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Technically Speaking
Sizing up regulation and risk

Accounting & Auditing

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Welcome

Dear colleagues

Welcome to our seventeenth edition of Technically Speaking!

This edition includes articles on the following topics:

The new European Union audit legislation

The European Union (EU) Member states and the European Commission reached a preliminary agreement on future EU audit legislation. This article highlights the requirements under the legislation.

Proactive monitoring of Annual Financial Statements by the JSE

The Johannesburg Stock Exchange (JSE) undertakes a process of reviewing Annual Financial Statements for compliance with International Financial Reporting Standards (IFRS) for the entities listed in the JSE. This article walks through the review process and highlights the results of the last review cycle carried out in 2013.

The new hedge accounting chapter of IFRS 9

The International Accounting Standards Board (IASB) recently released the hedge accounting chapter of IFRS 9. This article provides highlights of the new hedge accounting chapter and their potential impacts on hedge accounting market practices.

The Roadmap into the IFRS Future

Deloitte recently released the second edition of 'The Roadmap to IFRS Future' publication (The Roadmap). This article provides highlights of the content in The Roadmap and also provides links to accessing The Roadmap.

We look forward to your comments on this publication. Please continue to send your comments and suggestions to technicallyspeaking@deloitte.co.za.

N. Ranchod

Kind regards

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Preliminary agreement on new European Union audit legislation

Article by:

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Regulatory briefing[1]

The 28 European Union (EU) Member States and the European Commission reached a preliminary agreement on future EU audit legislation which was then submitted for a plenary vote before the European Parliament. The European Parliament voted to approve EU audit legislation in early April this year. As a next step, formal approval is needed by the 28 member states comprising the Council of the EU for the legislation to become law. Council approval is expected shortly.

The new legislation will be effective two years and 20 days after its official publication, so likely in the July to September 2016 time frame. With respect to firm rotation, there are specific transitional arrangements, which may mean that in certain instances firm rotation will be required as early as July to September 2022 (see below).

The EU rules pertaining to mandatory firm rotation and the prohibition of certain non-audit services are in the form of an EU Regulation. This means that it applies as law in all Member States. Even though all Member States are obliged to apply these rules, the EU Regulation affords the Member States some flexibility with respect to the application/implementation of the prescribed rules, including the ability to extend the rotation period (see below), designate certain entities as Public Interest Entities (PIE), or allow the audit firm to render certain non-audit services (certain services related to tax).

Which entities are affected?

The EU Regulation applies to all Public Interest Entities (PIEs). The definition of PIEs includes companies listed on EU regulated markets (as opposed to all markets in the EU) and governed by the law of an EU Member State (company is incorporated in the EU, or has its head office/main place of business in the EU), credit institutions authorised by EU Member States authorities (i.e. banks whose business is to receive deposits or other repayable funds from the public and to grant credit), insurance undertakings authorised by EU Member State authorities, as well as other entities that a Member State may choose to designate as a PIE.

The PIE definition
- Companies listed on EU regulated market and governed by the law of an EU Member State
- Credit institutions authorised by EU Member State authorities
- Insurance undertakings authorised by EU Member State authorities
- Other entities a Member State may choose to designate as a PIE

Considering extraterritorial implications, non-EU companies (i.e. companies that are not incorporated in the EU nor have their head office or main place of business in the EU) that are listed on regulated markets in the EU do not qualify as PIEs and are not bound by the new legislation.

Mandatory firm rotation

In terms of the EU Regulation, the mandatory rotation period has been set at 10 years. However, EU Members States are allowed to adopt their own legislation which may extend the mandatory firm rotation period to 20 years (or 24 years in the case of joint audits), but only if the Member State obliges companies to employ a mandatory tendering process after the initial 10 years. In this case PIEs will be obliged to have an open and transparent tender process with the close involvement of the audit committee when considering either the selection of a new auditor or reappointment of the current auditor for the extension period, if applicable.

