

# Fundamental changes to SA's BBBEE framework

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## 1. Introduction



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Amendments to the Codes ("Amendments") were published in the Government Gazette on 11 October 2013. The Amendments state that they will take effect "within twelve months" from the date of their publication and this is understood as providing a one year transitional period before the Amendments take effect (presumably this means 11 October 2014).

The Codes set out the methodology to be used when measuring a firm's BBBEE status. This measurement is made having regard to various compliance targets set out in the Codes.

Although the Codes and the BBBEE Act do not impose legal obligations on firms to comply with BBBEE targets, a firm's BBBEE rating is an important factor affecting its ability to successfully tender for Government and public entity contracts. Private sector clients also increasingly require their suppliers to have minimum BBBEE ratings in order to boost their own BBBEE ratings and, in certain sectors (for example mining), minimum BBBEE requirements are required to obtain a licence.

The Amendments indicate a more actively interventionist and prescriptive approach by Government to the implementation of BBBEE. This is reinforced by the amendments to the BBBEE Act (which have been passed by Parliament but have not yet come into force) which -

1.1 establish a BBBEE Commission which may investigate complaints relating to BBBEE, BBBEE transactions and "fronting practices" (which are very widely defined) and may apply to court to restrain a breach of the BBBEE Act and/or a "fronting practice";

1.2 introduce various criminal offences for misrepresenting or providing false information regarding a firm's BBBEE status or engaging in a "fronting practice". A contravention may result in a fine and/or up to 10 years imprisonment for individuals and the firm may be fined up to 10% of its annual turnover and be banned from contracting with Government and public entities for 10 years;

1.3 introduce a statutory right for Government and public entities to cancel any contract or "authorisation" awarded due to false information on BBBEE status;

1.4 impose an absolute obligation on Government and public entities to take the Codes into account in their procurement policies and in issuing licences and authorisations (previously they were only obliged to do so "as far as reasonably possible").

## 2. Changes to number of BBBEE points required to achieve BBBEE levels

The Amendments significantly change the manner in which a firm's BBBEE status (or level) will be calculated as the number of BBBEE points required to achieve a particular BBBEE level, have been increased. The changes are set out (and compared with the current position) in the following table.

BBBEE Level	Amended Codes	Current Codes
1	=100 points	=100
2	=95 but <100 points	=85 but <100
3	=90 but <95 points	=75 but <85
4	=80 but <90 points	=65 but <75
5	=75 but <80 points	=55 but <65
6	=70 but <75 points	=45 but <55
7	=55 but <70 points	=40 but <45
8	=40 but <55 points	=30 but <40
Non-Compliant	<40 points	<30

This is one of the most far reaching changes in the Amendments. It materially affects all firms' existing BBBEE rating and potentially results in an automatic downgrade of its BBBEE status from 11 October 2014. For example a firm with an "old" BBBEE level 4 rating (65 points) will automatically become a "new" BBBEE level 7. This has major implications for business especially for firms whose customers require a minimum BBBEE level from suppliers or which has contractual or other obligations to maintain a minimum BBBEE status. Firms will have to review their current BBBEE strategy to assess the impact of these changes and take steps to try and maintain their existing BBBEE ratings.

## 3. Changes to number of BBBEE elements taken into account to calculate BBBEE levels

Under the current Codes, there are seven "elements" that are taken into account for calculating a firm's BBBEE rating, namely ownership, management control, employment equity, skills development, preferential procurement, enterprise development and socio economic development. The Amendments reduce the number of elements to five by fusing the enterprise development/preferential procurement and management/employment equity elements. The changes are set out (and compared with the current position) in the following table.

