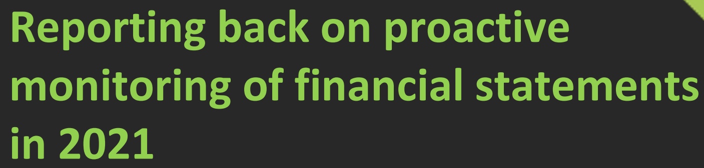

Reporting back on proactive monitoring of financial statements in 2021

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Introduction

The body of this report (the **"2021 report"**) discusses the findings of the proactive monitoring activities (the "**review process**") undertaken by the JSE during 2021. 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. This aligns with one of the general principles of the JSE Listings Requirements ("**the Listings Requirements**") namely to enhance investor confidence in our market. The healthy debate that often surrounds a review process is in of itself important for the credibility of our markets.

The aim of issuing this report is to highlight focus areas and provide details around our expectations for financial reporting to help prevent the misapplication of IFRS. 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 2021 report sets out important findings identified during the year to date, which we request issuers to consider. It also highlights an emerging focus area for the 2022 review process. At the request of SAICA, on behalf of the financial services sector, we have brought forward the release date of this report from February 2022. Whilst the 2021 report only includes our review activities for a 9-month period, this will normalise when we issue our next report in November 2022.

This report also provides statistical findings that highlight the regulatory value of the review process. We provide details of the review process for new issuers (and directors) for their understanding (see annexure 1). Annexure 2 indicates that there were no activities of the FRIP to provide feedback on. Annexure 3 includes an easy to use list of documents for audit committee's consideration.

Consideration by audit committees

The JSE acknowledges the important role that audit committees play in ensuring the integrity of the financial reporting. As our reports on the review process are intended to highlight areas of potential concern in the preparation of financial statements, the JSE specifically requests every issuer's audit committee to consider the detailed findings and emerging issues sections of this 2021 report together with certain other information previous published by the JSE. Annexure 3 contains a checklist of the information that the audit committee must consider, together with appropriate links to website references of where to find that information.

We ask that audit committees ensure that issuers take appropriate action to respond to the information detailed in annexure 3 when preparing both their interim and annual financial statements.

In order to ease the administration burden for issuers, we no longer request that a confirmation be included in the annual compliance certificate submitted to the JSE. Instead, to the extent necessary, the JSE may write to an issuer and ask that they explain how they have complied with the request set out above.

Detailed findings

2021 focus area: The impact of covid-19

Our objective in highlighting focus areas and providing details around our expectations for financial reporting is to help prevent the misapplication of IFRS.

This report includes a discussion of different areas of enquiry regarding the impact of covid-19 on disclosure and measurement matters for issuers. Whilst we use specific cases to illustrate a matter, we wish to point out that our findings were not limited to that specific case. We believe that the lessons learned in dealing with a 'shock event' (such as covid-19) can be replicated for other such events that may occur. These events could be unique to a specific issuer or affect a broad number of companies - the South African civil unrest of July 2021 being a case in point.

In May 2020 we issued a letter which set out our expectations for reporting the impact of covid-19, specifically in the context of interims.

Paragraph 15 of IAS 34 *Interim Financial Reporting* states that an entity shall include in its interim financials an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period. Information disclosed in relation to those events and transactions shall update the relevant information presented in the most recent annual financial report. We detail below some of our findings to covid-19 related disclosures, particularly in interims.

Lessor accounting for covid-19 lease concessions

In its first set of interims published after the covid-19 outbreak, a property entity included the following, limited commentary, when referring to tenant relief measures: "Negotiations with tenants on covid-19 related arrears are ongoing". This limited disclosure triggered a series of enquiries which unravelled to expose a recognition error.

At their interim reporting date, no rent concessions had been granted by the issuer and no tenant contracts had been terminated. Given what the issuer regarded as significant uncertainty regarding the collectability of rent during the hard lockdown, rental income for this period was recognised only to the extent it was probable that it would be received. This resulted in a significant portion of 'unrecognised rental income' not being recorded in the 2020 interims. During our enquiry process the issuer explained that they intended to recognise at least 25% of this amount in their AFS as the probability of collection had subsequently increased. Their view was that IFRS 16 *Leases* does not contain a collectability threshold for the recognition of lease income, and they therefore developed a new accounting policy based on IFRS 15 *Revenue from Contracts with Customers*.

We found that it was inappropriate for the issuer to look to the IAS 8.10 hierarchy in developing an accounting policy for this matter as:

- Paragraph 17(a) of IAS 1 *Presentation of Financial Statements* indicates that management uses the hierarchy (per IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*) in the absence of an IFRS that specifically applies to an item;
- Paragraph 81 of IFRS 16 specifically deals with the revenue recognition of operating lease contracts;
- The impairment requirements of operating lease receivables fall within the scope of IFRS 9 *Financial Instruments* (IFRS paragraphs 2.1 and 5.5.1). IFRS 9 defines a credit loss as "the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e. all cash shortfalls)";
- The issuer previously applied established accounting policies for both recognising revenue and testing receivables for impairment. These policies aligned to the requirements of IFRS 16 and IFRS 9 and should not have been affected by the covid-19 pandemic;
- IAS 34.28 states that an entity shall apply the same accounting policies in its interims that are applied in its AFS; and
- It is inappropriate to depart from IFRS to achieve a particular presentation of an entity's financial performance (IAS 8.8).

The outcome was that the issuer restated their interims to recognise the previously unrecognised rental income and separately considered the collectability of the receivables under IFRS 9.

