**DISCIPLINARY COMMITTEE FOR**
**THE INDEPENDENT REGULATORY BOARD FOR AUDITORS**

In the matter between:

**INDEPENDENT REGULATORY BOARD FOR AUDITORS** Complainant

and

**TWALIZIDANGA MGCINISIHLALO JORDAN** First Respondent

**DANIËL FRANCOIS CROWTHER** Second Respondent

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# DECISION

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## INTRODUCTION

### *Background*

1 This matter has its genesis in the events impacting African Bank Investments Limited ("ABIL") during 2013 and 2014, culminating in its subsidiary, African Bank Limited ("African Bank"), being placed under curatorship.

2 ABIL had banking, retail and insurance components to its business. Its banking business involved lending to the unsecured market. That business was conducted primarily through its subsidiary, African Bank. The auditors of the ABIL Group and its subsidiaries were Deloitte.

3 The origins of the decline of African Bank are matters that we need not explore. In order to set the scene though, some of the significant developments included the following, amongst others:

3.1 Towards the end of 2012, the Registrar of Banks and his team in the banking services division intensified their engagement with the management and board of African Bank, focussing on its impairment provisioning policy, rapid credit growth and business model.

3.2 On 4 March 2013, Moody's downgraded African Bank's global senior debt and deposit ratings by one notch to Baa3/prime -3 from Baa2/prime -2.

3.3 Despite having made a profit in the 2012 financial year, on 2 May 2013, ABIL published a trading statement in which shareholders were advised that headline earnings for the group were expected to decline between

25% and 28% relative to the same period in the previous year and that headline earnings for African Bank would decline between 19% and 22%.

3.4 On 22 May 2013, ABIL released its unaudited interim results for the six months ended 31 March 2013 announcing that headline earnings had declined by 26% and that there was an economic loss of R47 million.

3.5 On 5 August 2013, ABIL announced to the market that it intended to raise share capital through a rights offer underwritten by Goldman Sachs International, prompting an elevation of the audit risk by Deloitte to "much greater than normal".

3.6 In the annual reports for the 2013 financial year, ABIL disclosed a loss of R4.2 billion and African Bank disclosed a loss of R4.5 billion.

3.7 On 2 May 2014, shareholders were advised in a trading statement that ABIL expected a headline loss of between R3.1 and R3.3 billion and that African Bank together with Stangen were expected to show a headline loss of between R1.9 and R2 billion.

3.8 On 6 August 2014, in the quarterly operational update for the quarter ended 30 June 2014, it was announced that Mr Leon Kirkinis had resigned as CEO, the banking unit forecasted a basic and headline loss of at least R4.6 billion and the retail unit, consisting of Ellerine Furnishers (Pty) Ltd, forecasted a basic loss of R2.9 billion and a headline loss of at least R1.7 billion. The group was expected to show a basic loss of at least R7.6 billion and a headline loss of at least R6.4 billion for the full

year ending September 2014. ABIL required a capital raise of about R8.5 billion.

3.9 On 7 August 2014, it was announced that Ellerine Furnishers (Pty) Ltd had commenced with business rescue proceedings.

3.10 On 10 August 2014 the then Minister of Finance, Mr Nhlanhla Nene, placed African Bank under curatorship, after consultation with the Registrar of Banks.

4 Mr Tom Winterboer was appointed as curator. He was responsible for the preparation of the 2014 AFS of African Bank. Deloitte remained responsible for the audit of those financial statements but the first respondent was replaced as engagement partner by Mr Lito Nunes. When the curator published the AFS for African Bank in 2014 they included restatements in respect of the 2012 and 2013 AFS of African Bank for what were alleged to be various errors in the 2012 and 2013 AFS. It is those restatements which have, in the main, given rise to the investigation and prosecution of the charges now before the Committee.

5 The first and second respondents, Twalizidanga Mgcinisihlalo Jordan, and Daniël Francois Crowther, are auditors registered in terms of section 27 of the Auditing Profession Act No. 26 of 2005 ("the Audit Act"). The first respondent was the engagement partner for ABIL and for African Bank for the 2013 audit of the annual financial statements. The second respondent was to support the first respondent in the audit in respect of all areas outside of loans and advances (and related revenue, expenses and impairment). However, in the end he also provided the first respondent with additional partner support. The first

respondent was also the engagement partner for ABIL and African Bank in the 2009, 2010, 2011 and 2012 financial years.

6 The first respondent faces ten charges of improper conduct as contemplated in section 49 of the Audit Act. The second respondent faces a single charge, the tenth charge. The tenth charge is thus faced by both the first and second respondents.

7 A disciplinary hearing was convened in terms of section 50 of the Audit Act in order to consider the charges. This document records the decisions of the disciplinary Committee ("the Committee") of the Independent Regulatory Board for Auditors ("IRBA" or "the Board").

8 The disciplinary Committee is established in terms of section 24(2) of the Audit Act. Section 50(2)(a) of the Audit Act provides *"the disciplinary Committee … must appoint a person to present the charge to the disciplinary Committee"*. ENS Africa were appointed for this purpose and they instructed Mr S Symon SC as counsel. Although we refer to the pro forma complainant as "he" or "him" as a matter of convenience and because Mr Symon led the team, the term must be taken as referring to the entire legal team.[1]

9 The charges emanate from professional work done by the respondents and their firm, Deloitte, in auditing the annual financial statements of ABIL and African Bank. The charges relate to the audits for the financial year ending 30 September 2013, save in respect of the ninth charge, which pertains to the

[1] Which included a majority of women.

financial years ending 30 September 2009, 30 September 2010, 30 September 2011 and 30 September 2012.

10 Only one of the charges, the tenth charge, involves allegations of dishonesty. For the reasons given fully below, we find both first and second respondents not guilty on that charge. The second respondent faces no other charges.

11 As far as the remaining charges are concerned, this is not a case about dishonesty on the part of the first respondent or on the part of Deloitte. It is a case about whether the first respondent's audit work in respect of the annual financial statements in question was flawed in a manner giving rise to professional misconduct or "improper conduct", to use the term used in the Audit Act and the Rules.

12 The first respondent did not work alone. He had an audit team consisting of Deloitte auditors and trainee-auditors of various levels of seniority doing dedicated work on the audit. He had access to and made use of the Deloitte technical accounting department. He made use of the capital markets team within Deloitte that provided actuarial expertise. And he involved a number of Deloitte partners in different roles and at various stages of the audit, including the second respondent, Mr Geoff Pinnock, who acted as executive support partner, Mr Darren Shipp, who acted as engagement quality control review partner and Mr Brian Botes, additional special quality control review partner. The work under consideration is therefore the work of the firm. But the first respondent was the engagement partner for the audits of both ABIL and African Bank at the material times. That means that he alone must bear responsibility ultimately for the quality of the audit.

13 In setting out our decision, we will not seek to summarise all of the evidence that was presented. That would be both a mammoth and an unnecessary task. The oral evidence was presented over a period of 66 days between March 2018 and December 2019. The witnesses all provided very substantial witness statements which become part of their sworn testimony. These in many instances included extensive documentary evidence by way of annexures and otherwise. We also had access to Deloitte's audit working papers in respect of the audits. We had access to documentation pertaining to the Myburgh Commission and Deloitte's representations to it. We had the Myburgh Report. Many exhibits were handed in during the course of the proceedings, with the final one bearing exhibit number 42.24.

14 During a phase of the hearing when the matter was adjourned, the expert witnesses met and sought to identify and articulate areas in which they were in agreement and those in which they were not, to assist in narrowing the ambit of the issues in dispute. Substantial and helpful documents were generated recording the outcome of that process.

