

## **Duties of directors in relation to the approval of annual financial statements**

## **Summary**

Given the endorsement criteria set out in s 29 (5) of the Companies Act this paper submits that directors who approve annual financial statements, which are prepared in terms of International Financial Reporting Standards, are entitled to assume that the annual financial statements present fairly. This is subject to the provisions of section 29 (6) (a) of the Companies Act that if International Financial Reporting Standards were applied despite it being known to produce information that does not present fairly or is materially misleading, that is unlawful, and the wrongdoer may be subject to criminal sanction. This paper also advocates that the objective duty of competence requires that all the members of a board of directors have the ability to read and understand the financial statements, including the understanding that financial statements classify assets and liabilities as current and non-current, and what those concepts mean. Equally, a director should have an understanding of the need to disclose certain events post balance sheet date. It would not be possible for a director to approve annual financial statements without an understanding of the basic accounting conventions.

## 1 Introduction

There are no court judgments or judicial interpretations in South Africa on the steps directors of companies might follow to ensure that they understand and are familiar with the information contained in annual financial statements (AFS) prior to approving them. Margo J defined the term approval in a broad sense in *Transvaal Consolidated Land and Exploration Co Ltd v Johannesburg City Council*<sup>1</sup> as meaning “sanctioned, confirmed or accepted”. Therefore by approving the AFS directors are asserting that the information contained in them are fairly presented<sup>2</sup> and in compliance with financial reporting standards.<sup>3</sup> The JSE Limited (JSE)<sup>4</sup> issued an amendment to the JSE’s listing requirements which applies to JSE listed companies with a year-end on or after 30 June 2020. This amendment has regard to the approval of the AFS by the Chief Executive Officer (CEO) and the financial director (CFO), that the AFS fairly present in all material respects the financial position, financial performance and cash flows of JSE listed companies in terms of IFRS; and no facts have been omitted or untrue statements have been made in the AFS that would make the annual financial statements false or misleading.<sup>5</sup>

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<sup>1</sup> *Transvaal Consolidated Land and Exploration Co Ltd v Johannesburg City Council* 1972 1 SA 88 (W).

<sup>2</sup> Fair presentation is achieved by faithful representation of the effects of transactions. Representational faithfulness refers to that characteristic of financial statements that will reassure users of such statements that they can rely on the information contained therein to faithfully represent the economic circumstances and events that it purports to represent or would reasonably be expected to represent.

<sup>3</sup> Regulation 27 of the Companies Regulations 2011 requires compliance by companies with International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board. The International Accounting Standards Board has changed its name to the IFRS® Foundation, which is a not-for-profit international organisation responsible for developing a single set of high-quality global accounting standards, known as IFRS Standards. IFRS Standards are now required in more than 140 jurisdictions. IFRS specify how transactions and other events are to be recognized, measured, presented and disclosed in financial statements.

<sup>4</sup> The JSE Limited is the largest stock exchange in Africa.

<sup>5</sup> See JSE listing requirement 3.84 (k).

The question arises as to how such a rule be interpreted bearing in mind the requirements of section 29 of the Companies Act 71 of 2008. The punctuation<sup>6</sup> in section 29 of the Companies Act is crucial to its interpretation. Section 29 (1) of the Companies Act is separated by a semi colon<sup>7</sup> at the end of each single platform sentence. This has the impact of section 29 (1) (a) and (b) of the Companies Act having to be applied equally and they do not represent alternative choices. These two provisions relate directly to the wording of the new JSE listing requirements' amendment. Section 29 (1) (a) of the Companies Act requires a company to use IFRS when preparing AFS while section 29 (1) (b) of the Companies Act requires the same AFS to "present fairly". These two provisions represent very different legal obligations in South African law. A South African court of law would be obligated to surmise from section 29 (1) (a) of the Companies Act, that public policy supports both the issue of IFRS and compliance with them. A court will most certainly infer that AFS that meets the "present fairly" standard would, for the most part, have applied IFRS rather than having departed from them.

Section 30 (1) of the Companies Act obliges companies to prepare AFS. Once the company has prepared the AFS, section 30 (3) (c) of the Companies Act then requires the board of directors to approve them. Section 30 separates the responsibilities of the preparer of the AFS from the responsibility to approve them. There are pragmatic reasons for such a division of responsibilities. The preparation of AFS requires specialised skills in the application of IFRS that are not possessed by all the members of a board of directors. The directors would on behalf of the company recruit such specialists to make sure that the AFS comply with the numerous complex legal requirements. However, the requirement for the board of directors to approve the AFS indicates that they alone must take ultimate responsibility for the content of the AFS complying with the complex legal requirements.

