Report Back on Proactive Monitoring of Financial Statements in 2011

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JOHANNESBURG STOCK EXCHANGE

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INTRODUCTION

In February 2011 the Johannesburg Stock Exchange ("JSE") announced that it would commence a process of reviewing Annual Financial Statements ("AFS") for compliance with International Financial Reporting Standards ("IFRS"). The integrity of financial information is a critical element of a well functioning market. The objective of the review process is therefore to contribute towards the production of quality financial reporting of entities listed on the JSE.

This report provides an overview of the proactive monitoring activities in 2011.

This report is intended to be of interest to all market participants, including Issuers, investors, auditors, other regulators and the general public. It sets out the important points which came to our attention during the year with a view to assisting Issuers when they prepare their next set of accounts. By presenting the points in an uncomplicated manner we also hope that this will help demystify IFRS for the public.

From the onset we have sought to take a pragmatic approach to our review process. This requires a fine balance between not getting bogged down in trivial matters but also not overlooking something that, once unravelled, could materially alter the users understanding of the financial position of the listed entity ("Issuer").

We have been pleased with the positive approach adopted by the majority of the Issuers who have been subject to our review process. On the whole we have been provided with detailed, considered, IFRS arguments. Such an approach aids with the speedy resolution of matters.

GOOD REPORTING PRACTICE

Basic compliance with the requirements of IFRS is at the heart of our monitoring activities. There were however a few common themes we found in certain reports. If these matters were corrected, the quality of reporting would have been higher and the number of questions that resulted, fewer. We discuss these areas below and hope that Issuers will take note of them in order to improve the overall quality of their financial statements.

Accounting policies

There was a "boiler plate" approach to accounting policies. The AFS would include a myriad of accounting policies for instruments or transactions not contained in the underlying accounts and for matters not affecting the Issuer at all. It would appear that certain Issuers believe that including as many policies as possible is a safer option. This practice however causes confusion and raises questions as to where the figures that should be talking to this accounting policy have gone.

In other instances where an accounting policy was necessary, the Issuer included a generic policy or last year's policy, without amending it for the specifics of its own business environment or that specific year. Again this creates confusion and adds little value to the accounts.

A third category was instances where the accounting policies were silent, leaving the reader guessing as to what the Issuer had done. This could be particularly confusing where there was a choice of accounting policy in terms of IFRS or diversity in practice in the application of a specific IFRS standard.

The inclusion of a two separate accounting policies covering the same item (for example one on trade and receivables and one financial instruments) is another example of how accounting policies can cause unnecessary confusion.

Issuers would do well to revisit paragraphs 117 to 124 of IAS1–*Presentation of Financial Statements* and remember that the purpose of accounting policies is to inform users so that they can understand the financial statements.

A single story

Whilst Issuers are obliged to communicate certain matters to their investors throughout the year, the AFS cannot be divorced from these communications. Similarly, the actual IFRS figures (and their accompanying notes) within the annual report should tell the same story as the narrative contained in the directors reports and management commentary. Inconsistencies or omissions in the AFS are confusing and potentially misleading. Inconsistencies were also found between notes in different parts of the AFS themselves.

Cutting the clutter

The objective of financial reporting is to provide financial information to assist users in making economic decisions. Important transactions, figures and policies should be highlighted. By highlighting a specific item, for example in the statement of comprehensive income, the Issuer is sending the message to the reader that this is important for an understanding of the financial performance. The highlighting of immaterial items sends conflicting messages and furthermore it obscures the more relevant information that the reader should be focusing on.

The inclusion of generic explanations or notes that remain unchanged from year to year also creates clutter. Merely because something was included in the AFS in the previous year is not a sound basis for its repeated inclusion. The information should be refreshed in order to reflect the changing circumstances within that entity. Furthermore it is more useful to highlight changes to the reader rather than to leave them to sift through all the information in the hope of identifying an important change.

Finally, whilst cross referencing is often an effective way to ensure that all information is included by reference , it might be more useful to combine such information into one single note or place within the financials.

REVIEW PROCESS

Selection process

All AFS published after 1 January 2011 were eligible to be selected for review. We have stated that we intend to review every set of accounts at least once within a 5 year cycle and therefore our selection process was largely random. However, we aimed to ensure we had a view of the entire market. Our selection process therefore was directed to proportional representation across all sectors and all markets. In this regard we also ensured that we covered Issuers of all sizes from the Top 40 to those with a very small market capitalisation.