Of course, Member States may promulgate legislation that require a shorter rotation period in their own jurisdiction (e.g. in the Netherlands mandatory firm rotation is required after 8 years). In such an instance, all PIEs governed by the said legislation (in this example Dutch law) will have to ensure firm rotation after the shorter period. Where Member States promulgate their own legislation, their own rules must be stricter (and not more lenient) that the proposed EU rules.

With respect to the Competition Commission findings in the UK, they have opted for mandatory tendering after 10 years. They are currently reviewing these recommendations in view of the EU developments, and plan to issue final requirements in the fourth quarter of 2014. As Member States are not permitted to allow for a more lenient regime, the UK will have to abide by

1 This document contains preliminary information/conclusions. We'll only be in a position to provide clear and final guidance once the legislation is promulgated by the EU Parliament, and all the 28 EU Member States have promulgated their own legislation in this regard.

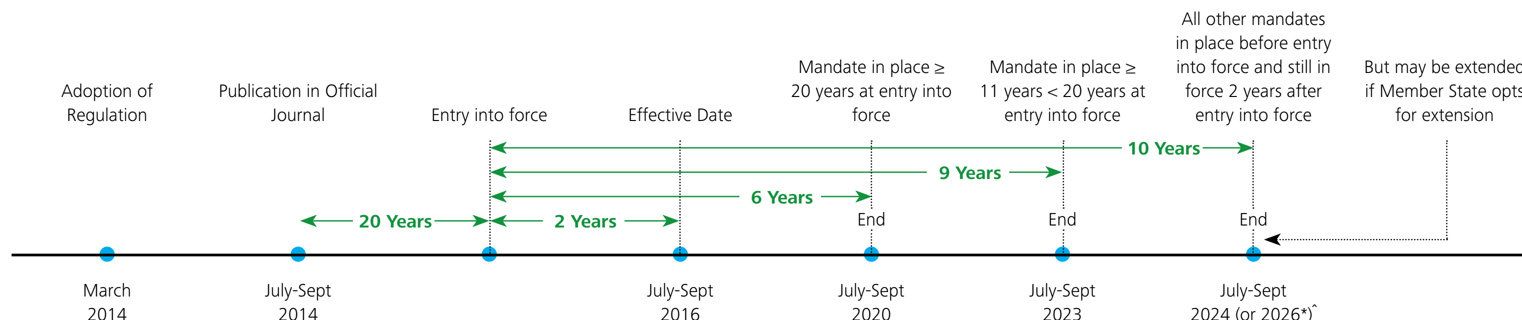
the mandatory firm rotation Regulation of the EU. It remains to be seen if the UK decides to allow for an extension of the mandatory rotation period by allowing companies to engage in mandatory tendering after first the 10 years.

Transitional periods

Transitional periods are provided for the application of provisions on mandatory firm rotation. At this point is not yet clear of the rotation date should be determined from the effective date of the legislation (2016), or from the date of entry into force (2014). This should be clarified when the final legislation is promulgated later this year. Although the maximum rotation period is set at 10 years, certain companies will be required to rotate their auditors earlier:

- Six years (starting from 20 days after publication of the audit legislation) for audit mandates that have been in place for 20 or more years.
- Nine years (starting from 20 days after publication of the audit legislation) for audit mandates that have been in place from 11 to 19 years.

For all other situations, all engagements entered into before the entry into force (e.g. before July 2014) and which are still running two years after the entry into force (e.g. July 2016) may continue until the end of the initial period (which may be the 10 years mentioned above, subject to Member State decision). Further, if a Member State chooses, for example, an initial period of 10 years and takes the option to provide for extension, the engagement may be extended by the period of time provided for in the Member State legislation, but not to exceed a total of 20 years in case of tendering or 24 years in case of joint audit.



* If 10-year period starts at effective date rather than entry into force – clarification being sought.
^ Or less if member State opts to reduce 10-year maximum.