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<sup>6</sup> Whether the words in section 29 (1) (a) and (b) of the Companies Act are to be read disjunctively or conjunctively, that is, whether they should be read disjunctively as having an "or" between them, or conjunctively as having an "and" between them. *Ngcobo v Van Rensburg* 1999 2 SA 1057 (SCA) the court favoured the conjunctive approach over the disjunctive approach because it believed that the disjunctive approach would lead to absurdity. Applying the disjunctive approach to section 29 (1) (a) and (b) of the Companies Act would create an absurdity as it would completely render compliance with IFRS superfluous.

<sup>7</sup> The semi-colon is a punctuation mark that separates major sentence elements. A semicolon is used between two closely related independent clauses.

It is important to understand that this “outsourcing” by the board of directors of the preparation of the AFS does not mean that a board of directors cannot be held accountable if the AFS have been erroneously prepared as section 66 (1) of the Companies Act states that: “[T]he business and affairs of a company must be managed by or under the direction of its board.” The preparation of the AFS, although being conducted by “others” is, nevertheless, still being done “under the direction” of the board of directors. Undoubtedly, this presents a problem for any member of a board of directors who is not an expert in the application of IFRS, which, for the most part, is nearly all the directors. Middleton J in *ASIC v Healey* explained as follows:

“The reading of financial statements by a director is for a higher and more important purpose: to ensure, as far as possible and reasonable, that the information included therein is accurate...I do not consider this requirement overburdens a director, or as argued before me, would cause the boardrooms of Australia to empty overnight.”<sup>8</sup>

Never has a South African court of law considered those steps a board of director’s have to consider prior to them approving their company’s AFS. In other words, when will a board of director’s be liable for a breach of their duty of care, skill and diligence if it is subsequently discovered that the AFS, the board of director's approved, contained material misstatements, which rendered the AFS unsuitable for use?

## **2 Public policy**

Section 32 (1) of the Constitution of South Africa<sup>9</sup> (Constitution) provides that a person has the right of access to any information that is held by another person that is required for the exercise of protecting those rights. Section 32 (2) of the Constitution creates a legal obligation on government to enact legislation to protect those rights. In the case of IFRS, it was not a difficult undertaking to devise the necessary legislation. AFS, have been a crucial component of the financial reporting process and company law legislation since the enactment of the Companies Act 46 of 1926, and ever since has been the central regulatory device that provides the apparatus for companies to disseminate information to those who have the right of access to such information. Common sense would suggest that this right would inherently contain the right of access to information that is “accurate and complete” to protect such rights.

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<sup>8</sup> *ASIC v Healey* 2011 FCA 717.

<sup>9</sup> Constitution of the Republic of South Africa, 1996.

There was a need to provide legislation to support this intrinsic right of “accurate and complete” by setting statutory rules and regulations that facilitated the practical ability to support such a right. Hence the statutory obligation for companies to apply IFRS, which represent a set of coherent, codified guidelines that if followed will go a long way in ensuring compliance with the “accurate and complete” test. This raises the question as to why do government feel it necessary that the “present fairly” standard be preserved when IFRS would in almost all cases enable a person to protect their rights? The answer is self-evident, IFRS cannot alone support the principles of: democratic values; open society; fairness; transparency; and accountability that are enshrined in the Constitution. The concern would be that if an entity were only required to apply IFRS, this may result in companies ignoring the rights of individuals.

In order to understand the present fairly standard; one can compare it to the reasonable person standard. It is a generally accepted view that such a standard is not too difficult to understand or to determine its intentions. However, there is much debate, whether it is in the courts or in the academic literature as to its application in practical circumstances. There will and can never be a definitive answer as to what a reasonable person may be or may not be. The meaning of present fairly or fairly present<sup>10</sup> is not defined in any legislation foreign or domestic. This omission is not without good reason, because the term is not susceptible to any precise and or generally applicable form of legal definition. Therefore, in terms of the law, the fair presentation of AFS remains unavoidably subjective, meaning that it is a matter of individual judgment. Therefore, as a legal requirement, its satisfaction is a question of law for the Courts to determine. This raises two crucial matters of law relating to the relationship between the two separate legal requirements of the present fairly Standard v IFRS. The question arises as to what happens if there is a divergence between IFRS and the decisions by a court of law on what is considered to present fairly?

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<sup>10</sup> These two terms are a tautology - using different words to say the same thing.

