

MEMORANDUM ON THE OBJECTS OF THE FINANCIAL REPORTING BILL

1. SCOPE OF BILL

- 1.1 The Financial Reporting Bill (“the Bill”) proposes to provide for the -
 - 1.1.1 setting of financial reporting standards for the preparation and presentation of financial statements by entities that are required by an act to prepare and present their financial statements in conformity with the financial reporting standards;
 - 1.1.2 setting of general purpose financial reporting standards as defined in clause 1;
 - 1.1.3 setting of limited purpose financial reporting standards as defined in clause 1;
 - 1.1.4 establishment and functions of the Financial Reporting Standards Council (“the Council”), the main function of which will be the developing and setting of financial reporting standards; and
 - 1.1.5 supervision and enforcement by the Financial Services Board (“the Board”) of compliance by designated entities (see clause 12) with the financial reporting standards.
- 1.2 In terms of the definition of “entity” in clause 1, an entity includes, but is not limited to, a company incorporated under the Companies Act, 1973. It was therefore decided to provide for the setting of financial reporting standards, and the supervision and enforcement of compliance with those standards, not in the Companies Act, 1973, but in a separate act. However, as a starting point it is proposed that the Companies Act, 1973, be amended, as set out in the Schedule to the Bill, so as to require companies to comply with the financial reporting standards. In time legislation regulating other entities should be amended for the same purpose.

2. BACKGROUND

- 2.1 The Companies Act, 1973, requires that the financial statements of companies, in conformity with generally accepted accounting practice, fairly present the state of affairs of the company and the results of its operations.

- 2.2 In 1973 the accountancy profession realised that the interpretation of "generally accepted accounting practice" might be problematical and took the lead in establishing a body composed of preparers, users and auditors of annual financial statements to codify South African Statements of Generally Accepted Accounting Practice (Statements of GAAP). This body is known as the Accounting Practices Board (APB). In 1993, the APB agreed that Statements of GAAP should be based on the International Accounting Standards (IAS) approved by the International Accounting Standards Committee (IASC). The appropriateness of this decision is evident from a recommendation of the International Organisation of Securities Commissions (IOSCO) in June 2000 that its members allow multinational issuers of annual financial statements to use IAS. In addition, the European Commission has announced that from 2005 all EU companies listed on a regulated market (including banks and insurance companies) have to prepare consolidated annual financial statements in accordance with IAS.
- 2.3 Legal opinions obtained in 1977 and 1987 confirmed that Statements of GAAP do constitute generally accepted accounting practice. However, in both opinions, senior counsel stated that other practices not codified in Statements of GAAP might also constitute generally accepted accounting practice as the concept of generally accepted accounting practice allows for this flexibility.
- 2.4 This dichotomy may result in unsound accounting practices being sanctioned purely because they are adopted by several enterprises. This situation may prejudice users of annual financial statements as accounting practices may be adapted to reflect management's and the company's performance in a favourable light, rather than to give an objective view to users of financial statements. In addition, there is little or no certainty that like transactions and events will be accounted for in a like manner. Clearly this position is unsatisfactory as it goes against the spirit of the Companies Act, 1973, which requires fair presentation in the annual financial statements.
- 2.5 In 1999 a legal opinion was obtained with regard to paragraph 5 of Schedule 4 of the Companies Act, 1973. Schedule 4 lays down requirements for annual financial statements, interim reports and provisional annual financial statements. Paragraph 5 of Schedule 4 authorises directors of a company to depart from Statements of GAAP if there are reasons to do so and subject to disclosure of the departure in the financial statements. According to this opinion, in order for directors to meet the requirements of the Companies Act, 1973, the annual financial statements must be prepared in conformity

with Statements of GAAP. However, if they materially depart from Statements of GAAP, the annual financial statements must disclose the departure, the particulars thereof, the reasons therefor and the effect of such departure on the financial statements.

