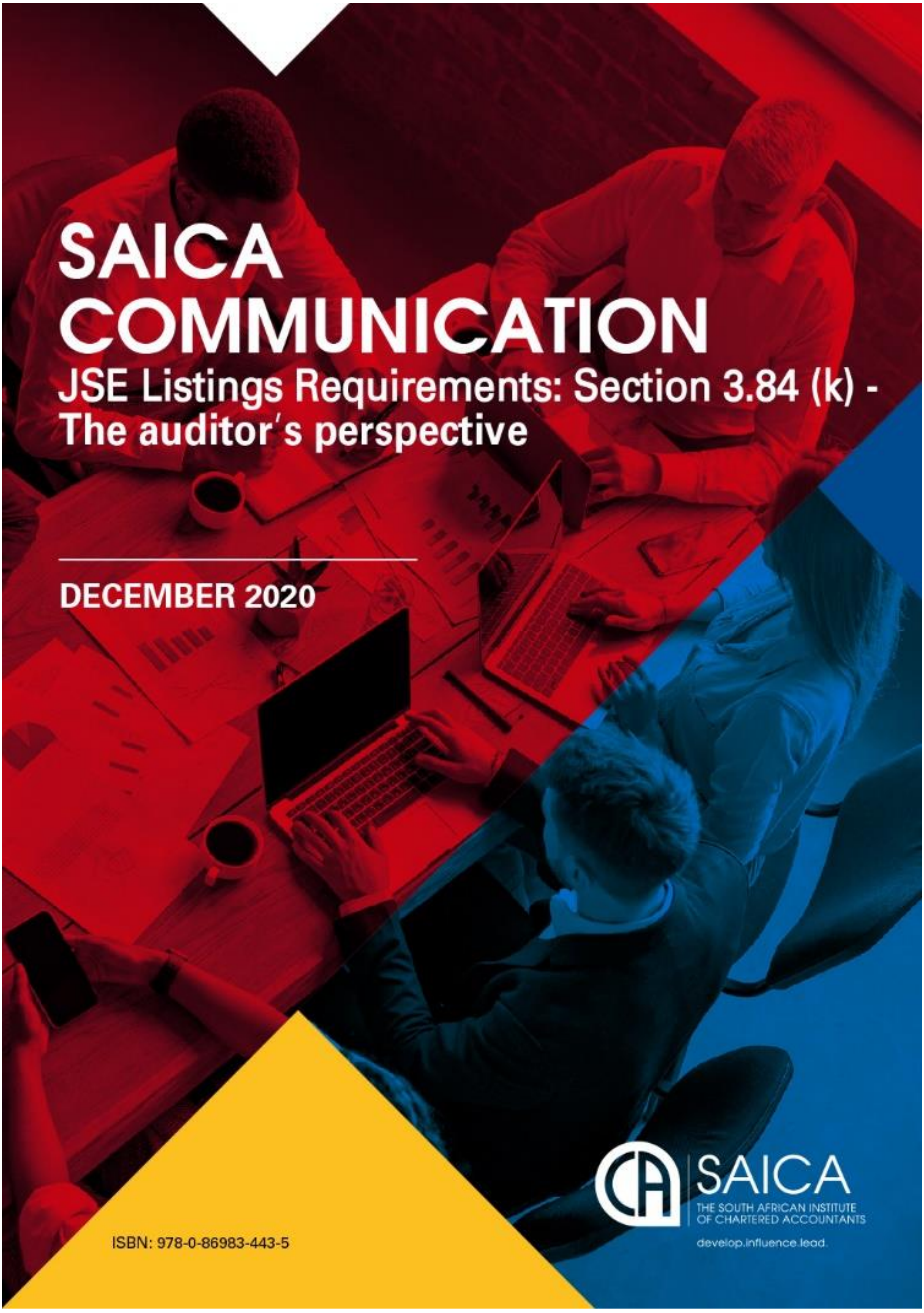

SAICA COMMUNICATION

JSE Listings Requirements: Section 3.84 (k) - The auditor's perspective

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1. INTRODUCTION – JSE LISTINGS REQUIREMENT 3.84 (K)

In November 2019, the Johannesburg Stock Exchange (JSE) amended certain of its Listings Requirements. One of the JSE Listings Requirements (Listings Requirements) amended was Listings Requirement 3.84 relating to Corporate Governance. A new paragraph (k) was added to the Listings Requirements that reads as follows:

