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22 November 2021

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Dear Julindi

CIRCULAR 52 of 2021

This letter refers to the above noted circular, in particular the last paragraph thereof that states that the '*CMS requires schemes in terms of section 37(2) to report on investment income received on scheme investments as investing cash flows, and not as operating cash flows, in their Statement of Cash Flows in their financial statements of the year ended 31 December 2021 onwards.'*

IAS 7, IAS 1 and Medical Schemes Act of South Africa ("MSA")

The economic decisions that are taken by users require an evaluation of the ability of an entity to generate cash and cash equivalents and the timing and certainty of their generation. The objective of IAS 7 – *Statement of Cash Flows (IAS 7)*, is to require the provision of information about the historical changes in cash and cash equivalents of an entity by means of a statement of cash flows which classifies cash flows during the period from operating, investing and financing activities.

The objective of IAS 1 – *Presentation of Financial Statements ("IAS 1")* is to prescribe the basis for presentation of general purpose financial statements to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. It sets out overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content.

The *Conceptual Framework for Financial Reporting (Conceptual Framework)* describes the objective of, and the concepts for, general purpose financial reporting. The purpose of the *Conceptual Framework* is, to *inter alia,* assist preparers to develop consistent accounting policies when a standard allows a choice of accounting policy and assist all parties to understand and interpret the Standards.

Paragraph 7 of IAS 1 affirms that many existing and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial statements[1] for much of the financial information they need. Consequently, these are the primary users to whom general purpose financial statements are directed.

The users thereof, as referred to above, read in context with IAS 1 are deemed to include a wide user base, with a focus on the primary users. In the context of a medical scheme which has no shareholders, but rather members, primary users of the Annual Financial Statements (AFS) could be considered to be the members.

Cash and cash equivalents per IAS 7 (paragraph 7) are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. The IASB Interpretations Committee (IASB IC) ruled in May 2013 that, on the basis of paragraph 7 of IAS 7, financial assets held as cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. In June 2018, the IASB IC further ruled that cash management includes managing cash and cash equivalents for the purpose of meeting short-term cash commitments rather than for investment or other purposes

[1] IAS 1 paragraph 1 defines general purpose financial statements (referred to as "financial statements") as those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

(paragraphs 7 and 9 of IAS 7). Assessing whether a banking arrangement is an integral part of an entity's cash management is a matter of facts and circumstances. In the context of a medical scheme, cash management in order to ensure adequate liquidity and meeting the required reserve ratios could be considered an integral part of its cash management activities.

Operating activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities (IAS 7, paragraph 6). Whilst members contributions could be defined as the principal revenue producing activity of a medical scheme, it could also be argued that the treasury management function and collection of income from investments are also operating activities as these activities generate sufficient cash flows to maintain the operating capability [2]of the scheme which in the context of medical schemes is to ensure adequate cash reserves are available to meet member benefit obligations as well as the required reserve ratios of the Council for Medical Schemes (CMS).

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. (IAS 7, paragraph 6). To this, it could be supported that interest earned from investments do not directly relate to the above definition as the cash flow is not due to the acquisition and disposals of long term assets. The interest or income earning assets too in the context of a medical scheme need not necessarily be of a long term nature. These factors indicate the requirement to apply judgement as to whether interest received is better represented by operating or investing activities. The above factors indicate that the better classification is dependent on the nature of type of instrument, the duration thereof and the intention for which the asset was acquired.

IAS 1 recognises the judgement criteria in annual financial statements, and reads as follows:
In the process of applying the entity's accounting policies, management makes various judgements, apart from those involving estimations, that can significantly affect the amounts it recognises in the financial statements (IAS 1, paragraph 123).

[2] IAS 7 paragraph 13

This theme of judgement, and the disclosure thereof also resonates directly with paragraph 33 of IAS 7 which states as follows:

> ‘Interest paid and interest and dividends received are usually classified as operating cash flows for a financial institution. However, there is no consensus on the classification of these cash flows for other entities. Interest paid and interest and dividends received may be classified as operating cash flows because they enter into the determination of profit or loss.’