15 We have paid careful heed to every item of factual evidence, expert evidence and documentary evidence and to both the written and oral argument. We have been assisted in this regard by extensive main and rebuttal heads of argument from each side, oral argument over two days and further written submissions elicited by the Committee on particular queries that we raised subsequent to hearing oral argument. We thank the legal teams for their assistance in navigating the complexity of the issues and the volume of the evidence.

16 Of necessity, we highlight in this decision only the most important parts of the evidence and argument that have informed our decision.

17 We set out our decision as follows:

17.1 The charges;

17.2 The expert witnesses;

17.3 The factual witnesses;

17.4 The weight to be afforded expert evidence;

17.5 The legal standards applicable to improper conduct;

17.6 The complaint in relation to splitting of charges;

17.7 Our decision in respect of each of the charges.

18 Before doing so, we provide a glossary of terms and a brief introduction to some of the main participants in the events upon which the charges are based and in the proceedings before the Committee.

***Glossary***

19 We take primarily from the pro forma complainant's heads of argument the following glossary of terms. We do so for convenience and we should not thereby be seen to prefer any interpretation of any term advanced by them. We have made some minor amendments. The meaning should only be taken as far as the context in the body of the decision does not indicate otherwise.

19.1 AFS – means Annual Financial Statements;

19.2 ABIL – means African Bank Investments Limited;

19.3 ACCIs – means the additional cash collection initiatives;

19.4 African Bank – means African Bank Limited;

19.5 Audit Act - means the Auditing Profession Act, No. 26 of 2005;

19.6 AWP – means audit working paper;

19.7 Banks Act – means the Banks Act, 94 of 1990;

19.8 Big Four Banks – means ABSA Bank Limited, FirstRand Bank Limited, Nedbank Limited and Standard Bank of South Africa Limited;

19.9 BSD – means the Bank Supervision Department of the SARB;

19.10 CD - means Contractual Delinquency;

19.11 Companies Act – the Companies Act, 71 of 2008 (as amended);

19.12 DTA – means deferred tax asset;

19.13 ECQR – means Engagement Quality Control Review partner required in terms of ISQC 1;

19.14 Ellerine Furnishers – means Ellerine Furnishers (Pty) Ltd, a subsidiary of Ellerine Holdings;

19.15 Ellerine Holdings – means Ellerine Holdings Limited, a subsidiary of ABIL;

19.16 Ellerine Loan – means the loan agreement entered into between African Bank and Ellerine Furnishers;

19.17 Emergence period – means the time period that it takes for a particular loss event to become known;

19.18 Emergence factor – means the emergence period expressed as a percentage calculated based on the emergence period over an outcome period;

19.19 The Gap – means the difference between the impairment cash flow model and the actual impairment recorded in the GL;

19.20 Goldman Sachs – means Goldman Sachs International;

19.21 GL – means the general ledger;

19.22 IBNR – means incurred but not reported and refers to a loss event that has occurred but which has not been reported;

19.23 IAASB – International Auditing and Assurance Standards Board;

19.24 IAS – means International Accounting Standard;

19.25 IFRS – means International Financial Reporting Standards;

19.26 IRBA – means the Independent Regulatory Board for Auditors;

19.27 IRBA Code – means the code of professional conduct prescribed by IRBA;

19.28 IRBA Rules – means the disciplinary rules prescribed by IRBA;

19.29 ISA – means International Standards on Auditing;

19.30 ISA E – means International Standard on Assurance Engagements;

19.31 ISRE – means International Standard on Review Engagements;

19.32 JSE – means Johannesburg Stock Exchange;

19.33 LGD – means loss given default and refers to the loss which is expected if a loan reaches a designated point of default where recovery of the loan is no longer expected;

19.34 ML – means the memorandum ledger;

19.35 Myburgh Commission – commission for the purpose of investigating the business, trade, dealings, affairs or assets and liabilities of African Bank;

19.36 Myburgh Report – means the Myburgh Commission Report compiled by Commissioner Advocate Myburgh appointed in terms of Section 69A(1) of the Banks Act, No. 94 of 1990;

19.37 NCA – means the National Credit Act, No. 34 of 2005;

19.38 NPL - means non-performing loans/loan book;

19.39 OEIR – means the original effective interest rate;

19.40 Old Code - the code of professional conduct made under the Public Accountants and Auditors Act, No. 80 of 1991, which remained in force under transitional provisions of the Audit Act until 31 December 2010;

19.41 Old Disciplinary Rules - the rules made under the Public Accountants and Auditors Act, No. 80 of 1991, rule 2.1 of which remained in force under transitional provisions of the Audit Act until 31 December 2010;

19.42 Outcome period – means, in the context of an impairment calculation, the period over which the occurrence of a potential loss event is observed;

19.43 PD - in the context of the element of a calculation formula to calculate impairment, refers to probability of default;

19.44 PL – means performing loans;

19.45 PWC – means PricewaterhouseCoopers International Limited;

19.46 Rights offer shares – means the shares offered by ABIL to qualifying shareholders in 2013;

19.47 RDS – Residual Debt Services (Pty) Ltd;

19.48 SAICA – means the South African Institute of Chartered Accountants;

19.49 SARB – means the South African Reserve Bank;

19.50 SENS – means the Stock Exchange News Service of the JSE;

19.51 Stangen – means the Standard General Insurance Company Limited a subsidiary of ABIL;

19.52 The Bank means ABIL and African Bank;

19.53 The Code - the Code of Professional Conduct for Registered Auditors made in terms of section 4(1)(c) of the Audit Act; and

19.54 The Rules - the rules made in terms of section 10 of the Audit Act, rule 2.1 of which regarding improper conduct was effective from 1 January 2011.

***Participants***

20 The following are the main participants in alphabetical order:

20.1 Mr Martin Bierman – Ellerine team leader on 2013 audit ("Mr Bierman");

20.2 Mr Pravin Burra – partner and head of the banking analytics team and later the capital markets team at Deloitte during the relevant period; ("Mr Burra");

20.3 Mr Robert Cameron-Ellis – investigator on behalf of the IRBA to identify possible improper conduct by the statutory auditor in 30 September 2013 audits of the AFS of ABIL, African Bank and EHL and expert witness called on behalf of the Pro-Forma Complainant ("Mr Cameron-Ellis");

20.4 Mr Peter Chidgey – expert witness called by the respondents ("Mr Chidgey");

20.5 Mr Richard Cohen – expert witness called by the respondents ("Mr Cohen");

20.6 Mr Daniël Francois Crowther – audit partner at Deloitte who supported the first respondent in the 2013 audit; ("Mr Crowther" / "second respondent");

20.7 Mr Trevor Derwin – Technical Partner at Deloitte ("Mr Derwin");

20.8 Ms Linda De Beer – expert witness called by the pro forma complainant ("Ms De Beer");

20.9 Mr Twalizidanga Mgcinisihlalo Jordan - audit partner at Deloitte and the responsible, registered auditor for the 2009 to 2013 audits of ABIL and African Bank ("Mr Jordan / first respondent");

20.10 Mr Leon Kirkinis - chief executive officer of ABIL and the Bank from 1998 until 6 August 2014 ("Mr Kirkinis");

20.11 Mr Fritz Malan - attorney from ENSafrica;[2]

20.12 Mr Brian Mavuka – senior manager at Deloitte responsible for impairments calculations in Ellerine Furnishers and African Bank ("Mr Mavuka");

20.13 Mr Nithia Nalliah - financial director of ABIL from 2009 to 2014. Previously from April 2006 to May 2009 he served as chief financial officer of African Bank ("Mr Nalliah");

20.14 Mr Costa Natsas - partner at PWC, banking and capital markets industry leader for PWC Africa and head of banking and capital markets risk and regulatory practice ("Mr Natsas");

20.15 Mr Reynold Ngobese - group financial manager of ABIL ("Mr Ngobese");

20.16 Mr Lito Nunes – audit partner at Deloitte and the responsible, registered auditor for the 2014 audit of the Bank ("Mr Nunes");

20.17 Mr Geoff Pinnock - managing partner of Africa Audit for Deloitte and acted as executive support partner during 2013 audit ("Mr Pinnock");

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[2] Only those members of the legal teams whose names appear in the quoted portions of the transcript are given here. The full legal teams are listed at the end of the decision.