Fair value of investment properties

In this matter, investment properties were the most significant assets for the issuer. In their 2020 interims (issued in the midst of the covid-19 pandemic) the issuer stated that:

> "Investment properties were last revalued at (the previous financial year end). Caution needs to be exercised by the user of this announcement, bearing in mind that the valuations were performed without the covid-19 impact".

IAS 1.18 states that:

> "An entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policy used or by notes or explanatory material."

The objective of an interim report is to provide timely and reliable financial information aimed at improving the ability of investors to understand the Group's financial condition. IAS 34.28 determines that an entity applies the same accounting policies in its interims as are applied in its AFS. The issuer's accounting policy is to subsequently measure investment property at fair value (Paragraph 33 of IAS 40 *Investment Property*). Consequently, fair value measurement must be applied in the interims.

The issuer initially asserted that there was no reliable information available with which to prepare valuations at the interim reporting date. IAS 34.41 notes that the preparation of interim results will generally require a greater use of estimation than for AFS.

Heightened uncertainty about the future does not justify the non-application of IFRS to determine the fair value at the interim date. This was confirmed by the IASB in their document 'Applying IFRS standards in 2020-impact of covid-19' which highlights that an increase in uncertainty is not a reason to "freeze" estimates.

Estimates must be made based on assumptions that reflect expectations of market participants of business performance and the existing trading environment at the reporting date (B14 of IFRS 13 *Fair Value Measurement*).

IFRS 13.9 defines fair value as the price that would be received to sell an asset at the measurement date. In the South African context in which the issuer operated, a buyer would not pay the same price for an asset at (say) 31 March 2020 as they would six months later. Fair value is a price obtained in the principal market under current market conditions, regardless of whether the price is directly observable (IFRS 13.24). Market conditions are not always perfect. In instances of widespread disruptions to markets (such as the covid-19 pandemic) reliance is placed on unobservable inputs applied in a valuation technique. Unobservable inputs can be developed using the best information available about the assumptions that market participants would use when pricing the asset.

IFRS 13.B23 describes the expected present value technique as a possible valuation approach. In so doing it describes as a starting point the use of a set of cash flows that represents the probability-weighted average of all possible future cash flows. It later caveats this (IFRS 13.B28) by noting that it might be possible to develop a limited number of discrete scenarios and probabilities that capture the array of possible cash flows. IFRS 9.B5.5.41 and B5.5.42 (applied by analogy) also explain that estimates are neither a worst-case scenario nor an estimate of a best-case scenario but rather an estimation that reflects a range of possible outcomes. A similar requirement for estimates of future cash flows is drawn in IFRS 17.B37, noting that the objective of estimating future cash flows is to consider the full range of possible outcomes. A caveat is again provided in B39 of IFGRS 17 in that, in practice, explicit scenarios may be unnecessary if the resulting estimate is consistent with the measurement objective of considering all reasonable and supportable information available.

On further enquiry it transpired that the issuer was indeed able to estimate the fair value. We found that the issuer had not complied with IFRS as they had not remeasured their investment properties to fair value at the interim date.

If the issuers original assertion regarding the inability to make an estimate was correct (which was not the case) their results would still have been lacking in compliance with IFRS from a disclosure perspective.

IAS 1.7 states that applying a requirement is only impracticable when the entity cannot apply it after making every reasonable effort to do so. The JSE would expect an issuer to apply (at least) the following when considering expected future cash flows (whether for fair value or impairments):

1) Assess feasible future scenarios (for example the end of covid restrictions by a specific date; continuation of current wave 'structure'; or worsening of the existing situation);
2) Determine the cash flows that relate to each scenario (i.e. return to normal; continuation of outcomes; effect of a worsening); and
3) Apply probabilities to each of the scenarios.

It is almost impossible to envisage a scenario where the high impracticable threshold of IAS 1.131 is triggered in each of the above three steps. We expect that an issuer is likely, at the very least, to be able to apply steps 1 and 2. Management is likely to be considering this type of information in its budgeting process. Should step 3 be problematic, applying IAS 1.17 with IAS 1.131 would compel the issuer to provide all available information that they considered to conclude that it was impracticable to complete the determination of an estimate. The issuer is required to disclose the information in steps 1 and 2 together with an explanation of the reasonable efforts that they made, including explaining what prevented them from completing the estimation exercise.

The above required disclosures provide valuable information. Not only do they assist investors in building their own models, but they provide insight into the state of the issuers financial reporting procedures. In terms of paragraph 3.84(g)(ii) of the Requirements, the audit committee must ensure that an issuer has appropriate financial reporting procedures in place. In a listed environment it would be extremely rare for a scenario to arise where an issuer cannot, through reasonable efforts, build models to determine expected future cashflows.

Debt covenants disclosures

Our letter of 10 September 2020 ("**our September letter**") explained that investors need insights regarding the future cash flow position of the issuer in terms of:

a) debt covenant triggers;
b) the proximity to breaching those triggers; and
c) the board's view of debt levels and how any potential debt covenant triggers can be addressed.

This information links to IFRS disclosure requirements regarding:

- going concern (IAS 1.25);
- the management of capital (paragraphs 134 to 136 of IAS 1); and
- the nature and extent of an entities risks exposure from financial instruments, including liquidity risk together with the steps entities are taking to manage those risk (paragraphs 31 to 32A of IFRS 7 *Financial Instruments: Disclosures*).

We challenged several issuers where one or more of these points (a) to (c) were omitted from their disclosures. Whilst some issuers included the required information in a presentation to investors, they had omitted it from their AFS and/ or interims. Our September letter refers to disclosure obligations from a continuing obligations perspective - which relates to the reporting of interims and AFS (inter alia) in terms of section 3 of the Listings Requirements.