The Financial Sector Regulation Act defines a financial institution as a financial product and financial services provider, it specifically identifies medical schemes as financial product providers under section 2 (1)(f) a health service benefit provided by a medical scheme as defined in section 1(1) of the Medical Schemes Act whereby products are defined and refers to the services of a scheme under section 3(1)(a) any of the following activities conducted in the Republic in relation to a financial product, a foreign financial product, a financial instrument, or a foreign financial instrument:

- (i) offering, promoting, marketing or distributing;
- (ii) providing advice, recommendations or guidance;
- (iii) operating or managing;
- (iv) providing administration services;

The World Bank defines Nonbanking Financial Institutions (NBFI) as a financial institution that does not have a full banking license and cannot accept deposits from the public. However, NBFIs do facilitate alternative financial services, such as investment (both collective and individual), risk pooling, financial consulting, brokering, money transmission, and check cashing. Medical schemes fall under the definition of a risk pooling institution and consequently fall under the definition of a financial institution.

The following Sections of the MSA are of importance in considering the nature of a medical scheme’s activities and the distinction between operating and investing activities.

Section 1 of the MSA defines the business of a medical scheme as the business of undertaking liability in return for a premium or contribution –

(a) to make provision for the obtaining of any relevant health service;
(b) to grant assistance in defraying expenditure incurred in connection with the rendering of any relevant health service; and
(c) where applicable, to render a relevant health service, either by the medical scheme itself, or by any supplier or group of suppliers of a relevant health service or by any person, in association with or in terms of an agreement with a medical scheme.

Section 26(11) of the MSA states that no medical scheme shall carry on any business other than the business of a medical scheme and no medical scheme shall enrol or admit any person as a member in respect of any business other than the business of a medical scheme.

Section 35(1) of the MSA states that a medical scheme shall at all times maintain its business in a financially sound condition by –

(a) having assets as contemplated in Section 35(3);
(b) providing for its liabilities; and
(c) generally conducting its business so as to be in a position to meet its liabilities at all times.

Section 35(6)(c) of the MSA states that a medical scheme shall not directly or indirectly borrow money without the prior approval of the Council or subject to such directives as the Council may issue.

Section 26(5) of the MSA prohibits the payment in whatever form by a medical scheme directly or indirectly to any person as a dividend, rebate or bonus of any kind whatsoever.

Section 37(2) of the MSA states:" The annual financial statements referred to in subsection (1) shall be furnished to the Registrar in the medium and form determined by the Registrar and shall inter alia consist of:

(a) a balance sheet dealing with the state of affairs of the medical scheme;
(b) an income statement;
(c) a cash-flow statement;
(d) report by the auditor of the medical scheme; and
(e) such other returns as the Registrar may require."

The limitations imposed by the MSA on medical schemes in terms of the business activities of a medical scheme (Sections 1 and 26(11)), restrictions on a medical scheme's ability to access external funding (Section 35(6)(c)) and the requirement that a medical scheme shall at all times maintain its business in a financially sound condition by generally conducting its business so as to be in a position to meet its liabilities at all times (Section 35 (1)(c)) can also be viewed as supportive of the classification of a medical scheme's investment activities being classified as operating activities. This can be demonstrated by medical schemes being required to invest surplus cash into liquid investments in order to generate cash flows and return these cash flows to members by way of medical claims [Section 26(5) prohibits medical schemes from the payment of dividends, rebates or bonuses] thereby ensuring sufficient cash flows are generated to maintain the operating capability.

Another important aspect to consider in assessing whether investment income is classified as operating or investing activity is the manner in which medical schemes manage their investments. This would include the investment strategy, the frequency of the review and the implementation and maintenance thereof. With the medical scheme operating cycle being twelve months, medical schemes often review their investment strategy annually and adjust the investment strategy based on operating requirements or change in market conditions, which can result in the realisation of investments which at initial recognition may have had a longer term investment horizon.

There are medical schemes which have a clear distinction between operating and investing activities in that certain investments are designated as operating and others as investing activity in nature. In these circumstances that accounting treatment would result in the investment income from investment designated as operating activities being classified under operating activities, with the investment income from investments designated as investing activities being classified as investing activities.

International Financial Reporting Standards (IFRS) is a set of principle based standards that require application and judgement so as to best depict information for users. Paragraph 7.2(a) of the Conceptual Framework clarifies the importance of focusing on principles rather than focusing on rules to achieve effective communication of information in financial statements and this principle needs to be kept in mind when determining the accounting policy for disclosures. Clearly then, within the ambit of IAS 1, and IAS 7, discretion and judgement is a key component.

To this end, and as medical schemes fall under the definition of a financial institution, there is reasonable grounds at a principle level, to consider the activities of a medical scheme within the ambit of a financial institution and therefore that interest paid (generally interest paid on Personal Medical Savings Account balances) and interest and dividends received can be classified as operating cash flows. This approach supports the classification as operating activities.

