# REPORTING BACK ON PROACTIVE MONITORING OF FINANCIAL STATEMENTS IN 2018

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**Table of Contents**

INTRODUCTION .......... 3
DETAILED FINDINGS .......... 4
Feedback on the 2018 focus areas .......... 4
Matters where action was required .......... 6
Common disclosure omissions .......... 13
THE FINDINGS IN NUMBERS .......... 15
Review process .......... 15
Statistics – what we did .......... 15
Statistics – what we found .......... 16
International comparison .......... 17
LOOKING FORWARD - THE 2019 REVIEW CYCLE .......... 19
ANNEXURE 1 - REVIEW PROCESS .......... 21
ANNEXURE 2 – ACTIVITIES OF THE FRIP IN 2018 .......... 25
ANNEXURE 3 – OTHER ACTIVITIES OF THE JSE .......... 33

## INTRODUCTION

This report (the **"2018 report"**) provides an overview of the proactive monitoring activities (the "**review process**") undertaken by the JSE during 2018. The objective of the JSE's process of reviewing Annual Financial Statements (**"AFS"**) and interim results ("**interims**") is both to ensure the integrity of financial information and to contribute towards the production of quality financial reporting of entities listed on our market. The review process leads to healthy debate which we believe is important for the credibility of our markets.

The target audience for this report is entities whose equity or debt securities have a primary listing on the JSE. The 2018 report sets out important findings identified during the year, which we request issuers to consider. It also highlights focus areas that issuers should be aware of for 2019. The review process is not the only avenue the JSE uses to engage with issuers on International Financial Reporting ("**IFRS**") matters. The JSE may interrogate IFRS reporting based on, amongst others, formal complaints that it receives from interested parties or through its own risk identification processes. As the intention of this report is to raise awareness of important IFRS findings, the JSE has expanded this report (see annexure 2 and 3) to cover some of those discussions.

The JSE specifically requests that the audit committee of every issuer considers the findings contained in this 2018 report when preparing their next set of AFS and interims and to provide the JSE with confirmation of such consideration. Audit committees should also consider the content of our previous reports issued from 2011 to 2017 (available on the JSE website at https://www.jse.co.za/current-companies/issuer-regulation/accounting-matters) ("**our reports**"), to the extent that the issuer is newly listed, or the issuer has had events or transactions that were not present when our previous reports were considered.

This report also provides details of the review process in order to assist new issuers in understanding the review process. On an annual basis we reconsider the detail behind our review process to ensure that we remain aligned with international trends and are attuned to local market developments. Finally, in this report we provide statistics on our findings, in order to highlight the regulatory benefit of the review process.

## DETAILED FINDINGS

We implemented a procedural change in 2016, requiring written confirmation from audit committees that our annual proactive monitoring report be tabled and considered at one of their meetings. As discussed in our report issued in February 2018 ("**the 2017 report**") this change has had a positive impact on certain of our findings, most visibly with respect to decluttering the financial statements. Given the timing of both our reports and the selection process, there is however a lag effect in terms of identifying the true impact of our reports.

### Feedback on the 2018 focus areas

#### Adoption of new standards

We advised the market in both our 2017 and 2016 reports that the adoption of the new standards would be a focus area in our review process. We therefore believe that the findings set out below should reflect issuers' reactions to that notification.

For 72% of the (55) reviews closed by the JSE no questions were asked regarding the disclosures provided under paragraph 30 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors,* for the application of new standards (most significantly IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers*). Given our ongoing message to the market of the importance of the new standards (since 2016) we would have expected higher compliance rates in this area.

In one instance the issuer incorrectly stated that they had early adopted the new standards. For the remaining 14 cases deficiencies were identified relating to the use of generic wording in the AFS, where qualitative and/or quantitative information was lacking. This caused the JSE to question the readiness of those issuers to apply the new standards. In all but one instance, we obtained comfort that (after the release of results considered during our review) the issuer had made sufficient progress on the recognition and measurement aspects of their implementation projects.

From our engagement with issuers we identified 3 instances where it was apparent that the issuer's accounting systems did not adequately capture the information necessary to report correctly under IAS 18 *Revenue* and by extension the impact of the changes brought about by IFRS 15. In one

instance we were of the view that the issuer would not be in a position to publish (interim) results that would comply with IFRS 9 and 15. That listing was subsequently suspended for late publication of financial information.

We will continue to challenge the sufficiency of disclosures as it relates to the adoption of IFRS 16 *Leases* in our future reviews and urge issuers to pay careful attention to this aspect of IFRS.

Disclosure of judgements and estimates

We discussed the importance of disclosing significant judgements in our 2016 report and indicated in our 2017 report that it would be a specific focus area. There were six instances where the disclosures of judgments made by management in applying their accounting policies were not in line with paragraph 122 IAS 1 *Presentation of Financial Statement*s. These included:

- the trigger point to determine when revenue should be recognised;
- whether an acquisition was a business combination or an asset acquisition;
- why an entity was regarded as an associate despite a 51% shareholding;
- the move to equity accounting for associates previously accounted for at fair value through profit and loss; and
- accounting for common control transactions and put options involving non-controlling interests\shareholders.

We again emphasise that the factual nature of the information supporting the judgement does not negate the need to provide disclosures under IAS 1.122. The focus should be on how management applies that information against its accounting policies to achieve compliance with IFRS.

There were two material findings in the area of disclosure of estimates, which are discussed in more detail below under the headings, 'Estimation uncertainty' and 'Change in accounting estimate'.

Transparent and fact specific discussion of judgements and estimates applied to financial reporting is necessary to enable users to have a full understanding of the impact that these significant matters have to the AFS.

**Matters where action was required**

This section does not discuss all the cases dealt with in 2018. Instead, we focus on specific aspects from the thirteen material cases.

Estimation uncertainty

An entity was carrying a relatively large deferred tax asset which it had raised on the back of unused tax losses over and above the reversal of taxable temporary differences. The deferred tax asset had been raised some 7 years ago, and had been increasing over time. The recognition of deferred tax assets for assessed losses is a subjective matter which carries a high degree of estimation uncertainty. The following generic disclosure was included in the AFS:

> "Assessing the recoverability of deferred income tax assets requires the Group to make significant estimates related to expectations of future taxable incomes."

