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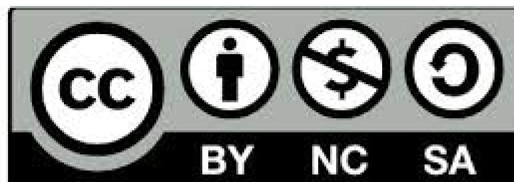

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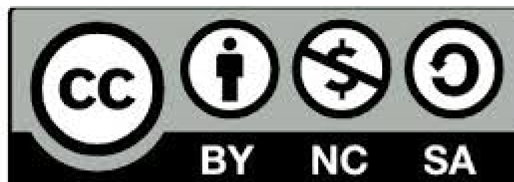

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REGULATION AND ENFORCEMENT OF FINANCIAL REPORTING IN SOUTH AFRICA: A HISTORICAL ANALYSIS FROM 1973 TO 2011

by

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MINOR DISSERTATION

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INDEX OF ABBREVIATIONS

The following abbreviations have been used throughout the study presented:

1. South African-specific acronyms

1973 Companies Act	Companies Act 61 of 1973
2008 Companies Act	Companies Act 71 of 2008
APA	Auditing Profession Act 26 of 2005
APB	Accounting Practices Board
APC	Accounting Practices Committee
ARP	Accounting Review Panel
CA(SA)	Chartered Accountant (South Africa)
FRIP	Financial Reporting Investigation Panel
FRSC	Financial Reporting Standards Council
FSB	Financial Services Board
GMP	GAAP Monitoring Panel
IOD	Institute of Directors
IRBA	Independent Regulatory Board for Auditors
IRC	Integrated Reporting Committee
JSE	JSE Limited (formerly Johannesburg Stock Exchange and later Johannesburg Securities Exchange)
King I	King Code of Corporate Practices and Conduct – 1994
King II	King Code of Governance Principles for South Africa – 2002
King III	King Report on Governance for South Africa – 2009 and King Code of Governance Principles for South Africa 2009 (together)
NC	National Council of Chartered Accountants (South Africa)
PAAA	Public Accountants' and Auditors' Act 51 of 1951
PAAB	Public Accountants and Auditors Board

PIS	Public Interest Score
SA	South Africa / South African
SAICA	South African Institute of Chartered Accountants
SARB	South African Reserve Bank
SME	Small and Medium Enterprise
UJ	University of Johannesburg

2. United States of America acronyms

AIA	American Institute of Accountants
AICPA	American Institute of Certified Public Accountants
APB(US)	Accounting Principles Board
ARB	Accounting Research Bulletin
ASR	Accounting Series Release
CAP	Committee on Accounting Procedure
EITF	Emerging Issues Task Force
FAF	Financial Accounting Federation
FASB	Financial Accounting Standards Board
PCAOB	Public Company Accounting Oversight Board
SEC	Securities and Exchange Commission
US / USA	United States of America

3. United Kingdom acronyms

ASB	Accounting Standards Board
ASC	Accounting Standards Committee
ASSC	Accounting Standards Steering Committee
CGAA	Co-ordinating Group on Audit and Accounting Issues
FRC	Financial Reporting Council
FRRP	Financial Reporting Review Panel
ICAEW	Institute of Chartered Accountants in England and Wales

LSE	London Stock Exchange
SSAP	Statements of Standard Accounting Practice
UITF	Urgent Issues Task Force
UK	United Kingdom

4. European Union acronyms

CESR	Committee of European Securities Regulators
EU	European Union
ICAI	Institute of Chartered Accountants in Ireland

5. International convergence acronyms / other

FoF	Forum of Firms
gaap	generally accepted accounting practice
GAAP	Statements of Generally Accepted Accounting Practice
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IFAC	International Federation of Accountants
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
IIF	Institute of International Finance
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions

6. Theories

PIT	Public Interest Theory

CHAPTER 1

INTRODUCTION

1. Introduction

One would be hard-pressed to find an accountant who does not know about the Enron collapse which took place over a decade ago. The scandal was the largest the corporate world had seen at the time, and its impact was significant. Shareholders of the company lost tens of billions of dollars (Jickling, 2002), 4,000 employees lost their jobs (Bratton, 2002), the reputational damage suffered by their auditors Arthur Andersen was severe enough to break up the firm (Fearnley, Brandt & Beattie, 2002) and members of the public stood in awe that this was even possible. This incident was succeeded in following years by more high-profile international corporate scandals involving Tyco International, WorldCom and Parmalat, each one affecting a variety of stakeholders and broader society.

The common thread that weaves these corporate collapses together appears to be seized opportunities to misreport financial information. Corporate failures of companies as big as Enron are inclined to give cause for future business regulation (Bratton, 2002). As noted by Fearnley et al. (2002), the Enron collapse provided regulators with an opportunity to reconsider fundamental issues associated with the regulatory framework for corporate financial reporting. Bratton (2002) explains that numerous regulatory-related concerns had been implicated prior to the completion of the Enron investigation. As with the demise of the other companies, the cause thereof involved questionable practices, particularly relating to the accounting treatment of transactions and the reporting of the financial position and performance to the users of financial statements. The result was that stakeholders of the entities did not have access to accurate and complete information regarding the entity in order to make sound economic decisions. This phenomenon is referred to as information asymmetry (Gaffikin, 2008).

While South Africa was affected to some degree by the international corporate disasters – such as Parmalat's bankruptcy protection at the end of 2003 as a result of its fraudulent accounting (Melis, 2005) – the country had its own share of business failures too. Corporate scandals have also emerged in local South African businesses and can be attributed for the most part to poor corporate governance practices (IIF, 2007). This dates as far back as nine years before the Enron scandal, in 1992, with the questionable financial reporting of Masterbond and its related entities. The appointed Commission of Inquiry found that the companies' financial statements could not be relied upon as they departed significantly from the Statements of Generally Accepted Accounting Practice (GAAP) (Du Plessis & Koornhof, 2000). Based on this case, the Commission linked the non-compliance with accounting standards to corporate failures (Gloeck, 2003). The findings thereof caused a greater emphasis to be placed on the protection of investors (Du Toit & Henning, 2003), and the need for regulation and enforcement of financial reporting in South Africa gained attention.

Following the Masterbond inquiry locally, was the insolvency of LeisureNet in 2002. The liquidation of the public company, listed in the Hotels and Leisure sector of the JSE Securities Exchange (JSE) and trading as the Health and Racquet Club, was one of the largest scandals in the financial history of South Africa, with claims against the entity estimated to be R1.15 billion (Steyn, 2005). Enquiries into the company's trade, dealings, affairs and property revealed that management had been fraudulently inflating revenues, leading to a profit of R177 million with a cash balance of only R3.4 million (Lessambo, 2013). As a result of its inappropriate financial reporting, the company was unable to pay its debts – ultimately necessitating its winding up. More recently, the most notable scandal to take place in South Africa was that involving the asset management company Fidentia, which was placed under curatorship in 2007 after the FSB inspectors could not locate R680 million of the almost R2 billion under Fidentia's management (Steenkamp, 2007). The highly-publicised scandal brought to the fore a separation between South Africa's corporate governance framework and the ongoing practice in the corporate environment (IIF, 2007). This lack of adherence by the company to good corporate governance principles was seen to increase the risk exposure of the shareholders and other involved parties.

Corporate scandals such as these, particularly the impact they have on financial markets, demonstrate the importance of financial reporting (Tweedie, 2003). This is supported by Di Petra, McLeay and Ronen (2010), who name accounting standards regulation as a significant cause of the financial turmoil witnessed globally.

In an ideal world, financial reporting would be true and transparent, giving all stakeholders the most reliable and relevant information. However, due to incentives such as personal financial gain and the desire to conceal poor financial results, the market has created doubt in its ability to self-regulate the desired nature and quality of reported decision-relevant information. As a result, the need for rules and regulations related to corporate financial reporting, and the enforcement thereof, arises within the market.

The definitions and meaning of regulation and enforcement of regulations, the link between the two and some introductory comments on regulation and enforcement in the South African financial reporting context, are now explained.

i. Definition of regulation

In order to understand the *development* of regulation, it is important to understand the *concept* of regulation, particularly in relation to accounting standards and financial reporting. As stated by Uche (2000), regulation generally implies some form of intervention, ranging from legal control to informal peer group control by government or other authoritative body. Regulation has also been defined as an intervention by an authoritative body in private decision-making (Richardson & McConomy, 1992), or as the set of institutions that constrain and enable the practice of accounting (Richardson & Kilfoyle, 2009).

Branston, Cowling and Sugden (2006) explain that the introduction of regulation to a free market is an arms-length response to failures that occur in arms-length relationships. This might include the relationships between a company and its shareholders, financiers, employees or the community in which it operates. By regulating financial reporting, governments or other legally constituted bodies

address the failure of the market to produce sound, reliable and understandable financial information to the public.

The need for regulation arises from information inadequacies and, in the case of financial reporting regulation, can take on the form of accounting standards to address the problem (Gaffikin, 2008). These may include the standards as prescribed by the International Accounting Standards Board (IASB), or by the Financial Accounting Standards Board (FASB).

ii. Definition of enforcement

Without enforcement of instituted financial reporting regulations it could be difficult for society to see the value of reporting standards such as those issued by the IASB. A framework for regulation, therefore, requires an effective enforcement mechanism that both deters and punishes offenders (Fearnley et al., 2002).

The Committee of European Securities Regulators (CESR) in a Consultation Paper issued in October 2002, defined enforcement as the monitoring of compliance of financial information with the applicable reporting framework, namely International Financial Reporting Standards (IFRS), and taking appropriate measures in case of infringements discovered in the course of compliance monitoring. Monitoring of financial information entails the comparison of reporting policies applied by issuers of financial statements with IFRS in order to make an informed assessment of their acceptability.

iii. The linkage between regulation and enforcement

Enforcement of regulation is both complicated and important enough to influence the effectiveness of the regulation (Fenn & Veljanovski, 1988). In an interview with Sir David Tweedie, the then chairman of the IASB, Street (2002) noted that financial reporting is a three-legged stool. There should be good accounting rules – these are the IFRS documents (including International Accounting Standards (IASs)) published by the IASB. There should also be proper, quality audits conducted upon the financial statements that are prepared in accordance with IFRS. Lastly, there should

be regulators to intervene when something goes wrong. As explained by Tweedie (Street, 2002), the IASB cannot enforce IFRS. They can provide the rules, but they need the auditors as well as the regulators to ensure that enforcement takes place.

Van Wyk and Taylor (2004) place a similar level of importance on the role of regulators in the enforcement of accounting standards. Because the process of standard-setting is usually slower than changes in the capital markets, accounting issues will arise for entities that standard-setters such as the IASB will not yet have identified or addressed. This, say Van Wyk and Taylor (2004), means that auditors need to exercise sound, professional judgment regarding their interpretation of complex and unique accounting issues that are not specifically addressed in the accounting standards. This reiterates the point raised by Tweedie that clear support of quality financial reporting is required among the standard-setters, auditors and regulators.

iv. Broad overview of regulation and enforcement of financial reporting in South Africa

The corporate scandals in the last two decades have shown that developed nations have encountered issues with the enforcement of sound financial reporting regulation (Tweedie, 2003). Tweedie (2003) maintains that the only way to restore the public's faith in the economic markets is to stop shocking them, and by providing full transparency so as to increase the confidence in accounting. While developing countries may not have encountered financial crises as vast as those of the developed world, there have been significant changes to the field of financial reporting, in South Africa in particular. As a result of South Africa's long association with Britain, its government system and company and mercantile laws resemble those of British Common Law (Prather-Kinsey, 2006). Therefore, up to at least 1968, the South African reporting requirements were almost identical to those of England (Oberholster, 1999).

The Public Accountants and Auditors Board (PAAB) was established as the statutory regulator of the accountancy profession in terms of the Public Accountants' and Auditors' Act 51 of 1951 (PAAA) (Verhoef, 2012). In 1977, the International

Federation of Accountants (IFAC) was founded as a global organisation for the accounting profession, of which South Africa was a member from inception. It is IFAC's mission is to serve the public interest (IFAC, 2013).

When the South African Companies Act 61 of 1973 was issued, a company's financial statements were required to conform to generally accepted accounting practice, fairly representing the state of affairs of the company at the financial year end, and the profit or loss of the company for the year (South Africa, 1973: section 286(3)). Generally accepted accounting practice, however, was not defined in the legislation, and due to an exception contained in Paragraph 5 of Schedule 4 to the Act, there was in fact no effective statutory duty to comply with generally accepted accounting practice. In 1972, the National Council of the Chartered Societies of South Africa (NC), predecessor body to the South African Institute of Chartered Accountants (SAICA), established the Accounting Practices Board (APB) in anticipation of the promulgation of the 1973 Companies Act (Verhoef & Van Vuuren, 2012). In accordance with its Constitution (APB, 2011), the objective of the board was "to establish and to procure the recognition and acceptance of what the Board considers is or should be generally accepted accounting practice". This board has therefore been responsible for the approval and issuance of accounting standards in South Africa, while the Accounting Practices Committee (APC) was established to identify the need for statements on specific topics and to receive suggestions on such matters from the profession (Verhoef, 2012). It was noted that the accounting standards of the APB were deemed as generally accepted accounting practice (Verhoef & Van Vuuren, 2012), with these being known as the Statements of Generally Accepted Accounting Practice (GAAP). However, accounting practices that were not codified but were nevertheless followed by a number of entities and therefore referred to as generally accepted accounting practice (gaap), although possibly not aligned with the Statements of GAAP, would still meet the requirements of the 1973 Companies Act.

In addition to the issuance of the Companies Act in South Africa, 1973 also saw the establishment of the International Accounting Standards Committee (IASC), an international organisation that promulgated IASs until 2001, when it was replaced by the IASB (Camfferman & Zeff, 2007). A year later, the South African NC was invited

to be an associate member of the IASC, and became a full voting member in 1978 (Verhoef & Van Vuuren, 2012). This collaboration caused the APB to aim at harmonising South African accounting standards with the international ones and, since 1995 IFRS have been adopted subject to occasional minor modifications. In 2003, the APB adopted IFRS as SA GAAP in order to attract investment to South African capital markets, among other reasons (SAICA, 2012).

A year prior to this adoption in 2003, a South African Accounting Review Panel (ARP) was appointed to improve the regulatory structure for accountants, auditors and the legislation surrounding the accounting profession. The ARP was required to report to the government on numerous issues, including the appropriateness and usefulness of accounting standards and the link between the legislation concerning the accounting profession, financial reporting and the Companies Act of 1973 (Verhoef & Van Vuuren, 2012).

In 2003, the national stock and securities exchange, the JSE Limited (JSE) (formerly known as the Johannesburg Stock Exchange and later the Johannesburg Securities Exchange), revised its listing requirements such that listed companies were required to comply with IFRS for financial periods commencing on or after 1 January 2005. A subsequent joint venture of the JSE with SAICA led to the creation of the GAAP Monitoring Panel (GMP) – a body to reactively enforce the application of IFRS by companies listed on the JSE. While there was no requirement placed upon unlisted companies to apply IFRS, SAICA Circular 3/2006 (SAICA, 2006a) stated that companies electing to not apply IFRS, were required to apply the Statements of GAAP.

Proposals made by the ARP were effected through the promulgation of the Auditing Profession Act 26 of 2005 (APA), replacing the PAAA and therefore also replacing the PAAB with the Independent Regulatory Board for Auditors (IRBA). The APA separated the regulatory framework of the audit profession from that of the accounting profession (Verhoef & Van Vuuren, 2012), and was regarded "…to protect the public in the Republic by regulating audits performed..." (South Africa, 2005: section 2(a)) and "...to improve the development and maintenance of

internationally comparable ethical standards and auditing standards..." (South Africa, 2005: section 2(c)).

With the promulgation of Companies Act 71 of 2008, legal backing was created for accounting standards. The Act required all companies to comply with financial reporting standards, permitting the application of either IFRS, IFRS for Small and Medium Enterprises (SMEs), or SA GAAP, depending on the type of company and the entity's Public Interest Score (PIS) (South Africa, 2008: regulation 26 & 27), and stating that regulations concerning financial reporting standards "must be consistent with the International Financial Reporting Standards of the International Accounting Standards Board" (South Africa, 2008: section 29.5(b)). In addition to the financial reporting statements regulations, the Companies Act of 2008 provided for the establishment of an independent Financial Reporting Standards Council (FRSC), assuming the standard-setting responsibilities from the APB and responsible for consulting with the Minister of Trade and Industry on the making of regulations establishing financial reporting standards, and the Financial Reporting Investigation Panel (FRIP) (to replace the GMP). The APC was not replaced, but is instead expected to fulfil the role of a SAICA secretariat to the FRSC. Its terms of reference and operating procedures were revised in June 2012 to include, inter alia, an objective of providing input in the setting of pronouncements issued by the FRSC (SAICA, 2012).

During this period of change in South African corporate financial reporting regulation, the effects of corporate governance gained attention. The release of King III in September 2009 represented a significant milestone in corporate governance in the country, brought about by the new 2008 Companies Act and changing trends in international governance (PwC, 2010). As with the previous two King Reports – King I as published in 1994 and King II as published in 2002 – the focal point of King III is the importance of a company's annual reporting of how it has both impacted on the economic life of the community in which it has operated, as well as how it plans to add to the positive aspects and reduce the negative impacts identified (PwC, 2010). King III is unique, however, as it is applicable to all entities. Under King III, the responsibility lies with the corporation to explain why it has not applied the best practices recommended by the report (Goodall & King, 2011).

Shortly thereafter, in 2011, the JSE implemented a proactive monitoring process for compliance of publicly-traded entities in preparing their financial statements in accordance with IFRS. The implication thereof is that all company results could be reviewed and possibly investigated at any time. In the past, reviews were conducted on the JSE's own initiative or upon receiving a query or complaint.

This section has provided a brief overview of the major factors influencing regulation and enforcement of financial reporting in South Africa for the time frame considered in this work. These are further explored and elaborated on in Chapters 3 to 5 of this study. However, in order to explore these concepts of regulation and enforcement, and specifically in a historical context relating to the South African environment qualitatively, a sound theoretical underpinning is essential. The following section aims to highlight some of the most pertinent theories surrounding regulation and enforcement.