The above debt covenant information was a key factor for several issuers in their consideration of the going concern assessment and would have assisted issuers in applying

IFRS as discussed in the IASB document titled ['Going concern-a focus on disclosure'] . One issuer did quantify both the debt covenant triggers and their actual ratios, which indicated they had breached those triggers. They did not however provide a narrative in either those AFS or their subsequent interims as to how they intended to deal with the liquidity event to explain why they were still a going concern. The breach related to a key source of finance for the issuer. Such disclosures were required under paragraphs 25, 122 and 135 of IAS 1.

Statement of comprehensive income ("**income statement**") presentation

Our May 2020 letter included a discussion of factors for issuers to consider when providing investors with a comprehensive impact of covid-19 within their IFRS results. In our reviews of the past few months, we have engaged with several issuers on the 'geography' applied in their income statements. Many of the discussions stem from issuers seeking to 'tell the covid-19 story'. We have not concluded on several of these matters and foresee it being a future focus area. We have therefore included a more detailed discussion on the topic under an "Emerging issues" section towards the end of this 2021 report.

'Negative confirmations'

Where economic circumstances may have changed significantly due to a specific event (covid-19; the July 2021 civil unrest), users may want to understand why a particular event did not have an impact on an issuer. For example, in an industry where the credit risk of debtors has deteriorated significantly, users may expect a similar increase in the ECL, and may be left with unanswered concerns if this does not occur.

In these circumstances, a 'negative confirmation' and supporting explanation as to why the economic event did not significantly impact the issuers' financial results is often as useful as the detailed disclosures that are provided in cases where the economic event did have an impact (IAS 1.17(c); IAS 1.31). These types of disclosures apply equally to year-end financial statements and interims and if included should also avoid a question being raised during the review process.

2021 focus area: Previous findings

Our previous reports included a table ranking the most common disclosure omissions in terms of the number of different instances. We are adapting our feedback on common disclosure omissions in this years' report as it was an identified specific focus area. We replace the rankings table format with a more detailed discussion of items where the disclosure was insufficient. We have included seven topics, ranked in order of the number of entities where there was a deficiency occurrence.

Presentation of financial statements

IAS 1 was the single largest contributor to our findings. It accounted for 52 different findings across 29 different issuers. The following paragraphs (ranked in order of prevalence) featured in 60% of those findings:

- paragraph 122 - including entity specific information about judgements made (apart from estimations) that have the most significant impact on amounts recognised;
- paragraph 117 - providing accounting policies (here our findings related to unusual transactions and unusual accounting treatments);
- paragraphs 17 (c) and 31 - providing additional disclosures when compliance with the specific requirements in IFRS are insufficient to enable a full understanding (our cases dealt specifically with unusual and complex transactions);
- paragraph 25 - detailed disclosure to support the going concern assumption; and
- paragraph 113 - consistency of presentation between various notes.

Matters covered under IAS 1.122 included (inter alia):

- factors considered when making the determination of the functional currency for a subsidiary;
- why the call option held by the issuer was not substantive and why this did not result in the entity being consolidated;
- what made an acquisition an asset acquisition rather than a business combination (and vice versa);
- why the issuer only identified one cash generating unit when they appeared to have three separate business units; and
- how a specific business met the definition of a discontinued operation.

After reading the disclosure in the AFS, will an independent user have a full understanding of the entity specific circumstances supporting the judgement without needing to ask management for an explanation?

Fair value measurement disclosures

Our reviews found the IFRS 13 disclosures of 20 individual issuers (from a wide range of sectors) to be insufficient. Areas included either the partial or entire omissions of significant unobservable inputs (both identifying them and quantifying the amounts) (IFRS 13.93(d)) or the sensitivity analysis for changes in those inputs (IFRS 13.93(h)). There was also an over aggregation of disclosed inputs (IFRS 13.92(c)).

By way of example, in two separate cases we advised that more careful consideration should have been given to the obligations under IFRS 13.92(d) and explanations provided as to why:

- there was an inconsistent impact of covid-19 across different assets, with some assets increasing in value and others decreasing; and
- an increase in base revenue from a plant did not have a positive correlation to the average utilisation rate of that plant.

The incorrect assessment of materiality (also a previous focus area) also had a detrimental impact on the level of disclosures. We disagreed where an issuer had only focused on the size of asset in the context of the balance sheet, without due consideration applied to the possible income statement impact of fair value changes.

Financial instrument disclosures

We reached agreement with 18 issuers that their disclosures under IFRS 7 across a range of topics were insufficient.

The biggest area of weak disclosure related to expected credit loss ("**ECL**") calculations in terms of the omission of:

- ECL assessments being carried out on 'other receivables';
- disclosing *entity specific* inputs and assumptions;
- details that demonstrated how forward looking information had been incorporated into calculations; and
- information that explained how changes in the gross carrying amount of receivables contributed to changes in the ECL.

Both our 2019 new standards thematic report (see annexure 3) and our 2020 report (issued February 2021) provide detailed IFRS referenced discussions and examples on these matters. We expect issuers to be reaching a level of maturity on their understanding of their obligations in this area and that we will have a reduced level of findings for IFRS 7 disclosures in our next cycle of reviews. Issuers are requested to ensure that the IFRS 9 sections of the above-mentioned reports are specifically considered by their audit committees to ensure a full understanding of the topic (see annexure 3).

Impairments of assets

The common finding table was included for the first time in our report issued in February 2018. Poor application of the disclosure obligations of IAS 36 *Impairment of Assets* has featured as a common item since then, and this year is no different.