Section 29 (4) of the Companies Act states that the Minister may make regulations prescribing financial reporting standards. Section 29 (5) of the Companies Act provides that any regulations must promote sound and consistent accounting practices; and in the case of IFRS for public companies, must be in accordance with the IFRS of the International Accounting Standards Board or its successor body. The entire suite of IFRS as issued by the International Accounting Standards Board are generally accepted as being compliant with those criteria as set out in section 29 (5) of the Companies Act. Given the endorsement criteria set out in s 29 (5) of the Companies Act, it must follow that unless and until a South African, court rules that IFRS was adopted in breach of these endorsement criteria, there can be no tension between section 29 (1) (a) and (b) of the Companies Act. This suggests that directors who approve AFS, which are prepared in terms of IFRS, are entitled to assume that the AFS present fairly. This it is submitted is subject to the provisions of s 29 (6) (a) of the Companies Act that if IFRS was applied despite it being known to produce information that does not present fairly or is materially misleading, that is unlawful, and the wrongdoer may be subject to criminal sanction.

Section 29 (2) of the Companies Act provides that AFS must not be false or misleading in any material respect. It is submitted that the phrase “present fairly” is a positive obligation upon the company and its directors to provide sufficient and appropriate information. The term “misleading” is one that applies where the company and its directors do not apply the “present fairly” override<sup>11</sup> when they should have. Zeff suggests that:<sup>12</sup>

“It strikes me that ‘fair presentation’ means that the financial statements meet a positive standard of informativeness. By contrast, ‘not misleading’ connotes that readers have not been led astray.”

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<sup>11</sup> IAS 1 acknowledges that, in extremely rare circumstances, management may conclude that compliance with an IFRS requirement would be so misleading that it would conflict with the objective of financial statements set out in the Framework. In such a case, the entity is required to depart from the IFRS requirement, with detailed disclosure of the nature, reasons, and impact of the departure (IAS 1.19-21).

<sup>12</sup> Zeff “The Primacy of ‘Present Fairly’ in the Auditor’s Report” 2007 *Accounting Perspectives* 15.

R. J. Chambers once wrote:

“[I]f accounting is to be related to choices, it requires ‘leading information’, not ‘not misleading information’”. Therefore, as Zeff indicates that ‘not misleading’ is not a phrase equivalent in substance and connotation to ‘fair presentation’.”<sup>13</sup>

### 3 Approving AFS

Middleton J explained what *ASIC v Healey*<sup>14</sup> was about:

“[T]aking responsibility for documents effectively signed-off by, approved, or adopted by the directors. What is required is that such documents, before they are adopted by the directors, be read, understood and focussed upon by each director with the knowledge each director has or should have by virtue of his or her position as a director.”

Navsa JA in *Axiam Holdings Ltd v Deloitte & Touche*<sup>15</sup> had the following to say about applying court cases from other jurisdictions:

“This is not to say that there is no useful purpose in having regard to English law and to the law in other common law countries for reassurance that we are not out of step with global norms as applied in the commercial world.”

Prior to applying the Centro decision in a South African context it would be prudent to establish if there are differences, between South African law and Australian law as regards the approval of AFS.

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<sup>13</sup> R Chambers “Comments of the seventh participant: The TIMS initiative of 1962” *The Accounting Postulates and Principles Controversy of the 1960s* (1982)53.

<sup>14</sup> *ASIC v Healey* supra, the Centro decision.

<sup>15</sup> *Axiam Holdings Ltd v Deloitte & Touche* 2005 4 All SA 157 (SCA).

The leading South African court case that deals with a board of directors' duty of care, skill and diligence is the case of *Fisheries Development Corporation of SA Ltd v Jorgensen Another*.<sup>16</sup> Margo J in *Fisheries Development Corporation of SA Ltd v Jorgensen Another* articulated the principles reflecting the legal position in South Africa: the extent of a director's duty of care and skill depends to a considerable degree on the nature of the company's business and on any other particular obligation assumed by or assigned to the specific director;<sup>17</sup> a director is not required to have any special business acumen or expertise, ability or intelligence, or even expertise in the business of the company;<sup>18</sup> however he or she is expected to exercise the care which can reasonably be expected of a person of his or her knowledge and experience, a mere error of judgment will not lead to the director being liable;<sup>19</sup> and a director may not be indifferent or a mere dummy, nor may he or she shelter behind culpable ignorance or failure to understand the company's affairs.<sup>20</sup>

The case of *Daniels v Anderson*<sup>21</sup> represented the highpoint in Australia as regards the development of a directors' duty of care, skill and diligence.<sup>22</sup> The Court of Appeal held that directors of listed companies are required to take reasonable steps to place themselves in a position to guide and monitor the management of a company; directors must become familiar with the company's business when they join the board; while directors need not have equal knowledge and experience of every aspect of the company's activities, they are under a continuing obligation to make inquiries and keep themselves informed about all aspects of the company's business operations.