2. Theories surrounding regulation and enforcement

One of the central tasks of the theory of economic regulation, as defined by Stigler (1971), is to explain who will receive the benefits or burdens of regulation.

Various theories have emerged around regulation over the decades, ranging from ideas centred on the need for regulation for the protection and benefit of society, through to more critical views that regulation is implemented for the benefit of a select few in establishing and maintaining monopolistic control over a certain area or industry. These two different streams of theoretical discourse surrounding regulation and enforcement are discussed below, under the headings of *Public Interest Theory*, and *More critically oriented regulation theories.*

i. Public Interest Theory

Public Interest Theory (hereafter referred to as PIT) is based on the view that regulation is constructed in order to benefit and protect the general public, or a

subclass thereof (Stigler, 1971). This theory holds that regulation is supplied in response to the demand of the public for the correction of inefficient or inequitable market practices (Abrams & Settle, 1978; Posner, 1974). PIT is therefore concerned with the needs of the general public with regard to an entity's financial information available to them, and suggests that those needs would not be met if left purely up to the market to self-regulate. Posner (1974) explained that under the PIT, the interventions made by government are simply responses to public demands for the rectification of inefficiencies and inequalities in the market.

Branston et al. (2006) describe the public interest as a moving consensus amongst people – the public – on private actions. This is the agreed upon standard which the public uses to assess those private actions. Therefore, in determining whether regulation is in the public interest, it is to be determined whether the standards set by members of the public have been met. Adopting the PIT, accounting is regulated as a result of market departure from the ideal, thus reducing the benefits available to society. Because of this, the government intervenes – through regulation – to promote the interests of the public (Richardson & McConomy, 1992), for public protection and maximisation of social welfare (Brown & Van der Zahn, 2007) and to pursue the general good regardless of the potential difficulties of the process in achieving this (Levine & Forrence, 1990).

Richardson and Kilfoyle (2009) agree that by applying the PIT to regulation, the only rationale for regulating financial disclosure is in order to correct the failures of the market. This would be the case where the market fails to produce transparent and reliable financial reports. It is argued that society in general requires laws and regulations to protect it from deceptive reporting of financial information.

The provision of accurate, relevant and complete financial statements and transparent disclosure of information enables members of the public to make the best decisions possible regarding the entity that is reporting that information. These decisions would predominantly be of an investing nature, such as whether an additional stake in the entity would be sought, or whether funding would be supplied to the entity through a subscription of shares. The fact that one's perception of a company may be misled through fictitious or unreliable financial reports that have

been made public also indicates the need for regulation and enforcement thereof, in order to ensure a standardised quality of the information to be used in decision-making. The PIT has been described as comprising two approaches (Richardson & Kilfoyle, 2009). The traditional approach assumes that regulation is the means by which market failures can be overcome, whether as a result of market inefficiencies or monopoly power. In contrast, the alternative approach is where regulation is used when the values of the public are not recognised by other means (Bozeman, 2002). Under this approach, the intervention of the regulators is not related to the efficiency of the market.

The PIT is regarded as both a positive theory focusing on what motivates regulators, and a normative theory focusing on what should motivate them (Levine & Forrence, 1990). Regulators are seen to be role players who act in the public interest, and aim to further the notion of the public good. Accounting firms support the attempts of regulators to improve the decision-usefulness of accounting. In this way, they are seen to promote public interest as the ultimate clients of the accounting firms are in fact the users of financial information (Willmott, 1984). Taking the view of the PIT, the government will intervene with regulation when markets fail, in order to guard the interests of the public. Simonis (2001) describes four categories of market failure that would result in the government intervening. The first is excessive market power, whereby a company is in such a position that it can make decisions without considering how its suppliers and consumers will react. The second category is external effects. This is the case where businesses affect members of the public, but do not take their interests into account. The third scenario that would necessitate government intervention involves public goods that are not subject to market forces, and the last is information asymmetry, where consumers cannot determine the usefulness of a particular product (including financial information) because they are without all necessary information, which may result in suboptimal decisions.

It should be stated at this stage that the PIT has been adopted as the lens from which to digest the information used in this study, and from which to judge and comment on the development of South African financial reporting regulation and enforcement. It is, however, necessary to remain cognisant of the vast array of other and sometimes ‘alternative’ or ‘more critical’ theories surrounding regulation. Many

scholars have argued that regulation and enforcement is possibly driven by some other 'ulterior' motives. As noted by Stigler (1971), the regulatory agencies do not consistently create regulation with the purpose of protecting the general public, but could become 'captured' by the industry they are aimed at regulating. While regulatory bodies may be formed for bona fide public purposes, Posner (1974) believes that they are subsequently mismanaged to the extent that the original purposes are not achieved. This suggests that regulation may be created to serve the private interests of specific groups within the industry being regulated, rather than the interests of the public at large.

The regulatory environment around financial reporting in South Africa is considered for the purposes of this study to be in place in order to protect the public interest, and therefore the PIT is considered the fundamental theoretical underpinning for this study. However, in digesting the sources and making sense of the evolution of the development of the regulation and enforcement of financial reporting in South Africa, where applicable and considered appropriate, commentary is made on some of the more critical theories, as the story develops. It is hoped that this approach will add the most value academically, and also aid the discussion to be as objective as possible. Some of these more critical perspectives on regulation and enforcement will now be discussed.

ii. More critically oriented regulation theories

Documenting his work on the theory of economic regulation, Stigler (1971) noted that the regulation that is enacted to address the interests of the public should also strive to protect them from monopolies and industries that generate substantial external costs or benefits. However, these objectives are not always achieved in practice. There appears to be a complex relationship between the regulators and the parties being regulated which evolves over time. During this time, the interests of the regulated parties may possibly be reshaped by regulators (Peltzman, 1993).

While the PIT states that regulation aims to protect and benefit the general public, Hantke-Domas (2003) argues that the public interest theory does not exist, but instead regulation protects the interests of special groups and not the public at large.

This is considered a more critical line of theorisation, and various theories have emerged stemming from the concept of regulation not being as altruistic as simply being there for the sake of society, but for the benefit of other role players.

The "producer protection hypothesis" (referred to by Simonis, 2001) states that regulation does not protect consumers, but rather producers – including producers of financial information – or other interest groups who stand to profit from the implementation of that regulation. Brown and Van der Zahn (2007) take a similar view, stating that while regulation appears to be created to protect the public, it is subsequently used by *self-interest groups* to protect their own interests, including the establishment of regulation by self-interested individuals in government to ensure their re-election. This is known as the self-interest theory, and was described by Spiller (1990) as the situation whereby various interest groups demand of government or their regulatory agencies that regulation be developed to address their interests. However, Spiller (1990) continues to state that an agency problem may arise when applying the self-interest theory – namely that both interest groups (who demand the regulation) and politicians (who appoint the regulatory body members) compete with one another to influence decisions of the regulators. This theory is therefore split into two: The first described as the *Capture Theory*, where the interests of the regulated parties are met through regulation, and the second being the *Interest Group Theory*, where the interests of specific groups, other than those to be regulated, are served through the institution of regulation.

Under the Capture Theory (also known as the Private Interest Theory, Special Interest Theory and Public Choice Theory), regulators such as the government can be seen as a body which takes orders from the industry for which the regulation is intended (Peltzman, 1993). The accounting scandals discussed previously can be attributed to a large degree to lenient regulation, as well as regulatory and enforcement agencies who served specific parties (including the companies subject to the regulation and enforcement) rather than its stakeholders (Di Petra et al., 2010). These stakeholders include not only shareholders, but also other investors, employees, customers, and the community in which the regulated companies operate. This leads to the Capture Theory, which holds that regulation is generally acquired by the industry to be regulated, and as such, regulation is both designed

and operated primarily for the benefit of that industry (Stigler, 1971). Posner (1974) agreed, stating that under the Capture Theory, regulation is supplied in response to the demand from interest groups wishing to maximise the benefits to their members. Etzioni (2009) explains that the Capture Theory suggests that regulators are frequently and expectedly captured and manipulated into serving the special interests of those subject to the regulation, or the legislators who write the regulation do so to meet their own interests. This captured regulation therefore serves the interests of these groups rather than the public interest. The Interest Group Theory views regulation as the product of relationships between various interest groups, and between those groups and the state (Gaffikin, 2008), and focuses on the competition for power rather than the interests of the public. The Interest Group Theory is often referred to as Corporatism, and is described by Richardson and McConomy (1992) as the granting of roles in the creation and implementation of regulation to special interest groups, in exchange for the acceptance by those groups of the political demands and the constraints placed on their behaviours. The Capture Theory views regulation as the opportunity for special interest groups to battle for the use of governmental power in order to meet their own needs (Levine & Forrence, 1990). Richardson and Kilfoyle (2009) define Corporatism as the theory whereby the state negotiates a deal with private sector groups: The state agrees to provide these groups with power and resources of the state in exchange for control over those to be regulated.

The theories discussed briefly in this section are recognised for their critical approach and scepticism with regard to the motives of regulatory bodies and interest groups who benefit from regulation. This study acknowledges these theories, and will comment on them where applicable; however, the grounding theory used in this study remains the PIT. This study therefore accepts that regulation and enforcement are implemented to safeguard the public.

3. Historiography and rationale for the study

South Africa has been a country of great change over the past four decades, and the country's development has driven investigation into its regulation and the broader

sphere of financial reporting. South Africa in general is regarded internationally as a developing country, and comparisons have been drawn by various authors between South Africa and other developing countries, as well as between South Africa and more developed nations (Prather-Kinsey, 2006; Bourne, 2007; Schmidt, Sutherland, Van Schalkwyk, Lowe & Bockmann, 2011). Much research has been conducted in the last decade on the effect that the adoption and implementation of international reporting standards would or have had on South African businesses, as well as global accounting firms (Van Niekerk, 1999; Van Wyk and Taylor, 2004; B. Parker, 2005; Anonymous, 2006; Coetsee, 2007; Verhoef, 2012; Coetzee & Schmulian, 2013).

As public awareness regarding corporate governance heightened across the globe in recent years, research has been done regarding the progression of the legal regulation of corporate governance, particularly within the South African economy (Malherbe & Segal, 2001; Rossouw, Van der Watt & Malan, 2002; World Bank, 2003b, Horn, 2005; Barac & Moloi, 2010; Ngoepe & Ngulube 2013). South Africa has been considered a leader in this area internationally. The Financial Development Index reported by the World Economic Forum (2011) revealed that South Africa is number one in terms of the strength of its auditing and reporting standards regarding company financial performance. Where a score of 1 represents “extremely weak” and 7 “extremely strong”, South Africa was rated 6.49 – a phenomenal achievement for a nation classified by the international community as ‘developing’. The report also indicated that South Africa was ranked first in the regulation and supervision of its securities exchange, namely the JSE. In addition to these areas of success, the emergence of the King Reports from South Africa indicated that the country was a pioneer in corporate governance regulation.

Regulation affecting the accounting and auditing professions has also been considered by researchers. A review of the South African literature available on the topic reveals that studies have been conducted on the development of statutory legislation affecting accountants and auditors respectively (World Bank, 2003a; Odendaal & de Jager, 2005; Van Wyk, 2005; Verhoef, 2013). These added to the knowledge of laws and regulations impacting accounting and auditing in South

Africa, and provided insight into the motives for changes made to professional bodies.

Regulatory and enforcement factors in relation to financial reporting, considered broadly, have changed dramatically in the country over the course of the last 40 years. This study aims to consolidate a longer period than the other studies, ranging from the promulgation of the 1973 Companies Act to the time of the 2008 Companies Act, and covering relevant regulation and enforcement mechanisms in place throughout this period. It attempts to view the developments in financial reporting regulations and enforcement from a broader perspective by considering the public interest theory through the consideration of all the relevant bodies and agencies involved in the process of regulating the corporate accounts distributed by companies to their shareholders in South Africa.

This research will supplement the existing body of knowledge by combining the numerous elements including national legislation, professional organisations, and other agencies such as newly formed committees and councils, in order to provide a holistic view of regulation and enforcement of financial reporting in South Africa during the period from 1973 to 2011. By considering a longer period, from 1973 to date, it is anticipated that some new perspectives on developments in financial reporting regulation in the country may arise, through consideration of the public interest theory and also that one is further removed from vast amounts of detail around specific significant events or changes in history, and thus better able to consider 'what it really means' (as opposed to simply 'what happened').

The relevance of accounting history appears to be widely accepted in developed countries, but many local accounting scholars may be unaware of the discourse surrounding accounting and business history, and more specifically, its relevance. The article by Previts, Parker and Coffman (1990) titled *Accounting History: Definition and Relevance* published over 20 years ago, defined and related contemporary applications of accounting history. Studying accounting as a social science with the emphasis on detailed interpretation and critical assessments through a descriptive narrative is essential for accounting pedagogy, policymaking and the practice of accounting in their opinion (Previts et al., 1990). Haskins (1904)

explained that accounting history "allows us to better understand our present and to forecast or control our future". It was Zeff (1982) who argued that historical research of accounting presents "a substantial opportunity for challenging and worthwhile study from which we can hope to increase our ability to make judgements on a broader, more informed basis". Previts, Parker and Coffman (1990) state that 'history' supports contemporary accounting research in the areas of standard-setting, policymaking and accountancy and auditing practice. They explain that history explains how a certain present day convention has been achieved, and encourages scholars to consider an interdisciplinary view of accounting and its social context. Lee (1990) explains that problems and concerns surrounding accounting and auditing (such as dependence on rules rather than principles, management failures, scrutiny of the role of auditors, and the future prospects for accounting as a discipline) could be solved by studying accounting in a historical context of organisations and societies.

This study therefore attempts, through a historical narrative of development in financial reporting regulation and enforcement in South Africa, to help assist educators, regulators, students and policymakers, to understand and appreciate how a small, developing African country has been able to obtain and maintain the 'top position' in auditing and reporting standards over the last few years, out of 148 countries, including those of Britain, the European Union and the United States, through the specific set of regulations and enforcement mechanisms functioning in the country. It should also be considered how international developments may have impacted the development or direction of financial reporting regulation in the country. Globalisation and international accounting and auditing standard-setting harmonisation attempts have surely had an impact on local developments in financial reporting. Historical consideration of these developments is essential and relevant. This is imperative so that lessons may be learnt from past successes and failures of the entire system that have contributed to the success of the country's financial reporting regulations, so that its prosperity may continue, and that possible future failures may be prevented. By learning from their past, South Africans may move, better informed, and with more resilience, into an unknown future.

4. Research questions and objectives

Internationally, the field of corporate financial reporting is a web of complex rules, standards, regulatory bodies and law. Similarly, the present regulatory and enforcement environment in South Africa is multifaceted and more complicated than ever before. The development of the country's regulation and enforcement of financial reporting has been a lengthy process, and will require additional development to address some remaining imperfections identified in practice. The Public Interest Theory suggests that regulation and enforcement is necessary. The previous section explained the relevance and necessity of studying accountancy within a historical context.

From this, the following research questions have been formulated: Firstly, in what manner has the regulation and enforcement of financial reporting in South Africa evolved between 1973 and 2011? Secondly, what lessons can be learned from developments in financial reporting regulation and enforcement internationally? Thirdly, which bodies in South Africa are currently the significant role players in the regulation and enforcement of financial reporting? And lastly, what is the current status of financial reporting regulation and enforcement in South Africa?

The objective of this paper is therefore to document the developments in financial reporting regulation and enforcement in South Africa between 1973 and 2011. International developments and the current status of South Africa's financial reporting regulation and enforcement will also be discussed to contextualise the findings related to the evolution of the process in South Africa, by applying a framework that accepts the Public Interest Theory as the driver behind regulation and enforcement.

5. Methodology

The methodology followed in addressing the research problem was that of a historical analysis, performed through the examination of secondary sources and the evaluation thereof against the Public Interest Theory. At each significant stage of

development in South Africa, the interests of the public, and the adequacy of the regulation and enforcement in providing for those interests, were considered against this theory from a broad perspective. Through an understanding of the theory and its assumptions, the regulation that has historically been enforced can be assessed for appropriateness, sufficiency and success in achieving its objective, and criticisms may also be levelled which should be addressed going forward. Historical enquiry through a narrative or interpretation is conditional, and never definitive, as historical enquiry has its own unique limitations. New knowledge is acquired on an ongoing basis, which changes past interpretations and explanations. Historical enquiry is seldom complete, as evidence may be lost or is not available through the passage of time. This study is limited in that it does not contain archival research on primary documents in South African archives (governmental or institutional), which may have shed more light or context on certain events in the development of financial reporting regulation in South Africa. Future research studies may build on this work by including an investigation into correspondence between role players over the course of history, regarding regulation and enforcement which may be contained in archives across the country.

6. Layout of the rest of the chapters

The following chapter deals with developments in financial reporting regulation internationally, so as to position the South African development from a constructive position. The literature surrounding the regulating bodies and rules enacted internationally over the past few decades in the United States, the United Kingdom and the European Union specifically, is examined. The regulations developed in these regions are analysed in accordance with the Public Interest Theory in order to ascertain whether the objectives of the regulators were aligned with this theory, and whether the enforcement of these regulations proved to be successful. From this, it was considered possible to determine whether South African regulators are able to gain insight from the faults, setbacks or accomplishments of other regulators in their ability to meet the needs of the different communities in which they had influence.

Chapters 3 to 5 explain the evolution of the South African financial reporting regulatory environment, in a chronological order. Developments locally have been categorised into three phases. Chapter 3 deals with the first phase of this work, and is titled: *The first formalised early South African developments in financial reporting,* and deals briefly with major events prior to the enactment of the 1973 Companies Act. The specific regulations that arose from this legislation for financial reporting are discussed, as well as how this was enforced, in the context of the Public Interest Theory. The regulatory bodies that were formed during that period, namely the APB and the APC, are also discussed, particularly with regard to their roles and responsibilities in addressing the public interest through the development of SA GAAP.

The harmonisation of SA GAAP with international standards from 1995, and the adoption of IFRS as SA GAAP in 2003 were milestones in the regulation of financial reporting. These are discussed as phase two in the South African development, and contained in Chapter 4, titled *Greater harmonisation of South African financial reporting with international standards*. This chapter presents the regulatory activities in South Africa during this period of transformation, including changes to the listing requirements, corporate governance developments and modifications to the accounting and auditing professions in light of the public interest.