Our findings continue to reveal the omission of all or some of the minimum obligations of paragraphs 130 to 134 of IAS 36. In 2021 this occurred for 14 issuers. We gave impairments heightened consideration in the covid-19 environment and shifted our line of questioning in certain areas. We specifically looked for:

a) explanations for significant changes in assumptions (IAS 36.134(d)(ii) or .134(e)(ii)); and
b) disclosures where a reasonably possible change in a key assumption might lead to an impairment (IAS 36.134(f)).

In order to understand (b) above, we asked some issuers to provide us with the amount of the available 'headroom' in their impairment calculations. Those enquiries revealed that certain issuers had very little available 'headroom' and that a very small change in assumptions could lead to an impairment. In such an instance, the entity must provide disclosures quantifying the 'headroom', the value assigned to each key assumption and the amount by which such a key assumption must change for there to be an impairment in terms of IAS 36.134(f).

We believe that items (a) and (b) above are areas where audit committees can play an active role in ensuring that the necessary disclosures are provided.

Extent of disaggregated revenue

Ten equity issuers did not disaggregate their revenue in sufficient categories so as to depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors (IFRS 15.114).

Some issuers appear to have read IFRS 15.B88(b) to mean that information need only be given if it is reviewed by the chief operating decision maker (per IFRS 8.7). Our response to such argument is that whilst segmental information is a useful starting point for the consideration of disaggregation of revenue, it is not the end point. The objectives of IFRS 15.114 must still be achieved, and consideration must also be given to IFRS 15. B88(a), (c) and B89.

Arguments that the contracts are all the same (IFRS 15. B89(d) and (e)) and therefore disaggregation is not warranted ignores the impact that other factors, such as the type of product, had for example on the total amount of revenue. Giving insufficient weight to sales channels (for example online platforms, wholesale sales or exports) and geographical considerations (in the context of both regions within South Africa and international markets) was also a common weakness. We found instances where issuers gave detailed revenue information on product categories in their investor presentation but did not bring this level of detail into their results, as would be expected when reading IFRS 15.B88(a).

In one instance an issuer had provided information on revenue growth per sales channel in the commentary accompanying their results. Through our engagement they acknowledged that the disclosures per sales channel were required under IFRS. However, they did not yet have the systems in place to accurately capture such information. We were able to close off on our review through accepting their commitment (which they subsequently fulfilled) to provide some limited information in their AFS (which were due for imminent publication) and to ensure full compliance in their next interims.

Tax rate reconciliation

We found shortcomings in the disclosure of IAS 12 *Income Tax* of seven issuers across three topics:

- the tax rate reconciliation not providing meaningful information for multi-jurisdictional entities (paragraphs 81(c) and 84);
- over aggregation of items within the tax rate reconciliation (paragraphs 81(c) and 84);
- insufficient entity specific disclosure supporting the recognition of deferred tax asset (paragraph 82).

Presenting disaggregated revenue in interims

We flagged disaggregation of revenue in interims as an area of concern in: the 2019 new standards thematic report (see annexure 3); our 2019 report (issued in February 2020); and our 2020 report (issued February 2021). We remind issuers that the same level of disaggregated revenue detail is required in the interims as is presented in the AFS (IAS 34.16A(l)).

Despite our communication of this potential pitfall, we found six issuers where the information was erroneously omitted in the interims. This still equates to 11% of equity issuers we reviewed. We do not believe that the application of this aspect of IAS 34 requires a high level of judgement or that it is a complex area of IFRS. We can therefore only conclude that issuers are not considering the messages in our various proactive monitoring reports when preparing their interims. This points to a potential weakness in financial reporting processes which can be easily addressed. We also ask that issuers provide their audit committees with the relevant IFRS 15 sections of those reports to ensure a full understanding of the topic (see annexure 3).

Effective internal financial controls should be in place for interims as well as for AFS.

Material cases

Annually we provide feedback on specific aspects from each of the material cases. Some matters are discussed above in the covid-19 section and the remainder are presented below.

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.

Herein are two cases for consideration:

Case 1
Paragraph 50(a) of IFRS 16 states that a lessee shall classify cash payments for the principal portion of the lease liability within financing activities in the SCF.

We had an instance where cash outflows related to the repayment of the principal portion of lease liabilities was classified under operating activities instead of financing activities. This caused a misstatement to both of these activities on the SCF.

Case 2
The issuer incorrectly classified cash flows associated with the acquisition and disposal of investments in various unit trust portfolios under investing activities in the SCF. In an apparent

contrast, changes in the fair value of its investments in unit trust portfolios were presented within a "Loss from operating activities" subtotal in the statement of profit or loss.

Paragraph 16(d) of IAS 7 explains that one of the examples of cash flows arising from investing activities are cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (other than … those held for dealing or trading purposes).

Paragraph 14 of IAS 7 states that, "Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. Therefore, they generally result from the transactions and other events that enter into the determination of profit or loss."

The issuer confirmed that it actively trades its investments in unit trusts and acknowledged that the associated cash flows should have been classified under operating activities leading to a misstatement of both the reported cash flows from operating and investing activities in the SCF.

Financial asset

Paragraph 11(c)(i) of IAS 32 *Financial Instruments: Presentation* defines a financial asset as existing where there are contractual rights to receive cash or exchange financial asset from another entity.

We queried the nature of a significant increase in an 'other income' line item in the statement of profit or loss of an issuer's interim report. The issuer explained that it had an agreement whereby it was entitled to recover (from a third party) certain costs it had incurred. The issuer accounted for this agreement by recognising:

- their right to the reimbursements within 'other income'; and
- including the corresponding (equal amount of) costs incurred as an expense within the 'operating expenses' line item.