For medical schemes that designate between operating and investing activities the appropriate disclosure would be to report based on these classifications and judgement is required to ensure the required classification.

Based on the different approaches adopted by medical schemes in terms of the management of their investments, a single, prescribed reporting format would lead to financial statements that do not faithfully represent the assets, income and expenses of medical schemes and would lead to less relevant information for users and ultimately financial statements that are not prepared in compliance with IFRS.

IAS 8

IAS 8 - *Accounting Policies, Changes in Accounting Estimates and Errors* is applied in selecting and applying accounting policies, accounting for changes in estimates and reflecting corrections of prior period errors. Changes in Estimates require only prospective adjustment, whereas changes in accounting policies and errors require retrospective application in order to allow comparative information to be uniform.

Should medical schemes, going forward be required to present all returns from investments such as interest as cash flows from investing activities, which would require a change in disclosure for any scheme who were previously of the view that these returns formed part of the entity's core operations and thus were cash flows from operating activities. This change in disclosure then would likely trigger IAS 8.

A consideration requiring deep reflection is how the change in disclosure of the cash flow statement would take place as there has been no change in business model of the medical scheme that prompted the change, and no accounting policy change in terms of IFRS, nor new revised estimates or measurement being utilised by the scheme. The change, should it be adopted, would be a change as required by the regulator and not in terms of IFRS.
To this end, it is envisaged that retrospective adjustment to the cash flow statement and its note would be necessary but not in terms of IFRS. On face value then, the required change would appear to either contravene IFRS, or at least mandate disclosure that is not mandated by the International Accounting Standards Board, and may land up with a component of the AFS that are not in accordance with IFRS. The impact thereof may be a cause for concern for auditors who would be required to attest to the fair presentation of the AFS in accordance with IFRS. The inability to do so may lead to audit opinion qualifications.

Similarly, those charged with governance within the medical scheme itself, such as audit committee members and trustees may also then be required to attest to the fair presentation of the AFS in accordance with IFRS. It is suggested that this may prove difficult for such individuals to do should they be of the view that the interest received from investments in the context of the scheme's business are more suited to operating cash flows rather than pure investing activities. We caution the CMS of the unintended IFRS noncompliance issues that may arise due to the circular.

Effect on the audit report

The ISA 700 audit report provides an audit opinion on whether the financial statements are prepared in accordance with IFRS and the requirements of the MSA. The cash flow statement is prepared in terms of IFRS, IAS 7. The requirements of IAS 7 have been discussed in the sections above.

The MSA furthermore, requires in Section 38(4) that the financial statements are prepared in accordance with general accepted accounting practice. The general consensus is that the general accepted accounting practice for a medical scheme is IFRS. The MSA further states in Section 39 that the Registrar, if he or she is of the opinion that any document furnished in terms of Section 37 does not comply with any of the provisions of the MSA or does not correctly reflect the revenue and expenditure or financial position, as the case may be, of that medical scheme, may reject the document in question.

The MSA does not explicitly specify that the AFS need to comply with any reporting requirements in terms of circulars issued by the Registrar. As such, AFS prepared in accordance with IFRS and the MSA would be compliant with the MSA, and should not be rejected by the registrar. In addition, since the Circulars are not prescribed as being part of the financial reporting framework by law, complying with the provisions of a circular that are in contradiction with IFRS will not be appropriate. Our view is that where a circular contradicts the requirements of IFRS, IFRS takes precedence, as it is the framework prescribed by law.

Circular 52 of 2021 requires schemes in terms of Section 37(2) to present investment income received on scheme investments as investing cash flows in their Statement of Cash Flows in their financial statements for the year ended 31 December 2021 onwards, without considering the nature of the particular investment income. The circular contradicts the requirements of IAS 7, as IAS 7 specifically requires an entity to present investment income based on the nature of the interest as per IAS 7.33 noted above. Circular 52 of 2021 currently prescribes the classification. It is clear that the classification is a scheme by scheme assessment that needs to be made per IAS 7 and therefore there cannot be a prescribed classification for all schemes that would meet the IAS 7 requirements. IAS 7.31 solidifies the concept to state that if there is no change in the nature of the cash flow, the classification should stay the same.

The change required by the Circular will be a change in presentation if the financial statements are restated to include the requirements of Circular 52 of 2001.

When the financial statements are changed to include the requirements of Circular 52 of 2021 regarding the presentation of interest as investing income where the scheme previously presented investment income as operating income, the change should be defined. IAS 8: Accounting policies, changes in estimates and errors gives guidance regarding the classification of the change.

