disclosure checklist,

supported by the directors' declaration and the consultation with his staff in which they assured him that everything had been done that needed to be done.

We submit that in those circumstances it would be quite absurd as Mr Wilmot has said, that the audit partner need to do more to satisfy himself that directors emoluments had been properly disclosed.

Then there is the question of the charge relating to the security for the advances to the trusts. It is important on this score that you have regard to the charge as it was formulated, and I am not going to ask you to do that purely for technical reasons, but I am going to ask you to do that for reasons of fundamental fairness. Because if you had listened to my learned friend's argument on this point, all of it related to and arose from features of the client trust quite unrelated to the trust identified in the charge and the grounds identified in the charge as the unprofessional conduct of which the respondents were charged.

The charges in paragraph 10 of the charge sheet, and I emphasise that the charge is confined to the shareholders trust, because that is the only one in respect of which there was said to be a deficiency of security and it was the shareholders trust advance of R19.7 million and the accusation was made in paragraph 10.3 :

“The security pledged for these loans and the recoverability of the loans were not properly investigated by the auditors. No further comments, tests or enquiries were made to investigate these advances and the underlying security for the advances.”

Well, it is now accepted at least that in relation to the shareholders trust, that that charge is unfounded. The shareholders trust is the one identified as item 28 on the schedule at page 10 in the defence bundle, *document 9*.

That item was not chosen for testing and it is common cause that it was entirely proper for it not to have been selected. The sample selected from the discretionary loans – it is a very large one, upwards of 80%, so the fact that that one was not selected was not criticised.

So on the charge as formulated, it is conceded that there is no case made. My learned friend seeks to make a case in



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relation to a different amount, for a different trust, for different reasons. He bases his case on the inadequacy of the test done on the Regal Treasury Client Trust for R15 million. So the shareholders trust of R19.7 million is now said to have been intended to refer to the Regal Treasury Client Trust advance of R15 million.

But in relation to that trust the first respondent testified that the note at page 14 in fact meant and must be understood to mean in its context that the security had been properly checked. And I do not know, my learned friend simply argued that the security was not checked, but with respect you can see from this note, the first respondent said it was evident from the note, that the clerk in fact checked the security of all these advances and that his note must be understood to mean that the security was checked but that there was no noteworthy deficiency found in relation to it.

That he did some check is quite clear. He inspected agreements, he inspected a cession, he saw that they were signed, he made a note in relation to the agreements that were not signed, but that the cession was. And the first respondent says it must be understood that he also checked the security. There is no contrary evidence.

There may be a lack of clarity because we are now into a different trust from the one in relation to which the charge was raised, but you simply cannot find as a matter of fact that the security was not properly checked. The first respondent says it was; he knows his clerk and he says that that is the proper interpretation of this note in its context. And there is simply no basis for you to find that an onus has been discharged to prove that the security was not checked.

My learned friend then says well, if that is so then there was insufficient record kept of the audit work that was done, and with respect I know that SAAS says that adequate record must be kept of the audit work that is done. But that does not mean that if your clerk makes an ambiguous note, one ambiguous note in one work paper renders the partner guilty of unprofessional conduct because of the ambiguity of the note. It certainly does not mean that. He and I and you may be uncertain what that note means, but if it is sufficiently clear to the audit partner for whose benefit the

note was made, and even if it is not, it does not constitute improper conduct that there is an ambiguity in one cryptic note in one work paper. That would be quite absurd and that is not what the standard means.

The standard means that on the whole records must be properly kept, and these records were properly kept. The fact that one little note on one paper is ambiguous, does not make either the author or his partner, his boss, guilty of improper conduct.

The last question then is the question of materiality that they say should have been revisited. It was not quite clear to me at the end of the day what it is that my learned friend is contending should have been done. I understand him to say that the first respondent ought to have revisited the issue of materiality in the light of the altercation with Mr Levenstein in the first half of May.

There were at times during this case other theories advanced as to why materiality ought to have been revisited, but those theories may be disregarded because the charge is confined to one cause for which it is said materiality ought to have been revisited. Paragraph 14 says that "There is an inverse relationship between materiality and the level of audit risk, i.e. if audit risk increases, then materiality should decrease. Although the level of audit risk increased during the audit of Regal, the materiality level calculated by the auditors did not decrease as required, but in fact increased."