Element	Weighting Points (Amended Codes)	Weighting Points (Current Codes)
Ownership	25	20 plus 3 bonus points
Management Control	15 plus 4 bonus points	Management Control - 10 plus one bonus point Employment equity - 15 plus three bonus points
Skills Development	20 plus five bonus points	Skills development - 15
Enterprise and supplier development	40 plus four bonus points	Preferential procurement - 20 Enterprise Development - 15
Socio Economic Development	5	5
Total	118	107

The changes indicate a greater emphasis on the three "priority sectors" of ownership, skills development and the new enterprise and supplier development elements. The total number of available points has also been increased from 107 to 118 which may (depending on each firm's circumstances) assist firms in minimising any adverse effects as a result of the changes in 2 above.

## 4. Exempt, small and start up enterprises

As provided under the current Codes, Exempted Micro-Enterprises (EMEs) are deemed to have a level 4 BBBEE status and Start-up enterprises are measured as EMEs. However the threshold for qualifying as an EME has been increased from R5-million (or less) to R10-million (or less) total annual income. This will assist small firms which would otherwise not have benefited from the deemed level 4 status.

The threshold for being a qualifying Small Enterprise (QSE) has been increased to between R10 million and R50 million total annual income (from between R5 million to R35 million under the current Codes). The Amendments provide that the BBBEE status of QSEs will be measured by reference to all five BBBEE elements (under the current Codes, QSEs may choose to be measured by reference to any four of the existing seven elements) and are subject to the automatic downgrade in BBBEE status if the minimum requirements referred to in 5 below are not met. QSEs will accordingly be subject to a more onerous regime than under the current Codes.

EMEs and QSEs that are 100% Black owned will be deemed to have a level 1 BBBEE status. Those that are 51% Black owned will be deemed to have a level 2 BBBEE status. This is a significant advantage over other EMEs and QSEs especially given the increase in the number of BBBEE points required to achieve a particular BBBEE level (see 2 above).

Under the Amendments, EMEs and QSEs will no longer need a certificate from a BBBEE verification agent to confirm its BBBEE status. All that is required is an affidavit certifying its total annual income and level of Black ownership. This will save costs for EMEs and QSEs.

## 5. Priority sectors and automatic downgrade of BBBEE status if targets are not met

Ownership, skills development and enterprise and supplier development are identified as "priority sectors". The Amendments impose minimum requirements of -

- 5.1 40% of the "net value" targets for the ownership element. "Net value" measures the "debt free" portion of the BBBEE ownership of a firm;
- 5.2 40% of the total weighting points for the skills development element;
- 5.3 40% of the three subcategories of the enterprise and supplier development element (being preferential procurement, supplier development and enterprise development).

If a "large enterprise" (which is not defined but presumably is a firm with a total annual income greater than R50-million) fails to comply with all three of the minimum requirements, its BBBEE status will automatically be downgraded by one level ie. if its score would otherwise have been level 4, it will automatically be downgraded to level 5. This downgrade also applies to QSEs which don't comply with the minimum requirement for BBBEE "net value" as well as those for either the skills development element or the enterprise and supplier development element.

This is draconian and punitive and has serious implications for BBBEE ownership transactions which often involve financing to the BBBEE shareholder which will be repaid out of dividend flows (which depend on the company's profits and ultimately factors which are generally beyond the company's control ie the state of the national and global economy). Existing BBBEE transactions will have to be reviewed to assess the likelihood and effect of a downgrade. Ironically BBBEE shareholders may be prejudiced by being required to fund transactions (in whole or in part) using their own resources. These new amendments to the Codes may also have an unintended "chilling effect" on funding for BBBEE transactions. Foreign multinationals may increasingly consider the little used "equity equivalent programme" available under the existing Codes (this allows a foreign multinational to earn BBBEE ownership points without actually having a BBBEE shareholder or partner). These amendments are indicative of the policy preference being shown by Government in favour of Black owned or controlled firms.

## 6. Changes to the current methodology of calculating BBBEE points

The Amendments make several significant changes to the current methodology for calculating a firm's BBBEE points and

will require firms to review their current BBBEE strategies. All the changes will have to be reviewed by firms to assess the impact on their BBBEE rating. Some of the changes are discussed below.