20.18 Ms Nita Ranchod - technical partner at Deloitte ("Ms Ranchod");

20.19 Mr Gustav Raubenheimer – head of group credit of African Bank from 1 October 2012 until 28 February 2014 ("Mr Raubenheimer");

20.20 Mr George Roussos - executive: collections of the Bank and the ABIL group and executive: central support service of the Bank from December 2010 to March 2016 ("Mr Roussos");

20.21 Mr Darren Shipp – audit partner in Deloitte's financial institutions services team ("Mr Shipp");

20.22 Mr Danie Smit - counsel for the respondents;

20.23 Mr Riaan Smit - employed in the credit division at African Bank ("Mr Smit")';

20.24 Mr Muller Strauss - chief financial officer of the Bank; ("Mr Strauss");

20.25 Mr Shem Symon SC - senior counsel instructed by ENS Africa for the pro forma complainant;

20.26 Mr Tom Winterboer, appointed as curator of African Bank on 10 August 2014 ("Mr Winterboer" or "the Curator");

20.27 Mr Michael van der Nest SC - senior counsel for the respondents.

21 The full membership of the legal teams and the Committee appear at the end of the decision.

## THE CHARGES

### *The rules and the code of professional conduct*

22 The charges involve alleged infringements of the disciplinary rules made by the IRBA under section 4(1)(c) of the Audit Act with effect from 1 January 2011.

23 Rule 2 of these rules provides, in relevant part, as follows:

> *"**2. Improper Conduct***
>
> *The Regulatory Board is obliged by s 48 to consider and, where it appears justified, investigate and deal with any complaint, charge or allegation of improper conduct against a registered auditor which may be laid before it, and is empowered to impose any of the prescribed sanctions set out in section 51(3) and Disciplinary Rule 8.1 and 8.2, in respect of any improper conduct. While the acts or omissions specified in the following paragraphs are not intended to be a complete list of acts or omissions which might constitute improper conduct on the part of a registered auditor and which are punishable in accordance with the provisions of the Act and Disciplinary Rules, a registered auditor shall be guilty of improper conduct if such registered auditor without reasonable cause or excuse –*
>
> *2.1 contravenes or fails to comply with any provision of the [Audit] Act with which it is the registered auditor's duty to comply;*
>
> *...*
>
> *2.4 is dishonest in the performance of any work or duties devolving upon the registered auditor in relation to-*
>
> *2.4.1 any professional services performed by a registered auditor; or*
>
> *2.4.2 any office of trust which the registered auditor has undertaken or accepted.*
>
> *2.5 contravenes or fails to comply with any requirements in Auditing Pronouncements prescribed by the Regulatory Board;*
>
> *2.6 contravenes or fails to comply with any requirements in the Code;*
>
> *2.7 fails to perform any professional services or duties with such a degree of professional competence, due care and skill as in the opinion of the Regulatory Board may reasonably be expected, or fails to perform the professional services or duties at all;*
>
> *...*
>
> *2.17 behaves in a manner which tends to bring the auditing profession into disrepute."*

24 Insofar as it is alleged in each of the first to fifth, seventh and ninth charges that there was an infringement of rule 2.1, it is alleged that there was a failure to comply with section 44 of the Audit Act. Section 44 of the Audit Act provides in relevant part, as follows:

> *"44* ***Duties in relation to audit***
>
> *(1) …*
>
> *(2) The registered auditor may not, without such qualifications as may be appropriate in the circumstances, express an opinion to the effect that any financial statement or any supplementary information attached thereto which relates to the entity –*
>
> *(a) fairly presents in all material respects the financial position of the entity and the results of its operations and cash flows; and*
>
> *(b) are properly prepared in all material aspects in accordance with the basis of the accounting and financial reporting framework as disclosed in the relevant financial statements,*
>
> *unless a registered auditor who is conducting the audit of an entity is satisfied about the criteria specified in subsection (3).*
>
> *(3) The criteria referred to in subsection (2) are –*
>
> *(a) that the registered auditor has carried out the audit free from any restrictions whatsoever and in compliance, insofar as possible, with auditing pronouncements relating to the conduct of the audit;*
>
> *(b) that the registered auditor has by means of such methods as are reasonably appropriate having regard to the nature of the entity satisfied himself or herself of the existence of all assets and liabilities shown on the financial statements;*
>
> *(c) that proper accounting records in at least one of the official languages of the Republic have been kept in connection with the entity in question so as to reflect and explain all its transactions and record all its assets and liabilities correctly and adequately;*
>
> *(d) that the registered auditor has obtained all information, vouchers and other documents which in the registered auditor's opinion were necessary for the proper performance of the registered auditor's duties;*
>
> *(e) …*
>
> *(f) that the registered auditor has complied with all laws relating to the audit of that entity; and*
>
> *(g) that the registered auditor is satisfied, as far as is reasonably practicable having regard to the nature of the entity and the audit carried out, as to the fairness or the correctness, as the case may be, of the financial statements."*

24.1 Insofar as it is alleged in the first nine charges that there was an infringement of rule 2.6, ie a contravention of, or failure to comply with, the Code, that is a reference to the Code of Professional Conduct made by the board in terms of sections 4 and 21 of the Audit Act. The sections of the Code alleged to have been infringed include the following:[3]

*"**Fundamental Principles***

*100.5 A registered auditor shall comply with the following fundamental principles*

*(a) …*

*(b) Objectivity - to not allow bias, conflict of interest or undue influence of others to override professional or business judgements.*

*(c) Professional Competence and Due Care – to maintain professional knowledge and skill at the level required to ensure that a client receives competent professional services based on current developments in practice, legislation and techniques and acts diligently and in accordance with applicable technical and professional standards.*

*…*

***Professional Competence and Due Care***

*130.1 The principle of competence and due care imposes the following obligations on all registered auditors:*

*(a) …*

*(b) to act diligently in accordance with applicable technical and professional standards when providing professional services.*

*130.2 …*

*130.3 The maintenance of professional competence requires a continuing awareness and understanding of relevant technical, professional and business developments. Continuing professional development enables a registered auditor to develop and maintain the capabilities to perform competently within the professional environment."*

---

[3] In some instances only an infringement of section 100.5(b) is alleged, in some only 100.5(c) and in some, both.

25 Insofar as infringements of rule 2.6 and the Code of Conduct are alleged under tenth charge, the sections relied upon by the pro forma complainant include, in addition to section 100.5(a) and (b), the following:

> *"**Fundamental Principles***
>
> *100.5 A registered auditor shall comply with the following fundamental principles*
>
> *(a) ...*
>
> *(e) Professional Behaviour – to comply with the relevant laws and regulations and avoid any action that discredits the auditing profession.*
>
> *...*
>
> ***Threats and Safeguards***
>
> *100.12 Threats may be created by a broad range of relationships and circumstances. When a relationship or circumstance creates a threat, such a threat could compromise, or could be perceived to compromise, a registered auditor's compliance with the fundamental principles. A circumstance or relationship may create more than one threat, and a threat may affect compliance with more than one fundamental principle. Threats fall into one or more of the following categories:*
>
> *(a) ...*
>
> *(b) Self-review threat – the threat that a registered auditor will not appropriately evaluate the results of a previous judgement made or service performed by the registered auditor, or by another individual within the registered auditor's firm, on which the registered auditor will rely when forming a judgement as part of providing a current service;*
>
> *(c) ...*
>
> *(d) Familiarity threat – the threat that due to a long or close relationship with the client, a registered auditor will be too sympathetic to their interests or too accepting of their work; and*
>
> *(e) Intimidation threat – a threat that a registered auditor will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the registered auditor.*
>
> *...*
>
> ***SECTION 120***
>
> ***Objectivity***
>
> *120.1 The principle of objectivity imposes an obligation on all registered auditors not to compromise their professional or business*

