# Reporting back on proactive monitoring of financial statements in 2020

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## Introduction

This report (the **"2020 report"**) provides an overview of the proactive monitoring activities (the "**review process**") undertaken by the JSE during 2020. 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 healthy debate that often surrounds a review process is in of itself important for the credibility of our markets.

The target audience for this report is entities whose securities have a primary listing on the JSE. Secondary listed issuers may also find benefit therein. The 2020 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 2021.

We provide details of the review process for new issuers (and directors) for their understanding. Finally, this report provides statistical findings that highlight the regulatory value of the review process.

## Confirmation by audit committees

The JSE specifically requests every issuer's audit committee to consider the findings of this 2020 report together with certain other information incorporated in this report and to confirm to the JSE (in a letter accompanying the annual compliance certificate) that they have ensured that the issuer has taken appropriate action.

Annexure 3 contains an easy checklist of the information that the audit committee must consider, together with appropriate website references of where to find the information. That information includes the 2020 report, previous reports issued by the JSE (either in their entirety or merely sections thereof), as well as covid-19 related letters and publications issued by the JSE and the International Accounting Standards Board.

> Effective boards should be challenging management in scenarios where the 'story' across different parts of the AFS does not reflect the same message. Disclosure obligations are not trivial: questions on disclosure can unravel into material measurement matters.

## Detailed findings

### 2020 focus area: Adoption of new standards

In November 2019 the JSE issued a report detailing findings from its thematic review for the adoption of the IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers* (the "**2019 Thematic Report**"). That report is available on the JSE website. Our reviews during 2020 continued to examine the level of application of these two standards and our findings are set out below.

Credit risk and expected credit loss "ECL" disclosures

We noted many similar findings to those contained in our 2019 Thematic Report regarding credit risk disclosures of IFRS 7. Our findings were most often characterized by insufficiently detailed or entity specific disclosures being provided that would assist users in understanding the extent of an entity's credit risk, the effect on the amount, timing and uncertainty of future cash flows or how this has changed from prior periods (paragraph 35B). The disclosure of methods, assumptions and inputs (including the use of macroeconomic information) as well how forward looking information has been incorporated into the Group's ECL assessments, should be provided in an entity specific manner (paragraph 35G).

In one case an issuer assumed a remote credit risk for certain transactions in which it acted as a facilitator. It offered lenders an indemnification of the borrowers' obligations arising under the transactions. The issuer considered the risk of a claim to be remote, given that the borrower had provided collateral greater than the value of the scrip lent. They only disclosed the following information in their AFS:

> *"Within the Securities Lending business there is an off-balance sheet exposure relating to bond and equity collateral receivables with a maximum exposure to credit risk of R4,216,290,701"*

Disclosures for 'off-balance sheet' credit risk exposure needs to be in sufficient detail to enable an understanding of why such exposure exists (paragraph35B(c)) and their disclosure fell short in this regard.

IFRS 7.35I requires disclosure of how significant changes in the gross carrying amount of financial instruments during the period contributed to changes in the ECL allowance. The relative value/ relationship between the ECL provision and gross carrying amount of an asset class is not static in all instances. We asked a number of issuers to disclose more information detailing the reasons why the significant increase/decrease in their ECL allowance was 'out of sync' with the underlying gross carrying amount in a particular period. Such disclosure is emphasised by IFRS 7.35H which asks for details of and an explanation of the changes in the ECL loss account.

Whilst disclosure of a provision matrix is no longer a specific requirement of IFRS 7, we found that many issuers who had applied the simplified impairment methodology made use of (and continued to disclose) a provision matrix in their ECL assessment. We found such information to be most helpful in providing insight into credit risk concentrations (paragraphs 35M and 35N). We must however caution issuers to carefully consider the extent to which such information is aggregated - both in terms of the bands (i.e. types of customers) as well as the 'buckets' (time periods) for which the balances are disclosed as being outstanding for. We queried the usefulness of information when a large proportion of the gross carrying amount was disclosed in a single band (say outstanding for 90 days +) without explaining what proportion was outstanding for (say) 90 days versus 180+ days and what default rates were applied to the different bands.

As it relates to the liquidity risk contractual maturity analysis (IFRS 7.39(a)), we identified the following deficiencies:

- insufficient disaggregation of the last column (often presented as 'one to five years') into narrower, more relevant periods (covid-19 has heightened the importance of presenting meaningful, narrow bands);
- omission of interest cash flows; and
- the erroneously inclusion of non-financial liabilities.

We find that many issuers concentrate on the credit risk (and related disclosures) associated with trade receivables only. Whilst trade receivables are often the most significant asset class, we remind issuers that they should evaluate credit risk across all classes of financial assets that are subject to credit risk. They should provide disclosures for all material assets.

Disclosure is still required if, after assessing credit risk for a material asset, the issuer concludes that no/an immaterial ECL provision is required. In such a situation, issuers should state this fact and provide the reasons supporting such an assessment (i.e. the inputs used in making this determination) (see paragraphs 35B, 35F and 35G of IFRS 7 *Financial Instruments: Disclosures*).

In one instance, an issuer in the property sector had raised the appropriate ECL provision against tenant trade receivables (in respect of monthly rental receipts) but had overlooked raising a similar provision against utility and rate recovery debtors. This class of financial assets was due from the same group of tenants and therefore subject to similar risk characteristics.

Amounts due from related parties (or inter-group receivables) was a common asset class for which ECL disclosures were found lacking in sufficient detail (or boiler plate). For receivables that are payable on demand, the disclosure in the company AFS should include an assessment of the liquid assets (including restrictions thereon) of the underlying subsidiary's (IFRS 7: 35G). The fact that a receivable is owing by a subsidiary (or related) company does not negate the need to both perform a credit risk assessment and provide disclosure thereof

<u>Presentation of revenue</u>
Unlike its predecessor (IAS 18 *Revenue*), IFRS 15 only deals with revenue arising from contracts with customers. This does not however mean that there are no other types of revenue or that such items are presented as 'other income' as opposed to revenue.

Revenue arises in the course an entity's ordinary activities (IFRS 15: Appendix A). Therefore, where an entity is an investment holding company (which is often the case in the context of the separate AFS), dividends received and interest income are typically 'ordinary activities' for that entity and must be presented as revenue (paragraph 82(a) of IAS 1 *Presentation of Financial Statements*).

Disaggregation of revenue

Our 2019 Thematic Report highlights the need to provide detailed disaggregated revenue disclosures. We continued to find instances of insufficient disaggregation of revenue (see IFRS 15.114-115 read together with paragraphs B87-B89).

The purpose of such disclosures is to provide categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors.

The disaggregation process is not restricted to and does not stop with an IFRS 8 *Operating Segments* assessment. Furthermore, providing information to investors in analysts' presentations is a clear indication of a category for disaggregation.

The same level of detail is also required in the interims as is presented in the AFS (paragraph 34.16A(l) of IAS 34 *Interim Financial Reporting*).