This disclosure was not specific to the entity and did not provide any detail about the nature of the assumptions made about the future as required by IAS 1.125. Furthermore, IAS 1.129 states that the disclosure should help users understand the sources of estimation uncertainty and details types of disclosures that should be provided.

After receiving the omitted disclosures and other supporting documentation from the issuer, the JSE raised concerns regarding the recoverability of the deferred tax asset, given:

- that the entities were barely breaking even;
- that the assessed losses were expected to take an exceptionally long time (between 10 to 30 years) to be utilised, under increasingly uncertain economic conditions;
- the nature of various uncertainties on which the estimates were based and the magnitude of their impact; and
- that a large portion of deferred tax assets were subsequently impaired and/or derecognised in the first set of interims published after the AFS under review.

It appeared to the JSE that the circumstances that lead to the subsequent impairment/derecognised either already existed at the date of AFS and /or brought into question the reasonableness of the assumptions made at the date of the AFS.

Change in an accounting estimate

IAS 18.14(a) deals with the timing of the revenue recognition for the sale of goods and states that one of the conditions to be satisfied is that "*the entity has transferred to the buyer the significant risks and rewards of ownership of the goods*". An issuer changed their determination of the point at which the risk and rewards of ownership is passed to customers. The issuer dealt with this matter prospectively as a change in estimate.

The JSE contented that a change in estimate was not appropriate in this instance, concluding that it was (at best) a change in accounting policy or (at worst) a material prior period error - given that this fact pattern had existed in the market for some time and was not new. Either of these approaches should have been applied retrospectively – not prospectively as the issuer had done. In addition, transparency when reporting prior period errors is important.

The issuer argued that "*When it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in accounting policy.*" (IAS 8.35). Their argument had however omitted the first sentence to paragraph 35 which explains that a change in the application of a measurement basis is a change in an accounting policy and not a change in an accounting estimate. In terms of the definition of IAS 8.5, a change in accounting estimate refers to an adjustment to the carrying amount of an asset or liability or the periodic consumption of that asset. These are examples of matters affecting the way in which financial information is measured – not recognised. The issuer subsequently conceded that the revenue recognition 'trigger' event affected the recognition (i.e. timing) and not the measurement of revenue in the AFS and that their initial assessment of a change in estimate was incorrect.

Financial instruments-debt issuers

*Case 1*

In this instance an issuer incorrectly classified its listed debt instruments as equity and subsequently also incorrectly re-measured the notes in equity. IAS 32.36 states that "*changes in the fair value of an equity instrument are not recognised in the financial statements*".

To support their classification the company stated in its accounting policy that all of the conditions pertaining to puttable financial instruments had been met (i.e. paragraph 16A of IAS 32 *Financial Instruments: Presentation*). The nature of the notes was as follows:

- that the company issued a series of notes;
- each note was secured against separate identifiable assets of the company; and
- the recourse for noteholders was limited to the proceeds of the specifically identified secured assets.

In addition to the above notes, the company had also issued ordinary shares.

On the basis that the redemption terms for each series of notes would be different (i.e. linked to reference assets) the JSE argued that the requirements of IAS 32.16A(c) would not have been met. The different series of notes would ultimately be redeemed at different amounts. IAS 32.16A(c) states that "*all financial instruments in the class of instruments that is <u>subordinate to all other classes of instruments</u>* (must) *have <u>identical features</u>*"….and that *"the <u>formula or method used</u> to calculate the repurchase or redemption price…* (must be) *the <u>same for all instruments in that class</u>"*

The issuer subsequently agreed that their classification was incorrect.

*Case 2*

An issuer classified a subordinated loan (from a related party) as an equity instrument. The JSE raised concerns as to the issuer's right to avoid paying cash (or deliver another financial instrument (IAS 32.16(a)) as the AFS:

- Described it as being an *<u>unsecured loan</u>*, implying that the issuer had an obligation to repay the capital portion of the loan; and
- Reflected the recognition of an interest expense, as the loan bore interest.

The issuer argued that:

- the loan met the balance sheet classification of a puttable financial instrument; and
- there was a specific minimum amount of the loan that could not be repaid in order for the company to meet its required subordinated funding ratios.

The JSE questioned how the full value of the loan would be classified as equity if only a portion thereof would not be repaid until liquidation. In any event, whilst having referred to the puttable

instruments references in IAS 32.16A-D, the issuer could not motivate how their fact pattern correlated to the features set out in IAS 32.16A(a)-(d).

The issuer had both ordinary and preference shares. Whilst explaining that the terms of subordinated debt placed the priority of payments behind the claims of 'other secured creditors', the company did not explain why the loan was the most subordinate class of equity.

Furthermore, the issuer did not provide an IFRS based argument in response to our concern that an instrument containing an obligation to pay interest should be classified as a financial liability, or at the very least as a compound financial instrument per IAS 32.28. From the loan agreement we noted that:

- the outstanding amount of each advance bore interest (which accrued on a daily basis);
- interest was due and payable on each payment date (subject to the priority of payments);
- interest not paid on a payment date (due to insufficient cash in terms of the priority of payments) remained owing by the issuer; and
- the loan amounts were due and payable at specified repayment dates (subject to the priority of payments).

It appeared to us that the priority of payments was a mechanism to manage the liquidity and cash flow requirements within the securitisation vehicle rather than one that placed the instrument within the most subordinate category of equity.

The classification of the subordinated loan as equity was not in accordance with IFRS and it should have been classified as a financial liability.

Statement of cashflows ("**SCF**")

Paragraph 10 of IAS 7 *Statement of Cash Flows,* states that the SCF shall report cash flows classified by operating, investing and financing activities. Whilst the incorrect application of these three definitions does not affect the net movement in cash, as previously communicated, the JSE continues to regard material misallocations between the categories in a serious light.

*Case 1*

We identified an instance where the acquisition of additional shares in a (non-wholly owned) subsidiary should have been classified as financing and not investing activities (IAS 7.42A). The result was that cash flows from investing activities were misstated by 35%, whilst cash flows from financing activities were misstated by 61%.