*judgement because of bias, conflict of interest or the undue influence of others.*

*120.2 A registered auditor may be exposed to situations that may impair objectivity. It is impractical to define and prescribe all such situations. A registered auditor shall not perform a professional service if a circumstance or relationship biases or unduly influences the registered auditor's professional judgement with respect to that service.*

*...*

***SECTION 290***

***Independence – an audit and review engagements***

***Structure of Section***

*290.1 This section addresses the independence requirements for audit engagements and review engagements, which are assurance engagements in which a registered auditor expresses a conclusion on financial statements. Such engagements comprise audit and review engagements to report on a complete set of financial statements and a single financial statement. Independence requirements for assurance engagements that are not audit or review engagements are addressed in section 291.*

*290.2 ...*

*290.3 In this section, the term[s]:*

- *'audit', 'auditing', 'audit engagement', 'audit client' and 'audit report' includes review, review team, review engagement, review client and review report; and*
- *'Firm' includes network firm, except where otherwise stated.*

***A Conceptual Framework Approach to Independence***

*290.4 In the case of audit engagements, it is in the public interest and, therefore, required by this Code, that members of audit teams, firms and network firms shall be independent of audit clients.*

*290.5 The objective of this section is to assist firms and members of audit teams in applying the conceptual framework approach described below to achieving and maintaining independence.*

*290.6 Independence comprises:*

***Independence of Mind***

*The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgement, thereby allowing an individual to act with integrity and exercise objectivity and professional scepticism.*

***Independence in Appearance***

*The avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude,*

*weighing all the specific facts and circumstances, that a firm's or a member of the audit team's integrity, objectivity or professional scepticism has been compromised.*

*290.7 The conceptual framework approach shall be applied by registered auditors to:*

*(a) Identify threats to independence;*

*(b) Evaluate the significance of the threats identified; and*

*(c) Apply safeguards, where necessary, to eliminate the threats or reduce them to an acceptable level.*

*When the registered auditor determines that appropriate safeguards are not available or cannot be applied to eliminate the threats or reduce them to an acceptable level, the registered auditor shall eliminate the circumstance or relationship creating the threats or decline or terminate the audit engagement.*

*A registered auditor shall use professional judgement in applying the conceptual framework."*

***The first charge***

26 The first charge involves alleged contraventions of rules 2.1, 2.5, 2.6 (with reference to sections 100.5(c), 130.1(b) and/or 130.3 of the Code), 2.7 and/or 2.17.

27 The facts giving rise to the first charge are described in the charge sheet as follows:

27.1 The AFS of African Bank for the year ended 30 September 2014 indicated a material restatement relating to differences between impairment models and impairment provisions recognised in the prior financial year, i.e. in the 2013 AFS. The impact of this restatement was a R656m downward adjustment of pre-tax income for the 30 September 2013 financial year.

27.2 The audit files of African Bank for the year ended 30 September 2013 show that the first respondent was aware of the following:

27.2.1 the final report to the audit committee stated that "management discretion, being the difference between impairment model values and the GL is R825m as at September 2013";

27.2.2 the final report to the audit committee further states that additional audit procedures had been performed on these collection initiatives and that these initiatives could produce an uplift of "*up to approximately R825m*";

27.2.3 audit work paper AB5450 indicates that two of the three cash uplift initiatives could not be justified or substantiated;

27.2.4 audit work paper AB5450 also states *"as per our assessments the cash upliftments range between R261m and R516m"* and indicates that the average is R388,829,935; and

27.2.5 a reconciling item of R512m between the general ledger and the impairment model relating to insurance reserves held by the Standard General Insurance Company Ltd ("Stangen") was accepted without documenting any procedures or considerations regarding its validity.

27.3 The impact of the R656m error relating to the differences between the impairment models and the impairment provision on the consolidated AFS of ABIL and African Bank for the year ended 30 September 2013 is material and accordingly the AFS were materially misstated. As the

AFS were not amended for this misstatement, an unqualified audit opinion was incorrectly issued.

27.4 This gave rise to breaches of the following ISAs in the conduct of the ABIL and African Bank audits for the year ended 30 September 2013:

27.4.1 ISA 200, *Overall Objectives of the Independent Auditor* and the *Conduct of an Audit in Accordance with International Standards on Auditing*, as the first respondent failed to maintain an attitude of professional scepticism and further failed to plan and perform the audit to reduce risk to an acceptable level as not all of the cash uplift initiatives or reconciling items could be substantiated;

27.4.2 ISA 220, *Quality Control for an Audit of Financial Statements*, in that the first respondent failed to ensure that there was sufficient appropriate evidence to support the conclusions reached on the difference between the impairment model and the impairment provision recognised in the AFS;

27.4.3 ISA 230, *Audit Documentation,* in that the first respondent failed to document how the information referenced in paragraph 6.2 of the schedule of charges (see paragraph 27.2 above), and workpaper AB5450 in particular, was addressed in forming a final conclusion;

27.4.4 ISA 330, *The Auditor's Responses to Assessed Risks*, in that the first respondent failed to take into account all relevant evidence in forming an opinion. The evidence that the "cash uplift" initiative amount of R825 million could not be fully justified or substantiated appears to have been ignored and/or not taken into account by the first respondent. The first respondent further failed to resolve the contradiction between workpaper AB5450 and the report to the audit committee;

27.4.5 ISA 450, *Evaluation of Misstatements Identified During the Audit*, in that the first respondent failed to accumulate and assess the misstatement related to the difference between the impairment model and impairment provision;

27.4.6 ISA 500, *Audit Evidence*, in that the first respondent failed to obtain sufficient appropriate audit evidence to draw reasonable conclusions on the difference that existed between the impairment model and the general ledger;

27.4.7 ISA 700, *Forming an Opinion on Financial Statements*, in that the first respondent failed to modify the report on the AFS of ABIL and AFS of African Bank for the year ended 30 September 2013 for the material misstatement referred to in paragraph 6.3 of the schedule of charges (see paragraph 27.3 above) and evaluate conclusions from audit evidence

relating to the differences between the impairment model and the general ledger; and

27.4.8 ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*, in that the first respondent incorrectly issued an unqualified audit opinion relative to the consolidated AFS of ABIL and AFS of African Bank for the year ended 30 September 2013, in circumstances where it was inappropriate to do so.

***The second charge***

28 The second charge involves the alleged contraventions of rules 2.1, 2.5, 2.6 (with reference to sections 100.5(c), 130.1(b) and/or 130.3 of the Code), 2.7 and/or 2.17.

29 The facts giving rise to the second charge are described in the charge sheet as follows:

29.1 the AFS of African Bank for the year ended 30 September 2014 indicate a material restatement relating to a change in the definition of a loss event (from CD4 to CD1), in determining the level of impairments to align with market practice and the requirements of IAS 39, *Financial Instruments: Recognition and Measurement*. The impact of this was the following:

29.1.1 cumulative impact for the financial year ended 30 September 2013 was a R3 674 million downward adjustment; and

29.1.2 cumulative impact for the financial year ended 30 September 2012 was a R2 529 million downward adjustment.

29.2 the above restatement related to non-compliance with IAS 39, and by definition was an error.