Revenue recognition: accounting policies

We identified the following omissions in accounting policies:

- a description of the treatment of 'trade-ins', discounts and other customer incentives (paragraphs 66-69 and 126); and
- an explanation of the types of transactions giving rise to commission revenue and the payment terms for such revenue (IFRS 15.119(b) read with paragraph (b) thereof)

When measuring the progress of revenue recognition, either using the input or output method, we found the required disclosures of IFRS 15.124 to be:

- absent;
- provided in such a generic manner that their usefulness was limited; or
- lacking the required justification as to why that method provides a faithful depiction of the transfer of the goods/ services.

Generic wording typically:

- can be read with any other set of AFS and still make sense;
- is a cut and paste from illustrative examples of AFS; and/or
- is merely brought forward from previous years AFS.

Revenue recognition: significant judgments and assumptions

IFRS 15 contains detailed and specific requirements for the disclosure of managements' judgements and assumptions. We found those disclosures to be insufficient in the following instances:

- an explanation as to why the entity recognised both of its revenue streams (being the sale of goods and the separate delivery of a service) at a point in time when seemingly this should not have been the case (paragraph 119(a));
- whether revenue was recognised either at a point in time or over time (paragraph 123(a));

- an explanation as to why all of the service revenue was recognised on a point in time bases, when ordinarily such revenue would be recognised over time (paragraph 123(a));
- why certain performance obligations were highly interdependent, as opposed to being separate performance obligations (paragraph 119). The issuer was entitled to a commission for performing the following obligations:
  (1) Obtaining the customer signature/referral for an insurance product; and
  (2) The ongoing collection of the subscription fee for the insurance product referred to in item (1).

  Although items (1) and (2) are potentially distinct from each other, for this issuer they were highly interrelated. This was because the collections in the micro credit industry (in which the issuer operated) were extremely specialised and very dependent on the branch network, branch level collections strategies and the customer relationship developed at point of sale. As a result, it would be very difficult for a third party to collect the subscription fees successfully over the life of the insurance product;
- a generic (or non-entity specific manner) description of the assessment of the transaction price and the timing of satisfaction of the performance obligations (paragraphs 123-124; 126(b) and B18);
- details of the methods, inputs and assumptions used for determining the transaction price, including estimation of variable consideration (such as rebates and discounts) (paragraph 126). In the instance identified, the issuer had only disclosed the following:

  "*Revenue is recognised net of rebates and discounts provided to the customers*"

  The omitted entity-specific inputs and methodology applied in estimating the variable consideration used for determining the transaction price, related to the fact that:
  (1) The discounts and rebates were based on either the volume or value of product purchased within a particular rebate/discount cycle; and
  (2) The key account managers responsible for that customer performed assessments of the most likely outcome for those contracts for which the variable consideration may fall.

## 2020 focus area: Disclosure of judgments and estimates

In our reports from 2017 to 2019 we indicated that the disclosure requirements of IAS 1 *Presentation of Financial Statement*s applicable to judgements (paragraph 122-124) and estimates (paragraph 125-133) would be a focus area for the subsequent year.

Audit committees should not place undue reliance on the auditor to be the only party sufficiently challenging the judgements applied by management.

Our number of findings is at a similar level for the past year as was the case in 2018. A third of those findings related to poor disclosures of judgments for classifications with the statement of cash flows and the application of various standards applicable to group accounting. As these and many other topics are similar to our findings in previous years, this report does not repeat that detail.

Issuers should ask the following question regarding the application or non-application of a specific IFRS: “Is it clear to the reader why we have reached this decision?”

A new area of (multiple) findings related to fair valuation calculations including the use of:

- a specific earnings multiple; and
- lower vacancy levels when compared to the historical vacancy rates (for a property valuation).

There were also two instances of insufficient disclosure of the factors considered and reasons supporting the conclusion that the entity was a going concern. Issuers are requested to include the Going concern section on pages 12, 50 and 60 of the ‘Combined Findings Report’ (see annexure 3) at their audit committee meeting.

The expectations regarding going concern disclosures are discussed in more detail below, under the heading “Looking forward - the 2021 review cycle”.

## 2020 focus area: Materiality

Our 2019 report explains that where a review process evolved into a discussion on materiality, the JSE would ask issuers to frame their responses to ensure an understanding of how decisions were made within the context of the issuers’ materiality framework. Such a framework needs to be robust enough to demonstrate that the treatment in question is appropriate under IFRS from a materiality perspective.

For some materiality discussions, it was clear that the issuer’s materiality framework was robust and appropriately applied. This was not the case in other instances.

Case 1: Appropriate materiality framework

In one case, the issuer was unable to provide us with convincing arguments for not correcting an error identified in their AFS. From a quantitative perspective alone, the error resulted in an 11% overstatement of the financial asset in question and was 21% of the profit before tax. Their response did not create the impression that they had developed a robust materiality framework (covering both quantitative and qualitative factors) that they applied to the decision not to correct for the error.

Case 2: Which aspects of the financial statements

An issuer’s assessment as to the immateriality of an error to the Statement of Cash Flows (“SCF”) was based on an argument that:

- users of the AFS rely on specific per share (and other key) measures; and
- the error was confined to the SCF and did not affect any of the identified key measures.

This reasoning assumes that the key measures are 'the only aspect' considered by a user of the AFS – implying that the primary financial statements and related notes are in themselves rendered irrelevant.

The JSE is concerned with issuers adopting a position that certain aspects of the AFS, or even worse that certain 'primary statements' within the AFS, are irrelevant and therefore errors made therein irrelevant. Whilst we appreciate that issuers have an understanding of the information needs of users, it is difficult to isolate the impact that one aspect of financial reporting would have (or would not have) to a user if that misstatement was material. The IASB's materiality practice statement emphasises a similar point when stating in paragraph 20 that:

> "When making materiality judgements, an entity needs to assess whether information could reasonably be expected to influence primary users' decisions, rather than assessing whether that information alone could reasonably be expected to change their decisions."

The AFS present a 'portrait' of an entities position and performance over a year, comprising individual components that work together to satisfy the information needs of users. Users often evaluate different elements within the AFS to measure reported information against. For example, they analyse cash flow information against earnings measures. To use an analogy of a building – what is 'more important' to the functionality of the building, a solid roof, its sturdy foundations or well-constructed walls? Each element of the building is instrumental in the building being able to achieve its stated purpose. Elevating the importance of one structure whilst another is defective leads to a compromise of the entire structure. Correction of errors are often qualitatively material in themselves as they talk to the quality of an issuers' financial reporting process.

Materiality must be considered holistically and not looking at the impact on the bottom line in isolation.

Case 3: Qualitative considerations of a materiality framework

Paragraph 41 of IFRS Practice Statement 2: *Making Materiality Judgements* states that:

> "An item of information is material for various reasons. Those reasons include the item's nature or magnitude, or a combination of both, judged in relation to the particular circumstances of the entity. Therefore:

"Making materiality judgements involves both quantitative and qualitative considerations. It would not be appropriate for the entity to rely on purely numerical guidelines or to apply a uniform quantitative threshold for materiality."