> **In addition to complying with paragraph 8.63(a), issuers must implement the following specific corporate governance practices and must disclose compliance therewith in their annual reports. (The effect of incorporating certain practices from the King Code in the Listings Requirements is to make their implementation mandatory, this is notwithstanding the fact that application of the corporate governance practices in the King Code is generally voluntary):**
>
> **…**
>
> **(k) The CEO and the financial director responsibility statement must be made by them after due, careful and proper consideration of same as follows:**
>
> ***(i) "The directors, whose names are stated below, hereby confirm that -***
>
> ***(a) the annual financial statements set out on pages […] to […], fairly present in all material respects the financial position, financial performance and cash flows of the issuer in terms of IFRS;***
>
> ***(b) no facts have been omitted or untrue statements made that would make the annual financial statements false or misleading;***
>
> ***(c) internal financial controls have been put in place to ensure that material information relating to the issuer and its consolidated subsidiaries have been provided to effectively prepare the financial statements of the issuer; and***
>
> ***(d) the internal financial controls are adequate and effective and can be relied upon in compiling the annual financial statements, having fulfilled our role and function within the combined assurance model pursuant to principle 15 of the King Code. Where we are not satisfied, we have disclosed to the audit committee and the auditors the deficiencies in design and operational effectiveness of the internal financial controls and any fraud that involves directors, and have taken the necessary remedial action.***
>
> ***Signed by the CEO and the financial director"***

The amendments to the Listings Requirements are available here.

The Chief Executive Officer (CEO) and the financial director (FD) of an entity listed on the JSE are therefore required to make a positive statement attesting that the annual financial statements fairly present the state of affairs of the company and/or group, that internal financial controls are adequate and effective and that where deficiencies and any fraud involving directors have been identified, these have been disclosed to the Audit Committee and the auditor and the necessary remedial action has been taken (the Statement). This amendment impacts both those responsible for the preparation of the annual financial statements (the preparer) and the independent external auditor of the entity responsible for the statutory audit engagement (auditor).

SAICA's Corporate Reporting Division issued a Discussion Guide in respect of the CEO / CFO attest function in terms of JSE Listings Requirement 3.84(k) of Item 14 of the amendments in August 2020. The objective of the Discussion Guide is to provide CEOs and FDs with principles-based guidance on how they can attest that the internal financial controls are adequate and effective and can be relied upon in compiling the annual financial statements.

An auditor may wish to refer to the Discussion Guide, which is guidance for the preparers of the annual financial statements, when considering the auditor's responsibility regarding the Statement made by the CEO and FD. The Discussion Guide does not provide a framework for internal controls and is also non-authoritative. The Discussion Guide is available here.

The JSE have also issued a *Guidance Letter: Directors' Responsibility on Financial Controls* providing further clarity on the CEO's and FD's responsibilities on financial controls. The Guidance Letter is available here.

From the auditor's point of view, the amendments to the Listings Requirements do not include a requirement for the auditor to express an audit opinion or provide any form of assurance on the Statement. The auditor will therefore consider the impact of the amendments to the Listings Requirements on the role and responsibilities of the auditor in the context of the statutory audit engagement on the financial statements. This communication aims to address the question around how the new requirements impact the roles and responsibilities of the auditor in this context.

2. THE AUDITOR'S RESPONSIBILITY

The auditor cannot represent compliance with the International Standards on Auditing (ISAs) in the auditor's report unless the auditor has complied with the requirements of all ISAs relevant to the audit[1]. In the absence of a requirement for the Statement to be audited, the auditor should consider the responsibilities contained in the ISAs in relation to the Statement that arise as part of the statutory audit engagement on the financial statements.

The ISAs contain specific responsibilities as it relates to laws and regulations and internal financial controls, as follows:

- **The auditor has a responsibility in terms of ISA 250, (Revised), *Considerations of Laws and Regulations in an Audit of Financial Statements* (ISA 250 (Revised) to consider laws and regulations in an audit of financial statements.**
- **Paragraph 13 of ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment* (ISA 315 (Revised)) requires the auditor to evaluate the design of controls that are relevant to the audit and determine whether they have been implemented.**

[1] ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing,* paragraph 20

ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information* (ISA 720 (Revised)) defines other information as financial or non-financial information (other than financial statements and the auditor's report thereon) included in an entity's annual report. The Listings Requirements require preparers to disclose their compliance with specific corporate governance practices, including those outlined in the Statement in the entity's annual report.