29.3 the following factors were known to the first respondent and are evident from *inter alia* discussions, emails and the audit files of African Bank for the year ended 30 September 2013:

29.3.1 the point at which loans become impaired had been identified as an "*issue of audit significance*";

29.3.2 the ABIL credit team had initially identified the credit IBNR provision of R1 317 million based on a CD1 point of impairment and provided this to Deloitte during the audit;

29.3.3 a consultation memo states: "*Therefore, given the loss event examples, - a CD1 categorisation should be considered a loss event. However, if ABIL is able to provide evidence that categorisation as CD1 to CD3 does not impact the expectation of future cash flows - that is, CD1 to CD3 loans generally are recovered in future periods - then it would be appropriate to consider CD4 to be the loss event that triggers the recognition of impairment.*" The audit file does not contain documented procedures to establish whether African Bank was able to provide

such evidence. The above rationale appears to equate eventual recovery of loans with impact on future cash flows;

29.3.4 on 11 October 2013, Mr Raubenheimer provided a member of the audit team with a summary of the 12-month PD per CD bucket for June 2010 to August 2012. This indicates a consistent flow of accounts from CDO to CD4, with around 60% of CD1 accounts moving to CD4, around 85% of CD2 moving to CD4 and around 93% of CD3 moving to CD4. Consideration of this analysis has not been documented on the audit file.

29.3.5 Mr Raubenheimer confirmed at a meeting on 10 October 2013 with the first and second respondents that he had sent an email dated 10 October 2013 to Mr Kirkinis requesting permission to convey his concerns to Deloitte in writing. The email indicates that Mr Raubenheimer was of the opinion that the CD1 versus the CD4 point of impairment resulted in an understatement of impairments in the amount of R1 123 million.

29.4 The impact of the abovementioned error of R3 674 million (pre-tax) relating to the definition of a loss event on the consolidated AFS of ABIL and AFS of African Bank for the year ended 30 September 2013 is material, and accordingly the AFS were materially misstated. As the AFS were not amended for this misstatement, an unqualified audit opinion was incorrectly issued in contravention of ISA 700, *Forming an Opinion and Reporting on Financial Statements* and ISA 705, *Modifications to the Opinion in the Auditor's Report* relative to the consolidated AFS of ABIL

and AFS of African Bank for the year ended 30 September 2013, in circumstances where it was inappropriate to do so.

29.5 Within the context of the above facts, the following ISAs were breached in the conduct of the ABIL and African Bank audits for the year ended 30 September 2013:

29.5.1 ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, as the first respondent failed to maintain an attitude of professional scepticism and further failed to plan and perform the audit to reduce risk to an acceptable level as he failed to take into account relevant evidence relating to the point of impairment;

29.5.2 ISA 220, *Quality Control for an Audit of Financial Statements,* in that the first respondent failed to ensure that there was sufficient appropriate evidence to support the conclusions reached relating to the point at which loans become impaired;

29.5.3 ISA 230, *Audit Documentation*, in that the first respondent failed to document how all of the information referenced in paragraph 9.3 of the schedule of charges (see paragraph 29.3 above) of the charge was addressed in forming a final conclusion. The non-compliance with IAS 39 was not a judgemental issue which could be explained away, it represented a material misstatement;

29.5.4 ISA 330, *The Auditor's Responses to Assessed Risks*, in that the first respondent failed to take into account all relevant evidence in forming an opinion regarding the point of impairment;

29.5.5 ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* in that the first respondent failed to obtain evidence to support the conclusion reached that there was compliance with IAS 39 and further failed to consider management bias;

29.5.6 ISA 500, *Audit Evidence*, in that the first respondent failed to obtain sufficient appropriate audit evidence to draw reasonable conclusions relating to the point at which loans become impaired;

29.5.7 ISA 700, *Forming an Opinion on Financial Statements*, in that the first respondent failed to modify the report on the AFS of ABIL and AFS of African Bank for the year ended 30 September 2013 for the material misstatement referred to in paragraph 9.4 of the schedule of charges (see paragraph 29.4 above) and adequately evaluate the qualitative aspects of the entity's accounting practice regarding the point of impairment including indicators of management bias; and

29.5.8 ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*, in that the first respondent incorrectly issued an unqualified audit opinion relative to the consolidated AFS of ABIL and AFS of African Bank for the year ended 30 September 2013, in circumstances where it was inappropriate to do so.

***The third charge***

30 The third charge involves alleged contraventions of rules 2.1, 2.5, 2.6 (with reference to sections 100.5(c), 130.1(b) and/or 130.3 of the Code), 2.7 and/or 2.17.

31 The facts giving rise to the third charge are described in the charge sheet as follows:

31.1 The first respondent identified the discount rates relating to the discounting of loan books as a specific area of emphasis in the audit planning documents.

31.2 IAS 39 requires that impaired loans be discounted at the original effective interest rate. The discount rate used to discount the impaired loan books excluded the initiation fee from the calculation of the effective interest rate. The rate used was lower than that required by IAS 18, Revenue and IAS 39.

31.3 Utilising the incorrect interest rate when discounting the impaired loan book resulted in the impaired loan book being overvalued by an amount of approximately R2 300 million.

31.4 It was apparent from working paper AB 5450.3 and AB 5450.2 in the audit file that the initiation fee had been excluded from the calculation of the effective interest rate.

31.5 The audit file indicates that the discount rate utilised for discounting impaired loans was compared to the prior year, however no further

procedures were performed to determine that the rate complied with the requirements of IAS 39.

31.6 The impact of the abovementioned error of approximately R2 300 million regarding the overvaluation of the loan book on the consolidated AFS of ABIL and AFS of African Bank for the year ended 30 September 2013 is material, and accordingly the AFS were materially misstated. As the AFS were not amended for this misstatement, an unqualified audit opinion was incorrectly issued in contravention of ISA 700, *Forming an Opinion and Reporting on Financial Statements* and ISA 705, *Modifications to the Opinion in the Auditor's Report* relative to the consolidated AFS of ABIL and AFS of African Bank for the year ended 30 September 2013, in circumstances where it was inappropriate to do so.

31.7 Within the context of the above facts, the following ISAs were breached in the conduct of the ABIL and African Bank audits for the year ended 30 September 2013:

31.7.1 ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, as the first respondent failed to maintain an attitude of professional scepticism and further failed to plan and perform the audit to reduce risk to an acceptable level as it was apparent that the initiation fee had been excluded from the calculation of the effective interest rate;

31.7.2 ISA 220, *Quality Control for an Audit of Financial Statements,* in that the first respondent failed to ensure that there was sufficient

appropriate evidence to support the conclusions reached regarding the calculation of the effective interest rate;

31.7.3 ISA 230, *Audit Documentation*, in that the first respondent failed to document how the information regarding the effective interest rate referenced in paragraphs 12.2 to 12.5 of the schedule of charges (see paragraphs 31.2 to 31.5 above was addressed in forming a final conclusion;

31.7.4 ISA 330, *The Auditor's Responses to Assessed Risks*, in that the first respondent failed to take into account all relevant evidence in forming an opinion regarding the discount rate to be utilised for impaired loans;

31.7.5 ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* in that the first respondent failed to obtain evidence to support the conclusion reached that there was compliance with IAS 39;

31.7.6 ISA 500, *Audit Evidence*, in that the first respondent failed to obtain sufficient appropriate audit evidence to draw reasonable conclusions on the effective interest rate; and

31.7.7 ISA 700, *Forming an Opinion on Financial Statements*, in that the first respondent failed to modify the report on the AFS of ABIL and AFS of African Bank for the year ended 30 September 2013 for the material misstatement referred to in paragraph 12.6 of the schedule of charges (see paragraph 31.6 above) and adequately

evaluate whether or not the accounting policies were consistent with IFRS; and

31.7.8 ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*, in that the first respondent incorrectly issued an unqualified audit opinion relative to the consolidated AFS of ABIL and AFS of African Bank for the year ended 30 September 2013, in circumstances where it was inappropriate to do so.