The matter discussed below was the subject of a process followed by the Issuer Regulation Investigations Unit, as opposed to a review process. We have included it as we believe that it is of relevance in understanding the JSE's position in this regard.

An issuer determined that a percentage of net asset value was an appropriate benchmark for their materiality for the following reasons:

- the business was in a growth/ recovery stage;
- the earnings were volatile;
- users do not only rely on the profit/ loss of the entity;
- users are more concerned with the progress being made towards the entities stated strategy than the actual level of profit/loss; and
- it's auditor also considered this to be the most appropriate benchmark.

The issuer decided not to adjust for an identified error in the FY1 AFS as, from a quantitative perspective, it was below the materiality threshold. They also took into account the following qualitative perspectives:

- the matter revolved around a complex accounting matter;
- there was no evidence of any intention to misstate the AFS; and
- the error did not arise from fraud or a break down in controls.

As it relates to the quantitative assessment, the JSE was concerned that it was not necessarily appropriate to apply a uniform quantitative materiality across all components of the financial statements.

In the subsequent year (FY2), the issuer passed an entry adjusting for the (cumulative) error. It did not restate the prior period results.

The JSE found that the manner in which the issuer corrected the prior period errors meant that the year FY2 AFS were materially misstated. Whilst the JSE acknowledged that the error may fall below the quantitative materiality level determined by the issuer, its view was that other qualitative considerations had a significant bearing on the assessment of materiality. These included the following:

- 65% of the adjustment made in the FY2 statement of profit or loss related to the results of previous years;
- Correcting the entire error in FY2 resulted in profit before taxation for FY2 being misstated by 38 %;
- the FY2 statement of profit or loss did not faithfully represent the operating results of the issuer for that year;
- the issuer did not disclose the above fact in its AFS;
- the trend (over a 3 year period, past and future) in the growth profit (and other key ratios) was materiality distorted;
- the trend in profit was an important matrix for users to assess the issuers delivery of its strategy.

## Matters where action was required

This section does not discuss all the cases dealt with in 2020. Instead, we focus on specific aspects from the material cases.

Statement of Cash Flows ("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, the JSE continues to regard material misallocations between the categories in a serious light.

Our findings have detected instances of non-compliance that have been discussed in previous reports. In order to prevent the ongoing misapplication of IAS 7, issuers are requested to include the Statement of Cash flows cases on pages 19 to 25 of the 'Combined Findings Report' (see annexure 3) at their audit committee meeting.

Herein a further two cases for consideration.

*Case 1*

The issuer classified proceeds from sale of financial investments under investing activities in the SCF. However, its accounting policy described the gain on the sale of financial investments as a principal source of income (i.e. operating in nature). The JSE questioned the apparent inconsistency between the SCF classification and this accounting policy.

We would have expected the proceeds on the sale of the financial investments to have been classified under operating activities if the accounting policy treatment were to be followed. IAS 7.14 states that Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity.

In contrast, if the SCF treatment had to be followed then, we would not have expected such an accounting policy. IAS 7.16(d) states that cash receipts from sales of equity or debt instruments of other entities should be classified under investing activities, unless those instruments are held for dealing or trading purposes.

*Case 2*

The issuer classified cash outflows related to the repayment of the principal portion of the Group's leases within operating activities instead of within financing activities on the SCF.

Paragraph 50(a) IFRS 16 *Leases* states that a lessee shall present cash payments for the principal portion of the lease liability within financing activities on the SCF.

In addition, the issuer did not comply with IFRS 16.53(g) which states that a lessee shall disclose the total cash outflow for leases for the period.

<u>Deferred tax</u>
Paragraph 51 of IAS 12 *Income Taxes* explains that the measurement of deferred tax balances shall reflect the tax consequences that follow from the way the entity expects to recover or settle the carrying amount of the respective asset or liability. Land and buildings are separate asset classes. Land is not depreciated, whilst buildings are depreciated over the period the entity expects to use them.

On querying the extent of the deferred tax movement for revaluation gains on owner occupied land and buildings, it emerged that an issuer had erroneously raised a deferred tax liability at the capital gains tax ("CGT") rate for the revaluation of both land and buildings elements.

The CGT rate was appropriate for land element, being a non-depreciable asset; IAS 12.51B. The deferred tax liability recognised on the revaluation gain for the building however should have been calculated with reference to how the carrying amount was to be recovered, which was through use. Consequently, the deferred tax liability on buildings should have been calculated using a higher tax rate (28% vs the effective CGT rate applicable at that time of 18.67%).

<u>Headline Earnings per Share</u>
Equity issuers are required to disclose headline earnings per share ("HEPS"). In one instance, an issuer erroneously added back the impairment loss incurred on a related party loan in their calculation of headline losses for the period. This led to a 17% understatement of their loss per share. As the related party loan was a financial asset accounted for per IFRS 9, the impairment loss did not qualify as a 'remeasurement item' to be added back per the SAICA HEPS circular.

<u>Impairment of associate</u>
An issuer fully impaired an associate through profit and loss in its interims. Our review identified that the issuer should have recognised this impairment in their preceding AFS.

Paragraph 8 of IAS 36 *Impairment of Assets* states that an entity shall at the end of each reporting period assess whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset.

<u>Loan forgiveness</u>
For the purposes of this report, we have included a high-level summary of a matter which also was the subject of a FRIP referral.

The JSE questioned whether the substance of a series of related party transactions occurring between the issuer (Company P), its acquired subsidiary (Company S) and the issuers' majority shareholder (Shareholder M) were fairly presented in the AFS.

*Initial loan*
Company P had acquired Company S from Shareholder M in the period under review. Company P (in its Group AFS) accounted for the transaction as a business combination under common control. A large portion of the acquisition price for Company S payable to

Shareholder M (who was the previous 100% shareholder of Company S) was contingent on future profits being earned by a specified reportable segment of the issuer.

Prior to the acquisition, Shareholder M had advanced a 'loan' to Company S. That loan was initially classified (in public documents) as an 'equity loan', i.e. Company S had no contractual obligation to repay any capital amounts to Shareholder M. In response to queries from the JSE, the issuer advised the JSE that the terms of the loan were amended prior to its acquisition of Company S. As a result, the loan was classified as a financial liability. The implication of a liability classification is that the subsidiary would be required to repay the capital amounts to Shareholder M, when Company P obtained control of Company S. Less than a month after the effective date of the acquisition the loan was waived by Shareholder M. The issuer recognised a substantial gain when derecognising the loan (then classified as a financial liability) in profit and loss. The gain contributed to profits being recognised in the specified reportable segment (absent the gain, the segment would have recognised a loss before tax) which in turn triggered a portion of the contingent settlement being earned by Shareholder M. The result was that contingently issuable shares were issued to the Shareholder M under the share purchase agreement in the year in question.