*Case 2*

The cash payment of a cash-settled share-based payment of a subsidiary company should have been classified as an operating cash flow and not a financing cash flow in the SCF. The incorrect application of IAS 7 resulted in financing activities being misstated by approximately 25%. IAS 7.6 defines financing activities as "*activities that result in changes in the size and composition of the contributed equity and borrowings of the entity*". Furthermore IAS 7.14(d) lists "*cash payments to and on behalf of employees*" as an example of a cash flow from operating activities.

*Case 3*

An investment was made into a company which in turn held shares in the listed issuer. The investee was regarded as a subsidiary to the group and consequently consolidated. The resulting shares in the listed company were therefore treated as treasury shares and not an asset in the Group AFS.

IAS 7.16 explains that "*Only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities*". IAS 7.17(b) lists the cash payment to owners to acquire or redeem shares as an example of a financing activity.

The issuer had incorrectly treated the acquisition of treasury shares as investing activities. The error accounted for 56% of the reported cash flows from investing activities and would have changed the net cash generated from financing activities to a net cash utilised in financing activities.

*Case 4*

In this instance, the issuer incorrectly presented cash inflows and outflows on a net basis in the SCF. The cash flows from interest paid/received must be disclosed separately (IAS 7.31). Furthermore, in terms of:

- IAS 7.32 the SCF must identify and separately reflect the actual cash flows paid with respect to finance costs (inclusive of borrowing costs capitalised); and

- IAS 7.21 requires an entity to report separately major classes of gross cash receipts and gross cash payments from investing and financing activities (with paragraph 22 and 24 limiting the instances in which cash flows may be presented on a net basis). Movements into and out of investments such as 'other financial assets' must therefore be disclosed on a gross basis and the interest elements must also be disclosed separately.

<u>Headline earnings</u>

The rules set out in the table for calculating headline earnings apply equally to the underlying earnings of an associate – i.e. a 'look through approach' is followed. Where an associate impairs an asset in terms of IAS 36 *Impairment of Assets*, that amount must be removed from headline earnings in the listed company's results.

<u>BEE transactions</u>

An issuer provided funding to a BEE partner to acquire shares in its existing subsidiary. In accounting for the transactions in their interim results the issuer neglected to give full consideration to the accounting implications of the funding transaction. The substance of the matter was that the issuer did not lose control of the subsidiary (in terms of IFRS 10 *Consolidated Financial Statements*) and should have continued to consolidate it. The correct accounting treatment was to recognise a share based payment expense in terms of IFRS 2 *Share-based Payments*.

<u>Business Combinations</u>

*Case 1*

Paragraph 37 of IFRS 3 *Business Combinations,* states that, "*The consideration transferred in a business combination shall be measured at fair value"* which is required to be calculated at the acquisition date. In terms of paragraph 24 IFRS 13 *Fair Value Measurements*, fair value is the price that would be received to sell an asset in the principle market at measurement date. The consideration paid cannot be determined using the 'contractual price' of the shares issued to the vendors. The resultant error in this case led to a material understatement of goodwill.

*Case 2*

IFRS 10.20 states that the "*consolidation of an investee shall begin from the date the investor obtains control of the investee*". An issuer made an error in their consolidation process by incorrectly bringing pre-acquisition amounts into profit and loss.

<u>Non-current assets held for sale</u> ("**NCAHFS**")

Paragraph 6 of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations,* states that a non-current asset should be classified as held for sale if the carrying amount will be recovered principally through a sale transaction rather than continuing use.

An issuer bought back stores from departing franchisees with the intention of finding new franchisees to licence the specific sites to. Whilst the classification of acquired stores and related equipment as NCAHFS may have initially been appropriate (year 1), the slow pace of sales of these assets in the subsequent two financial periods demonstrated that the expectation to sell reacquired stores and the related equipment within a one year period (as required by IFRS 5.8) did not appear to be achievable. Furthermore, subsequent to year 1, a number of the reacquired stores were closed down as they could not be sold. IFRS 5.13 states that assets that are to be abandoned or closed down rather than being sold shall not be classified as held for sale. A significant portion of the carrying amount classified as NCAHFS in year 2 and 3 represented equipment on hand for stores that were being closed down. Despite this fact pattern, the issuer continued to buy back stores and equipment and classify these as NCAHFS.

Given the lack of progress made in selling the reacquired stores and equipment, the majority (if not all) of the reacquired stores and equipment should therefore have been classified as property plant and equipment under IAS 16 *Property, Plant and Equipment,* rather than NCAHFS in subsequent years. That property plant and equipment should also have been considered for impairment in terms of IAS 36: *Impairment of Assets*.

<u>Transparency when reporting errors</u>

We remind issuers that we have emphasised in our previous reports (2017, 2016 and 2015) that we expect transparent disclosure regarding the correction of material prior period errors (IAS 8). Whilst providing the disclosures set out in IAS 8.49 is an important first step, it is equally important to

explain that the restatement is due to an inappropriate action or interpretation of IFRS by the issuer. Masking material prior period errors in a non-transparent manner (including referring only to the 'representation' or reclassification' of the numbers without explaining that these are the result of an error) runs contrary to the general principles of the JSE Listings Requirements. In these instances the JSE will require an issuer to take corrective action.

**Common disclosure omissions**

Putting aside the concerns regarding the adoption of new standards and disclosures regarding judgements (which have already been discussed in the 'feedback on the 2018 focus areas' section of this report) we wish to highlight the following disclosure areas most commonly found to be wanting in the AFS. The table below ranks the matters in terms of the number of different instances that issuers results were found to be deficient for this specific topic.

| | Ranking |
|---|---|
| IAS 1 *Presentation of Financial Statements*, paragraphs 31, 117, 119<br>Entity specific accounting policies, focussed on significant policies | 1 |
| IAS 36 *Impairment of Assets*, paragraphs 130-134<br>Insufficient information regarding impairment calculations | 2 |
| IAS 12 *Income Tax* , paragraph 81(c)<br>Insufficiently detailed tax rate reconciliations | 3 |
| IAS 34 *Interim Financial Reporting*, paragraphs 10,15,25<br>Three line statement of cash flows | 3 |
| IFRS 13 *Fair Value Measurement*, paragraph 93<br>Lack of details regarding unobservable inputs used in valuation models | 4 |
| IFRS 7 *Financial Instruments: Disclosures*, paragraph B11D<br>Liquidity risk disclosures incorrectly provided on an discounted basis | 4 |
| IFRS 3 *Business Combinations*, paragraph B64(e)<br>Entity specific factors in support of goodwill recognised for each acquisition | 5 |

Each of the above topics have been dealt with extensively in our previous reports. Therefore, other than for the tax rate reconciliation, no further discussion is included.