Chapter 5 deals with the most recent set of developments which represent phase three, titled: *A new era: a new companies act, councils, commissions and monitoring*. The implications of the JSE's proactive monitoring process for South African listed companies, as well as the members of the public who invest in these companies, are considered here. Following on the initiative of the JSE, this chapter examines the impact of the 2008 Companies Act, and the new requirements applicable to companies with regard to their financial reporting. In addition to the regulation, the enforcement thereof is discussed, and the envisioned functioning of the new regulatory body – the FRSC – as introduced by legislation.

Chapter 6 ends the study with a discussion based on conclusions or matters of interest stemming from the preceding chapters, and phases in history. Attention is given to both the development of the regulation regarding financial reporting as well

as the enforcement of these regulations, before concluding on what succeeded or failed in satisfying the public interest in South Africa. Consideration is also given to the public interest and an assessment made as to the status of the protection of the public interest – past, present and future.

CHAPTER 2

LITERATURE REVIEW: THE INTERNATIONAL FINANCIAL REPORTING REGULATORY ENVIRONMENT

1. Background to literature review

Under the Public Interest Theory, regulation is developed as a response to a failure of the market, resolution of which is seen to be in the public interest (Chalmers, Godfrey & Lynch, 2012). Concerns from the public, states Gaffikin (2008), demand that regulation is created in order to address the issues identified by society. The market's failure to deliver adequate accounting information therefore requires government intervention in the setting of accounting standards, which can be defined as the rules used by accountants to measure and report a company's economic transactions to the public (Stewart, 1986). This aligns with the objective of financial reporting, according to Tweedie (as quoted by Street, 2002), to be "true and fair" representation of the facts, expressing the economic substance of the underlying transactions rather than their legal form, thus achieving transparency and openness.

It can be said that financial reporting regulation varies significantly between nations. Gaffikin (2008) describes different systems of regulation, including the regime whereby the professional accounting body is responsible for accounting standard-setting (as is the case in Canada and Hong Kong), the regime whereby an independent body is created to set accounting standards (such as the United States and the United Kingdom) and the regime whereby responsibility for accounting standards lies with the government (such as Australia and China).

Because of the continuous evolution of financial reporting evident throughout its history, it is necessary for the accounting practice to respond to changes in its operational framework (Beattie, 2000). As such, the development of the financial reporting system of one of the world's leading economies, the United States, is analysed in order to gain insight into who the main role players were, what the motivation for the regulation was, and whether or not the regulation achieved its

objectives. Thereafter, the process undertaken in the highly influential United Kingdom is considered, on the same basis as that of the United States, followed by the noteworthy developments in the European Union in recent years. While differences in international accounting recognition and measurement have diminished over the years, enforcement of these accounting rules continues to differ between the various countries, being non-existent in some instances (Hope, 2003). The enforcement mechanisms that have come to exist in these territories are therefore also considered.

Willmott (1984) notes that members of standard-setting regulatory bodies are seen to act in the public interest by approving financial reporting standards which generally favour the users of the financial reporting information. However, by examining the history in these regions, an independent assessment was performed on its resemblance to either the Public Interest Theory or Capture Theory of Stigler (1971) and Posner (1974), as described in Chapter 1. From this, it was considered possible to draw comparisons to the South African narrative to follow, in Chapters 3 to 5.

2. The United States of America (USA)

In 1917, at the request of the Federal Reserve Board and the Federal Trade Commission, the body of the accounting profession, known as the American Institute of Accountants (AIA), issued a memorandum titled *Uniform Accounting*. This was the first official guidance on audit procedures in the United States, but was not readily accepted by the corporate world. Many professionals were critical of the limited set of accounting standards, and instead saw a need for more extensive, formalised rules. As a result, public accountancy was unable to serve the public effectively as financial custodians (Doron, 2009).

Pressure for new regulation can come from sizeable shocks to the economy, such as the Great Depression (Peltzman, 1993; Gaffikin, 2008). This US economic disaster was initially signalled by the Stock Market Crash in 1929, which created a great demand for financial information on which the users could rely. Financial disclosure

requirements were first introduced in the Securities Act of 1933 and the Securities Exchange Act of 1934 during this time (Richardson & Kilfoyle, 2009), and the New York Stock Exchange called on the accounting profession to develop accounting standards. In response to this call, the AIA produced a list of principles of financial reports – later to be known as Generally Accepted Accounting Principles (GAAP) (Gaffikin, 2008; Yallapragada, 2012). *Audits of Corporate Accounts*, a product of the American Institute of Accountants Special Committee on Cooperation with Stock Exchanges, was published in 1934. This document described the basic form of financial statements and "fairly general acceptance" in relation to auditing and accounting best practice (Doron, 2009). This was the start of the profession's regime of self-regulation to prevent state intervention regarding regulation.

However, the US Congress did intervene in order to protect the public interest, which came through the establishment of the Securities and Exchange Commission (SEC) in 1934 (Chalmers et al., 2012). Prior to this, there was no programme, private or public, that regularly issued pronouncements on accounting principles (Palmon, Peytcheva & Yezegel, 2011). This milestone in US economic history is therefore seen to be congruent with the Public Interest Theory. The Securities Act of 1933, in addition to its disclosure requirements, ordered that either public or certified public accountants audit all publicly-traded companies who were making initial stock issues. Before this Act, auditors had no legal backing, and reliance was instead placed on "moral regulation" (Steward, 1986). Public companies had no obligation to be audited, and those that chose to be audited could define the scope of that audit by arrangement between the auditors and management (Doron, 2009). In this way, the public was not protected by way of regulation, or the enforcement thereof, from false or misleading financial reports caused by information asymmetry and incentives for manipulative behaviour. The SEC, created by the Securities Exchange Act of 1934, is an independent federal regulatory agency, requiring public companies to disclose meaningful financial and other information to the public (SEC, 2013). In an attempt to establish a relationship with the private sector, the SEC from 1937 to 1938 pursued a policy imploring the accounting profession to provide what it called "substantial authoritative support" for generally accepted accounting practices.

The SEC itself did not assume the role of standard-setting from the profession, as a way of preventing the regulatory agency from falling prey to the influence of the regulated. Instead, the Commission's intention was to protect investors through the enforcement of disclosure and consistency. This was achieved by requiring that companies periodically file audited financial statements (Nel, 2001). In avoiding a Capture Theory scenario, this responsibility then fell to an independent body of the private sector, with its charter for developing accounting standards derived from the SEC. The first standard-setting group that was appointed to address uniformity issues in accounting procedures was the Committee on Accounting Procedure (CAP), who served from 1939 to 1959. The CAP issued 51 Accounting Research Bulletins (ARBs) and was a committee of the AIA (later the American Institute of Certified Public Accountants (AICPA)), established with the intention of meeting the needs of the public in terms of financial reporting. Upon the Committee's creation, the SEC chairman at the time, Frank (as quoted in Doron, 2009), asserted that the public should never be given a reason to lose confidence in the reporting made by public accountants, and for that reason the independence of the profession needed to be maintained. The Accounting Principles Board (APB(US)), a committee of the AICPA, succeeded the CAP in 1959 and issued pronouncements called Opinions (which were mandatory) and Statements (which were advisory).

The Public Interest Theory was proved again during the 1950s when the AICPA took on a new role as a financial watchdog, offering to rectify and remove corruption in trade unions and pensions. This was a move towards a more philanthropic profession that needed to fulfil certain responsibilities to the public. In 1973, a committee known as the "Wheat Committee", so called after its chairman, was appointed by the AICPA to improve the APB(US)'s operations. This led to the establishment of the Financial Accounting Standards Board (FASB), a private sector body consisting of full-time members representing the accounting profession, industry, financial analysts and academics, which functioned with greater autonomy (Yallapragada, 2012; Palmon et al., 2009). This group is responsible for regulating accounting practice (Gaffikin, 2008), and is overseen by an independent body of trustees – the Financial Accounting Federation (FAF) – which is sponsored by professional associations with an interest in financial reporting.

The FASB is currently responsible for issuing Statements of Financial Accounting Standards, produced after extensive procedures of "due process" have been performed (Palmon et al., 2009). The FASB's Statements, together with the pronouncements of the CAP and APB(US), constitute the present body of US GAAP, which, according to Van Wyk and Taylor (2004), is regarded as the most detailed, comprehensive body of accounting rules worldwide, and the set of rules that, if adhered to, would result in fair financial reporting (Steward, 1986).

In the same year as the FASB's establishment, the SEC issued Accounting Series Release (ASR) No. 150, which announced that Statements issued by the FASB would be considered by the SEC as having "substantial authoritative support", meaning that it considered its call in the late 1930s for generally accepted accounting practices had been answered. Should a company's financial statements not comply with US GAAP, its auditors will issue either a qualified or adverse opinion. From 1978, the FASB has been issuing Statements of Financial Accounting Concepts – statements which are used as the basis for accounting standard development, and therefore become the basis of accounting regulation (Gaffikin, 2008). While the FASB aims for consistency between users of the concept statements, neutrality is complicated as a result of the heterogeneity of those users. As such, argues Steward (1986), parties who are adversely affected by the statements do not believe that a balance between the various interests of the public is maintained, and therefore feel that the Public Interest Theory is not evident in the issue of these statements.

While the SEC is legally responsible for setting accounting standards and therefore holds the power to regulate standard-setting, the responsibility for this task is delegated to the accounting profession through the FASB (Palmon et al., 2009). According to the FASB website, the SEC relies on the private sector to establish financial accounting and reporting standards, "to the extent that the private sector demonstrates ability to fulfil the responsibility in the public interest" (FASB, 2013). This is evidence that the SEC and FASB aim to satisfy the Public Interest Theory through the work performed in relation to financial reporting regulation. The SEC is also responsible for publishing its position on accounting matters, and annually

presents a report to the US Congress regarding its oversight of the profession (Palmon et al., 2009).

It is important to note that as a public body, the SEC may be subject to political influence that the US Congress may use to manipulate the standard-setting process. It would appear that in order to avoid being captured, and thereby maintain the Public Interest Theory, this task was delegated to the FASB, rather than being performed by the SEC itself. This makes it possible for the SEC to avoid allegations of catering to the interests of specific groups. While the FASB is directly accountable to the SEC, Palmon et al. (2009) suggest that in line with the Capture Theory researched by Posner (1974) and Stigler (1971), the FASB may be influenced significantly by other groups. Watts and Zimmerman (1978) attribute the disbanding of the CAP and APB(US) to the pressure applied by corporate lobbyists, who will continue to apply pressure to standard-setting bodies (namely the FASB) as long as the financial reporting standards can potentially affect a company's future cash flows.

Fearnley, Brandt and Beattie (2002) find it surprising that the SEC's regulatory framework for standard-setting, disclosure and security oversight failed to identify such significant faults in the accounting system within a company the size of Enron. After the company's corporate collapse, and the manipulation of earnings in the WorldCom ordeal, 2002 saw an increase in government regulation (Gaffikin, 2008), including the passing of the Sarbanes-Oxley reform bill on accounting and corporate governance (Chalmers et al., 2012). As a result of the Enron collapse and other corporate scandals, the US Congress, following the creation of the Sarbanes-Oxley Act of 2002, required that the SEC determine the feasibility of principles-based regulation, as opposed to their previous rules-based accounting, due to the fact that Enron had technically followed the rules of GAAP but was able to get around them (Gaffikin, 2008). The Sarbanes-Oxley Act aims to prevent a repeat of the Enron debacle by correcting its causes. This includes improving corporate governance, limiting the consulting services that an auditor may provide to its audit clients in order to enhance auditor independence, mandating new systems of internal control, and requiring top company executives to take responsibility for the financial information supplied to the public. As this Act was the result of pressure applied by the public on regulators, Gaffikin (2008) viewed this as an example of the "public interest

approach" to regulation, and it was therefore enacted with the view of addressing the lack of public interest protection.

Through this Act, a federal regulatory agency for the accounting profession – the Public Company Accounting Oversight Board (PCAOB) – was created to work with and report to the SEC. The purpose of this board is "to protect the interests of investors and further the public interest" (United States, 2002: section 101). It is evident that the motive of the US Congress was therefore to protect the public interest, as a direct result of the recent corporate failures, which had a negative impact on society. Wegman (2008) explains the three enforcement mechanisms used by the PCAOB: inspections, investigations and disciplinary actions. Inspections are usually routinely performed, and are conducted without the knowledge of a problem being present. If irregularities in the accounting treatment are detected, the next enforcement mechanism – investigation – will arise. Investigations focus on the identified or potential problem area. Should this lead to the conclusion that a violation has occurred, and the company's accounting or auditing firm has not corrected or undertaken a plan to correct the violation, then the final enforcement mechanism of disciplinary action ensues. This final stage takes the form of a hearing, followed by the imposition of sanctions. These usually include suspension or revocation of the firm's registration, as well as substantial fines. The PCAOB Release of 2006 states that "the Board takes a supervisory approach to oversight and seeks through constructive dialogue to encourage firms to improve their practices and procedures". The PCAOB is funded from an independent source in the form of annual fees levied on companies in proportion to their capitalisation on the market, rather than from Congress. By maintaining its independence in this regard, the organisation is less likely to respond to political pressures (Wegman, 2008).

In enacting the Sarbanes-Oxley Act of 2002, congressional hearings were held. It was heard that the poor accounting rules that existed had caused the recent accounting scandals, but the new Act did not restructure the process of standard-setting in any way (Palmon et al., 2009). However, the Act did give the SEC the authority to approve the budget of the FASB, thereby giving the SEC added influence over the standard-setter.

It was noted by Palmon et al. (2009) that this power was exercised in 2007, when the SEC refused to sign off the FASB's budget until the FAF granted it the power to nominate, interview and review new board members. This can be seen as a move towards the Capture Theory, whereby the independence of the board from the politics involved in the standard-setting process could potentially be impaired. Etzioni (2009) argues that the Capture Theory became evident through dilution of existing regulation in 2006, as the regulations regarding audits to be performed were significantly reduced. This, he states, indicates that the SEC had taken note of special interests that had arisen from lobbying businesses. The SEC asserts that US GAAP provides information that is more accurate and offers protection to investors through its detailed set of rules, which it regards as more complete than International Financial Reporting Standards (IFRS), by limiting the instances where management discretion or judgment is required when preparing a company's annual report (Van Wyk & Taylor, 2004). B. Parker (2005) adds to this, stating that the FASB is the best funded accounting standards board in the world and that the SEC is the strictest of all accounting standard enforcers, ensuring that accounting standards issued by the FASB are in fact applied. There also exists the Emerging Issues Task Force (EITF), whose aim is to resolve issues of implementation raised by the companies themselves, their accounting firms or the SEC (Street, 2002; Palmon et al., 2009).

3. The United Kingdom (UK)

Aiken and Ardern (2005) describe a changing legislative and economic environment in the United Kingdom in the late 1860s, leading to the formation of the Institute of Accountants in 1870 in London. A decade later, this body was merged with numerous other professional accounting associations to form the Institute of Chartered Accountants in England and Wales (ICAEW). This body had high standards of new members, achieved through difficult entrance examinations. The ability of a person to enter the profession was therefore not an easy feat, and was impossible at that time for women to attain (ICEAW, 2014). The creation of a national body was aimed at fulfilling a regulatory and disciplinary role for the accounting profession.

Following the end of the First World War in 1918, criticism arose over the quality of corporate financial reporting, particularly in respect of groups of entities with numerous shareholders. To this end, the Company Law Amendment Committee (also known as the Greene Committee) was established to investigate group reporting of financial information and the possibility of publishing a financial statement for a company's profit and loss accounts. However, the accountancy profession showed conservatism, with the ICAEW giving its views to the Committee that providing detailed financial information would in fact disadvantage shareholders, and if those shareholders required additional information it could be requested at the company's annual general meeting (Napier, 2010). Edwards and Noguchi (2004) note that while the ICAEW had begun to recognise the need for improvement in corporate accountability the Institute did not believe that statutory intervention was required to meet this objective. As a result, the recommendations made by the Green Committee for enactment in the 1929 Companies Act were few. The acknowledgment of the fact that shareholders within the community might require more financial information than that which was provided, and that no regulation or mechanism of enforcement was developed in order to allow for this, indicates a neglect of the public interest on the part of the regulators, including the ICAEW. Following the new corporate legislation, the attention of the British government was devoted to the Great Depression of the 1930s. This equated to little if any progression in financial reporting throughout the decade.

The Second World War halted progression in financial reporting requirement, with the exception of financial reporting to assist with wartime economic planning (Napier, 2010). By 1942, the wartime conditions had caused the state to express its resolve to strengthen the law "to provide greater publicity" (Edwards & Noguchi, 2004). Shortly thereafter, a new Company Law Amendment Committee (also known as the Cohen Committee) was established in 1943 to develop new accounting requirements that would ultimately be incorporated into the Companies Act of 1948. This Act required disclosure of the reporting entity's profit or loss, and required financial statements to give a "true and fair view" of the company's state of affairs and that of the group (if applicable) – a statement to be justified by means of an auditor's report (Napier, 2010). The benefits of the true and fair principle, as well as the disclosure of an entity's profits and enforcement through the requirement to be audited, aided the

public in obtaining a more informed view of a company's operations. The changes to the 1948 Companies Act are therefore indicative of the Public Interest Theory.

Despite regulation and enforcement of what was to be reported, the manner of accounting for transactions remained differing across companies. The Accounting Standards Steering Committee (ASSC) was established with effect from January 1970 through a Statement of Intent issued by the ICAEW. The ASSC's objective, as stated by Chow and Haslam (2012), was to "define accounting concepts, to narrow differences of financial accounting and reporting treatment, and to codify generally accepted best practice in the public interest". The Statements of Standard Accounting Practice (SSAP) of the ASSC (later renamed the Accounting Standards Committee (ASC), were issued only after comments had been received from the public on the initial Exposure Draft. If insufficient support was obtained, a standard would not be issued. Standards were issued on a variety of matters, but companies in practice began opposing the ASC, which had no power to enforce the standards. When non-compliance arose, and was supported by major accountancy firms, standards were ultimately withdrawn, or a compromise was required on the part of the ASC in order to obtain acceptance by the market (Napier, 2010). In this way, stakeholders were able observe and provide commentary to the governing body on the level of governance, thus improving the transparency of an entity's reporting. As noted by Branston, Cowling and Sugden (2006), in order to govern in the public interest, inclusive participation of those affected by the process is required. Because of the meaningful input from the public in the development of the financial reporting standards, it would appear that regulators at this point had not become captured by specific interest groups in order to meet the needs of only a select few, as is consistent with the Capture Theory.