***The fourth charge***

32 The fourth charge involves alleged contraventions of rules 2.1, 2.5, 2.6 (with reference to sections 100.5(c), 130.1(b) and/or 130.3 of the Code), 2.7 and/or 2.17.

33 The facts giving rise to the fourth charge are described in the charge sheet as follows:

33.1 The following factors were known to the first respondent and are evident from inter alia emails, discussions and the audit files of ABIL and African Bank for the year ended 30 September 2013:

33.1.1 Management bias was identified as a significant risk in the calculation of the loan impairment provisions;

33.1.2 The first respondent communicated in the final report to the audit committee on the September 2013 audit that the boards of African Bank and ABIL were required to formally sign off the "cash uplift" initiatives. This measure was

apparently to compensate for the gap between the impairment model and the general ledger; however audit procedures indicated that two of the three "cash uplift" initiatives could not be substantiated;

33.1.3 The first respondent did not obtain or document a proper understanding of the IFRS requirements and the relevant accounting estimates relating to Loans and Receivables;

33.1.4 The report to the audit committee indicates that the auditor was concerned about the governance processes around credit impairment and modelling;

33.1.5 Strong indicators of bias were evident from the workpapers; however these were merely labelled as "less than prudent" estimates or judgements in the working papers and final report to the audit committee;

33.1.6 The first respondent failed to document point estimates, or a range of estimates (except those developed by the auditor's expert which were exceeded) to assess whether the identified "less than prudent" estimates and judgements resulted in misstatements;

33.1.7 The first respondent failed to recognise that bias may be present because of the familiarity of preparing estimates in a certain way, despite the fact that a prior year error had already been identified;

33.1.8 The first respondent did not document discussions of significant matters with management, including the nature thereof and suppressed information provided to him by Mr Raubenheimer at the time that may have indicated a contrary view regarding the adequacy of impairment provisions;

33.1.9 The first respondent failed to document his consideration of the use of a seven day emergence period in the impairment model instead of a 30 day emergence period;

33.1.10 The first respondent accepted methodologies relating to impairment provisions that were not in accordance with industry norms as set out in the final report to the audit committee; and

33.1.11 The first respondent failed to properly consider and document his assessment of the impact of third party payments in the estimation of future cash flows.

33.2 The annual financial statements of ABIL and African Bank for the year ended 30 September 2013 were compiled without taking into account the following amounts and issues which indicate that bias was not appropriately considered:

33.2.1 R656 million error relating to the differences between the impairment models and the impairment provision;

33.2.2 R3 674 million error relating to the definition of a loss event;

33.2.3 An estimated R2 300 million overvaluation of the impaired loan book arising from discounting impaired loans at the incorrect rate;

33.2.4 An estimated R600 million overvaluation of the impaired loan book arising from the inclusion of receipts on behalf of third parties in the estimated future cash flows;

33.2.5 R510 million arising from the loan valuation model over-forecasting cash flows in a slowing economy;

33.2.6 R83 million overvaluation arising from the 0.5% gap between the expert's model range and management's model for the Non-Performing Loan book;

33.2.7 R218 million overvaluation arising from the 0.7 cents difference between the expert's model and the African Bank model for the Near Memorandum Ledger (partially written off) book;

33.2.8 R700 million further provision required on post default advances;

33.2.9 R300 million further provision for the *in duplum* component of the IBNR provision;

33.2.10 Whether the projected cash flows from "cured loans" were properly estimated;

33.2.11 The effects on estimated future cash flows of premiums paid to Stangen after default;

33.2.12 An estimated R500 million overvaluation difference from industry norms arising from performing the cash forecast over 120 months instead of 60 months;

33.2.13 An estimated R1 992 million overvaluation difference from industry norms because industry wrote off debt at CD 6 instead of CD 12;

33.2.14 R374 million overvaluation difference to industry norms, arising from the use of a seven-day emergence period instead of the industry norm of 30 days in the calculation of the IBNR;

33.2.15 The recoverability of the R750 million deferred tax asset in Ellerines;

33.2.16 The doubtful debt allowances in African Bank's tax calculations; and

33.2.17 The R81 million impairment in the Ellerines Holdings' trademarks.

33.3 Within the context of the above facts, the following ISAs were breached in the conduct of the ABIL and African Bank audits for the year ended 30 September 2013:

33.3.1 ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing, as the first respondent failed to maintain an attitude of professional scepticism as he failed to identify that bias was present despite the fact that it was identified as a significant risk regarding loan provisions;

33.3.2 ISA 240, *The Auditor's Responsibility to Consider Fraud in the Audit of the Financial Statements*, in that the first respondent failed to review current and prior year accounting estimates for bias and evaluate whether or not this represented a risk of misstatement due to fraud;

33.3.3 ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* in that the first respondent failed to obtain sufficient appropriate audit evidence to support the conclusion that management had appropriately applied the requirements of IFRS relevant to accounting estimates. The first respondent further failed to identify and respond to management bias evident in estimates; and

33.3.4 ISA 700, *Forming an Opinion on Financial Statements*, in that the first respondent failed to adequately evaluate indications of possible bias in management's judgements when determining whether the AFS of ABIL and African

Bank for the year ended 30 September 2013 were prepared in all material respects in accordance with IFRS.

***The fifth charge***

34 The fifth charge involves alleged contraventions of rules 2.1, 2.5, 2.6 (with reference to sections 100.5(c), 130.1(b) and/or 130.3 of the Code), 2.7 and/or 2.17.

35 The facts giving rise to the fifth charge are described in the charge sheet as follows:

35.1 The first respondent identified management override in the passing of manual journal entries and the interest suspension on loan categories CD7 and greater, and the appropriate application thereof as fraud risks, and compliance with IFRS in the recognition of interest as an issue of importance in planning the audit.

35.2 IAS 39 and IAS 18 require that interest on impaired financial assets be recognised using the rate of interest used to discount the future cash flows for the purposes of measuring the impairment loss.

35.3 ABIL and African Bank instead partially or fully suspended interest recognition on loans in arrears for greater than six months. This methodology understated interest revenue and the credit impairment charge by at least R3 000 million and as a result significantly misrepresented the inherent risk of the loan book.

35.4 The audit file indicates that the primary work performed on interest recognised on impaired loans was to ensure that the journal entries to suspend such interest were passed.

35.5 It was apparent from the audit file that neither the specific requirements of IAS 18 and IAS 39 were considered in the audit of interest recognised on impaired loans, nor was any reasonability test performed on the interest recognised against the more general requirements of IAS 18.

35.6 The impact of the abovementioned error in the region of R3 000 million regarding interest on impaired loan balances on the consolidated AFS of ABIL and AFS of African Bank for the year ended 30 September 2013 is material, and accordingly the AFS were materially misstated. As the AFS were not amended for this misstatement, an unqualified audit opinion was incorrectly issued in contravention of ISA 700, *Forming an Opinion and Reporting on Financial Statements* and ISA 705, *Modifications to the Opinion in the Auditor's Report* relative to the consolidated AFS of ABIL and AFS of African Bank for the year ended 30 September 2013, in circumstances where it was inappropriate to do so.