Tax rate reconciliation

Despite highlighting this matter in numerous previous reports, the JSE continues to find problems in tax rate reconciliations. Issuers often use generic descriptors for reconciling items such as “non tax-effective income/loss”, “different rates of tax”, “disallowable charges/expenditure”, ”non-tax deductible items”, “non-allowable expenditure”. Descriptors are not only generic, but there is often too much aggregation which does not provide sufficient information with respect to the nature of the item/s or whether they are temporary differences or exempt/non-deductible items.

In this past year there were three specific instances where we challenged the disclosures for multi-jurisdictional entities. Given the likely complexities of multi-jurisdictional entities, they are required to be even more vigilant in their disclosures to ensure a full understanding of the drivers of the effective tax rate.

Issuers should ensure that the tax rate reconciliation and the descriptions used therein allow the reader to ascertain:

- the real nature of the reconciling items and their impact on the effective tax rate;
- the relationship between accounting profit and the tax expense (IAS 12.81(c)); and
- whether or not the relationship between the tax expense and accounting profit is unusual and if there are significant factors that could affect the relationship in the future (IAS 12.84).

## THE FINDINGS IN NUMBERS

The purpose of this section is two-fold. Firstly, it enables issuers to understand the process that is followed by the JSE. Secondly, it highlights the fact that, both in South Africa and internationally, a clean auditors' report is no guarantee that the AFS will not subsequently be subject to regulatory challenge and correction where these are found to contain material misstatements. The reason for this is best understood in light of the types of matters that we have found (as discussed in the detailed findings section) as well the concept of materiality. In the bulk of the cases where we have requested action, we have done so to ensure that there is no future investor prejudice for matters which fortuitously may not have been material in the results that we reviewed.

### Review process

Annexure 1 contains a high-level overview of the review process for the benefit of those readers who are not familiar with it. The areas of potential risk are updated on an annual basis. This is driven by both the entities specific business circumstances and our reconsideration of general risk areas both locally and internationally. The review of the same issuers AFS from one year to the next (if this were to be done) may therefore identify different matters.

Ignoring cases brought forward from the previous year, during the 2018 calendar year our reviews (on both equity and debt issuers) covered AFS for years ending between 28 February 2017 and March 2018.

### Statistics – what we did

Between January to December 2018, 51 equity issuers' AFS and interim results were reviewed and by January 2019 fourteen of the cases were still pending. During the same period 13 debt issuers' AFS were reviewed and three were pending completion.

We wrote letters of enquiry to 61 of the issuers, with 3 cases being closed immediately with no questions being asked. The reduction in the number of cases closed immediately to 4.7% of the total number of AFS reviewed (2017-11%) was a function of the revised approach for the 2018 reviews (as discussed in Annexure 1).

| | Equity | Debt [1] | Total |
|---|---|---|---|
| Letters of query | 49 | 12 | 61 |
| Cases closed immediately | 2 | 1 | 3 |
| **Number of AFS reviewed** | **51** | **13** | **64** |
| Cases b/f from previous year | 6 | 2 | 8 |
| Total cases reviewed during period | *57* | *15* | *72* |
| Cases still pending | (14) | (3) | (17) |
| Cases completed during period | 43 | 12 | 55 |

**Statistics – what we found**

Five cases resulted in the restatement of AFS and public announcements being made. In consultation with the respective issuers, these announcements were made as soon as possible. For 8 cases the non-compliance was material from an IFRS perspective, but often, due to the presence of other mitigating factors, not necessarily price sensitive. As such we agreed that the matters would be corrected in the issuers' next results announcement. For a further 10 cases, whilst fortuitously there was no material misstatement for the period reviewed, amendments needed to be made within the next published results to avoid potential investor prejudice. The remaining 22 cases involved smaller disclosure issues that the issuer agreed to clarify or correct in the future.

In 2018 material infringements were identified in 7% of the closed cases (2017-3.1%) for equity issuers and 17% for debt issuers (2017-nil). The number of cases where corrections were required in future reporting periods was at 39.5% (2017-34.4%) for equity issuers and 8.3% for debt issuers (2017-20%).

[1] Other hybrid instruments are also reviewed and are included in this category

| | 2018 Equity | 2018 Debt | 2018 Total | 2017 Equity | 2017 Debt |
|---|---|---|---|---|---|
| AFS needed restatement and public announcement made[2] | 3 | 2 | 5 | 2 | - |
| Non-compliance such that we agreed to a correction within the next published results | 8 | - | 8 | 9 | 1 |
| Non-compliance not material this year, but must be corrected in the future in order to avoid potential investor prejudice | 9 | 1 | 10 | 13 | 2 |
| Smaller disclosure issues that will be corrected in the future | 15 | 7 | 22 | 27 | 7 |
| AFS in respect of which it was concluded that there were no issues | 8 | 2 | 10 | 13 | 5 |
| **Total cases closed** | **43** | **12** | **55** | **64** | **15** |

In assessing the potential impact of matters for the current period the number of cases impacting measurement was at 40% (2017-33.3%) for equity issuers and at 30% (2017-20%) for debt issuers. The remaining 60% and 70% (for equity and debt issuers respectively) therefore related to disclosure issues. The data reveals that disclosure matters remain a key area of non-compliance.

**International comparison**

Our counterpart enforcers in Europe (through the European Securities Markets Authority (**"ESMA"**)) publish an annual activity report. For information purposes, we have included an extract from the ESMA reports and compared this against our current and previous findings.