In the UK in the 1980s, there was poor quality accounting and weak enforcement (Fearnley et al., 2002; Brown & Tarca, 2007). Change to the regulatory framework for financial reporting was required, and the Department of Trade and Industry led the movement by consulting with several interested parties. This ultimately resulted in a new Companies Act, which established the Financial Reporting Council (FRC), a private sector regulator, and various subsidiaries which included the Accounting Standards Board (ASB), a board to set accounting standards; the Financial

Reporting Review Panel (FRRP), a reactive body to investigate non-compliance with those accounting standards and the Companies Act; and the Urgent Issues Task Force (UITF), a group to improve financial reporting quality by addressing issues for which an accounting standard is yet to be developed. The establishment of these regulatory bodies came as a result of pressure from both the government and the media for the profession to better organise itself, or suffer the consequence of state intervention and loss of the profession's ability to self-regulate (Willmott, 1984).

The FRRP, while maintaining the involvement in the private sector through financial reporting regulation, encourages compliance using the authority of the law (Brown & Tarca, 2005). The Panel's role is to investigate apparent departures from the accounting standards, and it has the power to ask the court to declare that a company's financial reports do not comply with financial reporting regulation or obtain a court order instructing the preparation of revised reports. From 2004, however, this role was widened to include proactive, risk-based surveillance and enforcement of financial reporting standards (Brown & Tarca, 2007). Following on this change, in 1991 new regulation concerning auditors was introduced. Auditors were now required to be in possession of a recognised qualification, to demonstrate adequate experience and be publicly registered and licensed (Fearnley et al., 2002). Rights to these licences were subject to quality tests. In addition to the quality of the work of the auditors, corporate governance quality was highlighted to considerably impact the integrity of both auditing and financial reporting. This, say Fearnley et al. (2002), resulted in the codification of "best practice". An improvement in the quality of the work performed by preparers and auditors of financial reports can be seen to address the public's interest in accessing financial information that is both relevant and reliable.

The London Stock Exchange (LSE), from 1998, incorporated into the listing rules the requirement for disclosure in respect of a company's compliance with the Combined Code of the Cadbury, Greenbury and Hampel Reports (Fearnley et al., 2002). This code set out the principles of good corporate governance and the provisions applicable to all companies incorporated in the UK (Committee on Corporate Governance, 1998). From 2000, financial reports were also required to contain details of the reviews conducted by a company's directors of its internal controls and

risk management effectiveness. By disclosing the corporate governance practices instituted, listed entities were able to provide financial reporting transparency and dependability to their public investors.

Also in 2000, the UK Listing Authority took over the regulatory activities of the LSE, which included ensuring compliance with the UK Listing Rules requirements. The State, through the Department of Trade and Industry, remained responsible for overseeing the financial reporting and auditing. A year later, a Review Board was established to manage the accountancy bodies' regulatory responsibilities, and an Ethics Standards Board to manage the setting of ethics standards for the professional bodies (Fearnley et al., 2002). In the same year, the UK Listing Authority acquired additional power to investigate and prosecute company directors – the preparers of financial reports – who had breached the Listing Rules. While these public regulatory changes were taking place, criticism of the accounting profession arose after allegations of misleading financial reporting. This was when the ICAEW was prompted to respond, as previously discussed, and the ASSC was established (Chalmers et al., 2012). Members of the ASSC (and later the ASC) have consistently been aware of the interests of the public in meeting the demand from the users of accounting information for information that is standardised (Willmott, 1984). Members of the profession and the public were concerned that the professional bodies were acting as both regulators and as a service organisation for its members. This caused the establishment in 2000 of the Accountancy Foundation – an amalgamation of the professional accountancy bodies in the UK (Fearnley et al., 2002). The new, independent body oversaw ethical standards of the accountancy profession and its regulatory activities, set auditing standards that were in the public interest and investigated cases involving accountants.

Following the Enron and WorldCom scandals in the US, the UK government in 2002 established the Co-ordinating Group on Audit and Accounting Issues (CGAA) to determine the effectiveness of the current framework on financial reporting and corporate governance (Brown & Tarca, 2007), and in 2004 the UK government expanded the powers of the FRC to regulate financial reporting and corporate governance. In this way, the responsibilities of the Accountancy Foundation were assumed by the FRC (ICAEW, 2013).

Brown and Van der Zahn (2007) found the motive of this regulatory change to be an attempt at maintaining the status quo of the board's funding providers including large accounting firms, companies and the UK government, and ignoring national regulators. While it appeared that the FRC had been subject to regulatory capture, Brown and Tarca (2007) argued that the oversight role of the FRC to a body such as the FRRP, which is responsible for enforcing the regulations, provides a barrier to potential independence problems and undue influence by the fund-providers, thus avoiding control of the regulator by the parties to be regulated. Furthermore, Brown and Tarca (2007) are of the view that the willingness of the government and business community to fund the operations of the FRRP is a direct reflection of the level of enforcement activity carried out by the Panel.

The effectiveness of the UK's financial reporting framework was assessed by Fearnley et al. in 2002. Non-executive directors were identified as important role-players in the effectiveness of corporate governance structures, and the 1991 audit regulations were seen to improve the standard of the work performed by auditors. The financial reporting process was also considered to be bettered as a direct result of the new accounting standards set by the ASB, the pronouncements of the UITF and the FRRP's enforcement activities.

From this assessment, Fearnley et al. (2002) were able to derive three major strengths of the framework in the UK: Firstly, it is based on principles, meaning that it is easier to comply with than specific rules. Secondly, UK company law provides for an override of the framework where its compliance will not result in true and fair accounts. In these instances, the alternative accounting treatment is adopted and disclosed. Lastly, they state that the process of accounting standard-setting has not been subjected to political interference, as politicians and powerful lobby groups may compromise the integrity of the system by influencing the process in such a way that their own interests are met rather than those of the public. It appears then that the authors deem the regulators to not yet have been captured, as the Capture Theory would suggest, but rather function to meet the interests of the public, in line with the Public Interest Theory.

4. The European Union (EU)

A financial information system that operates efficiently and effectively in a transparent European capital market should include financial reporting standards and other disclosure requirements that are both clear and enforceable, a system of good corporate governance, auditing regulation, including standards on technical matters, ethical issues and quality control, and institutional oversight systems that are independent (CESR, 2002).

Much has been written about the decision taken by the EU that requires all listed companies within the union to prepare consolidated financial statements that comply with IFRS from 2005, in an attempt to create a single European market and facilitate cross-border transactions and listings (Fearnley et al., 2002; Quinn, 2004; Brown & Tarca, 2005; B. Parker, 2005; Berger, 2010; Yallapragada, 2012). This decision was supported by the ICAEW and the Institute of Chartered Accountants in Ireland (ICAI) (Street, 2002), as well as by the International Organisation of Securities Commissions (IOSCO), who had lobbied for the establishment of international standards in prior years (Gaffikin, 2008). This was also supported and promoted by the World Bank, the International Monetary Fund and the United Nations (Quinn, 2004), and since Regulation 1606/2002 (European Parliament and Council, 2002) established directly enforceable law, regulators of the individual countries were unable to influence this decision.

B. Parker (2005) explains that IFRS has been adopted by two parts of the world where the UK has its greatest political connections: the EU and the Commonwealth (leading members such as Australia, New Zealand, Singapore and South Africa have all adopted IFRS). Pressure from multi-national corporations and the rapid growth of capital markets has caused numerous other countries to also adopt IFRS for listed or other specific groups of entities, with the expectation that the demands of investors and shareholders for more detailed financial reporting that allows for greater comparability will be met (Al-Hussaini, Al-Shammari and Al-Sultan, 2008).

Fundamental to this regulation are not only the appropriate strict rules, but also the level of adherence to the standards. Schmidt, Sutherland, Van Schalkwyk, Lowe and Bockmann (2011) observe that while the EU has standardised the financial reporting standards by making IFRS adoption an EU law for countries within its borders, it have been unsuccessful in enacting union-wide enforcement procedures. Following this, a mutual concept for enforcement needed to be developed, specifically through the Committee of European Securities Regulators (CESR) (Berger, 2010).

The CESR was created in June 2001 to regulate enforcement for members of the EU, and comprises regulatory authorities from all member states of the EU, as well as Norway and Iceland (Berger, 2010). It was the view of CESR (2002) that in order to create efficient capital markets, improve investors' confidence therein and enhance the comparability of financial reports of listed companies in Europe, there needed to be harmonisation of enforcement systems across the continent. In addition to the creation of the CESR, regulation in each country was strengthened and 21 enforcement principles were provided by the CESR as guidance to each European securities regulator responsible for managing its own enforcement (Quinn, 2004). Because these principles are not mandatory, the cooperation of member states is required in the adopting of these principles (Brown & Tarca, 2005).

It is important to note that Principle 9 (CESR, 2002) states that the purpose of financial information enforcement is to "protect investors" and promote confidence in the market through improved transparency of the financial information that is "relevant to the investors' decision-making process", with Principle 21 requiring the enforcers to regularly "report to the public on their activities" (CESR, 2002; Brown & Tarca, 2005). As the EU regulation for compliance with IFRS relates specifically to listed companies, the "investors" referred to by CESR are deemed to be members of the public. The objective of the enforcement process is therefore to protect the interests of the public, while maintaining a level of transparency and openness between the regulating bodies and the public, as is consistent with the Public Interest Theory.

The preferred model of the CESR for selecting financial information of companies to be examined for enforcement purposes is a mixed model, whereby a risk-based

approach is combined with a rotation approach. A pure risk-based approach may be acceptable, but a pure rotation approach is not acceptable to the Committee (CESR, 2002; Brown & Tarca, 2005). The methods of enforcement upon countries of the EU range from pure formal checks to in-depth substantive in-nature checking. The intensity of the review to be performed by enforcers is usually determined by the level of risk present. From the perspective of the CESR, enforcement contributes to a consistent application of IFRS in the EU financial regulated markets.

While countries in Europe retained independence and responsibility for regulation, any major reporting disputes were to be referred to the International Financial Reporting Interpretations Committee (IFRIC), notes Quinn (2004). The US equivalent thereof is the FASB's EITF. The focus is on providing the best quality information to investors. In addition to the established bodies, auditors are required to exercise judgment when faced with complex or unique accounting issues at their clients that are yet to be identified or addressed by standard-setters, as capital markets sometimes move faster than the process of standard-setting (Van Wyk & Taylor, 2004).

5. International convergence and cooperation

Prior to the early 1970s, each country established and implemented its own set of accounting standards. The differences, particularly in recognition and measurement, resulted in a lack of comparability, and this led to inefficient utilisation of global capital (Wiecek & Young, 2010, as cited in Yallapragada, 2012).

During the 1960s, there was an increase in the growth of international trade which caused much discussion among investors about the differences in accounting standards between different nations, and the need for international accounting standards (Camfferman & Zeff, 2007). At the International Congress of Accountants in Sydney in 1972 it was determined that an international body was needed to address these concerns, and in 1973 the International Accounting Standards Committee (IASC), a private sector body with members from the accounting profession in various countries, was constituted (Yallapragada, 2012). From 1973 to

1987, the IASC agreed upon standards, many of which allowed alternative treatments, and were criticised as a result. As such, the IASC had little impact on the accounting practice and was not widely known (Camfferman & Zeff, 2007).

In 1977, the International Federation of Accountants (IFAC) was created as a group of accountants. The IFAC applied pressure on the IASC to involve the Federation in the standard-setting tasks, but the IFAC only had a say (by way of voting for the appointment of IASC Board members) in 1982, when a pact of mutual commitment was signed (Camfferman & Zeff, 2007).

A conceptual framework project was approved by the IASC in April 1989, and encouraged accountants to consider how to produce financial information that is useful to the users of that information (Gaffikin, 2008). It also attempted to reduce uncertainty by setting out "the concepts that underlie the preparation and presentation of financial statements" (IASB, 2010). The IASC was heavily reliant on the efforts of volunteers and the support it received from the employers of its members, and was not open with the public on matters such as total votes for issuing standards or dissenting views (Camfferman & Zeff, 2007). Through this lack of transparency, the public was unaware of the internal operations of the organisation, and as such it may have been difficult to judge whether these activities were conducted with the sole motive of satisfying the public interest.

During the 1990s, there had been a growing acceptance of the accounting standards issued by the IASC (Camfferman & Zeff, 2007), and in 1998, a set of International Accounting Standards (IAS) was completed (Yallapragada, 2012). Following multiple meetings in 1997 and 1998 and a strategic decision to separate the standard-setters from the accounting profession (Camfferman & Zeff, 2007), the IASC was restructured in 2000 to become the IASB – a full-time independent global setter of accounting standards (Van Wyk & Taylor, 2004) that are both understandable and enforceable, and that provide consistency and transparency of financial information (Quinn, 2004). Additional credibility was added to the IASB following the EU's endorsement of IFRS, making the IASB an acknowledged standard-setting leader (Camfferman & Zeff, 2007).

In 2000, the IFAC Forum of Firms (FoF) was established to assist the IFAC in the development and enforcement of international accounting and auditing standards, in an attempt to improve the global standard of financial reporting and protect the interests of international investors (Street, 2002). The meetings of the FoF are attended by the world's largest accounting firms, who have committed to adhere to and promote the consistent application of high-quality audit practices worldwide (IFAC, 2013). The FoF does not have the authority to create regulations for financial reporting, thus diminishing the risk of regulatory capture by accounting firms. On the contrary, the apparent commitment to appropriate enforcement of existing financial reporting regulation, through the audits performed by these firms, is perceived to substantiate the Public Interest Theory.

The IASB has sole responsibility for the setting of accounting standards (Street, 2002), with these activities being overseen by a body of trustees from various territories and professional backgrounds, known as the IFRS Foundation. These trustees serve the public interest, and are accountable to a group of public capital market authorities (the Monitoring Board) whose responsibilities include referring financial reporting matters of broad public interest to the IASB, through the IFRS Foundation (Deloitte, 2013). An external IFRS Advisory Council and the IFRIC provide guidance where practical divergence occurs. The IASB aims to engage with investors, regulators, business leaders and the global accountancy profession at every stage of the stand-setting process, and collaborates with the worldwide standard-setting community where necessary (IFRS Foundation, 2013b).

However, Brown and Van der Zahn (2007) argue that regulatory bodies such as the IASB have the ability not only to include as members those economically powerful groups who can exert influence over entities (such as accountants from the "Big Four" firms or developed world), but also to exclude other, perhaps non-financial, groups from membership. These other groups may provide better insight into issues such as health, poverty, climate change, employee rights and the like, for which future accounting decisions may be passed. Gaffikin (2008) supports this argument, stating that it has become widely accepted that accounting presents an economic reality that has been shaped by dominant, powerful economic forces. These groups, who use accounting to create a convenient economic reality, not only include large

international companies, but also other institutional organisations such as the World Bank and International Monetary Fund.

Companies listed on one or more stock exchanges are complex, and are subjected to various fluctuations and pressures from the market (Tweedie, 2003). Ideally, accounting should provide investors with accurate information that is reflective of the risks and fluctuations experienced by the entity, supplemented by the view of Hope (2003) that enhanced accounting disclosures made by companies would improve the transparency of financial information and limit the cases of information asymmetry. Globally, the IASB's role in standard-setting arose in response to the public interest need for harmonised financial reporting to improve the efficiency of markets (Chalmers et al.,2012), and while increased globalisation and internationalisation during the 1990s encouraged companies to become more competitive through transparency, the differing accounting standards between the nations hindered this (Berger, 2010). Van Wyk and Taylor (2004) emphasise that investors would benefit from there being a single, international set of standards as the administrative cost of accessing global capital markets would be reduced.

Financial reporting on regulatory convergence can improve the standard of financial data and encourage cross-border transactions (Quinn, 2004), and may be part of the process aimed at achieving financial reporting of improved quality at a global level (Al-Hussaini et al., 2008). However, financial reporting that is both transparent and reliable is unlikely to be achieved through standards harmonisation alone – successful harmonisation plans involve standard-setters, preparers of financial reports and the enforcers of financial reporting standards, namely the external auditors and independent enforcement bodies. It is the task of the auditor, states Berger (2010), to determine whether a company has properly applied the accounting standards, and in his audit opinion he informs the public about his findings. In doing so, public confidence in the accuracy of the financial information is enhanced, in line with the Public Interest Theory.

While the harmonisation of accounting rules across different countries through the efforts of the IASB has greatly decreased, the differences between the national financial reporting standards remain, while the enforcement of these standards by

the various nations is also variable. Moreover, firms within these countries implement widely varying disclosure practices (Hope, 2003). Brown and Tarca (2007) propose that an international enforcement strategy includes the following: common standards that apply in each jurisdiction (namely consistent international standards, such as IFRS, that have not been modified by local legislators), consistent application of these standards in each jurisdiction, and the promotion by national enforcement bodies of consistent, comparable IFRS application. Despite the fact that the harmonisation of financial reporting standards has an international focus, the enforcement of those standards is more of a national matter, as national governments are responsible for laws and regulations concerning companies, their securities and the auditors (Al-Hussaini et al., 2008). As yet, there is no fully-functioning financial reporting enforcement body that is internationally operational.

While global events have been explored in this chapter, Chapter 3 commences with the historical analysis from a South African standpoint, starting with the events that occurred around 1973 pertaining to financial reporting. The international happenings up to that time are compared to those of South Africa to assess whether an impact was made on the South African development that took place in the early 1970s. The regulatory and enforcement bodies that were fundamental to the South African financial reporting revolution are explored and contrasted with their international counterparts of the early 1970s.