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<sup>16</sup> *Fisheries Development Corporation of SA Ltd v Jorgensen Another* 1980 4 SA 156 (W).

<sup>17</sup> *Fisheries Development Corporation of SA Ltd v Jorgensen Another* supra, the Fisheries decision.

<sup>18</sup> Fisheries decision 19166A

<sup>19</sup> Fisheries decision 19165B

<sup>20</sup> Fisheries decision 19166C.

<sup>21</sup> *Daniels v Anderson* 1995 37 NSWLR 657.

<sup>22</sup> Lipton *Understanding Company Law* (2011) 451.

South African courts followed a lenient approach in holding directors accountable for breach of their duty of care and skill.<sup>23</sup> In this regard, a subjective test was used to determine or ascertain the duty of care and skill.

Section 76 (3) (c) of the Companies Act reads as follows:

“[A] director of a company, when acting in that capacity, must exercise the powers and perform the functions of director... with the degree of care, skill and diligence that may reasonably be expected of a person: carrying out the same functions in relation to the company as those carried out by that director; and having the general knowledge, skill and experience of that director.”

Section 76 (3) (c) of the Companies Act connects the directors duty of care, skill and diligence to circumstances where directors act “in that capacity” and when it is required for a director to “exercise the powers and perform the functions of director”. As regard the approval of the AFS it seems unlikely that a director can argue that they did not act in that capacity or exercised the powers or performed the functions of director. Section 180 (1) of the Australian Corporations Act 2001 provides as follows:

“A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they were a director or officer of a corporation in the corporation's circumstances; and occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.”

The most noticeable difference between these two provisions is that section 76 (3) (c) of the Companies Act refers to “general knowledge, skill and experience of that director” while section 180 (1) of the Australian Corporations Act 2001 refers to “reasonable person”. Section 76 (3) (c) of the Companies Act uses the words “reasonably be expected of a person” while section 180 (1) of the Australian Corporations Act 2001 uses the words “reasonable person”. However section 76 (3) (c) of the Companies Act then introduces a subjective element to the provision: “[H]aving the general knowledge, skill and experience of that director.” Such a provision can only mean that a South African director must act with the general knowledge, skill and experience of persons with comparable general knowledge, skill and experience.<sup>24</sup>

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<sup>23</sup> Bouwman. “An Appraisal of the Modification of the Director’s Duty of Care and Skill” 2009 *SA Merc LJ* 511.

<sup>24</sup> Du Plessis “A comparative analysis of directors’ duty of care, skill and diligence in South Africa and in Australia” 2010 *Acta Juridica* 269.

It is self-evident that when a South African court considers this provision it will have to decide what the expectations are of directors carrying out the same functions in relation to the company as those carried out by that director whose conduct is under scrutiny.<sup>25</sup> In the context of this paper a court in South Africa would have to determine what are the expectations of a director prior to the approval of the AFS and then compare these expectations to the director whose conduct is under scrutiny.<sup>26</sup> Thus there is in essence no difference between the two provisions.

In the *Centro* decision the non-executive Chairman, six other non-executive directors and the Chief Financial Officer of the Centro Property Group (“Centro”) faced allegations by the Australian Securities and Investments Commission (“ASIC”) that they had contravened sections of the Corporations Act 2001 arising from their approval of the consolidated financial statements of Centro. The relevant facts are that the 2007 AFS of Centro failed to disclose, or properly disclose, some AUS\$1.5 billion of short-term liabilities by classifying them as non-current liabilities and failed to disclose guarantees of short-term liabilities of an associated company of about US\$1.75 billion that had been given after the balance sheet date, but before approval of the AFS.

IAS 1 - Presentation of Financial Statements<sup>27</sup> para 1.69 states as follows: current liabilities are those expected to be settled within the entity's normal operating cycle held for purpose of trading due to be settled within 12 months for which the entity does not have an unconditional right to defer settlement beyond 12 months, other liabilities are non-current.

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<sup>25</sup> Du Plessis 2010 *Acta Juridica* 269.

<sup>26</sup> Du Plessis 2010 *Acta Juridica* 269.

<sup>27</sup> IAS 1 Presentation of Financial Statements sets out the overall requirements for financial statements, including how they should be structured, and the minimum requirements for their content, including the current and non-current classification.