The issuer subsequently acknowledged the recognition of items in the income statement was incorrect. The arrangement should have only affected the statement of financial position. Whilst the error had no impact on net profit (due to the recognition of the expense which matched the income) the affected line items within the statement of profit or loss were materially misstated.

Issuers should ensure that they correctly identify the true nature of the transaction or agreement and account for it accordingly.

Headline earnings per share

Paragraphs 18 and 19 of the SAICA Headline Earnings Circular 1/2019 (and its replacement 1/2021; "**the Circular**") explain that the Circular creates detailed rules for all items to ensure consistency. Deviations from the rules are not permitted, even if an entity believes that the

distribution between trading and platform remeasurements is inappropriate for their specific business.

Paragraph 14(vii) of the Circular states that, “Included re-measurements are the re-measurements identified in the table in paragraph .21 (Section C) of this circular and are to be included in headline earnings because: they are financial instrument adjustments arising from the application of IFRS 9 (whether as the result of revaluation, impairment or amortisation), except for all reclassified gains and losses for a hedge of a net investment in a foreign operation”.

Our findings detected two instances where items were erroneously excluded from headline earnings. The first related to fair value revaluations of derivative financial instruments and the second impairments of loan receivables.

For the impairment of loans case, the issuer explained that the loan was made to an associate. The loan was viewed as being akin to the investment in the associate. They therefore followed the treatment applicable to impairments on equity accounted investments in associates and excluded the impairment from headline earnings.

We reminded the issuer that:

- the Circular is rules-based as opposed to being principle-based;
- in terms of paragraph 19 of the Circular, deviations from the rules are not permitted as that would mean that the Circular does not achieve its objective as described in paragraph 18; and therefore
- the treatment that should have been applied for the impairment of loans receivable is clear.

The Circular is a rules-based document and deviation from the detailed rules are not permitted.

Investment property

An issuer included a revaluation (increase) on property, plant and equipment as a gain in the consolidated profit or loss. We questioned why the gain was not presented in other comprehensive income (paragraph 39 of IAS 16 *Property, Plant and Equipment)*.

Upon further enquiry it was found that:

- the property held by a subsidiary was classified as an investment property for that entity and was measured at fair value under IAS 40 *Investment Property*;
- the property was leased to a fellow subsidiary;
- from a group perspective the property was not leased to a party outside of the group and thus was required to be accounted for as owner occupied property plant and equipment at a group level;
- the groups’ accounting policy was to measure owner occupied properties on the cost model; and

- the issuer had omitted to reverse the fair value gain when consolidating the affected subsidiary.

Unconsolidated structured entities

Our inquiry led us to question the accounting treatment applied to certain unconsolidated structured entities of an issuer.

Paragraph 17 of IFRS 10 *Consolidated Financial Statements* states that an investor controls an investee if the investor not only has power over the investee and exposure or rights to variable returns from its involvement with the investee, but also has the ability to use its power to affect the investor's returns from its involvement with the investee.

It emerged that the issuer's initial assessment of control over these structured entities was incorrect. They concluded that they should have previously consolidated the structured entities as they had:

- power over the structured entities and the ability to use that power to affect their returns from these structured entities; and
- exposure to variable returns as a result of financial guarantees they provided to the lender of those structured entities.

In the context of structured entities, the provision of financial guarantees may often lead to an issuer having to consolidate that entity.

Black Economic Empowerment ("**BEE**") transaction

In vendor-financed transactions, the company issuing the shares also provides the necessary financing to the BEE party to subscribe for those shares. This financing is 'repaid' through dividend receipts on the underlying shares. In most 'vanilla-type' transactions of this nature:

- the identifiable consideration received (or to be received) by the company is less than the fair value of the shares issued to the BEE party; and
- the 'discount' indicates that other consideration has been (or will be) received by the entity.

This triggers an equity-settled share-based payment expense under paragraph 13A of IFRS 2 *Share-based Payments* (and Financial Reporting Pronouncement 2: Accounting for BEE transactions under IFRS) whereby the substance of transaction (rather than its legal form) is recorded. The shares (whilst legally issued) are accounted for as an option. They are only reflected in the AFS as 'issued shares' once the underlying financing has been repaid (often through dividend receipts on the underlying shares).

We considered an instance where an issuer had embarked on a BEE transaction where they did not directly advance the funds to purchase the shares. Instead, the issuer guaranteed the BEE party's loan obligation to a third-party financial institution. The issuer accounted for the transaction at inception by recognising:

- a share-based payment transaction under IFRS 2.13A (representing the ‘in substance option’ profile of the equity instruments issued to the BEE party); and
- the nominal value of the shares (legally) issued to the BEE party as a normal share-issue transaction. Their argument was this was necessary as the entity had received cash from a party external to the Group (the financial institution).

In subsequent years, the BEE party defaulted on its loan repayments to the financial institution. The financial institution called on the underlying guarantee and the issuer had to repay the outstanding balance of the BEE party’s loan. The issuer recognised the ensuing loan obligations (now triggered as the guarantees were called) against equity, arguing that this was effectively ‘undoing’ a previous equity transaction.

The JSE found that the accounting treatment applied by the issuer when initially accounting for the transaction was not appropriate under IFRS. At the time that the BEE transaction was concluded, the issuer had presented both:

a) An issue of shares to the BEE party; and
b) A credit to equity (equity-settled share-based payment transaction) representing the issue of an option to the BEE party over the same shares it had already reflected as having ‘issued’ under (a) above.

This meant that the BEE party was represented as both the owner of the issuer’s shares and the holder of an option over those same shares.