CHAPTER 3

PHASE ONE: THE FIRST FORMALISED EARLY SOUTH AFRICAN DEVELOPMENT

The Republic of South Africa, as it is known today, once consisted of four British colonies (namely the Cape Colony, Natal, the Transvaal, and the Orange River Colony) until 1910 when they joined to form a Union, the Union of South Africa (Houses of the Imperial Parliament, 1909), with the country becoming a Republic in 1961 (South African History Online, 2013). The history of company law in these colonies provides an appropriate foundation for a discussion on South African regulation, and is therefore explored briefly before the focus is narrowed to those regulations of financial reporting and the enforcement thereof, particularly around 1973. The history of company law in South Africa, the establishment of the Public Accountants and Auditors Board (PAAB) in 1951, the 1973 Companies Act, the establishment of the Accounting Practices Board (APB) and the Accounting Practices Committee (APC), and International Accounting Standards Committee (IASC) membership are discussed during this phase.

1. Brief overview of the financial reporting regulatory environment prior to the 1973 Companies Act

Company law in South Africa has its roots in English company law (Haupt & Malange, 2010; Oberholster, 1999; Prather-Kinsey, 2006; Pretorius, Delport, Havenga & Vermaas, 1991). Relevant English legislation and its influence on legislation in South Africa should therefore be considered.

The Joint Stock Companies Registration Act was enacted in England in 1844, establishing a Registrar of Companies and allowing for the incorporation of companies separate from the unincorporated partnerships (Pretorius et al., 1991), although this Act only provided for an unlimited company having personal liability for its members (Horn, 1995). This was later amended in 1855 by the Limited Liability

Act, which saw the limited liability principle being applied to all registered companies. The Joint Stock Companies Act of 1856 offered members of companies, now incorporated by registration, the benefit of limited liability. As a result of British occupation, British company law was transferred to its colonies, including South Africa (Horn, 1995). In the Cape, the Joint Stock Companies Limited Liability Act of 1861 was based on the English Liabilities Act of 1855 and the Joint Stock Companies Act of 1856, and the Cape Companies Act of 1892 based on the English Companies Act of 1862. In the Transvaal, Law 5 of 1874 followed the Cape's Act of 1861, Law 1 of 1891 adopted the UK's Directors' Liability Act 1890 provisions, and their replacement – Act 31 of 1909 – was based on the English Companies (Consolidation) Act of 1908. The Orange Free State's 1891 Act also followed the Cape's company law, with Law 2 of 1892 being based on England's legislation. Similar to the Transvaal and the Orange Free State, Natal's Joint-Stock Companies' Limited Liability Law 10 of 1864 followed the legislation adopted in the Cape, and was complemented by the Winding-Up Law 19 of 1866. While these pre-union provincial laws continued to apply after the formation of the Union, they were replaced by the Union Companies Act 46 of 1926. This was largely based on the 1909 Transvaal Act. The Union Companies Act was amended on numerous occasions, but was by and large based on the 1908 English Act (Haupt & Malange, 2010; Pretorius et al., 1991).

Before company legislation underwent transformation from the 1926 Companies Act to the 1973 Companies Act, regulation of accountants and auditors gained attention, particularly as a result of the Public Accountants' and Auditors' Act of 1951 which called for the foundation of the PAAB.

Since 1945, international meetings had become par for the course in all professional fields (Murphy, 1958), and the initiatives taken with regard to the accounting and auditing profession in the Union of South Africa were very much dependent on the developments of the profession in Britain (Verhoef, 2013). However, the difference between South Africa and the United Kingdom (or other Commonwealth nations) regarding the accountancy profession's regulation was that the South African state intervened through the introduction of a public act and a statutory body that would execute statutory regulation such as the registration, examination and licensing of

professional members. This public act was known as the Public Accountants' and Auditors' Act 51 of 1951 (PAAA). Odendaal and de Jager (2005) argued that regulation of the auditing profession was required to ensure that auditors did not act in their own interest, but rather in the public interest, thus ensuring the community that they were able to have confidence in the competence of those performing the audit services, and in the quality of those services. The PAAB was the statutory body that stemmed from the Act, and was responsible for regulating the South African auditing profession through the setting of ethical and auditing standards (Odendaal & de Jager, 2005). Although not legally enforceable (because they were neither set nor approved by the South African government), the adherence of auditors to these standards was monitored by the PAAB itself, through frequent inspections, investigations of suspected misconduct, hearing these cases and imposing punitive measures where applicable. The approach of PAAB to institute standards and follow up on the application thereof was in line with the view of Murphy (1958) that accounting professionals have a desire to achieve the most far-reaching exchange of accounting principles and procedures, and aim to work towards achieving international financial reporting and auditing standards that will advance the finance and enterprise of all countries. At this stage in the country's development, South Africa was already aiming at improved financial reporting and regulation of the professionals associated with these reports.

The PAAB had the responsibility of registering auditors in South Africa, and registration was based on meeting requirements in terms of examination and traineeship of article clerks (Verhoef, 2013). The 1951 Act prohibited partnerships and profit-sharing between accountants resident in South Africa and those not, and made it compulsory for all public accountants to register themselves with the board. This requirement ultimately gave the government regulatory power over the profession's right to practise (Verhoef, 2013). Section 26 of the PAAA required an auditor, upon detection of a "material irregularity", to report the matter to the PAAB. Government representatives fought criticism by stating that it was in the interests of the shareholders as well as the public to be informed of the existence of inappropriate conduct (Verhoef, 2013). It can be observed that the public interest was the focus of the regulators, who aimed to bring to light any misconduct in financial reporting that was subject to review by an auditor. By exposing what the Act

defined as material irregularities, auditors were effectively enforcing the regulations promoting sound financial reporting, and deterring dubious practices in financial reporting. Countering the Public Interest Theory, Odendaal and de Jager (2005) believe the PAAB may have faced difficulties in fulfilling its social responsibility of guarding the public interest as a result of the lack of independence of the PAAB from the auditing profession, evidenced through the majority of the board members being members of the profession and the profession being solely responsible for funding the board. This introduced an element that is indicative of the capture theory – namely that the regulator (PAAB) may have been influenced by those that it aimed to regulate (the auditing profession) due to membership or financing – and as such may not have acted in the interests of the public, but instead the interests of those parties for which the regulation was intended.

Members of the auditing profession had, and continue to have, a role to play in the regulation and enforcement of financial reporting. According to Brown and Tarca (2005), enforcement of financial reporting regulations consists of three components. The first is that companies need to implement an effective system of control and be dedicated to quality financial reporting, the second is that there needs to be independent auditors who have strong technical skills, and the third is that there needs to be an oversight body with the necessary authority to effectively enforce the rules. During the transformation in the profession's legislation, little had been done specifically regarding the development of high-quality financial reporting regulation. In addition to this, the Companies Act of 1926 had not been rewritten since South Africa had become a Republic; thus a new Companies Act became the focus of corporate regulators in the early 1970s.

2. Companies Act of 1973

The Companies Act 61 of 1973 was the result of the efforts of the Van Wyk de Vries Commission, and while loosely based on English law, it went its own way and severed the long-standing ties between English and South African corporate legislation (Pretorius et al., 1991). Haupt and Malange (2010) agree, stating that while the 1973 Companies Act accepted English precedents, it also took South

African developments and the country’s local needs into account. The 1973 Companies Act was reviewed by an appointed Standing Advisory Committee, and recommendations for subsequent amendments to corporate law were made as and when required, signalling that the days when South African company law mirrored that of the English had ended.

The changes brought about by the 1973 Companies Act were intended to address the need for stronger shareholder democracy and more effective investor protection (Pretorius et al., 1991). Among these changes were the stricter accounting and disclosure regulations set out in Chapter XI of the Act. Focus areas within this chapter included a company’s accounting records (sections 284-287), accounting performed by holding companies with regard to groups of entities (sections 288-294), the disclosure of certain matters in financial statements such as loans, securities, emoluments and pensions of directors (sections 295-297), requirements as to signing and approval of financial statements (section 298), the directors' report (section 299), an auditor's duties as to annual financial statements (sections 300-301), the issuing of copies of annual financial statements (section 302), interim accounting performed (sections 303-308), and the right of members and others to copies of annual financial statements and interim reports (sections 309-310).

Researchers have placed considerable importance on the need for financial information to be fairly presented. Holland (1998) describes the objective of financial disclosures as to increase the understanding of investors of the performance and outlook of a firm, and in that way to ensure that all users interpret the firm’s financial information in a similar, informed manner; while Berger (2010) states that the purpose of accounting is to relay information about a company’s financial position and performance that is both complete and decision-relevant. Section 286(3) speaks to these issues, requiring that a company’s annual financial statements conform to “generally accepted accounting practice” in fairly presenting its business at the end of the financial year and its profit or loss for the year concerned. South Africa’s financial reporting requirements had been codified, which appeared to aid the accuracy and comparability of financial statements prepared in accordance with the Act. If companies were to all apply the same accounting practice – that which was generally accepted – it was assumed that the needs of investors and the general

public to have financial reports which were a fair representation of the company's state of affairs, prepared on the same basis in order to enhance comparability, would have satisfied.

However, the phrase "generally accepted accounting practice" was not defined by the Act, leaving section 286(3) subject to wide interpretation. The accountancy profession took it upon itself to address this practical issue, through the formation of separate regulatory bodies. These included the APB and the APC.

3. The APB and the APC

From the end of the Boer War in 1902 until the formation of the Union of South Africa in 1910, significant bodies were formed representing the accountancy profession in the four colonies. The Transvaal Society of Accountants formed in 1904. The Cape Colony, Natal and Orange River Colony established accounting associations shortly afterwards, between 1907 and 1909. In 1945 a Joint Council of these four Societies of Chartered Accountants of South Africa was formed, and in 1966 was renamed the National Council of Chartered Accountants (South Africa) (NC) (R.H. Parker, 2005). Before it was dissolved and replaced by the South African Institute of Chartered Accountants (SAICA) in 1980, the NC developed the APB, with whom the development and publication of generally accepted accounting practice statements in South Africa rested (Oberholster, 1999). While the APB may have arisen independently of the government, there existed a risk that the board may favour the interests of specific groups or large corporations, and thereby not serve the public. Brown and Van der Zahn (2007) explain that the interests of the public may be better met by reducing the political influence in accounting standard-setting through sourcing alternative funding and broadening the membership of the Regulatory board. In accordance with these beliefs, membership of the APB was diverse. It was intended that the APB adequately represent the business community, thereby ensuring that the widest possible acceptance of the accounting standards developed was obtained (Samkin, 1996). The APB comprised members appointed by SAICA, the IRBA, the JSE, the Association of Chambers of Commerce, die Afrikaanse Handelsinstituut (directly translated from Afrikaans as "the Afrikaans Trade

Institute”), the Federated Chamber of Industries, the Chamber of Mines, and the Steel and Engineering Industries Federation of South Africa (APB, 2011a).

The objectives of the APB, in terms of its constitution, were firstly to establish and procure the recognition and acceptance of what it considered to be generally accepted accounting practice, and secondly to apply and use its funds in promoting the first objective. The board’s constitution stated that no portion of its funds were to be “paid or transferred directly or indirectly by way of dividend, bonus, or otherwise howsoever, to the constituent bodies or to the members of the Board” (APB, 2011a). The APB, in developing regulations regarding what constituted “generally accepted accounting practice” was therefore able to avoid the threat of regulatory capture, as the lack of monetary consideration to be granted to the parties involved explicitly mitigated the risk that the APB’s financers were able to unduly influence the decision-makers through the promise of financial reward.

The APB was not the only body to be created by the NC in 1972 – the APC was formed as a committee of the NC (and later SAICA) responsible for the development of GAAP. The development was a process that began with the APC identifying the need for a statement to address a specific topic, or receiving suggestions from members of the accountancy profession (Verhoef, 2012). Once these statements were developed, they were submitted to the APB for approval (Samkin, 1996). It was known that SAICA’s mission was to serve the interests of the chartered accountancy profession and society, and that the APC was operated to support that mission (APC, 2012). The APC was considered to be the official technical body of the SAICA Board regarding financial reporting, and appointed its members with the aim to represent those in public accounting, members in business, academics and users including the JSE. The objectives of the APC included reviewing and monitoring financial reporting frameworks (such as IFRS) and issues in South African financial reporting of general importance to users and preparers that may require guidance with regard to the appropriate accounting treatment (APC, 2012).

Maguire (1979) described the establishment of the APB and APC as following the trend of the US standard-setters, namely the AICPA’s CAP, APB(US) and FASB, of setting financial reporting standards in an attempt to improve the quality of the

accounting information. However, it is important to consider the nature and content of those standards that formed part of the financial reporting regulations in South Africa, together with their enforcement (if any), in order to assess the impact these made on the consumers of the financial information that was reported in compliance with the standards developed. The 1973 Companies Act had stipulated that ‘gaap’ be applied to achieve the aimed quality of financial information. What precisely ‘gaap’ consisted of, however, was a complex issue.

4. Statements of ‘gaap’

As discussed above, the Companies Act promulgated in 1973 required that annual financial statements of a company conform with *generally accepted accounting practice (GAAP)* (South Africa, 1973: section 286(3)), but this term was not considered to be clear in practice, with many practitioners interpreting the phrase differently. To this end, the APB took senior counsel’s opinion on the meaning of gaap as referred to in the 1973 Companies Act, which was that while compliance with GAAP, as issued by the APB, met the requirements of the Act to conform with gaap, non-compliance with GAAP may not necessarily constitute a contravention of the Act (SAICA, 1999). This legal opinion was supplemented in 1999, as a result of the amendment to Schedule 4 of the Companies Act in 1992. Schedule 4 paragraph 5 declared that if it appeared to the company’s directors that there were reasons for departing from any accounting concepts stated in APB-approved GAAP in preparing the company’s financial statements, then they were permitted to do so. However, the particulars of, effects of and reasons for the departure were required to be given. The senior counsel’s 1999 opinion was then that paragraph 5 of Schedule 4 required that disclosure be made whenever the financial statements of a company departed from any of the APB Statements (SAICA, 1999). It was this opinion that moulded the understanding of financial reporting such that financial statements should be prepared and presented in accordance with gaap in order to meet the requirements of the Companies Act, but if there was a material departure from Statements of GAAP, the financial statements were then required to provide disclosures relating to that departure.

It was therefore possible for company management to circumvent the financial reporting regulations created by the profession through standard-setting without suffering the consequences of non-compliance with legislation. Although the government is dependent on corporations for revenue, employment and supplies, Pretorius et al. (1991) believe that it would object if one of these entities plans to pursue a policy that is not in congruence with the interests of the public. To this end, compliance with GAAP was strongly encouraged in the interest of good financial reporting (SAICA, 1999), despite South Africa effectively having two financial reporting frameworks from the mid-1970s until the promulgation of the 2008 Companies Act in May 2011. One was based on GAAP – those accounting standards and practices codified by the APB and based on internationally accepted standards; and the other on gaap – those accounting practices that were uncodified but were nevertheless regarded as being generally accepted due to their being followed by a number of companies.

The choice of applying gaap or GAAP when reporting financial results ultimately rested with the companies themselves. Fearnley, Brandt and Beattie (2002) suggested that all parties to the financial reporting framework should constantly bear in mind for whom the company accounts are prepared, and for what purpose the financial information is presented to those users. Companies therefore had the opportunity to serve the interests of the public by preparing financial information in such a way that the investors or other interested parties using that information would not be misled as to the performance of a company over a period or its financial position at a given date. Should a company have been able to justify a particular accounting treatment, even though the approach differed from those recommended by the APB in their statements, the accounting for that transaction would not be labelled as going against regulation. Since the 1973 Companies Act did not require that companies comply with GAAP, there existed no statutory enforcement procedures for Statements of GAAP (United Nations, 2008), and as such, regulators had their hands tied with regard to those entities electing not to apply the formal accounting statements.

The development of these statements, as led by the South African accounting profession through the NC's APB and APC, was held in high regard by

representatives of the founders of the IASC (Verhoef, 2012), an international organisation established to promote international harmonisation of accounting standards (Zeff, 2012).

5. IASC membership

The establishment of the IASC in 1973, as detailed in Chapter 2, was preceded by numerous discussions and negotiations held between representatives of the accounting profession of different nations. Representatives of South Africa, however, were not included in these, because of the international sanctions imposed on the country during that period (Verhoef, 2012). A year after its formation, the IASC invited South Africa to take up “associated membership”, and the country became an associated member from 1974. In 1978, South Africa became a full voting member of the IASC, and remained an active member throughout the years of sanction and isolation from the rest of the world. South Africa was therefore able to remain updated on international accounting issues (Oberholster, 1999). South Africa’s relationship with the international body is an important factor when analysing the regulation of financial reporting in the country, because it caused international standards developed by the IASC (known as International Accounting Standards, or IAS) to have considerable influence over South Africa’s financial reporting. The accounting standards produced by the IASC assisted the South African standard-setters in developing SA GAAP (Coetzee & Schmulian, 2013). It is this international harmonisation – of local South African standards with international ones – that led to phase two of the development of South African financial reporting regulation and enforcement.

CHAPTER 4

PHASE TWO: GREATER HARMONISATION OF SOUTH AFRICAN FINANCIAL REPORTING WITH INTERNATIONAL STANDARDS

To this point, the status of financial reporting in South Africa from the early 1970s has been discussed, and it has been observed that the regulation and enforcement pertaining to financial reports of South African companies were largely uninfluenced by the international goings-on that were impacting the US and UK at the time, despite the 1973 Companies Act having British roots. This chapter will analyse the movements and harmonisation of South Africa towards international trends in financial reporting standards, before examining the development of new regulatory bodies and finally focusing on the influence of corporate governance regulations on South Africa's financial reporting. The adoption of International Financial Reporting Standards (IFRS) as SA GAAP, the revised JSE listing requirements, the Accounting Review Panel (ARP) and Auditing Profession Act 26 of 2005 (APA) and corporate governance developments are discussed under this phase of the development of financial reporting in South Africa, subsequent to the 1973 period discussed in phase one.