The Statement therefore constitutes other information as defined in ISA 720 (Revised) as it is required to be included in the annual report of the entity. As such, the auditor must comply with the requirements of ISA 720 (Revised) with respect to the Statement.

As required by Listings Requirement 3.84 (g)(ii) as well as section 94 (7)(f)(iii) of the Companies Act, 2008, the Audit Committee report also contains disclosures around internal financial controls and this report is also considered to be other information as defined in ISA 720 (Revised). The Audit Committee's evaluation of the internal financial controls and the communication of their assessment of such controls in their report, would be expected to take the Statement into account.

Paragraph 11 of ISA 720 (Revised) indicates that the objectives of the auditor, having read the other information, are:

> **a. To consider whether there is a material inconsistency between the other information and the financial statements;**
> **b. To consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit;**
> **c. To respond appropriately when the auditor identifies that such material inconsistencies appear to exist, or when the auditor otherwise becomes aware that other information appears to be materially misstated; and**
> **d. To report in accordance with this ISA.**

The auditor's opinion on the financial statements does not cover the other information, nor does ISA 720 (Revised) require the auditor to obtain audit evidence beyond that required to form an opinion on the financial statements[2]. However, as with any other amendment to laws or regulations that have an impact on the financial statements, the introduction of the requirement for this Statement would require the auditor to consider specific enquiries how management have responded to the amendment, as required by paragraph 13 of ISA 250 (Revised). The auditor should also consider the elements of the audit undertaken to express an opinion on the fair presentation of the financial statements when reading and considering the other information. This may include the following:

- **The auditor's understanding of the entity's internal controls relevant to the audit, as obtained through tests of design and implementation, including relevant controls around management's process to adhere to laws and regulations that impact the financial statements, specifically the Listings Requirements;**
- **The auditor's understanding of how the entity is complying with legal and regulatory frameworks, including the Listings Requirements;**
- **Review of management reports issued by the internal auditors and other assurance providers and the response by management to the deficiencies identified;**
- **Observing discussions held in the Audit Committee or other board committees with regard to the Statement, specifically the communication and discussion of deficiencies and the remediation plans presented by the CEO and FD;**
- **Results of walkthroughs performed;**
- **Results of tests of controls performed; and**
- **Results of substantive procedures performed, including misstatements identified, both corrected and uncorrected misstatements and control deficiencies identified and reported to management. It is important to note that even though the results of substantive procedures performed, including misstatements identified, may be a factor to consider when assessing whether there is a material**

[2] ISA 720 (Revised), paragraph 2

inconsistency in the other information or whether the other information is otherwise materially misstated, the effectiveness of a control cannot be inferred by the absence of misstatements detected through substantive procedures[3].

2.1 MATERIAL INCONSISTENCY

The auditor is required to exercise professional judgement in determining whether there is a material inconsistency in other information.

With respect to Listings Requirements 3.84 (k)(a) and (k)(b), the auditor would need to consider the impact on the Statement when the auditor issues a modified audit opinion.

In addressing the requirements of ISA 720 (Revised) in the context of Listings Requirements 3.84 (k)(c) and (k)(d), facts and circumstances that may indicate that there is a material inconsistency in other information include:

- **The CEO and FD make the Statement and the auditor identifies a material inconsistency in the Statement made, based on the knowledge of the client obtained during the audit. Such material inconsistency may emanate from one of the scenarios outlined below and should be considered in conjunction with how management have responded to the matter/(s):**
    - **The entity does not have a formal process in place that covers all material subsidiaries to ensure that the necessarily evidence is obtained to support the Statement made;**
    - **Management have not performed risk assessment procedures on internal financial controls across the group that are necessary to determine the controls that are required;**
    - **There is evidence that either the risk assessment process or the testing process undertaken by management is not complete and/or sufficient (i.e. it is flawed) to allow the CEO and FD to conclude on either;**
    - **The auditor identified significant control deficiencies in either the design or operation of the internal financial controls that were not identified by management;**
    - **Significant control deficiencies are identified by other assurance providers as part of the combined assurance approach adopted;**
    - **Fraud is identified;**
    - **The preparer does not report identified deficiencies that the auditor is aware of to the Audit Committee and/(or) the auditors;**
    - **The preparer reports identified deficiencies to the Audit Committee and/or the auditors, but does not remediate them; or the auditor believes that the remediation plan is either inappropriate or inherently may be ineffective. It should be noted that depending on the timing in terms of the identification of the deficiency and the implementation of the related control, the remediation may not have been effected as yet but it is reasonable for the auditor to expect that a remediation plan is prepared and presented to the Audit Committee and the auditors;**
    - **Misstatements identified by the auditor during the audit;**
    - **Non-compliance with laws and regulations that impact the financial statements;**
- **The Audit Committee report provides a contradictory or misleading view of the internal financial controls compared to that reported on by the CEO and FD, or the auditor's knowledge obtained in the audit;**
- **Significant deficiencies in the internal financial controls are identified and the Audit Committee makes a statement that there are no material breakdowns in controls and do not indicate that there were deficiencies for which a remediation plan has been established.**