That allegation that it was increased was not substantiated, it remained the same. And the question is whether the first respondent is guilty of unprofessional conduct for his failure to reduce the materiality threshold set at the outset in the light of the altercation with Mr Levenstein in May.

Well, the first respondent cannot be guilty of anything of the kind. He was relieved of this job on the 16th May and there cannot be any suggestion that he should before that date have reviewed materiality in the light of Levenstein's conduct. Levenstein's conduct manifested itself between the 5th and the 15th May, and if it triggered the need to do anything, that it was somebody else's duty, not the first respondent's duty. It would have been his successor, the intermediate person whose name was Mr [G], but he is not before you, and whether he reviewed materiality or not,



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you simply do not know, there has been no allegation and no enquiry into that question. So that there is absolutely no basis for this charge.

But even if you were to hold the planning materiality ought to have been reviewed, then with respect we submit that there is a fundamental flaw in a charge which says to an auditor that you acted negligently in your failure to review the planning materiality set at the outset of the audit. Because you would know and the evidence tells us that the materiality threshold set is merely a tool employed by the auditor to plan his audit, to guide him in the way that the audit is done, and whether it has any impact on the way the audit is done and if so what it is, depends entirely on how the materiality threshold is employed.

But the question at the end of the day is not whether the tool, that is, the materiality threshold, was correctly calibrated, but whether the audit was a proper audit, and in this case there is no suggestion that whatever the materiality threshold was, that the audit was not a proper one, that some further testing should have been done, and would have done if a different materiality level had been set.

So that the contention here speaks about materiality in the air, without suggesting that it had any impact on the audit that was done at all, and in the absence of any allegation that the audit was in some way deficient, we submit that there was no unprofessional conduct, there was no failure to do an audit in the way that a reasonable auditor would have done in the circumstances. So we submit for that reason too that there can be no conviction under this charge.

Reply by the *pro forma* complainant

I do not intend to go beyond the right. It relates only to points of evidence raised and there are none – new evidence and to law, and it is just to the law that I turn in two very brief respects.

The one is the law on negligence, and my only submission to the committee in that regard is to urge the committee not to be intimidated by this question of what is negligence and is it an entirely subjective matter and are we simply judging a man's subjective decision and accordingly that a judgement call is a judgement call and there is really no right or wrong.

The point about it is it is not an intimidating, mysterious legal concept in this enquiry, and I would refer just in that regard to Disciplinary Rule 2.1.5 which really sets the parameter, and it is that "A practitioner is guilty of improper conduct if he, without reasonable cause or excuse..." and subject to the proviso which you need not worry about for the time being "... fails to perform any work or duties commonly performed by a practitioner with such a degree of care and skill as in the opinion of the Board might reasonably be expected."

Now that is the point. The point is you are the Board for these purposes, you have auditing expertise, you are almost by definition sitting here as reasonable auditors and accordingly it is indeed your judgement that is applicable. And it is proper for you sitting as such to apply your standard of objectivity, and to judge the actions that were taken, on that basis.

And my submission is therefore that there is no need to concern yourself about any mysterious legal concept here that you are incapable of grappling with. Apply your minds as reasonable auditors and that will lead you to an understanding of whether 2.1.5 is breached or not.

And finally on the law, my learned friend makes the point that the second respondent in signing the financials off, in signing the audit opinion, does not sign as himself but signs as Ernst & Young. Of course the point is that Section 20 of the Public Accountants and Auditors Act makes it clear what an auditor's duties are, powers and duties of auditors. And the auditor it is speaking about is not Ernst & Young. Ernst & Young is not an auditor. Ernst & Young is not subject to your professional inspection. The auditor in these circumstances is the person, the auditor who signs, the auditor who represents to the public, and that is clearly set out in Section 20 of the Act, and it is that person and against that person in that capacity that the charge is directed, and I direct you with respect to the provision of Section 20 of the Act.

JUDGEMENT

Chairman: I now proceed to give the reasons of the Committee for the decision which I shall announce at the end of it.



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The three respondents are all of them registered public accountants. They were at different times partners in the firm Ernst & Young which had been appointed auditors of the group of companies to which I shall collectively refer as 'Regal'. The holding company in the group was Regal Treasury Bank Holdings Limited and an important subsidiary was Regal Treasury Bank Limited. The holding company was at the relevant time listed on the Johannesburg Stock Exchange but it collapsed in the year 2001, was de-listed and placed under curatorship.