1. Harmonisation of SA GAAP with IAS

In 1993, SAICA launched its Harmonisation and Improvement Project, the goal of which was to make corporate reporting in South Africa more useful to international investors (Oberholster, 1999). This, say Enahoro and Gervais (2012), arose from the recognition of SAICA, the JSE and the APB that South Africa needed to be part of the global economy when it came to financial reporting. The project resulted in the revision of existing SA GAAP to align with the IASC's International Accounting Standards (IAS), and the issuance of new statements for those areas covered by IAS, but not SA GAAP (Coetzee & Schmulian, 2013; World Bank, 2003a). This amounted to there being a South African accounting standard for each IAS. Oberholster (1999) stated that the decision to harmonise SA GAAP with IAS was

heavily influenced by the IASC, who sought that the majority of the revised South African standards be closely aligned with those of the Committee. Internationally, during 1993, the International Organisation of Securities Commissions (IOSCO) (of which South Africa was a full member) and the IASC agreed on core accounting standards for entities involved in cross-border offerings and listings (Coetzee & Schmulian 2013). The policy in South Africa did not allow SA GAAP to differ with IAS on fundamental issues, but did permit the elimination of alternative treatments, additional guidance, and additional disclosures. The policy also allowed for departure from IAS, if it was found that a requirement of the IAS was against national law (World Bank, 2003a).

Van Niekerk (1999) showed concern that while compliance with IAS was required it was not legally enforceable, which may have resulted in financial reporting that was not considered to be relevant to market participants. Members of the public were thus exposed to the risk that a company's financial reports were not prepared in accordance with the regulations set out by the APB, rendering them incomparable with those of other companies. This meant that investors wishing to make decisions on the basis of a company's financial statements were potentially being misled. The problem then arose as to who the responsible party should be for ensuring that companies were in fact applying the South African statements since harmonisation. Al-Hussaini, Al-Shammari & Al-Sultan (2008) believed that the onus generally rested on external auditors, stock exchanges (where applicable), central banks and bodies established by governments to monitor the compliance of companies with accounting standards. These concerns continued through to the early 21st century in South Africa, leading to the adoption of international standards as the local GAAP.

2. Adoption of IFRS as SA GAAP

An assessment performed in 2003 by the World Bank as part of its joint initiative with the International Monetary Fund (IMF) revealed that regardless of the fact that South Africa's national accounting standards were developed based on international standards, the lack of legal backing for the accounting standards caused problems (World Bank, 2003a). The assessment reported that even though South Africa had

accounting professionals with the necessary skills and capabilities, the mechanisms that existed for enforcing compliance with accounting standards were considered weak. The issue of enforcement remained a dilemma, despite the APB's decision to bring SA GAAP in line with IFRS in 2004 – 11 years after the harmonisation project.

In 2004, after due process was carried out, the APB started issuing IFRS (previously known as IAS, prior to the replacement of the IASC with the IASB) as SA GAAP without any amendments (IFRS Foundation, 2013a), meaning that future Statements of SA GAAP would be an exact replica of the relevant IFRS (Rossouw, 2005). The objectives of the APB's decision were to aid South African companies in attracting foreign investors, provide global credibility to South African financial statements and remove the requirement placed on dual-listed companies to prepare their financial reports in accordance with multiple financial reporting frameworks (Enahoro & Gervais 2012). The adoption of IFRS aimed to correct the problems in SA GAAP, including inconsistent financial reporting (Anonymous, 2006). Since IFRS required increased disclosures to be made by companies compared to those previously required by SA GAAP, the resulting financial data to be reported was of a more technical nature and not easily understood by laypersons. Considering that the average member of the public did not have a financial background (and there were only 24,080 registered CAs(SA) in 2004 (Verhoef, 2012) the needs of the general users for meaningful information that was not too complex or confusing were not met. Even though the regulators (SAICA and the APB) had not been captured by companies who had to apply IFRS – based on evidence that applying IFRS resulted in increased complexity, significant costs and possible confusion about companies' performance indicators (Coetzee & Schmulian, 2013) – the Public Interest Theory was not satisfied due to a decrease in the understandability of financial reporting, and the consequent failure to reflect the nature of the business.

The South African Reserve Bank (SARB) (2005) reported that as part of the process of adopting IFRS as GAAP, the APB reissued all Statements of GAAP when differences existed between the SA standards and those of the IASB. Therefore, any differences in wording between the statements were eliminated, with the exception of differing effective dates. As a result of the adoption, companies who had chosen to apply SA GAAP as opposed to applying gaap, and then disclosing why they had

chosen not to apply GAAP, and the impact thereof on their financial reporting – were in substance complying with IFRS, with the exception of IFRS 1, *First-Time Adoption of International Financial Reporting Standards* (Coetzee & Schmulian 2013). However, due to the transitional differences that existed, a company that complied with SA GAAP could not claim compliance with IFRS (United Nations, 2007).

Internationally, as discussed in Chapter 2, the EU required that all listed companies apply IFRS in the preparation of their financial statements for financial years ending on or after 31 December 2005. South African regulators took a similar approach to financial reporting regulation, through the revision of stock exchange requirements for listed companies, and seriously considered the enforcement of that regulation, through the development of a body to monitor compliance with financial reporting regulation.

3. Revised JSE listing requirements and the GMP

The JSE Limited, previously known as the Johannesburg Stock Exchange until 2000 and the Johannesburg Securities Exchange until 2005 (JSE, 2013a), was South Africa's national exchange, trading in both equity and debt instruments (Coetzee, 2007). From 2000, the JSE required that companies listed on the exchange perform their financial reporting in accordance with the 1973 Companies Act, and use either SA GAAP or IAS as the financial reporting framework in the preparation of their annual financial statements. The choice was made available to assist foreign companies and those that were dual-listed (Coetsee, 2007). A significant development occurred in 2004, when the JSE amended its listing requirements (specifically section 8.3) and so announced that for financial periods commencing on or after 1 January 2005, listed companies (whose primary listing was on the JSE) were required to use IFRS, rather than either SA GAAP or IFRS, as was previously stated in that section of the listing requirements (Coetzee & Schmulian, 2013, Deloitte, 2003; IFRS Foundation, 2013a). It is important to note, however, that if the company's primary listing was outside South Africa and the listing on the JSE was a secondary listing, the company could continue to use the GAAP of its home market. The adoption of IFRS had an impact despite SA GAAP being principally in line with

IFRS, not only in terms of some key differences between IFRS and GAAP, but also differences in the interpretation and application of GAAP in comparison to IFRS (Deloitte, 2003).

This regulation instituted by the JSE aligns with the hypothesis of Pretorius, Delport, Havenga and Vermaas (1991) that South Africa, much like the United Kingdom, had appeared to favour voluntary self-control by the stock exchange over legal regulation, as seen in the United States by the body of law built up by the SEC. The JSE (rather than the South African government) identified that monitoring of companies' compliance with regulations over the financial reporting framework used was required. This, together with highly publicised corporate collapses such as Enron, resulted in changes to the reporting environment of South African companies and as a result, numerous long-term projects were undertaken by various regulatory bodies to improve the quality of financial reporting. One of the significant developments was the establishment of the GAAP Monitoring Panel (GMP) by the JSE and SAICA in 2002 (Coetsee, 2007). The GMP was an oversight body of specialists appointed to monitor and advise the JSE on matters of non-compliance by JSE-listed entities with SA GAAP or IFRS (Deloitte, 2003).

The motive for the formation of the GMP can be considered in light of the public interest. SAICA's senior executive for standards at the time explained that financial reporting was highly important to investors and other market participants, as well as to regulators and users (Anonymous, 2009). Crucial to global financial stability and growth was the confidence of users in the integrity and transparency of financial reporting. Following the scandalous failures of companies around the globe, including LeisureNet and Fidentia in South Africa, a definitive loss of investor confidence arose (Watson & Rossouw, 2012). The GMP was the response of SAICA and the JSE to that loss of confidence in financial reporting by members of the public with a financial interest in those companies, and was formed because SAICA and the JSE were of the opinion that the 1973 Companies Act failed to enforce compliance with financial reporting standards (SAICA, 2004). The chairman of the GMP emphasised that the Panel operated as a deterrent rather than as a mechanism of policing, and performed its function to improve confidence in the accuracy and completeness of financial statement information (SAICA, 2006b). So

too was the Chief Executive of the JSE of the view that the GMP would enhance the confidence of the public in the reliability of published financial reporting. However, in light of the fact SAICA had recourse for action only where the directors involved were CAs(SA) (SAICA, 2008), the enforcement actions of the GMP may not have appeared as detrimental to non-CA(SA) board members, rendering the outcome of the GMP's investigation at times insufficient in achieving its objective of acting in the public interest.

Enforcement of financial reporting ensures, on a preventative basis, that material irregularities in accounting standards applications are avoided (Berger, 2010). The GMP performed its duties of investigation on a reactive basis, and investigated complaints on compliance of listed companies with IFRS, the JSE's required accounting practices (in terms of the Listings Requirements) and the accounting practices required by the 1973 Companies Act (SAICA, 2006; 2008). The GMP would consult with the relevant company, and subsequently report to the JSE, who was responsible for recommending the necessary corrective action to that company. Corrective action to be taken included a restatement of the published financial statements or stating a correction in the next financial year, and making a public announcement to that effect, or issuing a fine to the entity or its directors (Deloitte, 2003; Watson & Rossouw, 2012). This was the first incidence of financial reporting enforcement, as GAAP had no support in a legislative context (Mittner, 2002). Not only was the enforcement of IFRS under development, but the sufficiency and appropriateness of the regulation was also under consideration, particularly as a result of the numerous business failures that were making headlines at the time.

4. The ARP and the APA

The corporate collapses that had occurred up to 2002 gained the attention of the South African government. As many of those corporate scandals had involved auditors (including the Enron debacle, as discussed in Chapter 1), doubts were raised worldwide regarding the regulation of the auditing profession. South Africa's Minister of Finance intervened by appointing a regulatory body called the ARP (Puttick, Van Esch & Kana, 2007). The ARP's mandate was to assess the regulatory

framework of the accounting and auditing profession, including the APB, and following its investigations the Panel presented a reported on the accountability of auditors, usefulness of accounting standards and financial reporting legislation, amongst others (Verhoef, 2012). The report of the ARP gave recommendations that formed the basis of the APA, and since it aimed to introduce a more inclusive legislative framework for the regulation of the auditing profession, it served to repeal and replace the Public Accountants' and Auditors' Act (van Wyk, 2005).

Section 2 of the APA defined the objectives of the Act as protecting the South African public through the regulation of auditors, establishing the Independent Regulatory Board for Auditors (IRBA), improving ethical and auditing standards, advancing standards of competence and good ethics, and providing for disciplinary action for improper conduct (South Africa, 2005). As noted in section 2(a), public protection was important to regulators in the formulation of this Act. The IRBA replaced the PAAB as its successor, and was handed the duty of training, accreditation, registration and regulation of auditors, as well as prescribing auditing standards (Verhoef, 2012; Bourne, 2007). Similarities could be observed between the APA and the Sarbanes-Oxley Act (United States, 2002), in that both pieces of legislation recognised the importance of effective monitoring of the auditing profession and auditor independence and objectivity in maintaining investor confidence and integrity of financial markets. Both Acts ensured effective oversight of the auditing profession through the Public Company Accounting Oversight Board (PCAOB) and the IRBA (Bourne, 2007).

The IRBA defined its corporate mission as "to protect the financial interest of the South African public and international investors in South Africa through the effective regulation of audits" (IRBA, 2013). While the explicit intention appeared to be that the body would act in the public interest, the threat of regulatory capture deserves some consideration. According to the IRBA website, the board consisted of between six and ten members, and was not allowed to consist of more than 40% registered auditors (IRBA, 2013). If the board had been permitted to consist half or more of auditors, opportunity would have existed for those auditors (who the IRBA was responsible for regulating) to manipulate the decision-making processes of the board to serve their own purpose. As an additional precautionary measure, the IRBA was

funded through fees levied on registered auditors and auditing firms, receipts from other legal sources such as sanctions imposed by the board, and money appropriated by the National Treasury to serve its purpose (IRBA, 2012; 2013). No one interested party or group of parties was able to provide the board with an incentive (in the form of a sizable donation, for example) to influence regulations or enforcement against or in favour of specific persons. Fees to be paid by auditors were standardised, and since all those who were registered with the IRBA were liable to pay, those payments cannot be seen to have unduly pressured the regulation in a direction other than that of public protection.

One of the duties of the IRBA was to ensure that auditors who were registered with the board possessed the necessary professional competence to serve the public interest and the needs of the South African economy; the IRBA's process in awarding accreditation to auditing firms was intended to improve the quality and integrity of the profession such that it earned public confidence (IRBA, 2012). In placing a focus on the public, the IRBA aimed to ensure that the public were able to rely on the financial reporting of companies that were audited by those registered with the regulatory body. Since the role of the auditor in performing an audit was to examine, in accordance with the relevant auditing standards, financial statements in order to express an opinion "as to their fairness or compliance with an identified financial reporting framework and any applicable statutory requirements" (South Africa, 2005: s1), the auditors were effectively responsible for testing whether a company's financial reporting complied with IFRS or SA GAAP, as well as legislation such as the 1973 Companies Act. It can be presupposed that auditors indirectly had the power to enforce compliance with the financial reporting framework, with the threat that an unfavourable audit opinion may have been rendered should non-compliance have been detected. Hope (2003) described enforcement of financial reporting standards as just as important as the standards themselves, because the quality of the financial information produced is affected by both the quality of the standards and the enforcement of application of those standards. Without the enforcement, accounting standards would have little meaning. Both academics and practitioners therefore agree on the necessity of enforcement as an essential element of financial reporting.

According to Peltzman (1993), an important factor when concerned with regulatory theory is the nature of the commodity that is being transacted. When considering the regulation and enforcement of financial reporting, it is not only the financial position and performance of an entity that is being reported, but indirectly the ability of management to use the funds of investors successfully, through the acquisition of strategic assets and good returns. Since public companies are funded by a broad spectrum of investors, the regulation governing the financial data reported to those investors that focus on the transparency and fair presentation of a company's results is seen to fulfil the public interest. During the early 1990s, such regulation was being drafted, and was concentrated specifically on the manner in which companies were being governed; thus the discourse on corporate governance gained momentum.

5. Corporate Governance

The US Securities Act of 1933, brought about by the Great Depression as discussed in Chapter 2, was the first to require that companies provide potential investors with adequate information to make an informed investment decision (IRC, 2011). The need for the public to have access to sufficient financial records had been a continuous problem, as the accounting information provided was susceptible to fraud, human error and bias. Steward (1986) took the view that the lack of ability of management to impartially prepare financial reports indicating its own performance was a significant ethical problem of financial reporting. South Africa's history of corporate governance, defined as the system by which a company is directed and controlled (Haupt & Malange, 2010), began in the early 1990s, following the abolition of apartheid which had kept the country isolated from international practices (Malherbe & Segal, 2001). Global recognition was gained upon the release in 1994 by the South African Institute of Directors (IOD) of the first King Code of Corporate Practices and Conduct (King I), for its dealing with stakeholder and corporate responsibility issues (World Bank, 2003b). The scope of King I encompassed more than just the financial and regulatory facets of governance by promoting an integrated approach – which included supporting the interests of a wide range of stakeholders (Barac & Moloi, 2010). As good corporate citizens, Pretorius, Delport, Havenga and Vermaas (1991) believed that an entity should consider the interests of

not only the shareholders, but also those of its workforce, customers and the community at large, and although the so-called “King Code” was a voluntary piece of regulation, and therefore without related enforcement practices, the focal point appeared to be on protecting the public interest without manipulation by special interest groups.

However, the abundance of corporate collapses in the early 2000s led many stakeholders to doubt the relevance and reliability of financial reporting as a basis for decision-making regarding an entity (IRC, 2011). Most corporate failures were evidenced by a gross lack of appropriate checks and balances, inefficient corporate governance and unreliable financial reporting (SARB, 2002; Watson & Rossouw, 2012). The second and third King Codes were published in 2002 and 2009 respectively, and placed emphasis on good corporate governance and the responsibilities of the board of directors in achieving this. King II applied to listed entities, companies within the financial services industry, and public sector enterprises. All other corporations were encouraged to adopt the Code’s principles, which recognised the need to move away from *single* bottom line reporting which was focused only on turning a profit attributable to the shareholders, to *triple* bottom line reporting which encompassed an entity’s economic, environmental and social activities (Barac & Moloi, 2010). King III applied to all entities rather than specific types of companies, and followed an “apply and explain” approach (as opposed to the “comply or explain” approach of King II) whereby companies were required to either apply the recommended good practice per the Code, or explain in their financial reports the reasons for their lack of application. The third report also drew attention to the importance of integrated sustainability performance reporting over pure financial reporting (Haupt & Malange, 2010), and to governance principles that included good faith, acting in a company’s best interests, exercising due care and skill, stewardship of company assets and diligence (Barac & Moloi, 2010). Though not formally legislated, the King Code became generally accepted practice for South African business conduct and has attained recognition internationally (Haupt & Malange, 2010), with the JSE requiring that listed companies disclose the extent to which they comply with the King Code.

This chapter has discussed the changes that took place in South Africa surrounding its financial reporting standards, auditing profession and corporate governance. Fearnley, Brandt and Beattie (2002) asserted that the quality of accounting standards, audits and corporate governance was important in order for the public to place their confidence in the market. For the regulation covering these areas to be effective, there needed to be a culture of compliance as well as mechanisms of enforcement and oversight to deter and address non-compliance with that regulation. On the advent of the new Companies Act, numerous bodies for enforcement and oversight were created as an attempt by regulators to prevent incidences of non-compliance with financial reporting regulation. The Companies Act of 2008, the statutory bodies it established and the process undertaken by the national stock exchange in monitoring compliance with international reporting standards is analysed in Chapter 5. This is considered the third, and most recent, phase in the historical evolution of financial reporting in South Africa. It deals with the latest Companies Act of 2008, and the various councils, commissions and monitoring bodies that were subsequently put in place.

CHAPTER 5

PHASE THREE: A 'NEW' ERA: A NEW COMPANIES ACT, COUNCILS, COMMISSIONS AND MONITORING

As Fearnley, Brandt and Beattie (2002) note, a regulatory framework requires an enforcement mechanism that is both effective and efficient in determining non-compliance with regulation, and the punishing of offenders. The Companies Act of 1973, as covered in phase one, was administered by the Registrar of Companies, but there was a heavy reliance placed on self-regulation as the Registrar had limited capacity for enforcement (World Bank, 2003b). A significant driver for the development and enforcement of a new South African Companies Act was to create a regulatory framework for all companies, regardless of their size or nature, which would encourage growth, good governance and international competitiveness, among other reasons (Department of Trade and Industry, 2010), which appeared to be aimed at protecting the public interest. And so emerged a 'new' Companies Act in 2008, which once again steered the regulation of financial reporting in South Africa in a new direction.