35.7 Within the context of the above facts, the following ISAs were breached in the conduct of the ABIL and African Bank audits for the year ended 30 September 2013:

35.7.1 ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, as the first respondent failed to maintain an attitude of professional scepticism and further failed to plan and perform

the audit to reduce risk to an acceptable level as he failed to consider the requirements of IAS 18 and IAS 39 in the calculation of interest on impaired loans;

35.7.2 ISA 220, *Quality Control for an Audit of Financial Statements,* in that the first respondent failed to ensure that there was sufficient appropriate evidence to support the conclusions reached on interest on impaired loans;

35.7.3 ISA 230, *Audit Documentation*, in that the first respondent failed to document how the information relating to interest on impaired loans referenced in paragraphs 18.1 to 18.5 of the schedule of charges (see paragraphs 35.1 to 35.5 above) was addressed in forming a final conclusion;

35.7.4 ISA 240, *The Auditor's Responsibility to Consider Fraud in the Audit of the Financial Statements*, in that the first respondent failed to review the method used to recognise interest on impaired loans and evaluate whether or not this represented a risk of misstatement;

35.7.5 ISA 330, *The Auditor's Responses to Assessed Risks*, in that the first respondent failed to take into account all relevant evidence in forming an opinion regarding the discount rate to be utilised for impaired loans;

35.7.6 ISA 500, *Audit Evidence*, in that the first respondent failed to obtain sufficient appropriate audit evidence to draw reasonable conclusions on interest on impaired loans;

35.7.7 ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* in that the first respondent failed to obtain evidence to support the conclusion reached that there was compliance with IAS 39;

35.7.8 ISA 700, *Forming an Opinion on Financial Statements*, in that the first respondent failed to modify the AFS of ABIL and AFS of African Bank for the Year ended 30 September 2013 for the material misstatement referred to in paragraph 18.6 of the schedule of charges (see paragraph 35.6 above) and to adequately evaluate whether or not the accounting policies were consistent with IFRS; and

35.7.9 ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*, in that the first respondent incorrectly issued an unqualified audit opinion relative to the consolidated AFS of ABIL and AFS of African Bank for the year ended 30 September 2013, in circumstances where it was inappropriate to do so.

***The sixth charge***

36 The sixth charge involves alleged contraventions of rules 2.5, 2.6 (with reference to sections 100.5(c), 130.1(b) and/or 130.3 of the Code), 2.7 and/or 2.17.

37 The facts giving rise to the sixth charge are described in the charge sheet as follows:

37.1 The first respondent identified that there was a risk that African Bank could recognise a loan that is not fully recoverable from a related party due to the inability of the group company to repay the loan.

37.2 No specific work was documented regarding the potential impairment of the R493 million loan debt owed to African Bank by Ellerines Furnishers.

37.3 IAS 39 requires that it is necessary to determine whether or not there is any objective evidence that the abovementioned financial asset (R493 million loan to Ellerines Furnishers) is impaired.

37.4 It was apparent from the audit file that there was significant financial difficulty at Ellerines Furnishers.

37.5 Within the context of the above facts, the following ISAs were breached in the conduct of the ABIL and African Bank audits for the year ended 30 September 2013:

37.5.1 ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, as the first respondent failed to maintain an attitude of professional scepticism and further failed to plan and perform the audit to reduce risk to an acceptable level in that no specific work was documented on the R493 million loan to Ellerines Furnishers despite recoverability being identified as a risk;

37.5.2 ISA 220, *Quality Control for an Audit of Financial Statements*, in that the first respondent failed to ensure that there was sufficient appropriate evidence to support the conclusions reached regarding the recoverability of the loan;

37.5.3 ISA 230, *Audit Documentation*, in that the first respondent failed to document how the information regarding the recoverability of the loan to Ellerines Furnishers referenced in paragraphs 21.1 to 21.4 of the schedule of charges (see paragraphs 37.1 to 37.4 above) was addressed in forming a final conclusion;

37.5.4 ISA 330, *The Auditor's Responses to Assessed Risks*, in that the first respondent failed to take into account all relevant evidence in forming an opinion regarding the impairment of the loan to Ellerines Furnishers; and

37.5.5 ISA 500, *Audit Evidence*, in that the first respondent failed to obtain sufficient appropriate audit evidence to draw reasonable conclusions regarding the recoverability of the loan to Ellerines Furnishers.

***The seventh charge***

38 The seventh charge involves alleged contraventions of rules 2.1, 2.5, 2.6 (with reference to sections 100.5(c), 130.1(b) and/or 130.3 of the Code), 2.7 and/or 2.17.

39 The facts giving rise to the seventh charge are described in the charge sheet as follows:

39.1 The first respondent issued an unmodified audit report on the consolidated AFS of ABIL (dated 6 December 2013) for the year ended 30 September 2013 and an unmodified audit report on the AFS of African Bank (dated 10 December 2013) for the year ended 30 September 2013.

39.2 The following factors were known to the first respondent (as they formed part of the audit committee documentation and were documented in the audit file) prior to concluding the audit of ABIL and African Bank for the year ended 30 September 2013:

39.2.1 There was a material uncertainty regarding the ability of Ellerines Furnishers to continue as a going concern;

39.2.2 The turnaround strategy of Ellerine Holdings and Ellerine Furnishers required funding and as a result would have a significant impact on the cash reserves of ABIL and African Bank;

39.2.3 The audit files do not contain detailed cash flow projections of the funding requirements to implement the turnaround strategy of Ellerines Furnishers and also do not reflect the concentration risk of advancing funds to Ellerines Furnishers instead of individual bank clients; and

39.2.4 The existence of the abovementioned matters increased the level of uncertainty regarding ABIL's ability to continue as a going concern.

39.3 ISA 570, *Going Concern* requires the auditor to take into account all relevant information at his disposal when assessing management's

assessment of going concern. The first respondent failed to comply with ISA 570 as he did not take into account the abovementioned information in his assessment or did not document this consideration.

39.4 The annual financial statements of ABIL and African Bank for the year ended 30 September 2013 were misstated by the following amounts:

39.4.1 R656 million error relating to the differences between the impairment models and the impairment provision;

39.4.2 R3 674 million error relating to the definition of a loss event;

39.4.3 R2 300 million error regarding the overvaluation of the loan book; and

39.4.4 Any other adjustment that would have been considered necessary, had bias been appropriately considered.

39.5 Any of the abovementioned errors would have had a material impact on the capital adequacy requirements of African Bank and its ability to raise additional funding. This would have resulted in a material uncertainty relating to going concern which would have required disclosure in the annual financial statements of ABIL and African Bank for the year ended 30 September 2013.

39.6 ISA 570, *Going Concern* requires an auditor to express a qualified or adverse conclusion in accordance with ISA 705, *Modifications to the Opinion in the Independent Auditor's Report* if there is a material uncertainty that casts significant doubt about the entity's ability to

continue as a going concern that is not adequately disclosed in the financial statements. The first respondent accordingly failed to comply with ISA 570 as he failed to modify the report on the AFS of ABIL and African Bank for the year ended 30 September 2013 for the abovementioned material uncertainty.

***The eighth charge***

40 The eighth charge involves alleged contraventions of rules 2.5, 2.6 (with reference to sections 100.5(c), 130.1(b) and/or 130.3 of the Code), 2.7 and/or 2.17.

41 The facts giving rise to the eighth charge are described in the charge sheet as follows:

41.1 The independent reporting accountant's report on the reviewed interim financial information of ABIL for the 11 months ended 31 August 2013 contains an unqualified conclusion. This report was signed by the first respondent on 31 October 2013.

41.2 The reviewed interim financial information of ABIL for the 11 months ended 31 August 2013 was part of the documentation available regarding the rights offer available to shareholders of African Bank as at 15 November 2013.

41.3 The first respondent had concluded prior to 31 October 2013 that he would only sign an unqualified opinion on the annual financial statements of ABIL and African Bank for the year ended 30 September 2013 if the abovementioned rights offer was successful. This indicates that the first

respondent regarded whether or not the abovementioned rights offer was successful as a material uncertainty at the time.

41.4 The reviewed interim financial information of ABIL for the 11 months ended 31 August 2013 makes no disclosure regarding any uncertainties relating to going concern.

41.5 ISRE 2410 *Review of Interim Financial Information performed by the Independent Auditor of the Entity* requires an auditor to express a qualified or adverse conclusion - if there is a material uncertainty that casts significant doubt about the entity's ability to continue as a going concern that is not adequately disclosed in the interim financial information. The first respondent failed to comply with ISRE2410 as he failed to modify the report on the reviewed interim financial information of African Bank for the 11 months ended 31 August 2013 in circumstances where there was inadequate disclosure relating to going concern.