A direct comparison of the South African data against international trends is difficult due to the different reporting and cut off periods. Furthermore, regulators have varying powers to require correction action. The 2017 ESMA activity report (issued in April 2018) is the latest available information, which from a period perspective is best compared to the data contained in our 2017 report. The 2017 ESMA activity report includes an annexure of the types of IFRS issuers that were considered. This information reveals that certain bond and securitised debt issuers form part of the population. The comparative South African data has been updated (from our last report) to include debt issuers.

[2] The 2018 figures include one very old case involving an equity issuer from 2014 which was finally concluded during this period.

| | South Africa | | | ESMA[3] | ESMA[4] |
|---|---|---|---|---|---|
| **Coverage** | | | | | |
| Period when reviews were undertaken | 2018 | 2017 | 2016 | 2017 | 2016 |
| Date of regulator's report | Feb 2018 | Feb 2018 | Feb 2017 | April 2018 | April 2017 |
| Reviews closed at reporting date[5] | 55 | 79 | 81 | 1005 | 1147 |
| Examination rate (Percentage coverage of population) [6] | 14% | 21% | 19% | 21% | 19% |
| **Actions** | | | | | |
| Material infringement (Requested re-issuance or immediate public announcement) | 9.1% | 2.5% | 2.4% | 8.3% | 8.7% |
| Corrections required in future financial statements | 32.7% | 31.6% | 24.7% | 24.3% | 18.4% |
| Action rate (Total number of instances where action was taken) | 41.8% | 34.1% | 27.1% | 32.6% | 27.1% |

The 2017 ESMA activity report indicates that of the 1 005 ex-post examinations undertaken by the 30 European enforcers during the calendar year to December 2017, 8.3% of those identified material infringements (requiring public announcements or reissuing of AFS). For a further 24.3%, whilst classified as material, the enforcers accepted a correction in the next AFS. Although the action rate by the JSE in the 2017 review period was slightly higher (at 34.1% compared to 32.6%), the JSE did have a lower percentage of material infringements at 3.1%.

Due to high-profile and technical financial statement cases in 2018, together with the revised approached (as set out in annexure 1), the JSE's examination rate for 2018 was significantly lower than in previous years. This rate is out of line with both the JSE's target coverage rate and international trends. The JSE is adding more resources to the review process in order to bring the examination rate back up to the levels of previous years.

[3] Information extracted from the ESMA report entitled "Enforcement and Regulatory Activities of Accounting Enforcers in 2017"

[4] Information extracted from the ESMA report entitled "Enforcement and Regulatory Activities of Accounting Enforcers in 2016"

[5] Only the ex-post examinations have been considered. European regulators perform ex-ante examinations, which allow them to report a higher coverage rate. Given the nature of these reviews there is no re-publication and therefore no action rate to be used for comparative purposes.

[6] The total South African population is calculated excluding issuers that are both debt and equity issuers as well as replica special purpose vehicles ("SPVs"). A replica SPV is one where the arranger creates an exact replica legal entity for each new debt issuance.

## LOOKING FORWARD - THE 2019 REVIEW CYCLE

### Judgements and estimates

The JSE will continue to focus on the disclosure requirements of IAS 1 applicable to judgements (paragraph 122-124) and estimates (paragraph 125-133).

Judgements (other than estimations) relating to accounting policies could have a significant impact on the reported numbers. Disclosure of these judgements should also not be omitted on the basis that the answer was obvious to management based on the facts as, absent any disclosures, the user of the AFS does not have those facts and would be unaware of the details regarding this area of judgement. Sufficient entity specific detail must be provided to help the user of the financials understand how the accounting policies have been applied.

Disclosures regarding estimates are required where assumptions (made about the future) and other estimates (where there is uncertainty) have been made at the end of a reporting period and have a significant risk of a material adjustment to the carrying amount of assets and liabilities within the next financial period. When applied correctly one is likely to see a great depth of entity specific detail (including quantified specific amounts) on those items that are likely to have a material effect on the next year's accounts.

Several business sectors within the South African economy are under strain. As such, the JSE will continue to question issuers on their application of IAS 36, specifically as it relates to the assumptions used in assessing the impairment of goodwill and debtors balances, and IAS 12, in terms of the recoverability of deferred tax assets.

### Application of new standards

IFRS 16 is effective for financial years commencing on or after 1 January 2019. Issuers should be providing quality, entity-specific qualitative and quantitative information (per IAS 8.30) about the application of this new standard. Wording to the effect that 'the standard is likely to have a material impact/ no impact' is not regarded as meeting issuers' obligations under IFRS. Generic wording such as, 'we are still assessing the impact of this standard' raises concern to the readiness of the issuer

with respect to financial reporting procedures – particularly when considering the effective date of the new IFRSs.

In December 2018 the JSE issued a letter advising issuers of its intention to embark upon a thematic review for the adoption of the financial instruments and revenue standards, IFRS 9 and IFRS 15, ("**the new standards**") which are applicable for financial years commencing on or after 1 January 2018. In light of this new thematic monitoring activity, we urge issuers to place specific attention to new standards in their next set of annual financial statements.

**Previous findings**

Issuers should continue to pay careful attention to how all of the JSE's past findings could impact their results. Questions will be asked if problems are highlighted in the AFS for matters that were set out in this (and previous) proactive monitoring reports.

## ANNEXURE 1 - REVIEW PROCESS

This annexure provides a high level overview of the review process.

### Corporate scandals of 2017/2018

The South African financial markets were shaken by a range of corporate scandals, rumours and innuendo towards the end of 2017 and into early 2018. Whilst the review process will not identify fraud, in response to the above mentioned events, the JSE's approach to the 2018 reviews was more considered, resulting in more questions being asked than in previous periods.

### Selection process

We intend to review every issuer's AFS at least once within a 5 year cycle and therefore our selection process is largely random. We do however aim to ensure that we have a view of the entire market. Our selection process is therefore directed to a proportional representation across all sectors and all markets. In this regard we also ensure that we covered issuers of all sizes from the Top 40 to those with a very small market capitalisation. There are also instances where, due to the presence of specific risk factors, an issuer will be targeted for review.

