COMPLIANCE WITH SECTION 286(3) AND PARAGRAPH 5 OF SCHEDULE 4 TO THE COMPANIES ACT, 61 OF 1973 AND STATEMENTS OF GENERALLY ACCEPTED ACCOUNTING PRACTICE

Introduction

The objective of this circular is to assist directors of companies to meet their obligations in respect of financial reporting in terms of Section 286(3) and Paragraph 5 of Schedule 4 of the Companies Act and Statements of Generally Accepted Accounting Practice (GAAP). This circular is also intended to provide guidance to auditors concerning their audit responsibility in this regard. The information in this circular is based on the requirements of Statement of GAAP AC101 (Revised) on Presentation of Financial Statements and on senior counsel’s opinion as explained in paragraph .05 below.

Legislation

In terms of Section 286(3) of the Companies Act “the annual financial statements of a company shall, in conformity with generally accepted accounting practice, fairly present the state of affairs of the company and its business as at the end of the financial year concerned and the profit or loss of the company for that financial year and shall for that purpose be in accordance with and include at least the matters prescribed by Schedule 4, in so far as they are applicable, and comply with any other requirements of this Act”.

In October 1992, Schedule 4 of the Companies Act was amended. Amongst other changes, Paragraph 5 was introduced into Schedule 4. This paragraph reads as follows:

“If it appears to the directors of a company that there are reasons for departing from any of the accounting concepts stated in Statements of Generally Accepted Accounting Practice approved by the Accounting Practices Board, where such appropriate Statements exist, in preparing the company’s financial statements in respect of any accounting period they may do so, but particulars of the departure, the effects and the reasons for it shall be given”. 
Legal opinion

In 1977 and again in 1987 the Accounting Practices Board (APB) took senior counsel’s opinion on the meaning of “generally accepted accounting practice” (gaap) as referred to in S286(3). The opinion of senior counsel was that while compliance with a Statement of Generally Accepted Accounting Practice (GAAP) issued by the Accounting Practices Board (APB) meets the requirements of the Companies Act to conform with generally accepted accounting practice, noncompliance may constitute a contravention of the Act, but would not necessarily do so.

In September 1999 a further legal opinion was obtained by the South African Institute of Chartered Accountants (SAICA) from WH Trengove SC and T Plewman on the interpretation of Paragraph 5 of Schedule 4. Their conclusion was as follows:

“On the evidence available to us, paragraph 5 of Schedule 4 requires disclosure whenever the financial statements of a company depart from any of the Accounting Practices Board (APB) Statements”.

According to the opinion, in order for directors to meet the requirements of the Companies Act the financial statements should be prepared and presented in accordance with gaap. However, if they materially depart from Statements of GAAP, the financial statements should provide disclosure of the departure, the particulars thereof, the reasons therefore and the effect of such departure on the financial statements.

Primary basis of accounting

In South Africa, at present, there are therefore two financial reporting frameworks, the one based on generally accepted accounting practice (gaap) and the other based on Statements of Generally Accepted Accounting Practice (GAAP). This situation arises because of the wording of S286(3) of the Companies Act as explained in paragraphs .02 and .04 above. The essential differences between these two bases of accounting are:

- Statements of GAAP are those accounting standards and practices which have been codified by the responsible standard setting body
in South Africa, namely the Accounting Practices Board. These
accounting standards are based on internationally accepted
standards, and compliance therewith would therefore ensure fair
presentation in the financial statements and compliance with
S286(3), and
• generally accepted accounting practice includes those accounting
practices which are uncodified, but are regarded as being generally
accepted due to their being followed by a number of companies.
These practices may or may not comply with Statements of
GAAP, but would be the minimum required to meet the
requirements of S286(3), provided fair presentation is achieved.

Director’s responsibility
The directors of a company should select one of the above as its
primary basis of accounting and should disclose this primary basis of
accounting in its financial statements. This is essential in order to
enable a user of the financial statements to correctly interpret the
financial statements.

Although a company can meet the requirements of S286(3) by
complying with gaap, in the interest of good financial reporting
companies are strongly encouraged to comply with Statements of
GAAP.

When the directors elect to prepare the financial statements in
accordance with gaap and there is a departure from one or more
Statements of GAAP, they are required in terms of Paragraph 5 of
Schedule 4 to disclose the particulars of, the reasons for and the effect
of the departure in the financial statements. It should be noted that the
requirement to disclose the effect of the departure will only be met
where the financial statements provide sufficient quantitative
disclosures that would enable a reader of the financial statements to
compare the situation to that which would have prevailed had the
Statements of GAAP been complied with.

If a company’s financial statements purport to be prepared in
accordance with Statements of GAAP, it is a requirement that they
should comply in all material respects with all Statements of GAAP. In
this respect AC101 is particularly pertinent and directors of companies
should ensure that they have followed the requirements of this standard.

