Copy of email from Herman Bosman:

**From:** Herman Bosman [mailto:herman@bosmanconsulting.co.za]
**Sent:** 15 July 2016 04:35 PM
**To:** Standards Standards <standards@irba.co.za>
**Subject:** Comments on Proposed Guide: Considerations for an Auditor or a Reviewer of a Company which is Factually Insolvent

Comments on the Proposed Guide: Considerations for an Auditor of a Company which is Factually Insolvent

(i) 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.

I am of the view that the use of “insolvent” in section 128(1)(f)(ii) should not be equated to the definition of solvency in section 4. If that was the intention, there would have been a specific reference to section 4. If a company, despite being factually insolvent, is able to continue business on a basis which does not amount to reckless trading, with gross negligence and intent to defraud in terms of section 22, then the company is surely not “financially distressed” in the context of the business rescue provisions. To inappropriately force companies to issue a written notice in terms of section 129(7) could have dire consequences for companies.

Par. 72 of the Proposed Guide supports my contention, by stating that if a company has been, and is likely to be able to meet its debts when due in the future, then the breach of section 129(7) is unlikely in itself to amount to a reportable irregularity.

(ii) With respect to paragraph 56 of this proposed Guide, respondents are asked whether they agree with the interpretation of Regulation 29(1)(b).

I would interpret Regulation 29(1)(b)(iii) as meaning commercial insolvency and not factual insolvency. The Regulations should rather be amended by inserting a proper definition under Regulation 2 (Definitions) of the meaning of “to trade under insolvent circumstances”.

(iii) 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?

I agree with the identifications, but would have preferred that more prominence is given to the other remedies available that can materially affect factual solvency (and commercial insolvency) as is dealt with in par.120 under the heading “Other response to factual insolvency”.

The fresh issue of share capital for cash (or firm commitment for issue of shares) is surely the most preferred remedy for both factual and commercial insolvency, while the subordination of loans should be the last on the list since it is not a remedy for factual insolvency because it remains a liability.

(iv) 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.

By providing the illustrative subordination agreement, auditors (in general) would consider this as the default option as a quick fix, without affording clients the opportunity to consider other options aligned to their own financial position. By subordinating a loan account the lender is giving away value for the benefit of other creditors and it may be in his interest for the company to rather be liquidated.

If the illustrative subordination agreement is included, I recommend that the Proposed Guide in Appendix 3 (Illustrative Subordination Agreement) should contain a warning to the Registered Auditor on the following matters:

* to properly explain the financial and legal consequences of a subordination agreement to their clients
* not to be seen to be giving financial or legal advice to their clients by suggesting the subordination route
* to make their clients aware of all the other remedies available that can materially affect factual solvency (and commercial insolvency) as is dealt with in par.120 under the heading “Other response to factual insolvency”.

I am also of the opinion that the following wording under par. 7 of the illustrative subordination agreement in Appendix 3, namely “written assurance from the auditors of Y regarding the financial position at any other date” should be scrapped. The auditor will be hard put to provide “assurance” on the “financial position” of an entity in order to lift the subordination, when he/she normally would only opine on whether a set of financial statements fairly presents the financial position of an entity. The auditor would have to perform an audit to provide such assurance and I therefore suggest that par.7 be amended as follows:

“7. The asset and liability position for purposes of this agreement shall be based on the audited annual financial statements, or on audited financial statements prepared at any other date.”

(v) 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?

I believe that too much emphasis is placed on subordination agreements and that there should be examples of other remedies. I would especially welcome an illustrative letter of undertaking to subscribe for shares in the company.

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