The current Codes provide for one BBBEE ownership point (and a 2.5% compliance target to earn that point) for an economic interest in a firm held by "black designated groups" (which include Black unemployed, Black youth, Black disabled people, Black rural residents and Black military veterans) and/or Black participants in employee share ownership programmes and broad based black ownership schemes (an additional "bonus point" may be earned if a firm has such Black participants and meets the compliance target of 10%). The Amendments scrap the bonus point but increase the number of BBBEE economic interest points to 3 with a 3% target. This provides an incentive for firms to consider these "broad based" options.

Under the Amendments, two BBBEE ownership points (with a 2% compliance target) have been allocated to the economic interest of "new entrants" in the firm. Under the current Codes, two "bonus" points for new entrants have a 10% compliance target ie it is currently more difficult to earn these two points. The definition of "Black New Entrant" has also been widened to cover BBBEE owners who have not held equity in another firm with a total value of R50 million (R20 million under the current Codes). These changes widen the pool of "new entrants" and provide an incentive for firms to consider including new entrants (ie. small and medium sized Black firms) in their BBBEE ownership transactions.

The Amendments increase the number of factors to be considered under the skills development element. Under the current Codes, only three factors are taken into account for the skills development element whereas five factors are taken into account under the new Codes. The new factors provide points for training Black unemployed persons and the number of Black people "absorbed" at the end of learnership programmes. The number of points (and compliance target) for skills development expenditure have increased from 6 to 8 and from 3% to 6% respectively.

The concept of an "Empowering Supplier" has been introduced under the preferential procurement subcategory of the enterprise and supplier development element. The requirements for such a supplier are unduly complicated and include being a "BBBEE compliant entity" and a "good citizen", complying with "all regulatory requirements" and meeting at least three (or for QSEs, one) of certain local procurement, job creation, raw material transformation/beneficiation and skills transfer requirements. No preferential procurement points will be obtained if a supplier does not comply with these requirements. This is a major change from the position under the current Codes (which focus only on "BBBEE related" issues). The Amendments assume that "Empowering Suppliers" are generally available in every sector of the economy but in practice this may not be the case so earning procurement points may become more difficult under the new Codes. Ironically these changes will prejudice Black owned and controlled firms that don't comply with the requirements for "Empowering Suppliers" as there will be no incentive (from a BBBEE rating perspective) for a firm to prefer such Black owned and controlled firms over others. The process of verifying whether a supplier is an "Empowering Supplier" will also involve extra administration, management time and costs. Of greatest concern is that a firm's BBBEE status will be automatically downgraded (see 5 above) if it fails to meet the minimum 40% target for preferential procurement (even if the firm has made genuine efforts to comply).

## **7. The importance of Sector Codes**

The BBBEE Act allows a sector of the economy to have its own BBBEE code. The current Codes provide that a sector code has equal status with any other code. This has led to confusion as to whether a firm's BBBEE status should be measured under the sector code or the "generic" Codes. The Amendments (as well as the pending amendments to the BBBEE Act) resolve this by providing that the BBBEE status of a firm in a sector may only be measured in accordance with the sector code for that sector (if any). An interesting question arises as to whether the existing (and future) sector codes may be less onerous than the amended Codes or whether the Government will take steps to align the sector codes with the Amendments. Reliance on sector codes may (to the extent that they are less onerous) mitigate the effects of the Amendments. However, firms operating in sectors where there is no sector code will be measured having regard to the Amendments (and may be incentivised to develop a sector code).

## **8. Conclusion**

The amendments to the Codes and the BBBEE Act fundamentally change the current BBBEE framework and are a powerful expression of the Government's intention to promote and implement BBBEE. Unlike the current framework, the new framework introduces sticks as well as carrots. The new Codes are due to take effect by October 2014 and it is important that firms use the interim period to review and reassess their BBBEE strategies to mitigate (and preferably avoid) any adverse effects resulting from the changes.

## ABOUT PIETER STEYN

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