- 2.6 In December 1999, The South African Institute of Chartered Accountants (SAICA) issued Circular 8/99, providing guidance to directors and auditors on compliance with paragraph 5 of Schedule 4. Although this improved compliance with Statements of GAAP, a number of preparers and auditors are of the opinion that the requirement to prepare annual financial statements in conformity with Statements of GAAP should be apparent from a plain reading of the Companies Act, 1973.
- 2.7 The King Report on Corporate Governance, which was issued on 29 November 1994, recommended that there should be legal backing for and monitoring of compliance with accounting standards. This recommendation is repeated in the second report of the King Committee, which was issued in March 2002.
- 2.8 The revised JSE Securities Exchange Listings Requirements (effective from 2 October 2000) require listed companies to prepare their annual financial statements and group annual financial statements in accordance with Statements of GAAP or IAS.
- 2.9 Local and foreign users of annual financial statements, including rating agencies, require assurance that accounting standards are complied with, and that the law requires such compliance. Accordingly, in order to provide this assurance it is considered essential that legal backing for accounting standards is obtained and implemented.
- 2.10 When Sir David Tweedie, chairman of the International Accounting Standards Board (IASB) – successor body to the IASC – visited South Africa in October 2001, he referred to the fact that effective financial reporting is dependent on high quality accounting standards, high quality auditing and effective monitoring. He noted that, although the Statements of GAAP are considered to be of a high quality, there is no legal backing for and monitoring of compliance with the accounting standards. World Bank representatives, in conducting the Reports on the Observance of Standards and Codes in respect of corporate governance and audit and accounting in South Africa, raised the same issue.

- 2.11 As noted in the table below, experience in various countries shows that legal backing of accounting standards is necessary to ensure compliance.

<i>Country</i>	<i>Legal backing since</i>
USA	1930's
Canada	1940's
UK	Early 1990's
Australia	1990's
New Zealand	1993

3. OBJECTS OF BILL

- 3.1 As is apparent from what has been said above, the main object of the Bill is to remove any uncertainty as to what constitutes generally accepted accounting practice by providing for the setting of uniform financial reporting standards by the proposed Council and to afford legal backing for such financial reporting standards by providing for the supervision and enforcement of compliance with those standards. This approach will inevitably result in a more objective, credible, consistent and fair representation of an entity's financial statements.
- 3.2 The financial statements of an entity should be meaningful and reliable to users of financial statements. It is the object of the Bill to instil confidence into both local and foreign users of financial statements to rely on the information contained in an entity's financial statements.

4. SUMMARY OF SALIENT PROVISIONS OF BILL

- 4.1 In clause 1 the definitions "general purpose financial reporting standards" and "limited purpose financial reporting standards" are important. It is acknowledged that it is neither reasonable nor practicable to require small enterprises to comply with reporting standards that are based on general international reporting standards. In terms of clause 4(b) the Council must set limited purpose financial reporting standards for those entities that fall within the class of entity contemplated in the definition of "limited purpose financial reporting standards" It is proposed in the Schedule to the Bill that the Companies Act, 1973, be amended so as to provide for private companies, under specified circumstances, to prepare their annual financial statements in conformity with limited purpose financial reporting standards. General purpose financial reporting standards are set for entities contemplated in the definition of "general purpose financial reporting standards". In terms of clause 29

of the Bill all Statements of GAAP which are in terms of any act applicable to the preparation and presentation of the financial statements of an entity immediately before the commencement date of the Bill, continues to be so applicable as if set, approved and published under the Bill as general purpose financial reporting standards. Until limited purpose financial reporting standards are set under the Bill, entities that must comply with limited purpose financial reporting standards in terms of any act, must comply with the general purpose financial reporting standards.