What does this mean for South African companies?

- Mandatory firm rotation does not apply to South African companies.
- In South Africa, the audit committee is tasked with ensuring the independence of the auditor. In addition, section 90(2) of the Companies Act provides the rules for the provision of certain non-audit services by the auditor. Where non-audit services are allowed, the audit committee must pre-approve all such services. The Companies Act further provides for the rotation of the designated auditor (the person signing the auditor's report) every 5 years.
- The King Committee issued a Practice Note in which they argue that mandatory firm rotation is not suitable for the South African market, and that there are sufficient checks and balances in place to ensure auditor independence.
- Although the EU opted for mandatory firm rotation as discussed above, it is important to note that the US decided against mandatory firm rotation as a means to ensure auditor independence. It was argued that the audit committee should ensure auditor independence, and approve all non-audit services provided by the auditor.

Preliminary agreement on new European Union audit legislation

Summary

- Likely to be effective anytime between July and September 2016
- Applicable only to PIEs in the EU (companies that are incorporated outside the EU, or that do not have their head office or main place of business in the EU, even if they are listed on a regulated EU market, are NOT affected directly by this legislation)
- Maximum duration of audit engagement not to exceed 10 years (Member State may set the maximum duration to less than 10 years (e.g. in the Netherlands there is mandatory firm rotation after a maximum of 8 years))
- Member State may decide to extend rotation period beyond 10 years to:
  - Maximum 20 years in case where they adopt legislation to oblige companies to do mandatory tendering, or
  - Maximum 24 years in case of joint audit
- Competent Member State authority (for instance audit oversight authority and/or securities regulator) may extend auditor appointment on an exceptional basis for a further two-year term
- Four year cooling off period after the end of the statutory audit services before audit firm can undertake the audit of the entity again
- PIE to perform a transparent audit tendering process with close involvement of audit committee when a tender does occur

Building blocks to strong financial reporting

Proactive monitoring of Annual Financial Statements by the JSE

Article by:

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Efficient markets rely on transparent and high quality financial information to assist the various stake holders in making economic decisions and to demonstrate the extent to which the management has discharged its stewardship obligations. The integrity of financial information is therefore a critical element of a well functioning market.

In February 2011, in recognition of the above fact, the Johannesburg Stock Exchange (JSE) announced that it would embark on a process of reviewing Annual Financial Statements (AFS) for compliance with International Financial Reporting Standards (IFRS). The objective of the review process would therefore be to contribute towards the production of quality financial reporting of entities listed on the JSE.

The review process

Historically, regulation of compliance with IFRS was done on a reactive basis only i.e. through receipt of a complaint or by JSE staff identifying a concern on an ad hoc basis. Under the revised proactive monitoring review process, the financial statements of every listed company are subject to the review at least once within a five years review cycle, in addition to any other investigations arising from public complaints.

In order to ensure that it gets a view of the entire market, the JSE ensures that the selection of the AFS for the review is directed to proportional representation across all sectors and all markets. In this regard, the JSE ensures that it covers issuers of AFS of all sizes from the top 40 to those with a very small market capitalisation.

The review process is not a detailed review of the annual financial statements for compliance with every paragraph of IFRS. According to the JSE, "detailed IFRS disclosure checklists are often standard armoury for an issuer and their auditor and we do not intend to replicate this process".

In the AFS reviews, the JSE follow a risk-based approach. However, the risk areas of its focus are revised from year to year and from entity to entity and could include:

i. Consideration of a specific accounting standard where, at a point in time, the JSE has concerns with regards to the level of compliance;
ii. Consideration of issues driven by the business environment ; and/or
iii. Matters that are peculiar to the specific circumstances of an entity in that specific year.

Ultimately, the primary focus of the review is to identify matters that could be important to investors. These matters could have an immediate impact on the share price or a longer term impact to the extent that they could cloud investors understanding of the business and results.

