Mr Imran Vanker

IRBA Director of Standards

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Dear Mr Vanker

**PROPOSED GUIDE FOR REGISTERED AUDITORS: CONSIDERATIONS FOR AN AUDITOR OR A REVIEWER OF A COMPANY WHICH IS FACTUALLY INSOLVENT**

The Auditor-General of South Africa would like to take this opportunity to submit comment on the proposed guide referred to above.

We attach, annexed to this letter, our responses for your consideration. In general we request that the proposed guide take into consideration that there are many companies operating in the public sector and that as necessary the wording or guidance be amended accordingly.

Yours sincerely

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**ANNEXURE**

**GENERAL COMMENTS**

1. The guide states that it is applicable when a company is factually insolvent. The guide is not easy to follow and we would have expected it to start with, and focus on, the meaning of sections 22 and 128 of the Companies Act, i.e. what it means for a company to carry on with its business recklessly, with gross negligence or with intent to defraud as well as what it means to be in financial distress. It should then describe the auditor’s responsibilities in terms of these sections and provide more information on chapter 6 relating to business rescue and compromise with creditors.
2. It is our understanding that sections 22 and 128 apply when a company is commercially insolvent, i.e. the company is unable to pay all of its debts when they become due and not factually insolvent as concluded in the guide. For this reason the guide should deal with the circumstances when a company is commercially insolvent and not factually insolvent.
3. The guide should then describe how the auditor should respond to the commercial insolvency in terms of ISA 570. There is guidance on reporting in terms of ISA 570 in SAAPS 3 that should be referred to.
4. The detailed information and appendices on reportable irregularities is better suited in the reportable irregularities guide. This guide should then simply refer to the reportable irregularities guide.
5. Other suggestions to improve the document are to include:

* A definition section
* Subheadings
* Decision trees/ flow diagrams that explain the interactions between factual vs. commercial insolvency, reckless vs. fraudulent trading, RIs for audit engagements vs. review engagements.

1. The words ‘inter alia’ are used excessively in the guide and are in most cases unnecessary.
2. The words ‘judgement’ and ‘prudent judgement’ are used in the guide and should be replaced with the existing audit term ‘professional judgement’.

**COMMENTS ON SPECIFIC QUESTIONS**

**With respect to paragraphs 48 to 50 of this proposed Guide, respondents are asked to consider the implications of the interpretation of "financially distressed" as defined in Section 128(1)(f) of the Companies Act, 2008. Respondents are asked to share the basis of their views.**

We disagree with the conclusion in paragraph 50. A company should be commercially insolvent before it can be in financial distress cf. par18.

We suggest that a legal opinion be obtained from senior counsel on this matter.

**With respect to paragraph 56 of this proposed Guide, respondents are asked whether they agree with the interpretation of Regulation 29(1)(b). Respondents are asked to share the basis of their view.**

We disagree with the assumption made that ‘insolvent’ in terms of regulation 29(1)(b)(iii) deals with factual insolvency. We believe it should be commercial insolvency – it is also stated in terms of paragraph 29 of the guide that there is no prohibition against a company continuing to trade whilst its liabilities exceed its assets i.e. whilst it is factually insolvent.

We suggest that a legal opinion be obtained from senior counsel on this matter.

**Do respondents agree with the identifications, descriptions of and distinctions between the various types of common responses to factual insolvency dealt with in this proposed Guide, being the letters of support, letters of comfort, guarantees and subordinations?**

Yes, but also see the specific comment on paragraphs 113 and 114.

**This proposed Guide contains an illustrative subordination agreement in Appendix 3. Respondents are asked to comment on whether or not an illustrative subordination agreement should be included in this proposed Guide.**

Yes, including an illustrative subordination agreement should ensure that the minimum requirements are met in order for such an agreement to have the desired legal power/ standing. It will also ensure a level of consistency, even though the agreement should be tailored for the specific circumstances.