IAS 8. 14 states that:" . . . an entity shall change an accounting policy only if the change:

(a) is required by an IFRS; or
(b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flow."

Based on the requirements of IAS 8.14, the requirement by Circular 52 of 2021 and would not meet the criteria to allow a change in accounting policy as it is not required by IFRS nor will it result in the financial statements being more relevant or reliable as it is in contradiction with IAS 7, as outlined above.

IAS 8. 5 defines an error as:" Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

(a) was available when financial statements for those periods were authorised for issue; and
(b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud."

Based on the requirement of IAS 8.5, the requirements of Circular 52 of 2021 is not an error since IAS 7 allows interest received and dividend income to be represented as either cash flows from operating activities or investment activities; and hence the change required in Circular 52 of 2021 does not result in the correction of mathematical mistakes, mistakes in applying accounting policies of oversights or misinterpretations of facts, and fraud.

When considering the impact of the above on the ISA 700 audit report, ISA 700 A13 - A.15 is considered. IAS 700.A13 - A15 states the following:

“A13 In some cases, the financial statements may represent that they are prepared in accordance with two financial reporting frameworks (e.g., the national framework and IFRSs). This may be because management is required, or has chosen, to prepare the financial statements in accordance with both frameworks, in which case both are applicable financial reporting frameworks. Such description is appropriate only if the financial statements comply with each of the frameworks individually. To be regarded as being prepared in accordance with both frameworks, the financial statements need to comply with both frameworks simultaneously and without any need for reconciling statements. In practice, simultaneous compliance is unlikely unless the jurisdiction has adopted the other framework (e.g. IFRSs) as its own national framework, or has eliminated all barriers to compliance with it.

A14 Financial statements that are prepared in accordance with one financial reporting framework and that contain a note or supplementary statement reconciling the results to those that would be shown under another framework are not prepared in accordance with that other framework. This is because the financial statements do not include all the information in the manner required by that other framework.

A15 The financial statements may, however, be prepared in accordance with one applicable financial reporting framework and, in addition, describe in the notes to the financial statements the extent to which the financial statements comply with another framework (e.g., financial statements prepared in accordance with the national framework that also describe the extent to which they comply with IFRSs). Such description may constitute supplementary financial information as discussed in paragraph 54 and is covered by the auditor's opinion if it cannot be clearly differentiated from the financial statements."

Therefore, if the financial statements, in particular where the cash flow statement was prepared with interest classified operating and now as investing due to the requirements of Circular 52 of 2021, the scheme will be in contravention of ISA 700.A13-A15 as applying the one framework may contradict the other and vice versa. For example if the applicable reporting framework, i.e. IFRS, is not applied appropriately. IFRS requires an entity to disclose interest on the nature of the interest in terms of IAS 7 and not in terms of a Circular issued by the Regulator that prescribes IFRS application. Furthermore, if Circular 52 of 2021 is not included in the financial statements as the applicable framework, i.e. the MSA is also not applied appropriately as the MSA requires a scheme to adhere to all circulars, otherwise there is a possibility that the financial statements can be rejected by the Registrar.

Based on the above, the audit report will contain a modification as the financial statements will either not adhere to IFRS or it will not adhere to the MSA if the classification of the items per IAS 7 does not align to the requirements of Circular 52 of 2021. If the financial statements are modified to take into account Circular 52 of 2021, the qualified audit report will include a qualification on the classification of interest as investment activities as the interest should be classified as operating activities in the statement of cash flow as well as a classification of the IAS 8 disclosure. If the financial statements are not modified, the qualification will be on the basis of the financial statements not adhering to the requirements of the MSA as there is non-adherence to Circular 52 of 2021.

In contrast, there will be no effect on the ISA 800 report that is issued on the Annual Statutory Return (Return) as the ISA 800 report is prepared in accordance with the provisions of the MSA, related Regulations, the Guidance Manual for the completion of the Return and the applicable Circulars issued by the Council for Medical Schemes (the Act and related regulations). The ISA 800 report is not prepared in terms of IFRS and therefore the ISA 700 audit report qualification does not impact the ISA 800 audit report.

We therefore urge the CMS to reconsider Circular 52 of 2021 in prescribing an IFRS treatment and to make use of the Return if specific classifications are required.

Conclusion

In noting the above matters, highlighting the potential non-compliance with IFRS and the auditing implications thereof, we would like to urge the CMS to retract the Circular to allow engagements with industry, and defer the implementation of the Circular for preparation of financial statements for the year ended 31 December 2021. Your positive response would be appreciated.

Yours Sincerely

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