The JSE drives the process but it is assisted by the University of Johannesburg (UJ) and the Financial Reporting Investigation Panel (FRIP).

The reviews performed in 2013

On 21 February 2014, the JSE released its report on its proactive monitoring of the financial statements for the 2013 cycle. This formed the fourth cycle of the proactive review since the JSE commenced the proactive monitoring process.

During this cycle, the JSE reviewed 78 AFS. It wrote query letters to 59 of the issuers of financial statements, of which one case resulted in a further referral to the FRIP for advice. By January 2014, 9 of the cases were still pending finalisation. 19 cases were closed either with no comments or with a letter of potential areas of improvement being sent to the issuer.

Of the 59 sets of AFS which queries were sent to the issuers, 3 sets of AFS required restatements and a public announcement. A further 15 required corrections that would be made in the next published results or were immaterial in the year under the review but would require to correction in the future.

Building blocks to strong financial reporting
Proactive monitoring of Annual Financial Statements by the JSE

The table below provides the details of the reviews in more details:

	2013	2012	2011
AFS needed restatement and public announcement made	3	7	2
Non-compliance such that the JSE agreed to a correction within the next published results	8	2	2
Non-compliance not material during the year, but must be corrected in the next results in order to avoid potential investor prejudice	7	10	10
Subtotal of forced corrections	**18**	**19**	**14**
Smaller disclosure issues that would be corrected in the future	33	28	15
Subtotal of cases with corrections	**51**	**47**	**29**
Other AFS in respect of which no issues were identified, or only potential areas of improvement were identified	33	31	16
Total cases closed	**84**	**78**	**45**

Some of main themes arising from the reviews were:

- Presentation of Financial Statements (IAS 1);
- Statement of Cash Flows (IAS 7);
- Earnings per Share (IAS 33) and the Headline Earnings circular;
- Impairment of Assets (IAS 36);
- Share-based Payments (IFRS 2);
- Segmental Reporting (IFRS 8);
- Revenue (IAS 18); and
- Property, Plant and Equipment (IAS 16).

The above list accounted for the majority of the issues that were identified.

Looking forward

In closing the JSE indicated their intention to focus on the application of the new standards applicable to 2014 financial statements. These include IFRS 10- Consolidated financial statements, IFRS 11- Joint Arrangements, IFRS 12 Disclosure of interest in other entities and IFRS 13 – Fair value measurement.

Narrowing the gap between risk management and accounting

Article by:

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The new hedge accounting chapter of IFRS 9: Financial Instruments, the replacement of the existing standard (IAS 39) on financial instruments, was issued in late 2013.

The hedge accounting chapter has been positioned as an improvement in the rigid and cumbersome requirements of IAS 39.

In this article, we look at some of the highlights of the new standard and their potential impacts on hedge accounting market practices.

Risk management

The International Accounting Standards Board (IASB) approach to the development of the standard was focused on the objective of aligning risk management with hedge accounting.

IFRS 9 reinforces this notion by:

- Defining the objective of hedge accounting as the representation of the entity's risk management activities;
- Requiring the termination of hedge accounting when the hedge relationship no longer meets the entities risk management policy; and
- Outlining disclosure of risk management strategies and activities.

The guidance to the standard provides an illustration of how a constrained risk management strategy could result in the inability to apply hedge accounting. In the illustration, the entities risk management strategy was limited to 40% of a particular risk exposure. Because of market conditions at the time, the entity chose to extend its coverage to 60%. The guidance highlights that the entity would not be entitled to apply hedge accounting for 20% of the exposure as this element is outside the boundaries of the entity's documented risk management strategy.

The focus on risk management provides a clearer reference point for preparers applying hedge accounting. However, entities should balance the benefits of defining constraints in its risk management strategy whilst being able to flex its response to risk management in certain instances.