.12 Paragraph .12 of AC101 states: “An enterprise whose financial statements comply with Statements of Generally Accepted Accounting Practice should disclose that fact. Financial statements should not be described as complying with Statements of Generally Accepted Accounting Practice unless they comply with all the requirements of each applicable Statement and each applicable approved interpretation”.

.13 AC 101 does, however, acknowledge in paragraph 14 that in extremely rare circumstances management may conclude that compliance with a requirement in a Statement of GAAP would be misleading, and therefore that departure from that requirement is necessary to achieve fair presentation. In such cases the enterprise should disclose:

a) that management has concluded that the financial statements fairly present the enterprise’s financial position, financial performance and cash flows,

b) that it has complied in all material respects with applicable Statements of Generally Accepted Accounting Practice except that it has departed from a Statement in order to achieve a fair presentation,

c) the Statement from which the enterprise has departed, the nature of the departure, including the treatment that the Statement would require, the reason why that treatment would be misleading in the circumstances and the treatment adopted, and

d) the financial impact of the departure on the enterprise’s net profit or loss, assets, liabilities, equity and cash flows for each period presented.

.14 It should be noted that this ‘fair presentation’ override can only be applied in extremely rare circumstances where compliance with a Statement of GAAP would be misleading, resulting in fair presentation not being achieved in the financial statements. It is therefore expected that this override will rarely, if ever, be applied in practice. At the time of writing this circular, such a circumstance could not be identified.
Auditor’s responsibility

In terms of S301 of the Companies Act the auditor is required to report on whether or not the financial statements fairly present the financial position and results of operations in the manner required by the Act. In order to fulfil this requirement the auditor will have to ensure that the financial statements have been prepared in accordance with S286(3) and Schedule 4 of the Act. Therefore the auditor will have to satisfy himself that the financial statements have been prepared in full compliance with Statements of GAAP or where there is a departure from a Statement of GAAP, that the departure, its particulars, the reasons therefor and its effect on the financial statements have been disclosed in the financial statements. Where such disclosure is not provided the auditor will have to modify his opinion appropriately.

In accordance with Section 286(3) the auditor is required to satisfy himself that fair presentation is achieved in the financial statements in all material respects in accordance with GAAP. Therefore, in all circumstances this should be the auditor’s overriding consideration in determining the appropriate audit opinion.

In forming his opinion the auditor is required to consider the disclosed primary basis of accounting and the appropriateness thereof. Where the company discloses its primary basis of accounting as being Statements of GAAP, then the auditor is required to satisfy himself that all the requirements of AC101 have been met. Where the requirements of AC101 have not been met, the auditor will have to modify his opinion appropriately.

This circular does not repeat the general principles of audit reporting codified in the Statements of South African Auditing Standards (SAAS) and the auditor should make reference in this regard particularly to SAAS 700. However, the following circumstances could arise particularly in relation to the question of compliance with Statements of GAAP and Section 286(3) and Paragraph 5 of Schedule 4 to the Companies Act.

Where Statements of GAAP is the disclosed primary basis of accounting
In all of the three scenarios below, the audit report should refer to either Statements of GAAP or generally accepted accounting practice, whichever is considered by the auditor to be most appropriate in the circumstances. In appropriate circumstances, auditors are, however, encouraged to refer to Statements of GAAP in their audit reports.

**Scenario 1** - **Full compliance with Statements of GAAP**

Where the financial statements have been prepared in accordance with Statements of GAAP, and the auditor is satisfied that fair presentation is achieved the auditor’s opinion should be unqualified.

**Scenario 2** – **Non-compliance with a Statement of GAAP on the basis of the “fair presentation override” contained in AC 101.**

Where Statements of GAAP are the disclosed primary basis of accounting but there is a departure from a Statement on the basis of the fair presentation override contained in AC101, the auditor should consider whether or not the use of the “fair presentation override” is appropriate in the circumstances. In making this determination, the auditor must bear in mind the strict requirements of AC101 and particularly paragraph .16 of that Statement which states “In virtually all circumstances a fair presentation is achieved by compliance in all material respects with applicable Statements of Generally Accepted Accounting Practice”.

Where the auditor concludes that the use of the fair presentation override is not justified in the circumstances, then the auditor should issue a modified opinion.

In these instances, the audit opinion should be modified on an “except for” or “adverse” basis. If the departures from Statements of GAAP are adequately disclosed in the financial statements then the audit report need not disclose the departures. Where, however, the departures are not adequately disclosed in the financial statements, then the departures should be disclosed in the audit report, unless this is impracticable, in which case that fact should be stated.

Where the auditor concludes that the use of the fair presentation override is justified in the circumstances, then the auditor should issue an unqualified opinion provided that the disclosures required by AC 101
and Paragraph 5 of Schedule 4 have been adequately disclosed in the financial statements.