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:

(i) Consideration of a specific accounting standard where, at a point in time, we have concerns with regards to the level of compliance;
(ii) Consideration of issues driven by the business environment ; and/or
(iii) 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 to ensure that the reviewers have comprehensive IFRS knowledge. It is not just a case of ensuring compliance with a specific IFRS disclosure paragraph. Rather the reviewer needs to have a full understanding of all aspects of IFRS in order to understand the potential implications and 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 people

are required to do the initial reviews. Through the partnership with UJ, the JSE effectively had access to 20 additional high calibre personnel.

The following process is followed:

- 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 then engage with the Issuer and consider and debate the responses.

Aiming to be pragmatic, we have addressed our communication to Issuers in two separate sections. The first sets out matters of a potentially immaterial nature which could assist an Issuer in improving the quality of their financial reporting. The JSE did not require any further action or ask for any response on these matters but simply encouraged Issuers to take account of them with their next results. The second and more important section contains matters that could be price sensitive and therefore required further clarity. In our letter we note that some of these matters could be easily resolved if satisfactory responses are provided in the communication.

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

In 2002 the JSE and SAICA formed the GAAP Monitoring Panel ("GMP"), an advisory body of accounting experts to assist the JSE to enforce compliance with IFRS. With the launch of the proactive monitoring process the GMP 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.

The intention of the new review process is that only certain cases will be referred to the FRIP. These would be cases where the JSE needed detailed technical advice, for example:

(i) Complex and technical matters; or

(ii) Where there was 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 up to 5 members selected from the 16 panel members (the list of names is also available on the SAICA website). Where a restatement is brought about after a FRIP investigation, reference is normally made in the restatement announcement to the FRIP.

RESULTS

Statistics

From March to December 2011, 56 AFS were proactively reviewed. 16 cases were closed either with no comments or with a letter of potential areas of improvement being sent to the Issuer. We wrote enquiry letters to 40 of the Issuers, of which 2 resulted in a further referral to the FRIP for advice. By January 2012 11 of the 40 cases of enquiry were still pending finalisation. The statistics below therefore only deal with the 29 closed cases.

Number of AFS reviewed	56
Cases closed immediately	16
Letters of enquiries	**40**
Cases still pending	11
Completed cases	29

Two cases resulted in restatements of the AFS and public announcements. In consultation with the Issuers, these restatements were made as soon as possible. For a further 2 cases the misstatement was such that we therefore agreed with the Issuer that it could be corrected within the next published results. For a further 10 cases, whilst fortuitously there was no material misstatement and adjustments needed to be made in future to avoid potential investor prejudice. The remaining 15 cases revolved around the smaller disclosure issues that will be clarified or corrected in the future.

AFS needed restatement and public announcement made	2
Non compliance such that we agreed to a correction within the next published results	2
Non compliance not material this year but will correct in future to avoid potential investor prejudice	10
Smaller disclosure issues that will be corrected in the future	15
Completed cases	**29**

In assessing the potential impact of the matter, consideration was given to the number of different issues as well as whether the impact was an IFRS disclosure matter and/ or did it affect the measurement of items within the AFS. 66% of the closed cases dealt with IFRS disclosures matters, with the remaining 34% impacting both IFRS disclosure and measurement.

International comparison

Whilst our counterpart enforcers in Europe (through the European Securities Markets Authority) have not yet released their 2011 findings, the 2010 activity report provides a useful comparison. The report indicates that of the 1700 reviews undertaken by the 20 + European Union member states, 14% of those reviews identified material infringements, requiring public announcements or reissuing of AFS. For a further 22%, whilst classified as material, the enforcers accepted a correction in the next AFS.

Our findings are broadly in line with these international trends. Only 4.4% of our completed cases were regarded as requiring restatement and 26.6% needing correction in the future.

	ESMA	**South Africa**	Notes
Coverage			
Period of review	2010	2011	
Reporting date	Oct 2011	Feb 2012	
Number of reviews	1 700	56	
Percentage coverage of population	24%	15%	1
Reviews completed at reporting date	1 700	45	2
Findings			
Material infringement so asked for re-issuance or immediate public announcements	14%	4.4%	
Corrections required in future financial statements	22%	26.6%	
Total forced corrections	36%	31%	

Note 1 The JSE target coverage is at least 20% per annum. This first review cycle only commenced in April 2011 thus there is a lower coverage in this first reporting year.

Note 2 ESMA only reports back in the last quarter of the year, when all their reviews are completed. The earlier report back by the JSE resulted in some pending cases

DETAILED FINDINGS

This section deals with items of enquiry for the 29 closed cases only. It does not discuss the areas of potential improvements highlighted to the Issuers. Without the benefit of detailed correspondence it is difficult to know whether a potential improvement is just that or whether the issue could easily be explained.