The JSE considered many factors in its assessment of the substance of the transactions. After referring the matter to the FRIP and considering the FRIP's advice, the JSE concluded that the business combination under common control (acquisition of Company S from Shareholder M) and the subsequent waiver of the loan (also by Shareholder M) were inextricably linked and should have been considered one transaction from an accounting perspective. Consequently, the 'loan' acquired by the issuer when it assumed control of Company S should not have been classified as a financial liability, and no 'gain on derecognition' should have been recognised in profit and loss

For ease of reading, the more detailed IFRS arguments that formed the basis of the JSE's decision are set out in Annexure 2 as opposed to the body of this report.

*Further loan*
In a subsequent transaction (after having waived the 'loan' to Company S discussed above), Shareholder M advanced a further loan to the issuer. Shareholder M waived the further loan in the subsequent period and the event was accounted for as a gain in P Group's profit and loss. The gain on waiver contributed to profits being recognised in the reportable segment, triggering contingently issuable shares being issued to shareholder M under the share purchase agreement.

The JSE considered many factors in its assessment of fair presentation of the above transactions. The JSE concluded that the waiver by Shareholder M was, in substance, made by M in his capacity as a shareholder - not lender. No income (gain on waiver) should therefore have been recognised in profit and loss as the transaction was a contribution by the holder of equity claims (Conceptual Framework definition 4.68).

<u>Reclassifying inventory to investment property</u>
The below is a high-level summary of this matter, which was the subject of a FRIP referral.

An issuer held undeveloped and vacant property assets in its property development portfolio. It had classified these assets as inventory as they are sold to customers after development activities and bulk services have been undertaken.

During the period under review the issuer transferred a portion of the undeveloped property erven from inventory (measured at cost) to investment property (subsequently measured at fair value). The issuer recognised a substantial fair value gain in profit and loss due to the transfer.

Paragraph 57 of IAS 40 *Investment Property* sets out the prerequisites for classifying items to investment property stating that a change in use occurs when:

- the property meets the definition of an investment property; and
- there is <u>evidence</u> of a change in use.

An amendment to IAS 40.57 (effective for periods ended on or after 1 January 2018) states that, "*in isolation a change in management's intentions for the use of a property does not provide evidence of a change in use*". IAS 40.BC27 further explains that: "*an entity must have taken <u>observable actions</u> to support such a change*" (emphasis added). The test for transfer therefore requires more stringent requirements than the initial classification as investment property.

The JSE concluded that the evidence of observable actions to support a change in use was insufficient to satisfy the requirements of IAS 40.57. Consequently, the JSE found the reclassification from inventory to investment property by the issuer (and the resulting gain recognised in profit and loss) to be inappropriate under IFRS.

Furthermore, the issuer had presented the abovementioned gain as two separate transactions being 'deemed revenue' and an associated 'cost of sales'.

The JSE also concluded that it was inappropriate to classify the transactions as 'revenue' and 'cost of sales'. IAS 40.63 states that "*any difference between the fair value….and its previous carrying amount shall be recognised in profit and loss*". The reference to 'difference' is a single amount. Furthermore, revenue arises in the course of an entity's ordinary activities (Appendix A to IFRS 15). In this instance, the reclassification was not in the ordinary course of the issuers' activities, it was an internal reclassification.

<u>Financial assets held at fair value through profit or loss</u>
In its interims an issuer disclosed the ECL rate that it applied to a material financial asset. Given that the financial asset also existed in the AFS preceding the interims, we would have expected to see disclosure of management's inputs, assumptions and estimation techniques for that ECL rate in its AFS (IFRS 7.35G). The AFS provided no such disclosure.

Upon enquiry, the issuer initially responded that the ECL rate was the amount their external auditors reported to management, as the potential error in the valuation of this financial asset in the AFS. At the time, management concluded that this error was not quantitatively material and therefore no adjustment was recognised. The JSE found the issuer's conclusion on materiality to be unconvincing and thus pursued the matter further. It transpired that the:

- Issuer incorrectly used the term 'ECL' to describe a downward fair value adjustment to this financial asset. The asset was subsequently measured at fair value through profit and loss as opposed to at amortised cost; and
- Downward fair value adjustment should already have been processed in the AFS.

As a reminder on bullet point one:
- IFRS 9.5.2.1 allows for a qualifying financial asset to be subsequently measured at fair value through profit and loss; but
- IFRS 9.5.2.2 requires an ECL impairment assessment to be performed on financial assets that are subsequently measured at amortised cost.

Revenue recognition for property sales

The JSE queried the 'point' at which the issuer recognises revenue attributable to the sale of unserviced land. The issuer's adopted accounting policy resulted in a sale (i.e. revenue) being recognised at the date the customer signs a contract of sale. The JSE found that the requirements to demonstrate transfer of control under IFRS 15 (paragraphs 31 to 45) were not met at the date of signature and that revenue was being recognised prematurely.

The above is a high-level summary of this matter, which was the subject of a FRIP referral.

## Common disclosure omissions

The table below ranks the matters per number of different instances where there was insufficient disclosure for this specific topic.

| Ranking | |
|---|---|
| 1 | IFRS 13 *Fair Value Measurement*, paragraph 93<br>Details of entity specific unobservable inputs used in valuation models |
| 2 | IAS 12 *Income Tax*<br>Detailed tax rate reconciliations (paragraph 81(c) and 84)<br>Disclosures to support the recognition of deferred tax assets (paragraph 82) |
| 3 | IAS 24 *Related Party Disclosures* (paragraph 18)<br>Full disclosure for all related party transactions and balances |
| 4 | IAS 36 *Impairment of Assets*, paragraphs 130-134<br>Information regarding impairment calculations |
| 5 | IAS 7 *Statement of Cash Flows*<br>These finding related to the misapplication of this statement-most commonly in the classification of cash/cash equivalents and restricted cash (paragraphs 6-7 and 48-49) |

Apart from the concerns regarding the disclosures for financial instruments (IFRS 7), Revenue from contracts with customers (IFRS 15) and judgements (IAS 1.122) (which are discussed in the 'feedback on the 2020 focus areas' section of this report) the table above highlights the disclosure areas most commonly found to be wanting in the AFS.

Past findings

To assist with a full understanding of the above topics, issuers are requested to include the following at their audit committee meeting:

- The following extracts from the 'Combined Findings Report' (see annexure 3): Income Taxes (pages 26 to 28); Related Party Disclosures (page 31), Impairments (pages 36 to 38); and Fair Value Measurement (pages 55 to 57);
- The 'Investment property report' (see annexure 3). Whilst this report is specific to fair value disclosures for investment property (which accounted for a third of our findings under this standard), the messages are equally relevant for other assets classes.

After reading the disclosure in the AFS, will an independent person have a full understanding of the entity specific circumstances, without needing to ask or look for a further explanation?