Based on the procedures performed during the audit, the auditor should consider whether the information contained in the Statement is materially inconsistent with the financial statements or the auditor's knowledge obtained in the audit, or otherwise appears to be materially misstated. The concept of a material inconsistency in this case is therefore whether the auditor has obtained evidence that contradicts

[3] ISA 330, paragraph 16

the Statement through procedures performed in carrying out the statutory audit engagement on the financial statements.

Unless the auditor has obtained evidence during the statutory audit that infers that the system of internal financial controls is inadequate or ineffective and that appropriate communication has not taken place and/(or) a remediation plan has not been established, the auditor is unlikely to conclude that the Statement is materially inconsistent with the financial statements or the knowledge obtained during the audit, or otherwise appears to be materially misstated. In the context of the statutory audit engagement and with reference to the Statement, the auditor is likely to consider whether the audit procedures performed during the audit provide actual evidence of a material inconsistency or material misstatement in the Statement made.

Since the Statement requires the CEO and FD to make a positive statement confirming that, among other things, the internal financial controls are adequate and effective, it is important for the auditor to be alert to instances where the internal financial controls may not be considered adequate and effective and to understand what a deficiency in internal control is and when this is considered to be a significant deficiency as this may have a direct impact on the auditor's assessment of whether there is a material inconsistency in other information.

A deficiency in internal control exists when:

a) **A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or**
b) **A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing[4].**

In equating the above definition to the attestation made by the CEO and FD in the Statement, an internal control will be inadequate and/or ineffective if it fails to prevent, or detect and correct misstatements in the financial statements on a timely basis; or where such a control is missing.

A deficiency is considered to be significant when, in the auditor's professional judgement, it is of sufficient importance to merit the attention of those charged with governance[5]. From a practical point of view, a deficiency in internal financial controls is likely to be significant when this has resulted or may result in a material misstatement of the financial statements.

Factors that affect the magnitude of the potential misstatement that may result from a deficiency or deficiencies in controls include, but are not limited to:

- The financial statement amounts, or the total of transactions exposed to the deficiency.
- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

The consideration of the potential misstatement that could arise as a result of a deficiency in the internal financial controls is considered in relation to the annual financial statements being reported on. The auditor is not expected to perform an internal financial control assessment in relation to the potential future impact beyond this.

[4] Glossary of Terms to the International Standards issued by the IAASB.
[5] Glossary of Terms to the International Standards issued by the IAASB.

The ISAs do not contain any specific requirements indicating when deficiencies in internal financial controls result in a failure such that the design and/or implementation are either inadequate and/or ineffective. Rather, this is left to the professional judgement of the auditor. Paragraph A6 of ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* (ISA 265), contains examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal controls constitutes a significant deficiency while paragraph A7 contains indicators of significant deficiencies in internal control.

Other factors that the auditor could consider in applying professional judgement in concluding on whether a deficiency or combination of deficiencies in internal controls is significant include (not an exhaustive list):

- **Did the deficiency in the internal control result in a material misstatement, whether corrected or uncorrected? It is important to highlight that ISA 330, *The Auditor's Responses to Assessed Risks* (ISA 330), requires the auditor to evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively[6].**
- **Did the deficiency in the internal control result in a series of immaterial misstatements that may be indicative of a failure in internal financial controls?**
- **Did the deficiency in the internal control result in a material misstatement in disclosures?**
- **Did the deficiency in the internal control result in a financial loss to the company as a result of fraud?**
- **Did the deficiency give rise to any non-compliance with laws and regulations and any related reporting obligation for professional accountants employed by the client or the auditor?**
- **Were any deficiencies in the internal controls identified as part of the auditor's responsibility to obtain an understanding of the internal controls relevant to a significant risk?**
- **Were any deficiencies in the internal controls identified as part of the auditor's responsibility to obtain an understanding of the internal controls relevant to fraud risks, including management override and the internal controls relating to the processing of journal entries?**
- **Were any deficiencies in the internal controls identified as part of the auditor obtaining an understanding of related parties and related party transactions?**
- **Were any deficiencies in the internal controls identified as part of the auditor obtaining an understanding of account balances, classes of transactions or disclosures that involve significant judgement or estimate in applying the entities accounting policies?**
- **Other factors to consider include:**