This section does not distinguish between cases where the errors resulted in restatements or where the impact might be less significant. The reason for not making this distinction is that the objective of providing this information is to highlight these areas in order to advise Issuers of the potential pitfalls and where the quality could be enhanced.

For ease of use topics have been grouped together in terms of the specific IFRS standard, which is also included in the heading (being either an IAS or an IFRS).

Presentation of Financial Statements IAS 1

IAS 1 contains the overall requirements for the presentation of financial statements. There were various cases where some of the key issues covered by this standard were not adequately addressed. These are discussed below.

Assessment of going concern
There was insufficient and conflicting disclosure of the facts and circumstances that led to the conclusion that the entity was still a going concern. This was contrary to IAS1 par 25 which calls for the disclosure of any uncertainties regarding the going concern assessment.

Reclassification
Inter period comparability assists users in making their decisions. In one specific case we found insufficient disclosure of reclassification adjustments relating to components of other comprehensive income. This was contrary to IAS 1 and created potential confusion for the reader of the annual financial statements.

Offsetting
There was a concerning trend of Issuers offsetting derivative assets and liabilities and gains and losses on hedging instruments. IAS 32 par 42 indicates that offsetting of financial assets and liabilities is only allowed in terms for IFRS where a legally enforceable right exists for offset and the entity intends to settle on a net basis. IAS1 par 35 also deals with offsetting

gains and losses arising from a group of similar transactions. It specifically states that such offsetting should not occur if the gain/ loss is material.

Materiality

Some Issuers tried to justify that their error or misapplication of IFRS was acceptable as the issue was immaterial. IAS 1 par 7 states that materiality depends on both the size and nature of the omission or misstatement. IAS 8 par 41 also states that there is non-compliance with IFRS if material or immaterial errors are made intentionally in order to achieve a particular presentation.

In some instances matters were dismissed as being individually immaterial. The problem is that numerous immaterial errors when considered as a whole can become material. In other instances we dismissed matters as being immaterial as they were assessed to only cover disclosure and that they would not change the figures. On application of the disclosure requirements and careful consideration of the accounting policy the items were in fact found to have a quantifiably material impact on the results.

In any event it is frequently debatable whether errors are qualitatively or quantitatively material. The real test is the qualitative test as to whether the matters could influence investors and we would urge Issuers to pay careful attention to this issue in both the preparation of the AFS and their responses to us. Whilst we accept that materiality is a valid argument in certain circumstances it should not be considered as an easy alternative to a proper understanding and application of the specific IFRS requirements.

Statement of cash flows IAS 7

Information about the cash flows of an entity is important to enable investors to evaluate the ability of that entity to generate cash flows and to understand the timing and certainty thereof. In periods of economic downturn this focus is heightened, and specific attention is given to classifications within the statement of cash flows, for example operating cash flows.

The following problems / misapplication of this standard were found:

(i) The reflection of non cash flow items as cash flow items; and

(ii) Inconsistencies between amounts on the face of the statement of cash flows and note disclosures elsewhere in the AFS.

Taxation IAS 12

Tax rate reconciliations often did not reconcile or tie into the tax figures included in the statement of comprehensive income. These are mathematical calculations and not complex IFRS matters. The errors point to a careless approach to financial reporting, which is an unnecessary and worrying feature.

Deferred tax assets IAS 12

A deferred tax asset can only be raised if certain criteria are met. To this end it is crucial that an Issuer that is incurring losses complies with the disclosure requirements of IAS 12 and provides sufficient justification for the raising of the deferred tax asset. Whilst for most of our enquiries the matter could be cured by providing the necessary disclosure, in one instance our enquiry led to the realisation that there was no justification for the entity to raise the deferred tax asset. This resulted in a restatement of the statement of financial position.

Revenue recognition IAS 18

Careful consideration needs to be given to the treatment of interest income. In one particular case it was inappropriate to show interest income received on a lending business as “other income”. IAS 18 par 7 specifically defines revenue as “the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity“.

Related party transactions IAS 24

Disclosure of related party transactions is an important feature in the JSE’s regulatory approach. For this reason, the JSE has specific and detailed Listings Requirements (“LR”) dealing with these types of transactions. The disclosure requirements of IAS 24 complement these LR and provide valuable information to investors. By their very nature related party transactions are usually material. Regrettably, not all of the necessary disclosures were always provided. Readers need to be presented with a comprehensive and clear understanding of all the relationships that exist as well as the financial consequences thereof. This is a requirement for both the statement of financial position and statement of comprehensive income level, where the ongoing obligations of a single expense item such as a royalty or management fee could have a material impact on the understanding of the entity. The related party disclosures for intercompany transactions were also inadequate.