### Risk based approach

The review process is not a detailed review of the AFS for compliance with every paragraph of IFRS. Detailed IFRS disclosure checklists are often standard armoury for an issuer and their auditor and we do not intend to replicate this process. Instead, we follow a risk-based approach. Risk areas will change from year to year and from entity to entity and could include:

- consideration of a specific accounting standard where, at a point in time, we have concerns with regards to the level of compliance;
- consideration of issues driven by the business environment ; and/or
- matters that are peculiar to the specific circumstances of an entity in that specific year.

At all times our focus is on aspects that are potentially price sensitive or could impact investors understanding of the business.

**Collaboration with the University of Johannesburg ("UJ")**

A crucial part of this proactive monitoring process is the partnership that the JSE entered into with UJ. Whilst the initial review is based on the predetermined risk areas it is imperative that the reviewers have comprehensive IFRS knowledge. It is also not just a case of ensuring compliance with a specific IFRS disclosure paragraph. Rather the reviewers have a full understanding of all aspects of IFRS in order to understand the potential implications, the impact on the AFS of a particular matter and as well as assessing the potential non-compliance within the objective of financial reporting. Each AFS has at least two reviewers working on it, with the final sign off being done by a senior member of the UJ academic staff. The volume of issuers covered in a year means a large number of skilled staff is required to do the initial reviews. Through the partnership with UJ, the JSE effectively had access to approximately 29 additional qualified personnel.

The following process is applied:

- The selected AFS are sent to the staff of UJ for the initial review;
- A detailed report is prepared for each set of AFS; and
- The handing over of the report marks the end of the involvement in the case by the UJ staff.

**Communication with Issuers**

The detailed UJ report forms the basis of a potential enquiry by the JSE. JSE staff members use that report to engage with the issuer. An initial letter of enquiry will be sent to the chair of the Audit Committee which identifies and asks questions on matters that we believe required further clarity.

The JSE then receives and gives the responses received from issuers' careful consideration. The format of our communication is principally in a letter format. This is necessary not only to create an audit trial of the enquiry, but also to ensure a complete understanding of all the considerations, in what are often complex IFRS matters. Nevertheless, we welcome meetings with issuers which can aid in the understanding of the content of their written responses and/or any subsequent questions that we may have.

From the onset we aim to be pragmatic with our approach and look to unravel matters that could be price sensitive. As a result it is necessary to ask questions of issuers in order to understand certain accounting matters and in order to ascertain the materiality of those, either on past, current or

future accounting periods. Matters are often easily resolved through the provision of a satisfactory IFRS substantiated response.

**Collaboration with the South African Institute of Chartered Accountants ("SAICA")**

In 2002 the JSE and SAICA formed the GAAP Monitoring Panel, an advisory body of accounting experts to assist the JSE to enforce compliance with IFRS. With the launch of the proactive monitoring process the GAAP Monitoring Panel was renamed the Financial Reporting Investigation Panel (**"FRIP"**). The role of the FRIP under the new process continued as it did in the past. More specifically, the FRIP provides advice to the JSE on cases of possible non-compliance with financial reporting requirements.

Referrals to the FRIP may come from various sources including from the review process. These would be cases where the JSE needed detailed technical advice, for example:

- complex and technical matters; or
- where there is disagreement between the JSE and an issuer on a specific matter.

Once referred to the FRIP, a case follows the FRIP process as set out in the FRIP Charter (a copy of which is available on the SAICA website). In summary, each case is considered by a review panel of at least 5 members selected from the 16 FRIP members (the list of names is also available on the SAICA website).

On conclusion of a case, the FRIP, as an advisory body to the JSE, makes recommendations that will result in compliance with IFRS. The JSE will seek feedback from the issuer on the FRIP detailed technical view and will then make its decision as to any potential corrective steps after taking the following into account:

- the detailed technical report from the FRIP;
- the response from the issuer;
- the recommendations made by the FRIP;
- materiality;
- the general principles of the JSE Listings Requirements;
- the importance for investor protection; and
- the potential impact on price formation.

In certain instances the FRIP recommends that the JSE issue guidance to the market on a specific matter. We believe that the inclusion of the details in this report is the appropriate place for such guidance.

Where a restatement is brought about after a FRIP investigation, reference is normally made in the restatement announcement to the FRIP.

## ANNEXURE 2 – ACTIVITIES OF THE FRIP IN 2018

We wish to highlight that during 2018 neither of the FRIP cases discussed below came to light through the review process. Rather these were identified through other regulatory activities of the JSE. The content set out below reflects extracts from the reports received from the FRIP on these specific matters.

### Case 1

Revenue recognition

IAS 18, *Revenue*, ("IAS 18"), paragraph 20(b) requires revenue relating to the rendering of services to be recognised subject to it being probable that the economic benefits associated with the transaction will flow to the entity. Therefore this probability of future economic benefits is an estimation made at initial recognition and hence a threshold as to whether the rendering of the services meets the recognition threshold, or not.

The issuer's accounting policy in respect of revenue recognition stated that revenue is measured at the fair value of the consideration received or receivable. The accounting policy further states that in order to determine the probability of receipt of payment and expected future economic benefits, historical data was considered.

Over time, as data on revenue collection was gathered, it became apparent that some customers had no intention of paying for the service levied by the issuer, or were not paying for the service in the required 31 days. Both these categories of customers introduced different levels of uncertainty as to the probability of the inflow of future economic benefits, and hence the Issuer's revenue recognition policy. In effect these two new categories that emerged among customers provided the issuer with a basis to segment revenue streams into those that are probable of collection and those that do not meet the revenue recognition criteria.

IAS 1, *Presentation of Financial Statements* ("IAS 1"), paragraph 122 requires an entity to disclose, along with its significant accounting policies or other notes, the judgments, apart from those involving estimation, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. IAS 1.125 requires disclosure of information about the future and other major sources

of estimation uncertainty at the end of the reporting period, that have significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities.