    - **Deficiencies identified in the general internal control environment, including general IT controls and application controls;**
    - **Deficiencies identified in either the design, implementation or operating effectiveness of internal controls that are evaluated;**
    - **Deficiencies that existed in previous years, either identified by management, external or internal auditors, which management have not remediated**
    - **Recurring misstatements, as a result of incorrect application of the reporting framework, or inappropriate basis used inmaking accounting estimates;**
    - **Restatements required by the JSE based on the JSE Proactive Monitoring processes;**
    - **Inability of management and/or those charged with governance to obtain control reliance on key classes of transactions, account balances or disclosures;**
    - **Deficiencies identified by other relevant parties, such as Internal Audit and other service organisations;**
    - **Successful cyber-attacks or other similar IT security breaches that impact financial reporting.**

It is generally accepted that deficiencies in internal financial controls do arise. During management's process of designing and implementing internal financial controls and subsequent testing that such controls are adequate and effective, deficiencies in the internal financial controls may be identified,

[6] ISA 330, paragraph 16

particularly in the initial stages of the process. A deficiency in the internal financial controls is not, in itself an indication of a material inconsistency. It is important for the auditor to evaluate the response of the preparer to deficiencies identified when considering whether a material inconsistency exists.

If the auditor identifies a material inconsistency among the reports and statements that constitute other information, for example between the Statement and the Audit Committee report, it is possible there may be material inconsistency between the other information and either the financial statements and/or the auditor's knowledge obtained during the audit, or the other information is materially misstated. In that circumstance, the auditor is tasked with identifying the part of the other information that is misrepresentative of the facts and follow the guidance provided below in evaluating the auditor's response to the material inconsistency.

2.2 AUDITOR'S RESPONSE

If the auditor identifies that a material inconsistency appears to exist, the auditor is required to respond as follows:

The auditor is required to discuss the matter with management, and if considered necessary perform other procedures to conclude whether a material misstatement exists in either the other information or the financial statements; or whether the auditors understanding of the entity and its environment needs to be updated[7].

ISA 720 (Revised) provides guidance on how to determine whether a material misstatement exists in other information.

When a particular matter is disclosed in the other information, the other information may omit or obscure information that is necessary for a proper understanding of that matter.[8] When the auditor concludes that there is a material misstatement in the other information, the auditor should request that management correct the other information[9]. If management refuses to make the correction, the auditor is then required to communicate the matter to those charged with governance and request that the correction be made[10]. If, after taking the above steps, the auditor still concludes that a material misstatement exists in other information obtained prior to the date of the auditor's report, the auditor must consider taking appropriate action, including considering the implications for the auditor's report[11].

2.3 REPORTING

2.3.1 AUDITOR'S RESPONSIBILITIES AND IMPACT ON THE AUDITOR'S OPINION

The scope of ISA 720 (Revised) deals with the auditor's responsibility relating to other information and includes the auditor's reporting responsibilities relating to other information.

[7] ISA 720 (Revised), paragraph 16
[8] ISA 720 (Revised), paragraph A6 (extract)
[9] ISA 720 (Revised), paragraph 17
[10] ISA 720 (Revised), paragraph 17 (b)
[11] ISA 720 (Revised), paragraph 18

As outlined above, the auditor is required to determine whether the identified material inconsistency exists in either the other information or the financial statements[12]. The auditor will only consider a modification to the auditor's opinion as outlined in ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report,* if there is a material misstatement of the financial statements.

> When there is a material misstatement in the other information, the auditor is required to include a statement that describes the uncorrected material misstatement of the other information under the other information section of the auditor's report[13].

It is important to note that the auditor's statement in the other information section that indicates that deficiencies in the internal financial controls were noted during the performance of the audit does not necessarily result in financial statements that do not fairly present the state of the company's and/or group's affairs. One must remember that the auditor has the option to follow either a combined audit approach, where tests of controls and substantive testing is performed, or to follow a fully substantive audit approach. To the extent that there are deficiencies in the internal controls relevant to the audit but the auditor is able to still obtain sufficient appropriate audit evidence to support the auditor's opinion on whether the financial statements fairly present the state of affairs, the auditor's opinion will be unmodified.