1. The 2008 Companies Act

Haupt and Malange (2010) explain that it was the vision of the Department of Trade and Industry to create a new regime of company law that would promote entrepreneurship and enterprise development. The new Companies Act aimed to improve compliance, transparency and accountability, through introducing as legal rules many principles of good corporate governance, in accordance with the King Code. These principles are discussed in phase two. The Act provided a framework applicable to all companies, with added regulatory burden placed on those types of companies where the public was exposed to greater risk (Haupt and Malange, 2010). It is evident that the public interest was factored into the requirements of the Act, as the underlying theory behind the corporate regulations appeared to be aimed at addressing the need for protection of the public. As a deterrent, through the new

Companies Act, a company would be guilty of an offence if it undertook reckless, negligent or fraudulent trading (Department of Trade and Industry, 2010).

The Companies Act, no. 71 of 2008 (as amended by the Companies Amendment Act, no. 3 of 2011), became effective on 1 May 2011 following the publication of a draft Bill, a process whereby public participation was sought and the submissions made by a variety of stakeholders were considered (Haupt & Malange, 2010). The Act, together with its accompanying Regulations, provided detailed guidance on which financial reporting frameworks should be applied by companies; this differed significantly in some areas from the requirements of the 1973 Companies Act (APB, 2011b). Section 29(1)(a) of the 2008 Companies Act required a company preparing financial statements to satisfy the prescribed financial reporting standards as to form and content. Section 29(4) continued to state that the Minister of Trade and Industry, after consulting the Financial Reporting Standards Council (FRSC), may make regulations prescribing the financial reporting standards, and that these regulations must promote sound and consistent accounting practices, and in the case of public companies be in accordance with IFRS, and that, in addition, the Minister may establish different standards applicable to profit and non-profit companies, and even different categories of profit companies (South Africa, 2008). The fact that the new regulation required all companies to conform to IFRS was termed a “commendable development” by Farisani (2010).

Regulation 27 stipulated that the financial reporting standards required and permitted the use of either IFRS, IFRS for SMEs, or SA GAAP in specific instances (IFRS Foundation 2013a; South Africa, 2008), depending on a number of factors. These included the type of company (state-owned, public and listed, public and unlisted, other profit companies divided based on their Public Interest Score (PIS), and non-profit companies divided based on their PIS) and, if not state-owned or public, whether or not the company is owner-managed, and whether or not the company’s financial statements are internally or independently compiled. The PIS was designed to indicate the extent of public interest in companies that are unlisted, and was calculated in accordance with regulation 26(2) based on the average number of employees of the company during the financial year, the amount of third party liability of the company at the financial year end, the amount of turnover during the financial

year, and the number of individuals with a direct or indirect beneficial interest in any of the company's issued securities, or who were members of the company or members of an association that was a member of the company (South Africa, 2008). The focus of the regulators on those parties affected by an entity (including lenders, shareholders, directors and employees) indicated an attempt to address the need for public dissemination of sufficient and appropriate accounting information. The purpose of accounting, according to Berger (2010), is to relay information about a company's financial position and performance that is both complete and decision-relevant, and the new Companies Act focused on this through the regulation of financial reporting standards to be applied by the various types of companies.

The new legislation reinforced the listing requirements of the JSE, whereby companies with securities being traded in public markets were required to use IFRS, and extended legislative backing for IFRS to certain other companies whose equities were not publicly traded, but also required to use IFRS because they fell out of the scope of IFRS for SMEs (Coetzee & Schmulian, 2013; IFRS Foundation 2013a). Companies with higher PISs were required to comply with IFRS or IFRS for SMEs, as issued by the IASB, without the option of using SA GAAP. Even though a company may only have been required to apply IFRS for SMEs, it was still permitted to choose full IFRS (IFRS Foundation 2013a). All companies were required to meet the prescribed financial reporting standards in the preparation of their financial statements. These financial statements had to have been consistent with IFRS, regardless of the type of company (Department of Trade and Industry, 2010). Some companies with a low PIS and internally-compiled financial statements were allowed to use self-developed accounting policies, provided that they were in no other way required to comply with any other financial reporting standards (IFRS Foundation 2013a).

Under the new Companies Act, shareholders had extensive rights when requiring information of the company, thereby increasing the level of accountability. Transparency was enhanced by means of appropriate input provided by all company stakeholders (Department of Trade and Industry, 2010). The principles of accountability to equity holders and finance providers, and the transparency of companies' operations in the form of clear and truthful financial reporting, are in line

with the theory that regulation is instituted for the benefit of the public at large, as opposed to that of specific interest groups. These regulations, however, require enforcement mechanisms to ensure that the objectives of the corporate legislation are met.

The creation of enforcement bodies by government, who determines the scope of those bodies' activities and the source of their funding, is explained by way of the Public Interest Theory (Brown & Tarca, 2007) as covered in Chapter 1. The 2008 Companies Act created a number of new agencies for regulation and enforcement including the FRSC and the Companies and Intellectual Property Commission (CIPC). The impact of these bodies on financial reporting – and their impact on regulation and enforcement thereof – is discussed below.

2. The FRSC

Chalmers, Godfrey and Lynch (2012) agree that the failure of the market to deliver adequate accounting information is what requires government intervention in the setting of accounting standards. Former president of SAICA, Wiseman Nkuhlu, was quoted as saying that the setters of accounting standards should be independent of commercial and political pressures, yet still remain accountable for stakeholder engagement and oversight performed in the public interest (Anonymous, 2009). SAICA performed the role of advisor to the APB as the South African standard-setter until 2011 when the 2008 Companies Act created a new government body known as the FRSC, an advisory committee responsible for advising the Minister of Trade and Industry by drafting improvements to reporting standards and adapting international standards (IFRS) for the South African economic environment (Schmidt, Sutherland, Van Schalkwyk, Lowe & Bockmann, 2011).

The FRSC, formed in terms of section 203 of the new Companies Act, is responsible for providing recommendations on matters with regard to financial reporting standards governing the form and content of both public and private companies' financial statements, and in this way ensures that the those financial statements are in compliance with the specified standards (Department of Trade and Industry, 2010;

Farisani, 2010; SAICA, 2011). The Council does not have binding powers, but instead approves of the financial reporting standards prior to the Minister choosing to enact them as regulation in South Africa (Schmidt et al., 2011). Stemming from the establishment of this body, as well as direct references made in the new Companies Act to IFRSs and the IFRS for SMEs as issued by the IASB as the financial reporting frameworks, the APB's endorsement of IFRSs as SA GAAP was no longer relevant (IFRS Foundation, 2013a). Together with this development, the need for SA GAAP was re-evaluated, as these standards were essentially identical to those of IFRS except for IFRS 1 – First-time Adoption of International Financial Reporting Standards and the new IFRSs, IFRICs and amendments to IFRSs issued by the IASB after the enactment of the new Companies Act in May 2011 (SAICA, 2013).

Following the formation of the FRSC, the APC's objectives were amended to include the aim of providing input in the setting of new and revised/amended pronouncements as issued by the FRSC, and where appropriate, nominate members to the FRSC (APC, 2012). As the legally-constituted standard-setter for South Africa, and in the promotion of the public interest, the FRSC aimed to hear the needs of companies regarding reporting standards, and had a responsibility to advise the Minister on reporting standards in South Africa (SAICA, 2011). As noted by Davis et al. in Farisani (2010), by using international financial reporting standards as a basis for local standards, South African accounting practices would conform with those of the global investment community, making the capital markets in South Africa more easily understandable and accessible to overseas investors.

In order to enhance the value of the financial reports issued by companies and thereby allow the public to place reliance upon them, the new Companies Act termed it an offence to falsify documents or records, or to publish untrue or misleading information (South Africa, 2008). To improve the accountability of companies, a person who signed false or misleading financial statements, or agreed to them, would be punishable by a fine or a prison sentence of not more than 10 years (Department of Trade and Industry, 2010). The punishment meted out for intentionally misstated financial reporting indicated a willingness of the regulators to ensure that enforcement of the legislation is carried out. It is also noted that, in terms

of the 2008 Companies Act, the FRSC was also to consider recommended amendments to the financial reporting standards received from the CIPC.

3. The CIPC

The CIPC is an independent agency created by section 185 of the Companies Act that bears the burden of ensuring that the regulations of the Act are enforced (Farisani, 2010), and it has to fulfil its purpose as an "organ of state within the public administration, but as an institution outside the public service" (South Africa, 2008). As such, the CIPC is the main body for investigating alleged non-compliance with the relevant financial reporting standards, and for enforcing the application of those standards by the companies to which they apply. While reports of alleged non-compliance by companies with the prescribed financial reporting standards can be brought to the attention of the CIPC, or made by the CIPC itself, the Minister can also request the CIPC to investigate a company's non-compliance with the Act (Schmidt et al., 2011). The CIPC is also responsible for promoting the reliability of financial statements and compliance with applicable legislation, ensuring that the legislation is enforced efficiently and effectively, and both monitors compliance (or lack thereof) and makes recommendations to the FRSC regarding financial reporting standards with the aim of improving reliability and compliance (South Africa, 2008; Department of Trade and Industry, 2010).

As identified by Farisani (2010), the ability of the CIPC to intervene in matters pertaining to financial reporting standards may initially appear to interfere with the FRSC's role. The legislators considered it necessary that there be multiple regulatory bodies to oversee the enforcement of regulation pertaining to the reliability of financial statements. In this way, there is a greater protection of the public interest in having access to financial reports that can be trusted when making financing or investing decisions based on the information contained therein. The public interest theory of legislation, explained by Brown (1996), involves regulators adopting legislation that is in the best interest of society, as it is assumed that the regulators are altruistic individuals. Entities with the most far-reaching impact on the general society are public companies, and within this category, undoubtedly, are those

companies that are listed on a securities exchange. In South Africa specifically, the JSE has taken measures to protect the public interest through the establishment of an enforcement agency known as the Financial Reporting Investigations Panel (FRIP).

4. The FRIP

A study conducted by Stainbank and Peebles (2006) revealed that South African standard-setting and regulation of disclosure were considered to be important by preparers and users of financial reports for different reasons. Preparers believed regulation to be important because of the fact that it may prevent reporting abuses such as the manipulation of numbers. Users, on the other hand, considered it to be important because regulation aided in ensuring that management did not suppress unfavourable information. The impact of the accuracy and completeness of financial reporting by listed corporations on the public was considered relevant by national legislators in their establishment of a body corporate called the FRIP through section 440W of the new Companies Act (South Africa, 2008).

The objective of the FRIP was to enhance the reliability of financial reporting. This goal was to be met through the investigation of reported non-compliance with financial reporting standards, and the recommendation of corrective measures (South Africa, 2008). The FRIP was required by law to comprise members who were auditors, chartered accountants who were not registered as auditors, those qualified in law, a person nominated by the Financial Services Board (FSB) and a person nominated by each exchange that, as a listing requirement, imposed adherence to financial reporting standards (South Africa, 2008). Since this Panel was to replace the GAAP Monitoring Panel (GMP), at least five of these members were required to be members of the GMP at the time of the FRIP's establishment.

The FRIP's main area of responsibility was to advise the Issuer Services Division of the JSE regarding alleged instances of non-compliance with the financial reporting requirements – being IFRS, the financial reporting requirements of the Companies Act and the JSE listing requirements – involving entities listed on the JSE and their

groups or entities that were in the process of applying to list on the JSE (FRIP, 2011; JSE, 2011b). The Issuer Services Division derived its powers from the JSE Board and was responsible for regulating listed companies, ensuring that those companies complied with the ongoing Listings Requirements such as the publication of financial information, the real-time broadcasting of price-sensitive company information by means of the Securities Exchange News Services (shortened to SENS), and investigating non-compliant companies, their directors, sponsors or auditors. The goal of enforcement is to protect capital markets (Berger, 2010), and this is achieved by ensuring that accounting standards are correctly applied. In terms of its requirements for listing (JSE, 2013b), if the JSE found that a company listed on the exchange had not complied with the prescribed financial reporting regulations, on the basis of the advice provided to it by the FRIP, the JSE may have instructed the aforementioned company to re-issue the appropriate information. Any such non-compliance would also be referred to the relevant professional body, including SAICA and the IRBA.

By enforcing compliance with IFRS, as required for JSE-listed companies, this enforcement body ultimately ensured that the financial results disclosed would fairly present the financial position, financial performance and cash flows of the entity (IASB, 2007). Fair presentation would benefit the public, as bias on the part of the preparers would be greatly reduced. Wilmott (1984) named the private interests of the providers of the financial information as their concern for the survival of the company, the maximisation of shareholder value and the earnings of the company's key decision-makers. This observation inferred that the listed entities disclosing their financial results would be inherently less sympathetic to the interests of the public, therefore necessitating an enforcement mechanism to counter this.

While compliance with IFRS was made a requirement for listed companies in 2005, the JSE's approach to regulation thereof was amended in 2011 to follow international best practice (JSE, 2013b). The FRIP's responsibility under the new regime would continue as it had in the past (JSE, 2011b), but rather than the exchange focusing only on reactively addressing compliance with regulation, enforcement would incorporate an element of proactivity.

5. The JSE proactive monitoring process

As previously noted, the JSE required that listed companies apply IFRS in the preparation of their annual financial statements. Ball (2006) regarded internationally comparable, accurate and comprehensive information that is produced in a timely manner as an advantage for a company adopting IFRS. In addition to this, he stated that IFRS adoption was likely to result in a more efficient market – a view supplemented by the JSE's (2012) comments that the integrity of financial reporting is a key aspect of a well-functioning capital market. The new review process of the JSE therefore aimed to contribute towards the preparation by JSE-listed companies of good quality financial reporting.

As documented by the JSE (2013b), a securities exchange that is appropriately regulated is essential for listed companies to be able enjoy the benefits of being listed. In an effort to develop South Africa's standing in the international arena, the JSE put into operation a proactive structure for the compliance of financial statements with IFRS, which contrasted with the historical basis of reacting to complaints received or ad hoc reviews conducted by the JSE. Under the new proactive monitoring process, the annual financial statements of each listed company would be reviewed at least once every five years, in addition to reviews arising from public or other queries or complaints (JSE, 2011a). A company would be identified at random by the JSE, who would then provide its selection of companies to be reviewed within that calendar year to the Department of Accountancy at University of Johannesburg (UJ). A team from the academic institution's department would then assist the JSE by reviewing the set of accounts of the chosen companies. Financial statements eligible for review would consist of those published on or after 1 January 2011. Though the selection process of the JSE was largely random, the objective of the review necessitated a sample that covered all sectors and varying sizes of market capitalisation, and was in this way deemed to be representative of the entire market.

The results of the work performed by UJ would subsequently be assessed by the JSE. Where certain findings included more complex, technical matters, or where

there existed a disagreement between the JSE and the listed company on a particular issue, detailed technical advice would then be sought by the JSE from the FRIP (JSE, 2011b). While a company would not be notified if its financial report had been selected, the JSE (2013b) would inform the relevant company if the process had identified matters that the JSE believed would require further investigation. In accordance with Chapter 3 of the King Code on Corporate Governance and section 94(7) of the 2008 Companies Act, audit committees were required to be communicated if any concerns were raised involving accounting matters, and to subsequently address these issues. The audit committees of the companies involved would therefore have a role to play in the findings of the financial statement reviews performed.

The proactive monitoring process of the JSE therefore took a risk-based approach, applying focus to areas of companies' financial reports that were potentially sensitive to the market price of those companies' shares, or could impact the understanding of the business from the perspective of investors (JSE, 2011b). Quinn (2004) stated that a key objective of the SEC was to protect investors, and as a result the interpretation and application of financial reporting standards was very important in meeting this objective. While South Africa does not have a governing body equivalent to the SEC, the role of the SEC is performed in relation to companies listed on a securities exchange, and is therefore comparable to the function of the JSE in regulating financial reporting of companies listed in South Africa. The new JSE review process can thus be seen to be aimed at protecting those members of the public with an interest in the listed companies, particularly the shareholders. The manner in which these reviews take place, as well as their outcomes determines whether the interests of the public can be protected through the completion of this process.

In February 2012, the JSE issued a report on the outcomes of the first year of this monitoring process, with the target audience being all listed companies, their investors, auditors of those companies, other regulators and the general public (JSE, 2012). This report laid out the key items that had come to the attention of the JSE through the reviews performed in 2011, in order to aid companies in preparing their annual financial statements. The JSE (2012) explicitly stated that it hoped to help

“demystify IFRS for the public” by presenting the findings in a simplified format, thereby addressing the public interest in better understanding the financial reporting of the listed companies in accordance with the applicable financial reporting regulations. Matters identified relating to accounting policies – the purpose of which is to inform users to enable them to understand the annual financial statements – were the inclusion by entities of too many irrelevant policies, a lack of policy disclosure where IFRS offered a choice or where there was diversity in practice, policies that were too generic, or were the same as previous years despite a change in conditions, all leading to unnecessary confusion on the part of the user of the financial statements. Through the enforcement of appropriate accounting policies in line with IFRS, the JSE was able to promote the preparation of a true and fair view of a company’s financial results to be presented to the public.

In considering the development of both regulation and enforcement in respect of financial reporting in South Africa, arguments have been made for the Public Interest Theory, with certain events lending more favour towards the Capture Theory described in the introductory chapter. An overall discussion surrounding the development of regulation and enforcement regarding financial reporting in South Africa is presented in the concluding chapter.

CHAPTER 6

DISCUSSION

1. Introduction

The objective of this study was to document the developments in financial reporting regulation and enforcement in South Africa, specifically between 1973 and 2011. A historical analysis was performed through the examination of secondary sources, which included journal articles and national laws and regulations. The findings were then considered in light of the Public Interest Theory originally introduced by Stigler (1971) as the view that "regulation is instituted primarily for the protection and benefit of the public at large or some large subclass of the public". This was expanded by Deegan and Unerman (2006), who explained that under the Public Interest Theory, regulation is implemented for the benefit of society as a whole, rather than the private interests of the regulators or other institutions. The success of the South African regulation and enforcement in protecting the interests of the public throughout the period of the study is now assessed. This final chapter therefore aims to address the research questions proposed in the introductory chapter: How has the regulation and enforcement of financial reporting in South Africa evolved between 1973 and 2011? What lessons have been learnt from developments in financial reporting regulation and enforcement internationally? Which bodies in South Africa are currently the significant role players in the regulation and enforcement of financial reporting? And what is the current status of financial reporting regulation and enforcement in South Africa?