Classification of cash and cash equivalents

Cash and cash equivalents are defined in IAS 7.6 as:

- short term, highly liquid investments;
- that are readily convertible into known amounts of cash; and
- are subject to insignificant risk in changes in value.

IAS 7.7 expands the definition and explains the:

- intention with a cash and cash equivalent classification is that these funds are to be applied to meet short term commitments;
- funds are utilised/ recycled within a relatively short period (say 3 months); and
- classification as a cash and cash equivalent is done when the funds are initially invested. Funds do not therefore 'become' cash and cash equivalents when an instrument is nearing maturity.

Funds deposited in a bank account cannot automatically be classified as 'cash and cash equivalents'. Issuers are required to consider the facts and circumstances against the definitions in paragraphs 6 and 7 of IAS 7. Two common themes emerged from our reviews in this respect.

In the first instance, we questioned issuers who classified 'restricted cash' balances as being cash and cash equivalents balances where they did not appear to meet the above definitions. Many mineral (and other) companies are legislatively required to ring-fence funds in a separate legal entity (e.g. a trust fund). We questioned the appropriateness of classifying funds held by these trusts as cash and cash equivalents (and part of the reconciling cash balance at the end of the statement of cash flows) where funds could only be applied to a specific business activity (e.g. rehabilitation activities).

Our concern was particularly elevated when the associated rehabilitation liabilities were classified as non-current liabilities. This illustrated that the associated rehabilitation activities were expected to be undertaken in future periods. In the above instances we asked issuers to describe the amount as an investment (or similar) and to classify the cash flow effects within investing activities of the statement of cash flows.

In the second instance, we challenged issuers who classified cash balances as being 'restricted' where the issuer was not subject to any external restriction as to how the funds could be used. The ring-fencing or restriction on utilization of funds was due to an internal management decision that could subsequently be revoked should the need arise. The JSE directed these issuers to refrain from referring to the balances as being 'restricted' as this did not faithfully represent the true cash position available to the issuer to satisfy liquidity obligations in future periods.

## 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 be free from regulatory challenge and correction where these are found to contain material misstatements. The reason for this is best understood considering the types of matters that we have found (as discussed in the detailed findings section) as well as 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 potential risk areas 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.

The 2020 calendar year reviews (on both equity and debt issuers) covered AFS for years ending between 31 December 2018 and 28 February 2020.

### Statistics

<u>What we did</u>
Between January and December 2020, we performed new reviews on 65 equity issuers' AFS and interim results and 23 debt issuers' AFS. We wrote letters of enquiry to 75 of the issuers, with 13 cases closed immediately without any questions asked. By January 2021 eleven of the equity cases and two of the debt cases were still pending.

| | Equity | Debt [1] | Total |
|---|---|---|---|
| Letters of query | 59 | 16 | 75 |
| Cases closed immediately | 6 | 7 | 13 |
| **Number of new AFS reviews** | **65** | **23** | **88** |
| Cases b/f from previous year | 14 | 3 | 17 |
| Total cases reviewed during period | 79 | 26 | 105 |
| Cases still pending | (11) | (2) | (13) |
| Cases completed during period | 68 | 24 | 92 |

<u>What we found</u>

Three 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 two 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 38 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 30 cases involved smaller disclosure issues that the issuer agreed to clarify or correct in the future.

In 2020 material infringements were identified in 4.4% of the closed cases (2019-10%) for equity issuers and none of the debt issuers (2019-nil). The number of cases where corrections were required in future reporting periods was at 54.4% (2019-45%) for equity issuers and 12.5% for debt issuers (2019-9.1%).

| | 2020 Equity | 2020 Debt | 2020 Total | 2019 Equity | 2019 Debt |
|---|---|---|---|---|---|
| AFS needed restatement and public announcement made[2] | 3 | - | 3 | 6 | - |
| Non-compliance was such that we agreed to a correction within the next published results | 1 | 1 | 2 | 6 | - |
| Non-compliance not material this year, but must be corrected in the future in order to avoid potential investor prejudice | 36 | 2 | 38 | 21 | 1 |
| Smaller disclosure issues that will be corrected in the future | 20 | 10 | 30 | 13 | 8 |
| AFS in respect of which it was concluded that there were no issues | 8 | 10 | 19 | 14 | 2 |
| **Total cases closed** | **68** | **24** | **92** | **60** | **11** |

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

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

In assessing the potential impact of matters for the current period, the number of cases impacting measurement was at 15% (2019-32%) for equity issuers and at 18% (2019-11%) for debt issuers. The remaining 85% and 82% (for equity and debt issuers respectively) therefore related to disclosure issues. The data continues to reveal 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, below is an extract from the ESMA reports with comparisons to 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 2019 ESMA activity report (issued in April 2020) is the latest available information, which from a period perspective, is best compared to the data contained in our 2019 report.

| | South Africa | | | ESMA | |
|---|---|---|---|---|---|
| **Coverage** | | | | | |
| Period when reviews were undertaken | 2020 | 2019 | 2018 | 2019 | 2018 |
| Date of regulator's report | Feb 2021 | Feb 2020 | Feb 2019 | April 2020[3] | March 2019[4] |
| Reviews closed at reporting date[5] [6] | 92 | 71 | 55 | 900 | 885 |
| Examination rate (Percentage coverage of population) [7] | 24% | 17% | 14% | 16% | 15% |
| **Actions** | | | | | |
| Material infringement (Requested re-issuance or immediate public announcement) | 3.3% | 8.5% | 9.1% | 6.4% | 7.2% |
| Corrections required in future financial statements | 43.5% | 39.4% | 32.7% | 26.8% | 26.2% |
| Action rate (Total number of instances where action was taken) | 46.7% | 47.9% | 41.8% | 33.2% | 33.4% |

The 2019 ESMA activity report indicates that of the 900 ex-post examinations undertaken by the 25 European enforcers during the calendar year to December 2019, 6.4% of those

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[3] Information extracted from the ESMA report entitled "Enforcement and Regulatory Activities of Accounting Enforcers in 2019"

[4] Information extracted from the ESMA report entitled "Enforcement and Regulatory Activities of Accounting Enforcers in 2018"

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

[6] The JSE simultaneously considers the AFS and interims for a specific issuer and regards those as a single review. The ESMA data splits out AFS and interims reviews and considers them as separate events. Where the JSE to follow such an approach, its resultant action rate would double.

[7] 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.

identified material infringements (requiring public announcements or reissuing of AFS). For a further 26.8%, whilst classified as material, the enforcers accepted a correction in the next AFS. Although the material infringement action rate for the JSE was only 2.1 points higher (at 8.5% compared to 6.4%) the overall action rate was substantially higher (at 47.9% compared to 33.2%). The difference in the action rates of the JSE compared to ESMA in 2019 is in line with that of 2018.