Where the auditor concludes that the use of the fair presentation override is justified in the circumstances but the required disclosures have not been adequately provided in the financial statements, then the audit opinion should be modified on an “except for” basis. In these instances the departures from Statements of GAAP should be disclosed in the audit report, unless this is impracticable, in which case that fact should be stated.

**Scenario 3 - Where the auditor disagrees with the disclosed primary basis of accounting.**

Where the primary basis of accounting is disclosed as being Statements of GAAP, and the auditor disagrees with this on the basis that the financial statements have not been drawn up in all material respects in accordance with Statements of GAAP, then the auditor should issue a modified opinion.

In these instances, the audit report should be modified on an “except for” or “adverse” basis, and the audit report should disclose the departures from Statements of GAAP, unless this is impracticable, in which case that fact should be stated.

**Where generally accepted accounting practice is the disclosed primary basis of accounting**

Where the financial statements have not been prepared in accordance with Statements of GAAP there are a number of different scenarios which might arise. As noted above, the auditor must apply his mind to whether or not the financial statements still achieve fair presentation in accordance with gaap.

**Scenario 4 - Fair presentation in accordance with gaap and disclosure of non-compliance with Statements of GAAP provided.**

In circumstances where the auditor concludes that fair presentation is achieved in the financial statements, and that the financial statements provide the disclosure as required by Paragraph 5 of Schedule 4 then the auditor should issue a modified report.
In these instances the auditor should modify his audit report by including an emphasis of matter paragraph drawing attention to the non-compliance with Statements of GAAP and the disclosure thereof in the financial statements.

This emphasis of matter paragraph is considered essential as it would alert a user of the financial statements to the fact that the financial statements have not been prepared in accordance with Statements of GAAP. A user might otherwise be unaware of this fact without a detailed reading or knowledge of the financial statements.

Scenario 5 -  Fair presentation in accordance with gaap, however, no disclosure of non-compliance with Statements of GAAP provided.

In circumstances where the auditor concludes that fair presentation is achieved in the financial statements in accordance with gaap, but the financial statements do not provide the disclosure as required by paragraph 5 of Schedule 4, then the auditor should issue a modified opinion.

In these instances the audit opinion should be modified on an ‘except for’ basis and the departures from Statements of GAAP should be disclosed in the audit report, unless this is impracticable, in which case that fact should be stated.

Scenario 6 -  Fair presentation in accordance with gaap is not achieved but disclosure of non-compliance with Statements of GAAP provided.

In circumstances where the auditor concludes that fair presentation is not achieved in the financial statements in accordance with gaap, but the financial statements provide the disclosure as required by Paragraph 5 of Schedule 4, then the auditor should issue a modified opinion.

In these instances, the audit opinion should be modified as either an ‘except for’ or ‘adverse’ opinion.
Scenario 7 - Fair presentation in accordance with GAAP is not achieved and disclosure of non-compliance with Statements of GAAP is not provided.

In circumstances where the auditor concludes that fair presentation is not achieved in the financial statements in accordance with GAAP and that the financial statements do not provide the disclosure as required by Paragraph 5 of Schedule 4, then the auditor should issue a modified opinion.

In these instances the audit opinion should be modified as an ‘except for’ or ‘adverse’ opinion and the departures from Statements of GAAP should be disclosed in the audit report, unless this is impracticable, in which case that fact should be stated.

In all of the above scenarios where the auditor is required to modify the audit opinion, it is suggested that the wording in the audit report should make specific reference to the Statement(s) of GAAP that were not complied with.

Appendix I to this circular sets out a decision tree to assist auditors in deciding on the appropriate audit opinion in the various circumstances outlined.

Appendix II to this circular provides illustrative auditor’s reports to cover the situations outlined in Scenarios 1 and 4. Illustrative auditor’s reports covering the other scenarios will in due course be provided in the appendix to SAAS 700.

Conclusion

Preparers and auditors of financial statements should follow the requirements and guidance set out in this circular in order to meet their obligations in terms of Section 286(3) and Paragraph 5 of Schedule 4 to the Companies Act. In considering Statements of GAAP and whether or not there have been departures therefrom, all elements of the Statements should be considered, namely recognition, measurement, presentation and disclosure requirements.

The requirements of Paragraph 5 of Schedule 4 do not apply to interim reports.
While the requirements of the Companies Act apply only to companies falling within the ambit of the Act, and therefore the above-mentioned principles apply only to those companies, it is recommended in the interest of good financial reporting that these principles should also be applied by other entities when preparing general purpose financial statements.