2. Discussion on phase one

The discussions on the evolution of financial reporting regulation and enforcement began in phase one with a brief overview of South Africa's first formalised regulations that stemmed from the English law adopted as a result of South Africa forming part of the British Commonwealth. During British occupation, the unique

needs of the colonised local society in respect of financial information appeared not to be considered as important as, or more important than, perpetuating the British system of regulation, enforcement and record keeping. This was probably not due to regulators being under the control of specific interest groups, as the Capture Theory may suggest, but rather due to the fact that the country had become a Union only in 1910, and became a Republic just over five decades later. As a result, the nation was still forging its own identity, tending to remain in England's shadow for some years to come.

The 1951 PAAA was one of the first steps that South Africa took 'away' from the United Kingdom by creating statutory regulation of the accountancy and auditing profession. Through this Act and the body it created, which is known as the PAAB, protection of the public interest became a focus. The legislation, coupled with the enforcement function of the PAAB, resulted in a higher calibre of professional preparing and auditing of the corporate reports of entities, leading to improved financial reporting available to those entities' stakeholders. A major triumph for public interest protection was the requirement of auditors to report identified 'material irregularities', thus exposing to the public any cases of financial reporting misconduct. However, the risk of the PAAB effecting regulation in the interest of the auditors, rather than the general public did exist, due to the profession being the source of funding of the board. The influence of regulatory body finance is not specific to South Africa. As noted in the literature review, the UK's FRC is funded by large accounting firms, companies and the UK government – all of whom may influence the FRC to develop regulation and enforcement to meet the specific interests of the groups involved. Despite this, the PAAB appears to have taken on the responsibility of protecting the public interest as a major element of its formation and subsequent activities.

By 1948 Britain's corporate legislation had been reworked to include the public interest; however, South Africa seemed to lag behind as the country's focus was on its political landscape, rather than its financial or corporate regulation. This meant that the Companies Act of 1973 was the most significant shift in financial reporting that South Africa had seen. For the first time in the Republic's history, the Companies Act had taken the circumstances specifically pertaining to South Africa

into account: South African law that was written specifically for South Africans. The requirement was placed upon companies to prepare their financial statements in conformity with what it termed “generally accepted accounting practice”. This statutory obligation, as well as the regulations established by the APB in defining this concept, gave a company’s shareholders and other users of financial statements the right to access information that was deemed to be a fair reflection of its financial position and performance.

This financial reporting section of the 1973 Companies Act was a move towards more faithful and comparable corporate reporting in South Africa, and therefore triggered much attention and research. While the Act was generally well received and the feedback hopeful, companies were still able to skilfully circumvent the regulation through disclosure of the fact that they had not complied with certain accounting statements issued by the APB. In this way, the regulation was unsuccessful in protecting the public from certain entities’ deliberate misrepresentation of results. However, South African regulators wanted to improve the quality of their financial reporting standards through experience with international counterparts who were experiencing similar challenges, or who had already implemented methods of accounting for specific new transactions, and the country was permitted to join the IASC soon after its formation in 1973 and the promulgation in South Africa of the Companies Act. This was a positive advancement, as it enabled South Africa to be directly influenced by international developments of financial reporting standards. In this way, the international committee became a role player in the progression of South African regulation.

3. Discussion on phase two

Financial reporting regulation and enforcement in South Africa slowly began to align with the international field in other ways. This was covered in the second phase of this paper. A harmonisation and improvement project was launched in the early 1990s, with the aim of reducing the differences between South African and international accounting standards. This initiative was promoted by SAICA, and as such was well received by the accounting profession. At this stage, standards issued

by the IASC had a significant influence on financial reporting in South Africa as local standards were prohibited from differing from the international ones on fundamental issues. The South African public directly benefitted from the movement, as the alignment with international standards eventually led to the adoption of IFRS as SA GAAP, similar to numerous other developing nations, and finally resulted in the JSE incorporating into its listing requirements the need for a listed entity's financial statements to comply with IFRS. Investors in JSE-listed companies had, up to the change in listing requirements, lost confidence in the financial reporting of those corporations, and this was then addressed by SAICA and the JSE. In an effort to respond to the public desire for financial information to be provided that would assist the users in making economic decisions (which the JSE (2012) regards as being the objective of financial reporting), SAICA and the JSE paired up to form the GMP. As Watson and Rossouw (2012) observed through their study, the restatements of financial reports resulting from the GMP's investigations were found to contain information that was value-relevant for those companies' shareholders. The GMP was in essence the first effective enforcement body in respect of financial reporting regulations that South Africa had borne witness to, and the response from the public indicated that this initiative was a successful one. The disadvantage of the GMP, however, was the fact that only listed companies were subject to the work performed by the Panel. This was not seen to materially impact on the interests of the public, however, as privately-owned entities are usually either subsidiaries of listed companies, or have few individuals with a vested interest, as in the case of family-owned businesses.

Not only was the credibility of information reported by companies becoming a focus for investors, but the auditors who expressed opinions on that information were falling under the spotlight. In light of the pressures applied by shareholders on regulators for more reliable audit reports, the ARP was formed. Shortly thereafter, in 2005, the Auditing Profession Act was made effective. This Act replaced the PAAA, and was designed to be a more effective tool of regulation for the profession. One of the key objectives of the Act was explicitly stated as being "to protect the public in the Republic by regulating audits performed by registered auditors" (South Africa, 2005). This affirmation made by the legislators indicated a direct intent to protect the public interest. Auditors were now required to adhere to predefined standards of

quality, and, similar to the requirements of the PAAA, had to report any irregularities it identified to the responsible body, which in terms of the new law was known as the IRBA. Parallels can be drawn between the PCAOB of the USA, and the IRBA in South Africa. Both bodies are significant role players in the regulation and enforcement of financial reporting through audits conducted on companies within their respective nations, and their aim to protect the interests of the public in those companies. South Africa's regulation of the auditing profession has therefore also been harmonised with international trends, and the competency of the auditing professionals conducting these audits is an integral part of serving the public interest. In addition, the IRBA was made responsible for ensuring that strict standards of quality and integrity are maintained.

While the auditing profession both locally and internationally had gained negative publicity early in the twenty-first century as a result of various corporate scandals, another buzzword began to emerge as the world turned its focus to the way that companies were being managed. This word was 'corporate governance'. Corporate governance is rooted in many of the current financial reporting regulations and enforcement systems in South Africa. The public uneasiness over what appeared to be ineffective boards of directors and management led to an increase in awareness of corporate governance in both the public and private sectors, with business failures both internationally and locally contributing to the explosion of interest in corporate governance (Ngoepe & Ngulube, 2013). The local corporate scandals discussed in Chapter 1 can be seen as possibly having spearheaded the drive towards better corporate governance.

The 1992 Masterbond scandal was one of the first corporate collapses the country had seen, and involved non-compliance by the company with Statements of Generally Accepted Accounting Practice (GAAP). A decade later, soon after the bankruptcy of the American energy and commodities company Enron, the LeisureNet liquidation occurred, later found to be the result of fraudulent financial reporting. As part of the court proceedings (Mitchell and Another v Hodes and Others NNO 2003 (1) SACR 524 (C)) for the case, specific reference was made to the "indubitable public interest in the proper investigation of corporate collapses". The legal system was therefore very much aware of the impact that cases such as these

would have on the community and the affected stakeholders. The most recent significant corporate scandal in South Africa involved Fidentia and the considerably large assets included in its financial reports that could not be located. The cause of this was seen to be a lack of good corporate governance. The corporate governance issues that led to the demise of these companies in particular, were a driving force in the development of financial reporting regulation during this time.

Rossouw, Van der Watt and Malan (2002) identified the underlying problem that caused the aforementioned scandals as being the separation of company ownership from the company's control. Because the owners of the companies no longer managed them, this responsibility shifted to the company's directors, who were then able to use their managerial powers to their own advantage – often to the detriment of the owners – and therefore to the detriment of society. This was not an issue unique to South Africa, but was being experienced by leading economies across the globe. The introduction of corporate governance principles was aimed at ensuring that those charged with the management duties of a company would serve the shareholders' interests rather than their own. This motive echoes the definition of the Public Interest Theory as described by Posner (1974), whereby regulation is created to respond to the public demand for correction of inequitable market practices.

In South Africa, the issued King Report on Corporate Governance recognised that "a proper balance needs to be achieved between freedom to manage, accountability and the interests of the different stakeholders" (IOD, 1994). Once again, the interests of the public were openly stated as being of the utmost importance to the regulators. The so-called 'King Code', first published in 1994, further developed in 2002 and improved upon in 2009, targets corporate failures, including those caused by fraudulent financial reporting, by considering the ethical culture within entities and the risks faced in respect of fraud. To South Africa as a developing nation, it is crucial that companies transacting not only in the country but on the African continent, act in a responsible manner so as to prevent future situations where the public interest is unprotected. Responsible behaviour would include corporate financial reporting that is accurate, credible and reliable being made available to all stakeholders (Marx & Van der Watt, 2011).

4. Discussion on phase three

The recommended practices of the King Code continued to be considered when South Africa entered the third phase, or 'new' era. Financial reporting inconsistencies and anomalies had led to scandalous cases during the country's phase of harmonisation with the international regulatory community. However, as discussed at a high level by Deegan and Unerman (2006), accounting problems stimulated the public need for companies' information to be subjected to increased financial reporting regulation. The Companies Act of 2008 was the single largest change to the regulatory environment that South Africa had ever seen, and its enactment created not only regulation in respect of financial reporting, but also of related enforcement measures.

It is important to note that the new regime of company law was aimed directly at addressing the public interest. In contrast to the old 1973 Companies Act, the new Act details the specific financial reporting requirements for different types of companies. Regardless of the type of company, however, companies' financial statements were required to be consistent with IFRS, making them more easily comparable and improving the transparency of the results to be distributed to various stakeholders. Shareholders, in particular, were awarded additional rights through the 2008 Companies Act, and the level of accountability was improved. Sections of the Act were aimed at the conduct of company directors in an attempt to limit, if not prevent, the ability of those directors to serve their own interests without fair consideration of the equity holders, finance providers, employees, customers and suppliers. The method applied in encouraging positive behaviour was through clear definition of what would constitute an offence, including reckless, negligent and fraudulent trading by a company. Also unlike the Companies Act of 1973, the 2008 Act was only promulgated into law after following a process of public input and open discussion with concerned stakeholders. The South Africa of this 'new' era was evidently far more aware of the interests of its people, and following political transformation, had gained an appreciation for the diversity of the nation and the countless needs and views expressed by the South African public.

The three-year process from the draft Bill to the enacted legislation was not without obstacles. Many people had doubts about the vast number of amendments and new requirements of the regulations, and whether these would add benefit to the involved parties. The burden to be placed on companies who, under the new Act, were required to provide disclosures in accordance with IFRS rather than the previous, generally accepted, accounting principles was a heavy one, and the proposed changes were met with frustration. Nevertheless, in light of the public call for appropriate, reliable and sufficient financial reporting, this regulation made headway towards addressing the public interest needs. A key development that concerned some members of the business community was the enforcement mechanisms to be undertaken. The introduction by the 2008 Companies Act of several regulatory authorities and the revamping of those that were already in existence was a means of ensuring that the Act's provisions were enforced (Farisani, 2010). Regulatory authorities created by the new Act included the CIPC, who carries the majority of the Act's enforcement responsibility, and the FRSC, who is responsible for recommending and approving financial reporting standards enacted into South African regulation (essentially replacing the APB).

While the FRSC's focal point was on the financial reporting regulation itself, the enforcement of that regulation fell under the control of the FRIP. This Panel, which was also created by way of the new Companies Act and effectively replacing the GMP, was primarily concerned with the adherence of listed public companies to the corporate reporting regulations (including the requirement to comply with IFRS). Where instances of non-compliance were identified, the JSE could require that the company re-issue the relevant financial information. In addition to this, depending on the nature and severity of the offence, non-compliance would also be reported to the professional body affected, being either SAICA for Chartered Accountants or the IRBA for Registered Auditors. Through the work of the FRIP, companies are encouraged to prepare financial statements that are a faithful representation of the underlying transactions, leading to the year-end financial position and the overall performance of the company during that financial year, which have been prepared in accordance with IFRS. Shareholders and the public are thus able to obtain financial information reported in line with international standards, thereby meeting their desire for reliable results.

Similar to the FRIP is the new monitoring process established by the JSE in 2011. One of the key differences lies in the timing of the procedures performed – the FRIP operates based on complaints or allegations of suspected non-compliance with financial reporting regulation, whereas the JSE's process is entirely proactive. A random selection of companies listed on the JSE would be made, and the presentation and disclosure of information in those companies' financial statements assessed against the requirements of IFRS, compliance therewith being regulated through the 2008 Companies Act as well as the JSE listing requirements. The public are able to therefore obtain a substantial degree of comfort that the financial reporting regulations have been appropriately adhered to by the companies in which they have an economic interest, and if these have not been complied with, the process undertaken by the JSE in collaborating with UJ would identify those breaches that would negatively impact the decision-making of the users of the financial statements. The public interest in credible financial reporting can thus be seen to be protected as a result of changes made during this phase in the country's development.

5. Concluding comments

The 'public interest' is not easily measured – and some may argue that it is not measurable at all. There are, however, factors that can be considered in determining whether the needs of the company's stakeholders have been satisfied. Significant stakeholders of a company include its shareholders (who stand to lose their share of the profits in the form of dividends, their initial investments, or both), the employees (who could potentially lose their bonuses or jobs), the suppliers (who are not paid what is owed to them or lose business), and the customers (who may suffer increased costs). Corporate collapses impact on all stakeholders, as well as the community in which the company operates. The regulation and enforcement of financial reporting should therefore aim to promote the public interest, and in doing so, directly or indirectly prevent or detect financial scandals.

In order to protect the public interest, there is a range of factors that need to be in place in corporate reporting regulation and enforcement.

According to Tweedie (2003), as noted in Chapter 1, there are three important components in financial reporting. The first is the principle-based accounting standards that promote the reporting of economic reality over legal form. The second is the auditing firms, who obtain evidence in the application by companies of those accounting standards. The third is a regulatory framework which is able to ensure that the accounting standards' principles are applied. An assessment of the financial reporting plane of South Africa can be made on this basis. Firstly, the accounting standards adopted by the regulators in South Africa are those of the IASB, being IFRS. Due to the fact that these standards are international, and adopted by all leading nations in the world bar the USA, their quality is regarded as being high. The IFRS are founded on principles, rather than rules (as is the US GAAP). A key principle of IFRS is termed "substance over form", whereby the true substance of the transaction that has occurred is recorded and reported, instead of the legal or contractual form of that transaction. Due to the adoption of IFRS as SA GAAP during the harmonisation phase, this component is deemed to be appropriate in meeting the needs of the public for true and fair reporting. The second element mentioned – the auditors – began with the phase of the early formalised financial reporting development in the form of the PAAA and the PAAB. This was improved upon with the APA and the establishment of the IRBA in 2005 which, like the adoption of IFRS, fell into the phase of harmonisation with international standards. This auditing legislation placed the public interest at the forefront of the profession's functioning, and requires both the auditors' conduct and their products of work to be in accordance with the Act, thereby protecting any stakeholders who intend to rely on the audit report issued in respect of any company.

The final constituent in Tweedie's financial reporting model is the regulatory framework, which was made over during the 'new' era and was signalled by the enactment of the 2008 Companies Act and the new councils, commissions and monitoring process that accompanied it. As such, the regulation and enforcement of financial reporting was made more aggressive in pushing the protection of the public,

in an attempt to avoid a repeat of the corporate collapses previously experienced in the country.

Since the Fidentia debacle in 2007, there appear not to have been any significant notable, or large corporate business failures that caused undue harm to the South African public. One can draw from this the conclusion that the overhaul of company legislation, together with other regulations such as corporate governance codes and enforcement mechanisms – for instance proactive reviews of annual reports, has successfully protected the public interest.

Expanding beyond the problems relating to specific companies, it is important to observe the international status of the South African regulatory environment. The number one ranking by the World Economic Forum (2011) in the strength of the country's auditing and reporting standards indicates a global awareness for regulation of financial reporting in South Africa. The regulation and supervision of South Africa's securities exchange was also regarded to be the best in the world, owing to the regulations implemented by the JSE. The JSE has earned numerous prestigious accolades such as this, and is positioned among the world's 20 largest equity exchanges (Watson & Rossouw, 2012) and the largest exchange by market capitalisation on the African continent.

The research performed has addressed the questions presented in Chapter 1, through the exploration of how the regulation and enforcement of financial reporting in South Africa has evolved across three broad phases between 1973 and 2011. International advancements, particularly in the USA, the UK and the EU, were considered in Chapter 2. South Africa was seen to have taken note of these developments, as well as from the various local corporate scandals that the country encountered, such as that of Masterbond, LeisureNet and Fidentia. The lessons learnt from these international and local events are primarily linked to the weaknesses in financial reporting laws and regulations, often coupled with a poor system of enforcement in respect of these regulations. By examining the actions taken and progression made, it was determined that these business collapses have resulted in better regulation and enforcement in order to effectively protect the public interest. Significant role players in the South African regulatory environment have

ranged from the government to independent professional bodies, and these bodies and their functions have evolved over time to create better financial reporting regulation and enforcement mechanisms in the country. In considering the evolution of financial reporting in the three phases of the history of South Africa's regulation and enforcement, it is evident that this has developed in leaps and bounds, particularly over the four decades leading up to 2011, to such a time where the current status of the country's corporate regulatory environment positively impacts on the public interest.

The historical narrative shows that South Africa has learned from its own (and international) mistakes – corporate failures and the link with financial reporting. It is hoped that the process followed by all the parties involved in regulation and enforcement of financial reporting standards continues to learn from mistakes, re-looks and re-works regulation and enforcement practices and laws, and continues to promote regulation that appears to be serving the public interest well.

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