Hedge effectiveness

Under IAS 39, an entity needed to prove an offset between the hedging instrument and the hedged exposure within a range of 80-125%. The new standard removes these boundaries in favour of an approach that assesses the sources of ineffectiveness. Hedge effectiveness is proven when the entity is able to:

- Define an economic relationship of the hedged item and the hedging instrument;
- Which is not dominated by credit risk movements;
- In a hedge ratio that does not purposefully create ineffectiveness or impede on the objective of hedge accounting.

The cost of hedging

Under IAS 39, the impact of forward points in a forward exchange contract or the time value of an option contract often frustrated hedge accounting and in particular, the achieved ratio of hedge effectiveness.

IFRS 9 allows a preparer to strip-out the effects of these costs from the designated hedging relationship. Although this could be done under IAS 39, the implication was a knock to earnings before the hedged transaction was recognised. Preparers will be able to defer the recognition of the hedging cost to the same period as the hedged transaction impacts profit or loss. This will mimic IAS 39's "all-inclusive" hedging but with the advantage of simplier and more efficient spot rate hedge accounting.

The policy choice

The IASB have not completed the macro hedging review of IAS 39. Until the finalisation of the macro hedging provisions, the IFRS will allow entities to adopt an accounting policy for hedge accounting being either:

- IFRS 9 for all hedges;
- IFRS 9 for general hedging and IAS 39 for macro hedging; or
- IAS 39 for all hedges.

Hedging non-financial items

Apart from foreign exchange risk, IAS 39 restricted an entity from defining a component of non-financial item as a hedged risk. For example, an entity could not hedge the maize component of a cereal product.

IFRS 9 permits the identification of a component as a hedged risk provided certain measurement and effectiveness criteria are satisfied. This leaves the door open for entities to apply hedge accounting techniques to economic hedges which did not satisfy the rules of IAS 39.

The effective date

IFRS 9 should be completed, except for macro hedging, by June this year. December 2018 year-ends will be the first preparers, required to apply IFRS 9.

The Roadmap to the IFRS Future

Article by:

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A rapidly changing financial reporting landscape

The financial reporting landscape is changing significantly with the International Accounting Standards Board (IASB) having issued several new standards. The key standards that became effective during periods beginning 1 January 2013 are iFRS 10 Consolidated Financial Statements; iFRS 11 Joint Arrangements; iFRS 12 Disclosure of Interests in Other Entities; IFRS 13 Fair Value Measurement and iAS 19 (2011) Employee Benefits.

With each new standard comes new considerations and reporting requirements. The standards affect, among others, systems, processes, estimates, management judgment, key financial metrics and income taxes. Therefore, implementation of a standard may require a well considered plan.

Why The Roadmap?

In response to the adoption of the above mentioned standards, Deloitte has released the second edition of 'The Roadmap to IFRS Future' publication (The Roadmap).

The Roadmap has been designed to jumpstart the adoption of the new and revised standards, and to be a guide through the implementation process. It gives entities an interactive and step by step guide to the implementation of each of the new standards. Each of these standards is reflected by a separate route on The Roadmap, which represent the steps to follow in the implementation process.

The Roadmap also contains useful tools that entities may consider using at the various stages of implementation of each of the standard adopted. These include impact analysis spreadsheets, illustrative financial statements and useful templates.

This second edition of The Roadmap supersedes the first edition and updates the guidance, tools and content for the standards covered in the first edition. These updates include the latest industry thinking and disclosures.

Accessing The Roadmap

Standard version

Click here to download the standard PDF version of The Roadmap.

Version for iPads and Apple devices

An iPad or Apple compatible version can be downloaded from the link below: http://deloitteblog.co.za/files/AA_Roadmap/Roadmap.ibooks

Please note that iBooks is required to view The Roadmap on an iPad or Apple device and can be downloaded from the App Store or via the link below: http://itunes.apple.com/us/app/ibooks/id364709193?mt=8

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