The issuers’ justification for (b) above was that the benefit for the BEE party was similar to that of an option. The BEE party bore no (effective) obligation to the financial institution to repay loan. They could ‘walk away’ with no liability to the financial institution for the subscription price of the shares or the related interest on the loan.

Whilst the legal and accounting situation may have been different, only one relationship (i.e. economic event) representing the BEE transaction should have been reflected in the AFS.

The JSE found that, by issuing the guarantee to the financial institution, the issuer bore the legal obligation (for the liability) from day 1. When receiving the cash for the ‘shares issued’, the issuer should have recognised the liability to the financial institution rather than recognising an additional ‘credit leg’ in equity. This is supported by IAS 32.19(b) which explains that a contractual obligation which is conditional upon a counterparty (i.e. financial institution) exercising its right to redeem the instrument is a financial liability (to the issuer). This is because the issuer does not have the unconditional right to avoid delivering cash under the arrangement.

Emerging issues – looking to the 2022 review cycle

As mentioned in our 2021 covid-19 focus section at the beginning of this report, we have been considering the 'geography' applied by issuers to their income statement. Our engagements are generally centering in one of three areas, which are explored below under separate headings.

This is likely to continue to be a focus area for us over the short term, both in the context of covid-19 and the July 2021 civil unrest.

> Whilst we understand that we will be reviewing AFS issued before the publication of this report, we would look favorably on issuers who consider the content set out below and take the necessary corrective action in any upcoming interims.

Presentation by nature versus by function

IAS 1.99 requires an entity to present an analysis of expenses recognised in profit or loss using a classification based on either their nature or their function - whichever provides information that is reliable and more relevant to the entity.

- A nature of expense analysis aggregates expenses according to their nature - depreciation; changes in inventories; raw materials used; employee benefits expense etc. (IAS 1.102)
- A presentation by function analysis (or cost of sales method) classifies expenses according to their function within the entity - cost of sales; distribution costs; administrative expenses etc. (IAS 1.103).

IAS 1.99 refers to 'either/ or' with respect to presentation format therefore we have raised questions where issuers have used a mixture (i.e. both nature and function) on the face of the income statement. In our engagements we have accepted arguments that IAS 1.100 encourages entities to present the analysis in terms of IAS 1.99 on the face of the income statement. As such it does not expressly prohibit presenting the information in the notes.

Issuers have explained that they are looking to balance the obligations of IAS 1.99 with IAS 1.97 (which calls for the separate disclosure of the nature and amount of material items). In such a scenario these issuers have demonstrated that they can still achieve compliance with IFRS by clearly identifying the 'function' related to a specific expense along with its nature on the face of the income statement by using subtotals and/or by providing additional notes to the financial statements. Other issuers appear to have challenges unpacking the interplay between a 'by function approach' and their obligation under other paragraphs within IFRS such as paragraphs 82 and 104 of IAS 1. IAS 1.82 calls for the separate presentation on the face of the income statement of certain items such as impairment losses arising from applying the expected credit loss model. IAS 1.104 also requires an entity to provide additional information on the nature of expenses where a function of expenses format has been used. We have seen instances were issuers present such items (for example depreciation) separately and neglect to link the item back to its relevant function (for example cost of sales).

If the 'by function' format is being applied there must be a clear link tying items that are presented 'by nature' to their relevant function in order to avoid unintended noncompliance with IAS 1.99. A manufacture may present expenses such as depreciation and staff costs separately (i.e. 'by function') over and above a cost of sales expense (i.e. 'by nature'). On the understanding that a proportion of depreciation and staff costs are absorbed into the cost of inventory (which becomes cost of sales when sold) issuers should clearly explain how the separately disclosed expenses relate to other line items presented on the face of the income statement. For example, is the separately disclosed depreciation expense the total depreciation expense for the period or only that portion that was not absorbed into inventory (to become cost of sales).

IAS 1.103 cautions that, whilst the 'by function' method can provide more relevant information to users than the classification of expenses by nature, allocating costs to functions may require arbitrary allocations and involve considerable judgement.

The JSE believes that a mixed presentation should not unduly elevate the importance of certain expenses over others (see discussion on operating activities below) and that ultimately the performance of the issuer must be fairly presented.

Quantifying the impact of covid-19/ the July 2021 civil unrest

The discussion set out below deals with IFRS information. Our May 2020 also included a section (under the heading 'Covid-19 financial analysis') dealing with presenting information outside of the financial statements. The detail under that heading (which is not repeated here) applies equally to an analysis of the July 2021 civil unrest as it does to covid-19.

We agree that highlighting the impact of an expense directly attributable to covid-19 (or the recent civil unrest) may be required or allowed by IFRS. To the extent that it is material, IAS 1.97 requires such disclosure. Our concern however lies with:

a) how such items are labeled;
b) how the judgements to reliably measure what aspects of an expense are directly attributable to covid-19 compared to 'normal operations' are applied and disclosed; and
c) their positioning in the income statement.

This section deals with (a) and (b) whilst item (c) is discussed in the 'use of subtotals' section below.

Labels

Our May 2020 letter reminded issuers of the constraint under IFRS that items of income or expense cannot be presented as being 'extraordinary'. We have challenged issuers who use the term 'abnormal' which we believe is, in substance, the same as 'extraordinary' and therefore prohibited by IAS 1.87.

In noting their reasoning for abolishing the disclosure of extraordinary items (IAS1.BC60 – BC64) the IASB explained the need to eliminate an arbitrary segregation of effects of related external events - some recurring and others not. It is the nature or function of a transaction/event rather than its frequency that should determine its presentation in the income statement (IAS 1.BC63).