An enquiry was thereafter held under the chairmanship of Adv J Myburgh. In the report of the Commission strong criticisms were made of the conduct of the Regal group, and in particular of the person who was for a long time its chief executive officer, one Levenstein. Fraudulent schemes were held to have been committed *inter alia* by Levenstein.

Ernst & Young were also dealt with, and we infer that adverse findings against them were recorded. Probably in consequence of these findings, an investigation was directed by the Public Accountants' & Auditors' Board, which led to disciplinary charges being brought against the three respondents. They [the respondents] complain of the fact that the Myburgh Commission made adverse findings concerning Ernst & Young. They say that when the Myburgh Commission was set up they were asked to assist, which they did. They were called as witnesses but were never informed that the investigation by the Myburgh Commission might involve findings concerning their own conduct and omissions. Had they been apprised of these possibilities they would have sought the opportunity of cross-examining witnesses and of adducing adequate evidence. They did not do so and have in the result to face this enquiry in which unprofessional conduct relative to the audit of the Regal companies by Ernst & Young is attributed to them.

This Committee was set up and given delegated powers under the Public Accountants' and Auditors' Act to hear and adjudicate on the charges of unprofessional conduct. Several charges against the respondents were formulated after the initial investigation which was conducted by the witness, Patterson, and were presented to the respondents.

In broad terms the charges related, in the first instance, to the audit opinion given in regard to the financial statements for the 2000 financial year. In the second instance the charges related to auditing work rendered in respect of the 2001 financial year. Some of these charges were subsequently abandoned.

At the hearing, after the *pro forma* complainant closed his case, application was made for discharge on *inter alia* the charges relative to the auditing work rendered concerning the 2001 financial year. Counsel for the *pro forma* complainant did not support the case in regard to the latter group of charges and absolution was granted in regard to those charges. One charge in the group relative to the 2000 financial year was also not supported.

At the end of the day the committee was left with the following charges:

1. A comprehensive charge that on 16 May 2000, the respondents issued, caused to be issued or permitted to be issued, an unqualified audit opinion stating that the financial statements of Regal Holdings for the year ended 29 February 2000 fairly represented the financial position of the Regal group whilst the following matters were improperly dealt with, namely:
 - a) branding assets
 - b) branding income
 - c) branding expenditure
2. A second charge, that the second respondent, who was at the relevant time in charge of the relevant audit failed to note and identify a payment of R2m to Jeff Levenstein which should have been recorded as an emolument.
3. A third charge, that the second and third respondents failed to note and report on the fact that insufficient security had been provided for certain advances made by the group.
4. A fourth charge, relevant to the materiality level.

Mr Patterson gave evidence, for the *pro forma* complainant, all of the respondents testified, and Mr Peter Wilmot gave expert testimony.

Before dealing with the details of the charges and the



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evidence, I should refer to certain matters which were either common cause or which were supported by credible evidence.

The first is that it was afterwards established that Levenstein and possibly some other persons were busy with fraudulent schemes in regard to the Regal group. In the examination of witnesses the question was raised whether Ernst & Young should not have unearthed these schemes at an earlier stage. The committee notes that the defence evidence is that only at a late stage was the truth discovered, and that the whistle was blown when Ernst & Young saw what was going on. To use the words of their then counsel, they pulled the plug on Regal and Regal collapsed.

The second is that the material presented to Ernst & Young at the stage that the work was done, did not reveal the fraud subsequently ascertained.

It also appears that the auditors challenged the management of Regal strenuously on a number of issues, including accounting policies, and the auditors required Regal to make adjustments. They consistently consulted on the matter. It is axiomatic that in a disciplinary enquiry such as the present, the *pro forma* complainant has, through evidence, to establish the charge made, on a balance of probabilities. It is also clear that the *pro forma* complainant is bound by the charge as formulated and to which the respondents have responded.

This is important for in the discussions which follow, the committee considers itself bound to dismiss a certain charge because it does not correctly set out what can be seen to be the essence of concern. It is also relevant that in considering the conduct of the respondents and the decisions made by them, the fact that if it is found that other accountants or the accounting members of this tribunal may have viewed the matter differently, this does not necessarily attract the inference of unprofessional conduct.