Due to both high-profile cases and the technical nature of several cases in 2018, the JSE's examination rate for 2018 was significantly lower than in previous years. This rate was out of line with both the JSE's own target coverage rate and historical international trends. The JSE expanded its resources for the review process during 2019, enabling it to increase the examination rate to the 17% set out above. With the targeted reviews covered in the thematic review process (not discussed in this report) the JSE achieved an examination rate of 22%.

On reflection, the increasing technical nature of reviews that the JSE encountered in 2018 do not appear to be unique. The ESMA activity reports reflect a declining examination rate from 19% in 2016 to the level of 15% in 2018. The 2018 ESMA activity report explains that this was due to a combination of two factors. Firstly, there was a shift in the focus of regulators to review non-financial information and alternative performance measures. Secondly, that the financial statement reviews dealt with more complex and resource intensive matters.

## Looking forward - the 2021 review cycle

The information included in this section is intended to assist issuers in identifying key areas that could benefit from specific attention.

### Previous findings

Issuers should continue to pay careful attention to how all the JSE's past findings could impact their results. If problems are highlighted in the AFS or interims for matters that were set out in this (and previous) proactive monitoring reports, audit committees will be asked to explain how they fulfilled their obligation to consider this report and to ensure that appropriate action was taken.

### Covid-19

Covid-19 and the resultant economic implications of the lockdown dominated much of 2020. The JSE published various letters to assist issuers with reporting under covid-19. The JSE also believes that the IASB educational material issued in January 2021 on going concern serves as a useful guide for issuers. This report incorporates the aforementioned documents by reference (see annexure 3) and the application thereof will be a key focus area for our 2021 reviews.

The JSE has already commenced reviewing results published under a covid-19 environment. It has identified several instances where disclosures are not in line with IFRS and/or the JSE covid-19 letters, specifically in the context of estimates, judgements, impairments and going concern. These topics have often been the subject of our review finding (even before covid-19). This 2020 report and the Combined Findings Report (see annexure 3) provide detailed examples of the JSE's expectations in this regard. Covid-19 tenant relief measures (in the context of lessors and lessees) also appear to be the subject of poor disclosure.

Poor disclosures have also created the impression that, within some interims, issuers have not reconsidered the fair value of assets (where those are measured at fair value) or conducted impairment tests. The JSE is of the view that the adverse impact of covid-19 is a strong indicator that one or more impairment indicators of IAS 36 may have been triggered. Our engagements with those issuers are still in the preliminary stages so it is not possible for us to conclude if there are indeed underlying measurement problems.

Paragraph 41 of IAS 34 acknowledges that the preparation of interims will generally require a greater use of estimation than for AFS. It is for this reason that the disclosures around estimates are critical. The fact that it is difficult to make estimates (of fair values or impairments) is not an IFRS justification to do nothing. The IASB issued a document called "Applying IFRS standards in 2020-impact of covid-19" which highlights that an increase in uncertainty is not a reason to 'freeze' estimates at pre-covid-19 period amounts. Furthermore, paragraph 9 of IFRS 13 defines fair value as the price that would be received to sell an asset at the measurement date. In a South African context, a buyer would not pay the same price for an asset at the 28 February 2020 as they would at the 31 August 2020.

The JSE focus will be on results that leave the impression that estimates were 'frozen', as opposed to issuers who have made a reasonable estimate and have provided full disclosure thereof. We would look favourably upon issuers who, reading the content of this report, provide supplementary disclosures to the market via SENS.

# Annexure 1 - review process

## Why the review process

2020 marked the 10th anniversary of review process. A Financial Sector Assessment Programme ("FSAP") conducted by the World Bank in 2010 highlighted that the lack of proactive monitoring of periodic company disclosure reports was a weakness within the South African Capital Market. The findings were similar to those of their 2005 FSAP. The Financial Services Conduct Authority (previously the Financial Services Board) therefore requested the JSE to implement the recommendations set out in the FSAP and to proactively monitor financial statements. 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.

## Details of the review process

A high-level overview of the review process was detailed in the 2018 report (and previous reports). We do not repeat that content here. It is recommended that individuals that are unfamiliar with the review process should refer to page 21 of the 2018 report (which is available on our website) for a full understanding thereof.

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 to ascertain the materiality thereof either on past, current or future accounting periods. Matters are often easily resolved through the provision of a satisfactory IFRS substantiated response.

## Amendments to the review process

Accounting topics examined and risk areas considered are likely to change from year to year. We identify these changes annually as we aim to ensure that the review process remains both attuned to local market developments and aligned to similar international processes. We have based our model largely on the guidelines that the European Securities and Market Authority sets out for the member states of the European Union.

For 2021, the JSE will be making a fundamental change to the selection process. Historically the random selection process was such that we treated all issuers equally, aiming to review every issuer's AFS at least once every 5 years. The JSE's revised approach considers the risk to investors in terms of market concentration. As part of the random selection process, we will select issuers (equity and debt) that have a larger market capitalisation and/or who are active in both the equity and interest rate markets more frequently. Furthermore, in order to remove the element of predictability, our review cycles have been amended from a 'once every 5 years' approach to the principle of 'once within a set window'. The selection period will be either a 3, 5, 8 or 10-year window, depending upon the size of the issuer. By way of example, an issuer within the top 40 index will now be selected at least once in the period 2021 to 2023 and then again once somewhere in the period 2024 to 2026.

## Revised ALT$^{X}$ process

The overall approach to the ALT$^{X}$ market as detailed in section 21 of the Requirements is one of a reduced level of regulation compared to the Main Board. This is intentionally so, as the ALT$^{X}$ is positioned as a market for small to medium companies. It is an important entry point to the South African capital markets where issuers can focus on growing their business and are not overly burdened with red tape. Issuers and investors alike are accustomed to this lighter approach. Investors make their investment decisions with the knowledge of this different regulatory model.

Historically the JSE applied the review process in the same manner across both Main Board and ALT$^{X.}$ The detailed review process that the JSE applies can be a time consuming, and a drain on resources of small companies who are structured to be lean and nimble. To treat ALT$^{X}$ issuers in the same manner as Main Board companies is at odds with the overall philosophy of ALT$^{X}$ and not in line with international practice.

Taking the above into consideration, the JSE has revised its approach to the ALT$^{X}$ market.

We will review these issuers less frequently. The JSE also intends to utilise its experience gained during the thematic review process to inform the nature of the interactions with ALT$^{X}$ issuers. The benefits of a pre-warning system and the collaborative effort that ensued are detailed in our 2019 Thematic Report. For AFS ending in 2021 onwards, the JSE will pre-warn ALT$^{X}$ issuers that they have been selected for review. Finally, the JSE will aim to reduce the length of time that it takes to complete a review. The JSE will aim to conclude the reviews after one or (on in a worse case scenario) two exchanges of letters. This may be possible as the focus will largely be on considering the past results with an eye to the future financial reporting. This type of approach was successful during our thematic reviews as there was an acknowledgement by both the JSE and the issuer of the benefits to the market of ensuring future compliance with IFRS, which led to a more collaborate style of engagement.