The FRIP concluded that the revenue recognition policy consisted of boiler plate IFRS language only and provided very little indication to the users of the financial statements as to the assumptions the issuer made about the future and other sources of estimation uncertainty in respect of the various segments of revenue.

The issuer's accounting policy and other disclosures relating to assumptions and risks were unclear as to what assumptions were applied in determining the amount of revenue to be recognised with respect of services rendered, considering delinquent payers and late payers.

The probability of future economic benefits flowing from the latter two was less likely and therefore consideration should have been given as to what portion of such revenue, if any, should be recognised. Furthermore, disclosure in respect of such assumptions should have been provided in the financial statements.

It was evident that revenue recognition in the years under review did not consider the probability of future economic benefits and hence the full revenue number was recognised, which was later subject to impairment provisioning. As a result, the allocation between revenue and impairment losses was inaccurate. However, as it would have been extremely complex for the issuer to correct the matter in prior financial years, and considering the benefit of hindsight, the FRIP concluded that a prior year correction would be impracticable.

Recognition and measurement of impairment losses

In respect of the same issuer to which the revenue recognition matter set out above referred, the JSE questioned the level of impairment of receivables which was not aligned to cash collections, the growth in the outstanding receivables, as well as the Issuer's disclosure in its annual financial statements in terms of recovering these receivables.

The issuer argued that the non-payment by its customers constituted a criminal offence and, as such, debt never prescribes and it is inappropriate for it to be impaired.

The JSE questioned why the fact that this application of the legal framework, which interferes with the effect of the application of IFRS, was not disclosed as a departure from IFRS in the issuer's accounting policies. The issuer argued that there has been no departure from IFRS in determining the impairment of receivables and explained that, in the following year's financial statements, on the back of more and better data in respect of receivables being available a greater proportion of receivables were impaired. Therefore, the increased impairment charge was accounted for as a change in estimate.

IAS 39.58 requires an entity to annually, at the end of every reporting period, assess whether there is objective evidence that a financial asset or group of financial assets is impaired. Paragraph 59 refers to events that occurred after the initial recognition of the asset and that such loss events have an impact on the estimated future cash flow of the financial asset or group of financial assets. It also refers to possible combined effects of several events that may have caused the impairment. Examples of loss events mentioned include, *inter alia*, a breach of contract, such as a default or delinquency in interest or principal payments; observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, etc.

IAS 39.63 states that *"(i)f there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognised in profit or loss*".

IAS 39.64 requires an entity to first assess "*whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant (see paragraph 59). If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment*".

IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors* ("IAS 8"), in paragraph .5 describes a change in accounting estimates as "*an adjustment of the carrying amount of an asset or a liability … that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not correction of errors*".

IAS 8.5 describes prior period errors as "*omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that (a) was available when financial statements for those periods were authorised for issue; and (b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements*".

In terms of IAS 8.36 the effect of a change in an accounting estimate is recognised prospectively in the period of the change, whereas paragraph .42 requires an error to be corrected retrospectively in the period on which it occurred, by restating opening balances.

IAS 1, *Presentation of Financial Statements* ("IAS 1"), paragraph 32 states that *"(a)n entity shall not offset assets and liabilities or income and expenses, unless required or permitted by an IFRS*".

In the specific instances, it was evident to the FRIP that impairment indicators existed for the group of financial assets in that large groups of debtors chose not to pay for the services rendered.

The issuer should, in terms of IAS 39, have segmented its debtors' book in terms of similar risk characteristics for purposes of calculating the level of impairments, taking into account the incurred loss events and after adjusting for the appropriate revenue recognition. Both these aspects would have a material impact on both the revenue and the impairment as reported.

Furthermore, despite the accounting policy stating otherwise, the debtors were not discounted in earlier financial reporting periods. This was corrected in latter periods. Given the change in the methodology, further disclosure should have been provided in terms of how this affected the recognition of revenue. Further, the accounting effect of debiting interest income and crediting the debtor was inappropriate. Instead, the debtors should have been recognised initially at the present value of the expected amounts to be received, if determined to be required in terms of IAS 18 and SAICA's Circular 2/2017, *Determining revenue/purchases as a result of financing components* ("SAICA

Circular 2/2017"). Any impairments thereafter, either through a reduction in the amounts expected to be received, or delayed settlement, would result in an impairment loss that should have been recognised separately in the income statement, and not against interest income.

**Case 2**

Consolidation of trusts

Two related matters were involved in this instance. Firstly, the JSE questioned the manner in which the issuer accounted for its arrangements with trusts and whether those trusts should be consolidated. If not, the JSE questioned whether IFRS 12 applies to these trusts, with specific reference to additional disclosure requirements in certain instances.

The issuer has made investments in trusts as charitable institutions which are registered as public benefit organisations. They have been identified as corporate social responsibility vehicles as well as its choice for BEE initiatives.

The JSE questioned whether these trusts should have been consolidated due to the fact that some of the trustees are employees and/or directors of the Issuer and the group of companies to which Issuer is related, and hence not independent. The JSE also questioned the nature of the returns and to what extent the Issuer has power to remove and replace trustees etc. in order to establish whether Issuer has control, joint control or significant influence over these trusts.

Lastly, if it is appropriate not to be consolidated the JSE questioned whether the trusts meet the definition of structured entities as defined in Appendix A to IFRS 12, *Disclosure of Interested in Other Entities* ("IFRS 12"), in which case further disclosures are required.

IFRS 10, *Consolidated Financial Statements* ("IFRS 10"), paragraph 5, states that an "*investor, regardless of the nature of its involvement with an entity (the investee), shall determine whether it is a parent by assessing whether it controls the investee*".

IFRS 10, paragraph 6 and 7, state that control is achieved when the investor is exposed the variable returns from its involvement in the investee and has the ability to affect those returns through its

power over the investee.  Power is described as the right that gives the investor the current ability to direct the relevant activities of the investee.

In assessing control and whether such power as described exists, consideration should be given to the nature of the investor's relationships with other parties and whether those parties are acting on the investor's behalf.  For example, as per IFRS 10, BC 75, related parties include an investee for which the majority of the members of its governing board or key management are the same as those of the investor or a party that has a close business relationship with the investor.  BC 69 states that only one party, if any, can control an investee.