This view is consistent with what is said in paragraph 4.4 of the Code of Professional Conduct. I think that the words of Lord Clyde in the English decision in **Hunter v Hanley** reported in 1955 SC 204 are apposite. I quote:

“But where the conduct of a doctor, or indeed of any professional man, is concerned, the circumstances are not so

precise and clear-cut as in the normal case [of negligence]. In the realm of diagnosis and treatment there is ample scope for general differences of opinion and one man clearly is not negligent merely because his conclusion differs from that of other professional men, nor because he has displayed less skill or knowledge than others would have shown. The true test for establishing negligence in diagnosis or treatment on the part of a doctor is whether he has been proved to be guilty of such failure as no doctor of ordinary skill would be guilty of if acting with ordinary care.”

In a South African case reported as **Castell v De Greef** reported in 1994 Volume 4 SA 416 the full bench of the Cape quoted the following the following dictum in a House of Lords decision with approval.

“Merely to describe something as an error of judgement tells us nothing about whether it is negligent or not. The true position is that an error of judgement may or may not be negligent; it depends on the nature of the error. If it is one that would not have been made by a reasonably competent professional man professing to have the standard and type of skill that the defendant held himself out as having, and acting with ordinary care, then it is negligent. If, on the other hand, it is an error that a man, acting with ordinary care, might have made, then it is not negligent.”

I turn now to the charges which at the end of the day were still in issue.

I find it convenient to firstly discuss the two components of charge one, relative to the branding asset and branding income, together. The first point made by the prosecution was that the value of R5,5 million placed on those assets was not, and could not have been, made in accordance with generally accepted accounting practice. The evidence was that a valuation was obtained by the respondents and in the subsequent enquiry by KPMG, they did not differ therefrom.

This committee accepts that the question of whether an asset can be measured reliably is a matter of professional judgement. There is no reason to differ from the view taken [by the respondents] that the investments could be measured with sufficient reliability and qualified as assets. The committee considers that it was not adequately established that the shares were issued in consideration for services to be rendered in future years, or if they had not. The



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case was simply not proven and the *pro forma* complainant did not press for a conviction on this part of the case.

I turn to the question of the branding expenditure. This relates to the deferral of R6 million of expenses. The question was whether this was in accordance with generally accepted accounting standards. The evidence established that the deferral of the expense was a last minute decision of Regal which had the effect of improving the profits for the year. That decision was taken without consulting the respondents and without careful analysis of the expenses incurred. It appears that the respondents had either to accept the results as published by Regal or to immediately announce their disagreement. It also appears that the latter course would probably have resulted in the closing of the bank. The respondents had therefore to decide, and to decide quickly, whether a potential error of R6 million which, after eliminating the tax effect of R1,8 million resulting in an increase in after tax profits of R4,2 million, was material. In this context it should also be mentioned that the impact of R4,2 million was within the materiality limit of R5 million.

The basic question in this part of the case is whether the decision to abide for the time being is so manifestly unsupportable as to amount to unprofessional conduct. In this context it is important that the expert witness called by the *pro forma* complainant, Mr Patterson, conceded that a decision as was taken by the respondents could have been made by a reasonably qualified and experienced accountant. Opinions may well differ on this point. It may well be said that the respondent should at least have informed the Registrar of what had happened. This committee concludes that it was not adequately proved that the decision under consideration was so bad as to amount to unprofessional conduct. This charge also fails.

The next charge is that the second respondent omitted to pick up that included in the fixed assets was a figure of R2 million which related to a cash bonus of R2 million that was paid to Mr Levenstein. The respondents admitted that an error was made by one or both of two staff members of Ernst & Young in not drawing the attention of the second respondent to this fact. The question is whether he can be held responsible. His evidence was that he was assigned the task of overseeing the audit at a

late stage. He said that he agreed to do so out of the goodness of his heart. He admitted that he was responsible for the glossies but was unaware of the payment to Levenstein. The question is whether he can be held responsible on the basis of vicarious responsibility for the error of the members of the staff of Ernst & Young. It is questionable whether the common law concept of vicarious responsibility can be applied to disciplinary steps such as the present. However, rule 3 of the Code of Professional Conduct says that a practitioner may be held responsible for a breach of the Code on the part of all persons who are under his supervision. The use of the word “may” suggests that the rule is permissive only. The Committee considers that the considerations of fairness dictate that he should not be held vicariously responsible. The charge does not mention him by name. All the other charges specify which of the respondents are being addressed, but not this one. We think that if it was intended to hold the second respondent personally responsible, the charge would have spelt out on what basis he is responsible. This charge also fails.