## Year to year findings

Given that the:

- JSE reconsiders the overall process on an annual basis;
- risk areas change from year to year; and
- materiality of matters within the context of specific set of AFS or business environment may differ,

it is possible that a subsequent review of the same issuer may lead to different questions being asked, even where matters are treated on an identical basis from one year to the next.

# Annexure 2 – Activities of the FRIP

## Case 1

Whilst the JSE referred this case to the FRIP during the course of 2019, it only concluded the matter in 2020, after the publication of the 2019 report (issued in February 2020). The details are therefore included in the report.

An issuer (Company Y) acquired a company (Company B) in Y1. The sellers of Company B provided a profit warranty. The acquisition was effected by Company Y subscribing for new shares in Company B, followed by Company B repurchasing its shares from the existing shareholders. As a result, the sellers of Company B received cash and Company Y shares. An incentive trust ("the Trust") was created and it was agreed that the sellers of Company B would transfer (donate) cash and some of the shares it received in Company Y to the Trust for the purposes of incentivising employees of Company B, in order to ensure that the warranted profits will be met.

Company Y accounted for the acquisition of Company B in Y1 in terms of IFRS 3. The Trust was not consolidated until the Y3 financial year, when Company Y concluded that it controlled the Trust, and consolidated it from the beginning of that year.

<u>The recognition of 'pre acquisition' income</u>

IFRS 10.B92 states that the financial statements of the parent and its subsidiaries (used in the preparation of the consolidated financial statements) should have the same reporting date. If this is not the case, then additional financial information should be prepared for the subsidiary, as of the same reporting date of the parent. Should this not be practicable, the difference in reporting dates should not be more than three months.

When the issuer consolidated the Trust it used the financial statements of the Trust for 23 months. It did so on the basis that these were the first financial statements prepared by the Trust. Donation income was recorded in those financial statements of the Trust for a period before the issuer took control thereof.

IFRS 10.B88 is clear that 'pre-acquisition' income and expenses of a subsidiary cannot be recognised in the consolidated financial statements. A subsidiary is consolidated only from its date of acquisition.

Therefore, if a subsidiary is acquired during a financial period, it is not appropriate to simply include all the income and expenses of that subsidiary from its financial statements:

- adjustments are required to exclude pre-acquisition income and expenses; and
- the reporting dates must be in line with IFRS 10.B92.

<u>The recognition of donation income</u>

The Trust appropriately recognised a donation received (both cash and shares) as income in its financial statements.

The cash and share donations made by the sellers were made for the purposes of ensuring that the profit warranties issued by the sellers would be met. Accordingly, the donations are related to the acquisition by Company Y and hence, to faithfully present the substance of the donations from a group perspective, the donations should be accounted for in this context.

*Cash donation*

From the perspective of the group (which is a single reporting entity) cash was paid to the sellers, of which an amount was paid back by the sellers in respect of the acquisition.

IFRS 3 *Business Combinations* does not address specifically how payments received from the sellers of a business should be treated. Paragraph 10 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, provides guidance on selecting an accounting treatment when an IFRS does not apply specifically to a transaction.

Given that IFRS 3 does not address specifically how payments received from the sellers of a business should be treated, and applying the requirements of IAS 8.11(a), consideration must be given as to whether any guidance or insights can be gleaned from another IFRS. IFRS 15, *Revenue from Contracts with Customers* addresses payments made to customers when determining the transaction price in the context of measuring the amount of revenue recognised from a contract with a customer. The similarity with the matter under consideration is that there is a transaction in which a payment is made to and received by the same party.

In terms of paragraph 70 of IFRS 15.70, "An entity shall account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service (as described in paragraphs 26–30) that the customer transfers to the entity".

Applying IFRS 15.70 by analogy to payments received from sellers of a business, would result in such payments being recognised as a reduction of the purchase price for the business, unless the payment received is in exchange for a distinct good or service that the entity transfers to the sellers. It was stated explicitly by Company Y that the donation was to ensure that the seller's profit warranty, issued in connection with the acquisition, would be achieved. There is no evidence that the cash donation received was in exchange for distinct goods or services that the group provided to the sellers.

The FRIP was of the view that the cash donation received was not in exchange for distinct goods or services that the group provided to the sellers. Accordingly, the cash donation was not related to a transaction independent of the acquisition. Applying the guidance in IFRS 15.70 in developing an accounting policy for the cash donation, Company Y should have accounted for the cash donation as a reduction of the cash purchase price for the acquisition. Even in the absence of referring to IFRS 15.70, the cash donation should have been treated as part of the acquisition. This is because the purpose of the donation was to incentivise the employees in order to achieve the profit targets in terms of the acquisition, which if not met would affect the amounts receivable by the sellers. The cash donation was not simply a fortuitous gain, even though Company Y may not have insisted upon the donation being made to the Trust and that the sellers made the donation of their own volition. The cash donation related to the acquisition and, in order to faithfully represent it and to reflect the economic reality of the transactions, the cash donation should have been treated as part of the acquisition. The FRIP concluded that the only way to do this was to treat the donation as a reduction of the cash purchase price for the acquisition. The cash donation should not have been recognised as income, in any period, in the consolidated financial statements of the group.

*Share donation*
The above conclusion relating to the cash donation applies equally to the share donation received. In addition, the FRIP stated that the requirements of paragraph 33 of IAS 32 should have been applied, which prohibit the recognition of a gain or loss on the reacquisition of an entity's own shares.

## Case 2

The FRIP considered three independent matters for the same issuer. The details of two of these matters are set out in the body of this report under the following headings:

- Reclassification of inventory to investment property; and
- Revenue recognition for property sales.

In order to streamline the body of the report, whilst it is referred to in the body of the report, we set out the third matter below. The below is a high-level summary, combining both the JSE's considerations and the advice of the FRIP.

<u>Loan forgiveness</u>
The JSE questioned whether the substance of a series of related party transactions occurring between the issuer (Company P), its acquired subsidiary (Company S) and the issuers' majority shareholder (Shareholder M) were fairly presented in the AFS.

*Initial loan*
Company P had acquired Company S from Shareholder M in the period under review. Company P (in its Group AFS) accounted for the transaction as a business combination under common control. A large portion of the acquisition price for Company S payable to Shareholder M (who was the previous 100% shareholder of Company S) was contingent on future profits being earned by a specified reportable segment of the issuer.

Prior to the acquisition, Shareholder M had advanced a 'loan' to Company S. That loan was initially classified (in public documents) as an 'equity loan', i.e. Company S had no contractual obligation to repay any capital amounts to Shareholder M. In response to queries from the JSE, the issuer advised the JSE that the terms of the loan were amended prior to its acquisition of Company S. As a result, the loan was classified as a financial liability. The implication of a liability classification is that the subsidiary would be required to repay the capital amounts to Shareholder M, when Company P obtained control of Company S. Less than a month after the effective date of the acquisition the loan was waived by Shareholder M. The issuer recognised a substantial gain when derecognising the loan (then classified as a financial liability) in profit and loss. The gain contributed to profits being recognised in the specified reportable segment (absent the gain the segment would have recognised a loss before tax) which in turn triggered a portion of the contingent settlement being earned by Shareholder M. The result was that contingently issuable shares were issued to the Shareholder M under the share purchase agreement in the year in question.