**Do respondents believe that this proposed Guide should include an illustrative letter of guarantee or letter of support, particularly taking into account the many variations thereof in practice?**

Yes, including an illustrative letter of guarantee and letter of support should ensure that the minimum requirements are met in order for such letters to have the desired legal power/ standing. It will also ensure a level of consistency, even though the letters should be tailored for the specific circumstances.

**COMMENTS ON SPECIFIC PARAGRAPHS**

1. Paragraph 2 – states that the guide is applicable to registered auditors. We suggest that “application to” be amended to “guidance for” as per the purpose on page 1. The question of registered auditors should also be addressed as this guidance would be relevant to all audits of companies which includes those audited by the AGSA.
2. Paragraph 14 – the last part of the paragraph includes the words “… - in regard to” which does not read well.
3. The background information in paragraphs 16 – 26 describes the meaning of factual and commercially insolvent as well as certain scenarios that may exist that does not necessarily mean the that the company is commercially insolvent. These paragraphs should be written in such a way that it concludes when a company should be considered as commercially insolvent and that sections 22 and 128 of the Companies Act then apply. (Please refer to overall comment in paragraph 1.)
4. Paragraph 22 – the second sentence that starts with “This is so as the…” does not read well.
5. Paragraphs 27 to 81 – The ‘Law’ section does not consider the Municipal Finance Management Act (MFMA) section 109 which relates to financial problems at municipal entities. Municipal entities may be registered as companies in terms of the Companies Act and should in addition comply with MFMA section 109 when the municipal entity is commercially insolvent.
6. Paragraphs 29 to 32 should be consolidated.
7. Paragraphs 29 to 44 could be better positioned after the Companies Act requirements in paragraphs 45 to 50.
8. Paragraph 30 – reference is made to ISA 570 under the case law section. We don’t believe that it is appropriate to make reference to ISA 570 in the sentence that states that trading whilst factually insolvent does raise the potential for possible recklessness, or even fraud. The reference to 570 relates to examples when there could be doubt that an entity is a going concern. It does not refer to the potential for possible recklessness or even fraud.
9. Paragraph 33 – consider using simpler language than ‘but subjectively to postulate’.
10. Paragraph 43.3 – ‘profit (or loss) after interest’ is not a recognised accounting term and should therefore be defined or described in the guide.
11. Paragraph 74 – the words “of itself” should be “in itself”.
12. Paragraph 77 – the matters described in the sub-paragraphs are duplicated in the sub-paragraphs to paragraph 122. We further believe that paragraphs 121 to 122 are unnecessary as the auditor has to comply with ISAs.
13. Paragraph 87 – Reference to IFRS in the guide should be changed to ‘the applicable financial reporting framework’ as there are companies that apply GRAP for example.
14. Paragraph 90 – The statement that the ‘subordinated liabilities would be excluded as liabilities’ appears to contradict the conclusion reached in paragraph 87 which states that ‘the subordination by a creditor does not change the accounting nature of the amount which remains a liability’. Further clarity should be provided to clear any contradiction/ confusion.
15. Paragraphs 113 and 114 – The section on Guarantees does not sufficiently explain and conclude on the impact of guarantees on the factual solvency assessment and on the going concern assessment. The section should be expanded to address these matters.
16. Paragraph 122.1 – makes reference to ISQC1 and ISA 220, but these standards do not deal with addition audit risk due to factual insolvency.
17. Paragraph 122.18 – it is our understanding that material uncertainties relating to going concern will be reported as a separate section in the auditor’s report under a heading titled ‘Going concern’ and if the financial statements were incorrectly prepared on the going concern basis, the auditor’s opinion will be modified. These matters will therefore not be reported in the KAMs section of the auditor’s report (Please refer to paragraph 11 of ISA 701).
18. Paragraph 122 – If this section is to remain, a further requirement should be included for the auditor to consider whether the assets and liabilities of the entity have been appropriately valued in the financial statements and whether all the required disclosures have been included in the financial statements as required by the applicable financial reporting framework.