The defendable route under IFRS is therefore to describe the nature of the income or expense on the face of the income statement, rather than labelling it 'non-recurring', 'abnormal' or 'extraordinary'. If the issuer applies a 'by function' approach to their income statement they must still ensure they comply with IAS 1.99 (as discussed above).

Faithful representation
The second consideration is to ensure that the information is reliable and ensures faithful representation (IAS 1.15).

An issuer looked to quantify the impact of covid-19 by comparing their actual results to budgets and presenting this difference as being attributable to covid-19. We consider that there are likely to be too many moving parts and uncertainties in such a simplistic approach for the outcome to lead to faithful representation. An issuer would need to have absolute confidence that their financial controls over their budgeting system are effective, ensure that the 'budget' amount was not a stretch target, and be able to reliably isolate the impact of other factors that contributed to the non-achievement of the budget. 'Hypothetical' determinations are or can be misleading.

If an issuer is able to overcome the above hurdles and presents a 'covid-19' item, this should be accompanied by detailed disclosure of the judgement applied by management in calculating such figures (IAS 1.122).

<u>The use of subtotals</u>

Example 1
The use of additional subtotals are required in terms of IAS 1.85 when such subtotals are relevant to the understanding of an entity's performance. The use thereof is however subject to the requirements of IAS 1.85A. Furthermore, IAS 1.15 requires fair presentation and that an entity must faithfully present the effects of transactions, other events and conditions.

We challenged an issuer who included the subtotal 'trading profit' in their income statement but excluded the movement in expected credit loss from the subtotal. We argued that the exclusion did not lead to fair presentation being achieved - particularly as the entity had many banking operations which were considered part of their normal business activities.

Example 2
Paragraph 20(a) of IFRS 12 *Disclosure of Interests in Other Entities* requires an entity to disclose information that enables users to evaluate the nature, extent and financial effects of interests in joint arrangements and associates. We have identified instances where there is an inconsistency in the presentation of

a) the income from associates; and

b) profit on sale of shares in associates and/or impairments of loans to associates

Item (a) was presented below a subtotal called the 'operating income after impairments' whilst item (b) was included within the subtotal. We challenged this inconsistency. We are concerned that all of the income streams linked to associates should be within the same section of the income statement i.e. either all part of operations or not, in order for the financial effects of the interest to be understood.

Example 3

Issuers may choose to present an 'operating profit/loss' or similar subtotal in the income statement. Whilst the term is not defined in IFRS, when electing to disclose results of operating activities the IASB noted in IAS 1. BC56 that an entity:

> "…should ensure the amount disclosed is representative of activities that would normally be considered to be 'operating'. In the Board's view, it would be misleading and would impair the comparability of financial statements if items of an operating nature were excluded from the results of operating activities, even if that had been industry practice. For example, it would be inappropriate to exclude items clearly relating to operations (such as inventory write-downs and restructuring and relocation expenses) because they occur irregularly or infrequently or are unusual in amount. Similarly, it would be inappropriate to exclude items on the grounds that they do not involve cash flows, such as depreciation and amortisation expenses"

Furthermore, as discussed above, IAS 1.87 prohibits the presentation of any item as extraordinary. A previous (1993) version of IAS 1 required extraordinary items to be disclosed (in the income statement) separately from the profit or loss from ordinary activities. That standard had defined 'extraordinary items' as:

> "income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and therefore are not expected to recur frequently or regularly" (IAS 1.BC60).

In its revisions to IAS 1, the IASB decided that items treated as extraordinary do result from the normal business risks faced by an entity and do not warrant presentation in a separate component of the income statement (IAS 1.BC63).

It is difficult to envisage which expenses, if any, would not be regarded as being part of the issuer's operating activities. An analogy to IAS 7.6 may be appropriate where 'operating activities' are defined as "the principal revenue-producing activities of the entity….".

Certain issuers have looked to the Headline Earnings Circular to argue that any remeasurements excluded from the headline earnings circular should be excluded from an operating profit subtotal. These arguments fail to give full consideration to the definition section of the Circular which states that.

> "Operating/ trading activities are those activities that are carried out using the 'platform', including the cost associated with financing those activities."
>
> and
>
> "The platform is the capital base of the entity. Capital transactions reflect and affect the resources committed in producing operating/trading performance and are not the performance itself."

Importantly, both definitions include a note that:

> "The meanings of the words 'operating' and 'capital' in this circular are different from their meanings in IFRS."

The platform identified in the Circular is by its very nature linked to the operating activities of the entity from an IFRS perspective. These are the very assets used for operating activities.

Significant impairments (even those attributable to the covid-19 pandemic) may occur as a consequence of 'normal business activities' of the entity. Whilst covid-19 was clearly an unexpected occurrence, for most entities, the consequential financial impact is tantamount to a business risk. We challenged issuers who had separately disclosed the impact that impairments had to the financial performance (IAS 1.97) but included this below an operating profit subtotal on the face of the income statement.

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 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 2021 calendar year reviews (on both equity and debt issuers) covered AFS for years ending between 30 June 2019 and 31 December 2020.

Statistics

What we did

	Equity	**Debt** [1]	**Total**
Letters of query	45	8	53
Cases closed immediately	5	4	9
Number of new AFS reviews	**50**	**12**	**62**
Cases b/f from previous year	11	2	13
Total cases reviewed during period	61	14	75
Cases still pending	(9)	(4)	(13)
Cases completed during period	52	10	62

Between January and September 2021, we performed new reviews on 50 equity issuers (which included both their AFS and interim results) and the AFS of 12 debt issuers. We wrote letters of enquiry to 53 of the issuers, with 9 cases being closed immediately without any

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

questions asked. By October 2021 nine of the equity cases and four of the debt cases were still pending.