Johannesburg  
December 1999  

K G Mockler  
Chief Executive

The contents of this circular which pertain to the auditor’s responsibility are issued with the approval of the Public Accountants’ and Auditors’ Board.
Appendix I
FORMING AN OPINION ON THE TYPE OF AUDIT OPINION TO BE ISSUED
This appendix sets out, in the form of a table, guidance to auditors in deciding the type of auditor’s report to be issued. The purpose of this appendix is to illustrate the application of paragraphs .20 to .37 of the circular.

<table>
<thead>
<tr>
<th>What is the disclosed primary basis of accounting</th>
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<tbody>
<tr>
<td>Statements of GAAP</td>
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<tr>
<td>Yes</td>
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<tr>
<td>Have the financial statements been prepared in full compliance with Statements of GAAP</td>
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<tr>
<td>No</td>
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<tr>
<td>Has the fair Presentation override been Applied</td>
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<tr>
<td>No</td>
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<tr>
<td>Does the auditor Concur with the use of the fair presentation override</td>
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<tr>
<td>No</td>
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<tr>
<td>Yes</td>
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<tr>
<td>Has the non-compliance with Statements of GAAP been properly disclosed?</td>
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<tr>
<td>Yes</td>
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<tr>
<td>No</td>
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<tr>
<td>Unqualified audit report</td>
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<tr>
<td>Modified opinion “except for” or “adverse” with disclosure of departures in audit report</td>
</tr>
<tr>
<td>Modified opinion “except for” or “adverse”</td>
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<tr>
<td>Modified opinion “except for” or “adverse” with disclosure of departures in audit report</td>
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<tr>
<td>Unqualified audit report</td>
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<td>Modified opinion “except for” with disclosure of departures in audit report</td>
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<table>
<thead>
<tr>
<th>What is the disclosed primary basis of accounting</th>
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<tr>
<td>Generally accepted accounting practice</td>
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<tr>
<td>Do the financial statements fairly present in accordance with generally accepted accounting practice?</td>
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<tr>
<td>Yes</td>
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<tr>
<td>No</td>
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<tr>
<td>Unqualified audit report</td>
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<tr>
<td>Modified audit report with emphasis of matter paragraph</td>
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<tr>
<td>Modified opinion “except for” with disclosure of departures in audit report</td>
</tr>
<tr>
<td>Modified opinion “adverse” or “except for”</td>
</tr>
</tbody>
</table>

Issued December 1999
Appendix II

EXAMPLES OF AUDITOR’S REPORTS
The examples given in this appendix are for general guidance to illustrate the principles involved. These illustrative reports cover the situations outlined in Scenarios 1 and 4 of the circular.

Where Statements of GAAP is the disclosed primary basis of accounting

Full compliance with Statements of GAAP

REPORT OF THE INDEPENDENT AUDITORS TO THE MEMBERS OF......

We have audited the annual financial statements of .... set out on pages ... to ... for the year ended .... These financial statements are the responsibility of the company’s directors. Our responsibility is to express an opinion on these financial statements based on our audit.

Scope
We conducted our audit in accordance with statements of South African Auditing Standards. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. An audit includes:

- examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements,
- assessing the accounting principles used and significant estimates made by management, and
- evaluating the overall financial statement presentation.

We believe that our audit provides a reasonable basis for our opinion.

Audit opinion
In our opinion, the financial statements fairly present, in all material respects, the financial position of the company at .... and the results of its operations and cash flows for the year then ended in accordance with South African Statements of Generally Accepted Accounting Practice, and in the manner required by the Companies Act in South Africa.
Where generally accepted accounting practice is the disclosed primary basis of accounting

Fair presentation in accordance with GAAP and disclosure of non-compliance with Statements of GAAP provided

REPORT OF THE INDEPENDENT AUDITORS TO THE MEMBERS OF ..... 

We have audited the annual financial statements of .... set out on pages .... to ... for the year ended .... These financial statements are the responsibility of the company's directors. Our responsibility is to express an opinion on these financial statements based on our audit.

Scope

We conducted our audit in accordance with statements of South African Auditing Standards. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. An audit includes:

- examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements,
- assessing the accounting principles used and significant estimates made by management, and
- evaluating the overall financial statement presentation.

We believe that our audit provides a reasonable basis for our opinion.

Audit opinion

In our opinion, the financial statements fairly present, in all material respects, the financial position of the company at .... and the results of its operations and cash flows for the year then ended in accordance with generally accepted accounting practice in South Africa, and in the manner required by the Companies Act in South Africa.
Departure from South African Statements of Generally Accepted Accounting Practice

Without qualifying our opinion above, we draw attention to the fact that the financial statements have not been drawn up in accordance with South African Statements of Generally Accepted Accounting Practice. Note x to the financial statements discloses the reasons for, nature and effect of the departure from these Statements.

Name
Registered Accountants and Auditors
Chartered Accountants (SA)
Address
Date