The JSE considered many factors in its assessment of the substance of the transactions. After referring the matter to the FRIP and considering the FRIP's advice, the JSE concluded that the business combination under common control (acquisition of Company S from Shareholder M) and the subsequent waiver of the loan (also by Shareholder M) were inextricably linked and should have been considered one transaction from an accounting perspective. Consequently, the 'loan' acquired by the issuer when it assumed control of Company S should not have been classified as a financial liability, and no 'gain on derecognition' should have been recognised in profit and loss.

The requirement to consider the substance of a transaction (and not merely its legal form) is a cornerstone of IFRS.

Paragraphs 2.12 and 4.59 of the IFRS Conceptual Framework for Financial Reporting (2018) ("the Conceptual Framework") require financial statements to report the substance of the rights and obligations created by contracts. These may, in certain instances, differ from their legal form. In certain cases, a contract (or a group of contracts) may require further analysis to identify the substance of the rights and obligations inferred by those contracts.

The JSE also considered the definition of income in terms of paragraph 4.68 of the Conceptual Framework, which excludes contributions from holders of equity claims from income .

In the JSE's view, reliance on, and reference to, the Conceptual Framework is appropriate considering the purpose of the Conceptual Framework to "…*assist all parties to understand and interpret the* (IFRS) *Standards*" (SP1.1(c), 2018). Accordingly, the JSE considered the Conceptual Framework as an interpretive aid to IFRS and existing IFRS guidance.

Before a transaction is accounted for under IFRS 9 the underlying instrument needs to be classified (by applying IAS 32 *Financial instruments: Presentation*) as either a financial liability (within the scope of IFRS 9) or an equity instrument. A requirement of IAS 32.15 is to consider the substance of contractual arrangements (not only the definition of a financial liability/ equity instrument) when classifying an instrument as either a financial liability or equity. The JSE concluded that the substance of the loan was always equity and it should have been treated as such when accounting for the business combination under common control.

The JSE did not question the treatment of the transaction as a business combination under common control ("BCUCC"). The JSE accepts that BCUCC are scoped out of IFRS 3, and the JSE did not propose the use of acquisition accounting (as set out in IFRS 3) or IFRS 3 as a whole. The JSE did not disagree with the development of an accounting policy for the common control transaction (i.e. application of a merger-based policy in which no goodwill is recognised). Rather, the concern was regarding what is, or is not, included in the scope of that business combination. Paragraph B50 of IFRS 3 *Business Combinations* was considered as providing guidance to determine what should or should not be part of the acquisition which, in turn, goes to what the economic substance of the transaction is.

Paragraph 11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* identifies, in descending order, how an accounting policy should be developed. Therefore, even though IFRS 3, as a whole, is not applied to the BCUCC, the guidance in IFRS 3.B50 is appropriate (IAS 8.11(a)) when determining what forms part of the business combination.

The general principle in IFRS is that equity instruments are never measured or remeasured (Conceptual Framework 6.89). On the basis that the JSE does not accept that there is substance to the classification of the initial loan as a financial liability there cannot therefore be a gain (on an equity transition). This is supported by the fact that the 'gain on waiver' does not meet the definition of income (per the definition in the Conceptual Framework) as it has been provided by the holder of an equity claim. This principle is further embedded when considering (by analogy) IAS 32.33 which states 'no gain or loss shall be recognised in profit or loss' on any dealings by a company in its own instruments.

IAS 1.15 also explains that:

- financial statements must fairly present (amongst others) the financial position and performance of an entity; and
- fair presentation requires faithful representation of the effects of transactions and other events in accordance with the definitions and recognition criteria for 'income' as set out in the Conceptual Framework for financial reporting.

The BCUCC and the subsequent waiver of the loan were inextricable linked. This required the two transactions to be accounted for as one to reflect their economic substance. Reflecting the loan as a financial liability and recording a gain on the waiver thereof does not lead the transactions being fairly presented.

*Further loan*
In a subsequent transaction (after having waived the 'loan' to Company S discussed above), Shareholder M advanced a further loan to the issuer. Shareholder M waived the further loan in the subsequent period and the event was accounted for as a gain in P Group's profit and loss. The gain on waiver contributed to profits being recognised in the reportable segment, triggering contingently issuable shares being issued to shareholder M under the share purchase agreement.

Once again, the JSE considered many factors in its assessment of fair presentation of the above transactions. The JSE concluded that the waiver by Shareholder M was, in substance, made by M in his capacity as a shareholder - not lender. No income (gain on waiver) should therefore have been recognised in profit and loss as the transaction was a contribution by the holder of equity claims (Conceptual Framework definition 4.68).

# Annexure 3 – List of documents for the audit committee's consideration

We consolidated our previous annual reports on the review process into one report entitled "Combined findings of the JSE Proactive Monitoring of financial statements: Reviews done 2011 to 2019" ("**the Combined Findings Report**"). The report was updated from the one issued in October 2019 and reissued simultaneously with this the 2020 report.

For ease of reference, this annexure contains the details of the information that all audit committees must consider in fulfilling their responsibilities.

1. This, the 2020 report;
2. The "Investment property: Common findings report", issued on 3 November 2020 ("**Investment property report**");
3. The following sections from the Combined Findings Report:
   a. Going concern (page 12, 59 and 60);
   b. Statement of Cash Flows (pages 19 to 25);
   c. Income Taxes (pages 26 to 28);
   d. Related Party Disclosures (page 31);
   e. Impairment of Assets (pages 36 to 38); and
   f. Fair Value Measurement (pages 55 to 57);
4. The following JSE covid-19 letters:
   a. Financial Reporting (issued April 2020);
   b. Reflecting the impact of covid-19 in financial results (issued May 2020); and
   c. Effective communication with Investors (issued September 2020); and
5. The IASB covid-19 documents:
   a. Going concern-a focus on disclosure; and
   b. Applying IFRS Standards in 2020-impact of covid-19.

Audit committees should consider the entire content of the Combined Findings, if the issuer:

- is newly listed; or
- had events or transactions that were not present when they considered our previous reports.

The above documents are available on the following websites:

Items 1 to 3

- https://www.jse.co.za/current-companies/issuer-regulation/accounting-matters

Item 4

- https://www.jse.co.za/issuer-regulation-covid-19; and

Item 5

- https://cdn.ifrs.org/-/media/feature/news/2021/going-concern-jan2021.pdf?la=en
- https://cdn.ifrs.org/-/media/feature/news/2020/inbrief-covid19-oct2020.pdf?la=en