What we found

Two 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 after the review had been concluded. For six 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 20 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 34 cases involved smaller disclosure issues that issuers agreed to clarify or correct in the future.

In 2021, material infringements were identified in 3.8% of the closed cases (2020-4.4%) for equity issuers and none of the debt issuers (2020-nil). The number of cases where corrections were required in future reporting periods was at 48% (2020-54.4%) for equity issuers and 10% for debt issuers (2020-12.5%).

	2021 Equity	**2021 Debt**	**2021 Total**	**2020 Equity**	**2020 Debt**
AFS needed restatement and public announcement made	2	-	2	3	-
Non-compliance was such that we agreed to a correction within the next published results	6	-	6	1	1
Non-compliance not material this year, but must be corrected in the future in order to avoid potential investor prejudice	19	1	20	36	2
Smaller disclosure issues that will be corrected in the future	20	4	24	20	10
AFS in respect of which it was concluded that there were no issues	5	5	10	8	10
Total cases closed	**52**	**10**	**62**	**68**	**24**

In assessing the potential impact of matters for the current period, the number of cases with findings impacting measurement was at 14.9% (2020-15%) for equity issuers and nil (2020-18%) for debt issuers. The remaining 85% for equity issuers 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, we present an extract from the ESMA reports (below) 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 2020 ESMA activity report (issued in April 2021) is the latest available information, which from a period perspective, is best compared to the data contained in our 2020 report.

	South Africa			**ESMA**	
Coverage					
Period when reviews were undertaken	2021	2020	2019	2020	2019
Date of regulator's report	Nov 2021	Feb 2021	Feb 2020	April 2021 [2]	April 2020[3]
Reviews closed at reporting date[4] [5]	62	92	71	689	900
Examination rate (Percentage coverage of population) [6]	18.1%	24%	17%	16%	16%
Actions					
Material infringement (Requested re-issuance / immediate public announcement)	3.2%	3.3%	8.5%	8.1%	6.4%
Corrections required in future financial statements	41.9%	43.5%	39.4%	30.3%	26.8%
Action rate (Total number of instances where action was taken)	45.2%	46.7%	47.9%	38.5%	33.2%

The 2020 ESMA activity report indicates that of the 689 ex-post examinations undertaken by the 24 European enforcers during the calendar year to December 2020, 8.1% of those identified material infringements (requiring public announcements or reissuing of AFS). For a further 30.3%, whilst classified as material, the enforcers accepted a correction in the next AFS. The material infringement action rate for the JSE was 4.8 points lower (at 3.3% compared to 8.1%) but the overall action rate was substantially higher (at 46.7% compared to 38.5%). The difference in the action rates of the JSE compared to ESMA in 2020 is in line with that of 2019.

Annexure 1 explains that the reduction in the JSE's examination rate, which is heading downwards towards ESMA levels, is intentional. In terms of that approach, the top 40 equity issuers and top 20 debt issuers (measured by market capitalisation) will account for one third of selections. The UK follows an even more aggressive approach, where two thirds of their 216 selections in 2019/2020 were attributed to FTSE 350 companies [7].

[2] Information extracted from the ESMA report titled "Enforcement and Regulatory Activities of Accounting Enforcers in 2020"

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

[4] 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.

[5] The reduction in the number of reviews reported by ESMA in 2020 is attributable to Brexit. The UK is now removed from their figures.

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

[7] Information Extracted from the FRC report titled "Annual Review of Corporate Reporting 2019/2020" .

Annexure 1 – Understanding the review process

Why the review process

Our 2020 report includes a reminder that the JSE undertakes the review process because it was requested to do so by The Financial Services Conduct Authority (previously the Financial Services Board) in 2010. 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 is included 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 refer to page 21 of the 2018 report (which is available on our website) for a full understanding thereof.

We aim to be pragmatic in 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.

The 2021 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.

In 2021, the JSE made 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

Our 2020 report includes an explanation of the revised approach that was introduced for issuers listed on the ALT^X market. Not only will they be reviewed on a less frequent basis but the process itself has been amended. Those involved in ALT^X market are referred to page 23 of that report (which is available on our website) for an understanding of that process and our objectives.

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 by the issuer from one year to the next.

Annexure 2 – Activities of the FRIP

The process linked to matters referred to the FRIP during this period have not yet reached a conclusion. We will include details of such FRIP matters at an appropriate future date.

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 2020" ("**the Combined Findings Report**"). The report was updated from the one issued in February 2021 and reissued in October 2021.

For ease of reference, this annexure contains information that all audit committees must consider in fulfilling their responsibilities referred to on page 3 of this the 2021 report.

1. This, the 2021 report;
2. The "Final Findings of our thematic review for compliance with IFRS 9 and 15", issued on 6 November 2019 ("**2019 new standards thematic report**");
3. The following sections from the Combined Findings Report issued in October 2021
   a. Disclosure of judgements and estimates (pages 15 to 18);
   b. Revenue (pages 35 to 37); and
   c. Financial Instruments: Disclosures (pages 52 to 56).
4. The letter we issued in May 2020, (containing our expectations for reporting the impact of covid-19) which should now be reconsidered in the context of reporting the impact of the July 2021 civil unrest.

Our 2020 report included reference to:

- Certain sections of the combined findings report detailing with common disclosure omissions; and
- JSE covid-19 letters and IASB covid-19 documents.

On the understanding that audit committees have already given that information due consideration, it is not repeated here.

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

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

The above documents can be accessed via the hyper-link reflected in green or downloaded from the JSE website https://www.jse.co.za/current-companies/issuer-regulation/accounting-matters.