- 4.2 Chapter II of the Bill deals with the establishment and functions of the Council and with matters connected therewith. The Bill establishes the Council as a corporate body and the Board appoints, in addition to the executive officer of the Board who is a member of the Council in terms of the Bill, the other 11 members of the Council. The Council may appoint a committee to develop, subject to the instructions of the Council, general purpose financial reporting standards and a committee to develop, subject to the instructions of the Council, limited purpose financial reporting standards. Financial reporting standards or an amendment of the financial reporting standards proposed by the committees must be approved and published with or without amendment by the Council, having regard to the International Financial Reporting Standards of the International Accounting Standards Board. The Board must appoint the staff of the Council and must remunerate the members of the Council and its committees as well as the staff of the Council.
- 4.3 Chapter III of the Bill deals with the supervision and enforcement of compliance with the financial reporting standards. In terms of clause 12 the executive officer of the Board must designate by notice in the *Gazette* those classes of entity whose compliance with the financial reporting standards will be supervised and enforced. The Bill provides for the establishment by the Board of an investigation committee to supervise, and an enforcement committee to enforce, compliance with the financial reporting standards. The Board and the enforcement committee are empowered to direct an entity to terminate or remedy any non-compliance with the financial reporting standards. The enforcement committee may in addition impose an administrative penalty after consideration of the investigation report and the affidavit of the respondent in response to the report. The procedure to be followed by the enforcement committee is aimed at the speedy and cost-effective disposal of cases of non-compliance with the financial reporting standards. The respondent may appeal against a direction of the Board or the enforcement committee or the imposition of a penalty by the enforcement committee to the board

of appeal established by section 26 of the Financial Services Board Act, 1990 (Act No. 97 of 1990).

- 4.4 Chapter IV of the Bill deals with general matters, one of which is the financing of the Council and the Board. The costs of performing the functions of the Council and its committees and those of the Board, the investigation committee and enforcement committee, must be paid out of a levy that the Board may impose by notice in the *Gazette* on entities. The Board may impose different levies in respect of different categories and different sub-categories of entities and according to whether or not an entity's compliance with financial reporting standards is supervised and enforced in terms of Chapter II of the Bill.
- 4.5 The Companies Act, 1973, is amended in the Schedule to the Bill by requiring companies to comply with general purpose financial reporting standards except in the case of private companies, which with the consent of all of their members (which must be obtained annually) may comply with limited purpose financial reporting standards. All of the existing provisions of that Act relating to financial reporting are deleted, save for certain disclosures relating to loans to and emoluments of directors. Existing Statements of GAAP, which in terms of the proposed transitional provisions of the Bill in Chapter IV, will become financial reporting standards, already require the preparation of consolidated financial statements for groups of companies. For this reason the reference in the Companies Act, 1973, to "group financial statements" has been deleted throughout.

5. ADMINISTRATION OF BILL

It is proposed that the Board administers the proposed new Financial Reporting Act – possibly for a limited period of time, after which an independent private sector body could replace the Board. The proposed processes of supervision and enforcement are new and complex with new ground to be broken. The Board has been involved in establishing similar processes in the past and can contribute a wide range of experience, expertise, infrastructure and other resources. Accounting standard setting and supervision and enforcement of compliance are of interest to government, making the Board the ideal body to assist in the establishment of these processes.

6. CONSULTATION

- 6.1 The Bill was discussed at a Consultative Forum that was arranged by

the South African Institute of Chartered Accountants on behalf of the Board. The Forum took place on 5 December 2001 and all interested parties were invited to participate in the discussions. Approximately 70 individuals attended the event, which was opened by the Deputy Minister of Trade and Industry, Ms Lindiwe Hendricks and the Accountant-General, National Treasury, Mr Ismael Mamojee. Mr Jeff van Rooyen, executive officer of the Board, acted as chairman.

- 6.2 In general, those present were supportive of the Bill. A number of comments were received and the Bill has been revised based on the comments received at the Forum, as well as written submissions made at a later stage by persons who attended the Forum. The consultative process goes on and is now in its final stage. A list of persons and bodies consulted will later on be added to this memorandum.

7. FINANCIAL IMPLICATIONS FOR STATE

The Bill has no financial implications for the State.

8. PARLIAMENTARY PROCEDURE

The State Law Advisers and the National Treasury are of the opinion that the Bill must be dealt with in accordance with the procedure set out in section 75 of the Constitution since it contains no provision to which the procedure set out in section 74 or 76 of the Constitution applies.