Impairments IAS 36

During the current times of financial instability, attention needs to be given to the application ofthe Impairment Standard IAS 36. Insufficient application of all of the disclosure requirements of IAS 36 could point to a more fundamental problem of incorrect measurement and the overstatement of assets. The disclosure of a seemingly minor issue, such as the discount rate applied in the calculation should therefore not be excluded.

The correct application of this standard in relation to goodwill is also important. Compliance with the disclosure requirements of the impairment testing (which should be done down to a cash generating level) is relevant for an understanding of the measurement issues.

Loans receivable IAS 39

In determining the fair value for initial recognition purposes of a financial asset or liability preparers cannot simply assume that the transaction price is the fair value. This is particular relevant for an interest free financial instrument. In one instance the Issuer ignored these measurement criteria for their long term interest free loan receivable and recorded it at the initial transaction value.

Share based payments IFRS 2

Share based payment arrangements are common especially in the context of employee share incentive schemes. Full compliance with the disclosure requirements of IFRS 2 is necessary to ensure that the users of financial statements fully understand the nature and extend of these share based arrangements. The necessary disclosures were found to be lacking in several instances. In some cases, the lack of an accounting policy specifically for forfeitures led to confusion.

Whilst IFRS2 is not a new standard, there were also some misapplications as it relates to the measurement requirements of this standard.

Business combinations IFRS 3

Much of the LR deals with acquisitions and disposals by Issuers. Through these LR, investors are immediately provided with price sensitive information and given the right to approve the larger transactions. It follows that we want to ensure the accounting for these transactions is complete and accurate in the AFS. Transactions can fundamentally alter an

Issuer and it is important for investors to be able to evaluate the nature and effect of these transactions.

The following problems/ misapplication were found to exist for this standard:

(i) The incorrect identification of the date at which effective control passed which had an impact on the measurement of the transactions. The existence in one case of an agency agreement did not override the substance of the transaction and that control of the business had already passed;

(ii) The disclosure requirements of IFRS 3 were incomplete prejudicing investors with regards to the valuable information they could use to assess the impact of a transaction; and

(iii) Incorrect measurement of the contingent consideration applicable to a business combination. The classification of this contingent consideration as either a liability or equity (which must be done in terms of IAS 32) potentially has implications on the financials on an ongoing basis when re-measurement occurs.

Financial instruments disclosures IFRS 7

IFRS 7 aims to ensure disclosures are provided that enable users to evaluate the significance of financial instruments, the nature and extent of risks relating to those instruments and how these risks are managed. In these current financial times this information is even more crucial. We were concerned about insufficient disclosure of the measurement basis of financial instruments, as required by IFRS 7. This lack of disclosure could have meant that the measurement of those instruments was incorrect.

The required disclosures on hedging (see par 23 of IFRS 7) were often scarce. This lack of information makes it difficult for investors to fully understand the impact of hedging on the financial statements. In one case, with regards to a cash flow hedge, whilst the Issuer tried to argue that the disclosure was immaterial to investors, preparation of the necessary disclosure at our insistence resulted in the realisation that in fact the measurement of the item was incorrect and cash flow hedging had been incorrectly applied.

There was also insufficient compliance with the following disclosure requirements of IFRS 7:

(i) Par 7 and the requirements to disclose collateral for loans receivable;

(ii) Par 27 which deals with the fair value hierarchy disclosure requirements was incomplete. This information becomes even more important when a large part of the assets are measured on a fair value basis;

(iii) Par 36 which deals with the credit quality of receivables. IFRS 7 requires disclosure to allow users of the AFS to understand the assessment of the quality of for example trade receivables. The crux is to understand whether or not the Issuer is exposed to any material risk of financial loss; and

(iv) Par 40 as it relates to a sensitivity analysis for foreign exchange and interest rate risk. Again this information could point to material risks which the users need to understand.

Segmental reporting IFRS 8

The core principle of IFRS 8 is to provide information so that the nature and financial effects of the business activities and economic environment can be understood.

It would appear that an incorrect understanding of the principles of this standard has lead to incorrect reporting or at the very least conflicting messages. In terms of IFRS 8 operating segments are identified as components of an entity whose results are regularly reviewed by the chief operating decision maker. It is contradictory when management discuss in great detail a particular component of the business in the annual report or in other communication to investors, but do not then identify that component as an operating segment for segmental reporting purposes.

The disclosure requirements of IFRS 8 were also poorly applied in certain instances, specifically as it relates to the detailed accounting policy note, identification of the "chief operating decision maker" and the basis of accounting between reportable segments.