The main issues in this case can be summarised as follows: whether the directors knew or ought to have known at the time of approving the 2007 AFS that Centro, had substantial liabilities in the order of \$2.611 billion which were due to be repaid or refinanced within 12 months from the balance sheet date and in relation to which there was no unconditional right to defer payment for at least 12 months after the balance sheet date; and since the balance sheet date, guarantees had been given relating to loans totalling in excess of US\$2.8 billion which might significantly affect the current state of affairs of the Centro in subsequent financial years, whether a reasonable director in the like position of the directors of Centro was required to have: sufficient knowledge of conventional accounting principles and practices, including that current liabilities generally mean financial obligations which must be “paid” or “satisfied” within 12 months of the balance sheet date and that significant events which occur after that date must be disclosed in the AFS; and applied their minds and carried out a careful review of the 2007 AFS to determine whether they accurately reflected the financial position and performance of consolidated entities known to them. In analysing the director’s duty of care and skill, the court commented that:

“[A]ll directors must carefully read and understand financial statements before they form the opinions which are to be expressed...[s]uch a reading and understanding would require the director to consider whether the financial statements were consistent with his or her own knowledge of the company’s financial position. This accumulated knowledge arises from a number of responsibilities a director has in carrying out the role and function of a director.”

Middleton J explained in the Centro decision:

“This proceeding is about financial reporting and the role and responsibilities of directors in relation to that task...[i]n my view, the objective duty of competence requires that the directors have the ability to read and understand the financial statements, including the understanding that financial statements classify assets and liabilities as current and non-current, and what those concepts mean. This classification is relevant to the assessment of solvency and liquidity. Equally, a director should have an understanding of the need to disclose certain events post balance sheet date... [i]t would not be possible for a director to [approve the AFS] without such an understanding.

#### **4 Business judgment**

Does the approval of AFS constitute a business decision? It is submitted that it does not, because the approval of AFS of the company is a statutory requirement rather than a discretionary business judgment. The Centro directors would not have been able to rely on the business judgment rule as it was questionable whether the court would have considered the Centro directors' failure to apply their "independent enquiring minds" to be a "judgment" that would be captured under the business judgment rule.

#### **5 Final comments**

In the past, the law applied a very lenient approach in determining the standards expected of directors. The rules governing director's standards of care, skill and diligence were established in a series of English cases in the late 19th and early 20<sup>th</sup> centuries. In those days there were relatively few companies and their boards largely comprised part-time, non-executive directors who were regarded as figureheads and who were often appointed because of their title or reputation and not because of their business abilities. The effect of the early cases, such as *Re City Equitable Fire Insurance Co Ltd*<sup>28</sup> was that directors would only be regarded as having breached their duty of care if they were grossly negligent. The old cases also did not require directors to possess minimum levels of skill. In more recent times there has been a change in community attitudes and expectations concerning directors' standards of care, skill and diligence. The changed judicial attitudes were explained by Tadgell J in *Commonwealth Bank of Australia v Friedrich*.<sup>29</sup>

"As the complexity of commerce has gradually intensified for better or for worse the community has of necessity come to expect more than formerly from directors whose task it is to govern the affairs of companies to which large sums of money are committed by way of equity capital or loan. In response, the parliaments and the courts have found it necessary in legislation and litigation to refer to the demands made on directors in more exacting terms than formerly; and the standard of capability required of them has correspondingly increased. In particular, the stage has been reached when a director is expected to be capable of understanding his company's affairs to the extent of actually reaching a reasonably informed opinion of its financial capacity."

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<sup>28</sup> *Re City Equitable Fire Insurance Co Ltd* 1925 Ch 407.

<sup>29</sup> *Commonwealth Bank of Australia v Friedrich* 1991 9 ACLC 946.

The importance of AFS is one of the fundamental reasons why the directors are required to approve them and resolve that they present fairly. Because of their nature and importance, within the confines of South Africa's legal framework the directors must understand and focus upon the content of AFS. Directors cannot substitute reliance upon the advice of management for their own attention and examination of an important matter that falls specifically within the board of director's responsibilities as with the reporting obligations. The Companies Act places upon the Board and each director the specific task of approving the AFS. Consequently, each member of the board of directors is charged with the responsibility of attending to and focusing on the AFS and, cannot delegate or abdicate that responsibility to others. The complexity and volume of information contained in AFS cannot be an excuse for each director failing to properly read and understand the financial statements. In the end a court has to determine the impact of the omitted disclosures and consider how users of the AFS would have reacted if the omitted disclosures had been included in the AFS. As they were not disclosed it will be necessary for a court to consider what impact their disclosure would have had under the hypothetical or "but for" scenario if proper disclosure had been made. Middleton J in the Centro decision placed the entire corporate governance environment in perspective with these words: "Whilst there are many matters a director must focus upon, the financial statements must be regarded as one of the most important."