The next charge is that the respondents failed to investigate the recoverability and value of the security, if any, held for certain advances. The evidence of the defence is that the audit work done on an advance to the Regal Treasury Charity Client Trust was the inspection of an unsigned agreement and a “ceding of shares”. The record shows that what was “ceded” were Regal Treasury Holdings shares, and that that was what was made. The draft summary review memorandum did, at paragraph 7, recall the existence of this advance and stated it “would seem to be a trust set up to hold shares in [the] bank as some form of loss of control protection...” and “would appear to be under the personal control of Jeff Levenstein”. It appears that the advance was made to this trust which then purchased shares in Regal Holdings. This should have given rise to a query on whether this constituted an impediment in the capital of the bank which would have lead to the capital adequacy of the bank being called into question. However, the prosecution confused the identities of the trusts involved. There were serious errors in the evidence presented on this score. No clear picture emerged. The respondents are entitled to the benefit of the doubt.



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Lastly, there is the charge relative to materiality. The evidence shows that planning materiality was properly assessed at the commencement of the audit. However, and that appears to be the point made by Mr Patterson, there were differences of opinion on accounting estimates. These do not, however, affect the position. The major difference was openly discussed between management and the auditors and the Reserve Bank, and did not require the auditor to reduce this level of materiality. In any event assessment of materiality is merely a tool in assessing the overall position. This charge must also fail.

In all these circumstances the respondents are acquitted and found not guilty on all counts.

6. THE FUTURE

The adequacy of the Board's powers to discipline its members is frequently brought into question. We believe that the PAAB has adequate disciplinary powers and that these are exercised in a competent manner. We believe that the time that it takes for us to deal with complaints, from start to finish, is at least equal to that of any disciplinary authority and is certainly far better than that of our courts. This was demonstrated again in this matter – and also in the Tigon matter – where the PAAB's disciplinary proceedings were completed long before the civil or criminal proceedings arising out of the same matters.

There are, however, certain areas for improvement that we ourselves identified as long ago as May 1998 when we gave evidence before the Nel Commission. These were

- that evidence given at disciplinary proceedings should not be permitted to be used by or against an RAA who is the subject of those proceedings in any subsequent civil or criminal proceedings;
- that in disciplinary proceedings, copies of documentary evidence should be permitted to be used without having to produce the originals, subject to the safeguard that a witness is able to lead evidence as to the validity of the evidence;
- that the PAAB should be given the specific right to attach, *inter alia*, the working papers of an RAA whom it believes might be guilty of improper conduct, and to inspect those working papers and make extracts

therefrom and copies thereof, notwithstanding any duty of confidentiality owed by the RAA to his client.

During April 2000 the PAAB, as part of its strategic plan, conducted a review of its disciplinary process. It was agreed with SAICA that a joint investigation should be conducted. The investigating committee was co-incidentally headed by Adv John Myburgh SC.

One of the issues on which the PAAB specifically requested to address the investigating committee, which was relevant in the Regal matter, was that of subpoenas, and particularly the limitations inherent in the subpoena process. These are to be found in the restrictive wording of section 24 of the PAA Act which effectively allows documents to be subpoenaed only at a hearing. The effect of this is that where it is necessary for the PAAB to have earlier access to documents in the possession of a third party, or the accused, in order to mount an efficient prosecution, this is not possible.

The committee identified the increasing difficulty of proving cases and the adequacy of evidence as an issue to be addressed, and endorsed the PAAB's suggested amendment to the PAA Act to overcome this problem. However, we were advised in 2002 that, as the Draft Auditing Profession Bill ('DAPB') was imminent, no amendments to our current legislation would be entertained, and hence disciplinary proceedings (including Regal) had to be conducted subject to these restrictions.

Our proposed amendments have been carried over in principle – although not in the way we initially drafted them – into the DAPB.

Our comment on the DAPB as drafted ran to nearly 150 pages, and was well received by government. We expect a streamlined and strengthened disciplinary process.

One of the criticisms also levelled against the process is that disciplinary action is taken only against individuals and not firms, and that sometimes issues can accordingly 'fall between the cracks'. This, too, has been addressed in the DAPB.

As at the time of writing we are advised that the Bill will be published in August 2005.