IFRS 12, Appendix A, defines a structured entity as an "*entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements*".

B22 – B24 elaborate on features and attributes of structured entities, such as restricted activities, a narrow and well-defined objective, insufficient equity to permit the entity to finance its activities without subordinated financial support and financing in the form of multiple contractually linked instruments to investors that create concentrations of credit or other risks.

IFRS 12, paragraph 24, requires the investor to disclose information regarding its interest in a structured entity in order to enable users to understand the nature and extent of its interest as well as to evaluate the nature of, and changes in, the risks associated with its interest in the unconsolidated structured entity.

IFRS 12, paragraph 29, further requires an entity to provide disclosure in respect of the nature of risks, by providing information in a tabular format of "*(c) the amount that best represents the entity's maximum exposure to loss from its interest in unconsolidated structured entities, including how the maximum exposure to loss is determined.  If an entity cannot quantify its maximum exposure to loss from its interest in unconsolidated structured entities it shall disclose that fact and the reasons*".

BC 97 states that an entity would be required to provide additional information about the assets and funding of structured entities, if relevant to an assessment of its exposure risk.

In determining whether the Issuer has power to direct the relevant activities of the trusts, consideration should be given to the existing trustees. Extensive questions in this regard were asked and answered in the correspondence between the JSE and the Issuer.

In essence, the trusts, which perform similar services for another and related Issuer, seemed to have very loose, unstructured and undocumented arrangements by which both Issuers have influence on the decision making of the trust, through employees who serve as trustees. Furthermore, both Issuers provide material amounts of funding to the trusts, in addition to external debt from a bank.

Based on the information provided, the FRIP could not conclusively determine that the Issuer has control over the trusts, or that the two Issuers collectively have joint control over the trusts. Although evidence of joint control of the trusts was identified, the lack of rights to the assets and obligations for the liabilities ruled out the classification as joint operations and the lack of rights to the net assets of the arrangements ruled out the classification as joint ventures.

It appears as if these structures and arrangements were very cleverly designed to avoid meeting the control definition and hence the need for either Issuer to consolidate the trusts. However, the underlying commercial arrangements, including the lack of documentation, brought into question whether this was a conscious attempt to circumvent IFRS.

The FRIP is however not tasked with making business judgements or investigating the matter by interviewing role players. The role of the FRIP is to consider the appropriate application of IFRS based on information and facts presented. To this end, the FRIP could not conclude that the Issuer was incorrect in not consolidating the trusts.

In this matter, the FRIP held the view that it should place on record that huge unease existed in this matter that the Issuer, through its joint arrangements with the related Issuer in respect of these trusts, appeared to have designed the structures and arrangements in a manner to avoid consolidation.

[By way of feedback, the JSE wishes to advise that it gave careful consideration to the FRIP's concerns set out above. It decided, in this instance, not to pursue this aspect any further given that

the other party to the structure had already restated its results to consolidate the trust, and IFRS 3 BC 69 states that only one party can control an investee.]

This led to the next consideration for the FRIP, as to whether the trusts should be classified as unconsolidated structured entities, as defined in IFRS 12. The description of structured entities aligns with the information provided by the Issuer in so far as the nature of the trusts and the arrangements of the Issuer with the trusts are concerned.

The FRIP therefore concluded that the trusts are unconsolidated structured entities and hence the disclosure requirements in that regard, per IFRS 12, should have been provided. As an unsecured lender, the recoverability of the loans provided by the Issuer to the trust is subject to the risks attached to the financial performance of the trusts. Inadequate disclosure was provided, especially in respect of the requirements of IFRS 12 in so far as the nature and changes in the nature of the risks associated with the Issuer's interest in the unconsolidated structured entities, is concerned, especially in light of its announcement as to the anticipated impairment of the loans to the trusts.

**ANNEXURE 3 – OTHER ACTIVITIES OF THE JSE**

Over and above the proactive monitoring process, the JSE engages with issuers on IFRS matters. The JSE may interrogate IFRS reporting based on either formal complaints that it receives or through its own risk identification process. The content of a pre-listing statement is governed by both IFRS (in terms of the historical information included therein) and the JSE Listings Requirements.

Following a formal investigation process, the JSE made a finding against an issuer which led to both a fine and a public censure. The details of the accounting matter are set out below.

Applicable IFRSs:

- paragraph 18 of IAS 24 *Related Party Disclosures,* requires disclosure of the amount of related party transactions as well as details of any outstanding balances, commitments and guarantees given or received; and
- IFRS 7.36 read with IFRS 7.B9 and B10 requires disclosure of the amount that best represents the entity's maximum exposure to credit risk which includes activities such as granting financial guarantees i.e. the maximum amount that an entity could have to pay if the guarantee is called on, which may be significantly greater than the amount recognised as a liability.

Applicable JSE Listings Requirements:

- paragraphs 7.20 and 7A.22 ask for detailed disclosure (per 7.A20(a) to (i) and 7.A22) of material loans made by the issuer and its subsidiaries;
- paragraph 7A.21 details (per 7.A20(a) to (i) and 7.A22) of loans made or security furnished by the issuer or any of its subsidiaries to or for the benefit of any director or manager of the issuer; and
- paragraph 8.3 and 8.62(b) state that financial information must be prepared in accordance with IFRS

A company issued a pre-listing statement and subsequently listed on the JSE. At listing, the issuer and/or its subsidiaries had the following arrangements in place:

- the issuer's wholly owned subsidiary unconditionally and irrevocably guaranteed the Domestic Medium Term Note Programme for a fellow subsidiary;

- the issuer, through its subsidiaries, provided loans to directors/key management personnel in terms of a management investment scheme through a special purpose vehicle (”**SPV**”) ; and
- the issuer, through its subsidiaries, was party to a guarantee of third party debt related to the SPV.

These disclosures of the above arrangements were neither included in the pre-listing statement nor in the AFS published by the company post its listing. It is important to note that these disclosures are required even if an issuer is of the view that the likelihood of the events occurring is remote.