2.3.2 KEY AUDIT MATTERS

With reference to whether material inconsistencies identified in other information may result in the auditor communicating a key audit matter (KAM) in the auditor's report, one needs to consider the definition of a KAM as contained in ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report* (ISA 701).

> KAMs are defined as those matters, that in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period.

A KAM cannot originate from other information, as this is not the subject matter that the auditor is expressing the opinion on and will therefore not be a matter that is, in the auditor's professional judgement, most significant in the audit of the financial statements. The auditor may, however, communicate a KAM relating to deficiencies in internal controls identified as part of the audit engagement that meets the requirements contained in ISA 701 to be included in the auditor's report. In this scenario the auditor would also need to consider whether there is material inconsistency in other information if the items reported in the KAM are not identified and responded to by the Audit Committee in the Audit Committee report.

2.3.3 NON-COMPLIANCE IDENTIFIED

The JSE Listings Requirements are clear in requiring the Statement to be included in the Annual Report and are prescriptive in terms of the wording to be used by the CEO and FD in making the Statement. Although the JSE Listings Requirements are prescriptive in terms of the wording to be used, the auditor should be cognisant that the CEO and FD still have an obligation to ensure that the Statement made does not omit or obscure information that is necessary for the proper understanding of the matter.

If the Statement is not included in the Annual Report and/or the CEO and FD do not use the prescribed wording made, this constitutes non-compliance with the Listings Requirements and the auditor would need to consider the responsibilities of the audit firm as contained in paragraph 22.16 of the Listings Requirements with respect to monitoring compliance with the disclosure requirements as set out in, among others, section 8 of the JSE Listings Requirements as they relate to annual reports where an

[12] ISA 720 (Revised), paragraph 16
[13] ISA 720 (Revised), paragraph 22(e)(ii)

auditor's report has been issued on such financial report, as well as any obligations in terms of paragraph 8.64 to report matters of non-compliance directly to the JSE.

The auditor is also reminded of the professional obligations contained in section 360 of the *IRBA Code of Professional Conduct for Registered Auditors (Revised November 2018)* (the IRBA Code) relating to non-compliance with laws and regulations (NOCLAR), as well as section 45 of the *Auditing Profession Act, 26 of 2005*, relating to the reporting of Reportable Irregularities to the IRBA.

ISA 720 (Revised) does not require the auditor to report non-compliance with the Listings Requirements in the other information section of the auditor's report. In considering the other information, the auditor is required to comply with the requirements of ISA 720 (Revised) in ensuring that the information contained in the Statement is not materially inconsistent with the financial statements or the auditor's knowledge obtained in the audit or does not otherwise appear to be materially misstated. The auditor is alerted to the fact that the outcome of the auditor's consideration of the professional obligations may result in modifications to other sections of the auditor's report.

To the extent that this non-compliance gives rise to either a non-compliance that is reported to the JSE in accordance with paragraph 8.64 or paragraph 22.16 or to a Reportable Irregularity, the auditor would report this fact in the section of the auditor's report titled *Report on Other Legal and Regulatory Requirements*[14].

3. JSE LISTINGS REQUIREMENT 3.84 (K)(C)

JSE Listings Requirement 3.84(k)(c) of the Statement relates specifically to a situation involving a Group. This is seen as an extension of JSE Listings Requirement 3.84(k)(d) down to each subsidiary that is included in the consolidated financial statements. The CEO and FD may experience challenges in confirming this part of the Statement for the following reasons:

- **The subsidiaries have not implemented internal financial controls to ensure that material information has been provided to effectively prepare the financial statements; or**
- **The subsidiaries have implemented internal financial controls, but these are not adequate and/or effective in ensuring that material information has been provided to effectively prepare the financial statements.**

The overarching principle relating to the implementation of adequate and effective internal financial controls is contained in JSE Listings Requirement 3.84(k)(d), with 3.84(k)(c) bringing in the components of the Group that the CEO and FD need to consider in making the Statement. The information contained in this communication is therefore equally applicable in the auditor's consideration relating to JSE Listings Requirement 3.84(k)(c) but expanded to include the internal financial controls implemented at subsidiaries that form part of the Group.

[14] ISA 700 (Revised), paragraph 43


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