***The ninth charge***

42 The ninth charge involves alleged contraventions of -

42.1 rule 2.1.1 of the Old Disciplinary Rules and rule 2.1 of the rules, read with section 44 of the Audit Act;

42.2 rule 2.1.1 of the Old Disciplinary Rules read with section 44(3)(a) of the Audit Act, and rule 2.5 of the rules;

42.3 rule 2.1.20 of the Old Disciplinary Rules (with reference to paragraphs 4.1, 4.4 and 8.2 of the Old Code) and rule 2.6 (with reference to sections 100.5(c), 130.1(b) and/or 130.3 of the Code);

42.4 rule 2.1.5 of the Old Disciplinary Rules and rule 2.7 of the rules; and/or

42.5 rule 2.1.21 of the Old Disciplinary Rules and rule 2.17.[4]

43 The facts giving rise to the ninth charge are described in the charge sheet as follows:

43.1 The consolidated AFS of ABIL and AFS of African Bank for the year ended 30 September 2013 indicate that a material restatement relating to a change in the loan impairment provisioning methodology was made. The impact of this change on the 30 September 2012 year end was as follows:

43.1.1 A decrease in net advances of R1 330 million;

43.1.2 A decrease in retaining earnings of R957 million; and

43.1.3 A decrease in the credit impairment charge of R355 million.

43.2 The above restatement relates to non-compliance with IAS 39 in that loans that had reached the *in duplum* threshold were not accounted for at the original effective interest rate, the interest rate had been set to zero. This represents a prior period error, not only a change in methodology.

[4] In each case the old disciplinary rule is to the same effect as the corresponding (new) rule effective from 1 January 2011.

43.3 The disclosure of the abovementioned error in the consolidated AFS of ABIL and AFS of African Bank for the year ended 30 September 2013 states "As a result of the growth in threshold loans over time, the difference between the two provisioning methodologies has cumulatively become material for the financial year 2013". This disclosure creates the impression that the impact has only become material for the financial year ended 30 September 2013 which is misleading as the impact of the difference was already material in prior periods, and accordingly does not meet the requirements of IAS 8.

43.4 The first respondent failed to detect that the disclosure of a prior year error was inappropriate despite having knowledge of the nature of the restatement. The fact that retained earnings in 2012 was R957 million indicates that the error regarding the loan impairment provisioning methodology was already material in 2012. ISA 710, comparative information - corresponding figures and comparative financial statements requires that where the corresponding figures have not been properly restated or appropriate disclosures have not been made, the auditor shall express a qualified or adverse opinion. The first respondent failed to modify the audit opinion on the consolidated AFS of ABIL and AFS of African Bank for the year ended 30 September 2013, and accordingly an unmodified opinion was issued in circumstances where it was inappropriate to do so.

43.5 The following factors were known to the first respondent and are evident from the audit files of ABIL and African Bank:

43.5.1 The final audit committee reports for the year ended 30 September 2009 and 30 September 2010 state "*We differ with management on this aspect in that an in duplum loan rate is not accounted for at its original effective interest rate as required by IAS 39*";

43.5.2 An 8 November 2010 memo from Deloitte to the audit committee indicates that the approximate impact of the *in duplum* issue is that the ABIL loan book was overstated by R510 million (five hundred and ten million) for the year ended 30 September 2009 and overstated by R690 million (six hundred and ninety million) (ABL NPL R350 million and ABL ML R340 million) for the year ended 30 September 2010;

43.5.3 The African Bank report to management for the year ended 30 September 2011 identifies the growing impact of *in duplum* accounts as a significant matter;

43.5.4 The African Bank report to management for the year ended 30 September 2011 under the heading of refinement of credit impairment models states "*The impact of the concerns raised above could result in significant misstatement of the impairment charges raised by ABL on all loan portfolios*";

43.5.5 *The IAS 39 Impairment Review regarding the July 2011 results states "The impact of not setting the interest rate on*

*the in duplum accounts to zero is R520 million increase in the NPL provision*"; and

43.5.6 A presentation to the audit committee chair on 16 May 2011 by Deloitte states "*in duplum treatment of discount rates is not IAS 39 compliant.*"

43.6 The impact of the above mentioned *in duplum* errors set out in paragraphs 30.1 to 30.5 of the schedule of charges (paragraphs 43.1 to 43.5 above) on the consolidated AFS of ABIL and AFS of African Bank for the years ended 30 September 2009 to 30 September 2012 is material, and accordingly the AFS were materially misstated. As the AFS were not amended for this misstatement, an unqualified audit opinion was incorrectly issued in contravention of ISA 700, *Forming an Opinion and Reporting on Financial Statements* and ISA 705, *Modifications to the Opinion in the Auditor's Report* relative to the consolidated AFS of ABIL and AFS of African Bank for the years ended 30 September 2009 to 30 September 2012, in circumstances where it was inappropriate to do so.

43.7 Within the context of the above facts, the following ISAs were breached in the conduct of the ABIL and African Bank audits from 30 September 2009 to 30 September 2013:[5]

43.7.1 ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, as the first respondent failed to

[5] In each case, the relevant preceding standard that was effective up to and including 14 December 2009, is also cited in respect of the audit of the 2009 AFS.

maintain an attitude of professional scepticism and further failed to plan and perform the audit to reduce risk to an acceptable level as he failed to take into account the error relating to the *in duplum* loan rate in formulating a conclusion regarding the audit opinion despite having knowledge of the fact that it was not compliant with IAS 39;

43.7.2 ISA 220, *Quality Control for an Audit of Financial Statements*, in that the first respondent failed to ensure that there was sufficient appropriate evidence to support the conclusions reached on the *in duplum* loan rate;

43.7.3 ISA 230, *Audit Documentation*, in that the first respondent failed to document how the information referenced in paragraph 30.5 of the schedule of charges (see paragraph 43.5 above) was addressed in forming a final conclusion. The non-compliance with IAS 39 was not a judgemental issue which could be explained away, it represented a material misstatement;

43.7.4 ISA 450, *Evaluation of Misstatements Identified During the Audit*, in that the first respondent failed to accumulate and assess this misstatement despite identifying material non-compliance with IAS 39 during the course of the audit;

43.7.5 ISA 700, *Forming an Opinion on Financial Statements*, the first respondent failed to modify the report on the AFS of ABIL and AFS of African Bank for the years ended 30

September 2009 to 2012 for the material misstatement referred to in paragraph 30.6 of the schedule of charges (see paragraph 43.6 above) and evaluate whether or not the accounting policies were consistent with IFRS; and

43.7.6 ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*, in that the first respondent incorrectly issued an unqualified audit opinion relative to the consolidated AFS of ABIL and AFS of African Bank for the years ended 30 September 2009 to 2012, in circumstances where it was inappropriate to do so;

43.7.7 ISA 710, *Comparative Information - Corresponding Figures and Comparative Financial Statements* in that the first respondent failed to modify the audit opinion on the consolidated AFS of ABIL and AFS of African Bank for the year ended 30 September 2013 as appropriate disclosures referred to in paragraph 30.4 of the charges (see paragraph 43.4 above) were not made, and accordingly an unmodified opinion was issued in circumstances where it was inappropriate to do so.

***The tenth charge***

44 The tenth charge is made against the first and second respondents and involves alleged contraventions of rules 2.4, 2.5, 2.6 (with reference to sections 100.5(a), (b) and (e), 100.12(b), (d) and (e), 120 and 290.7 of the Code), 2.7 and/or 2.17.

45 The facts giving rise to the tenth charge are described in the charge sheet as follows:

Dishonesty

45.1 It is contended that the following conduct of the first and second respondents constituted dishonest conduct that was intentional, alternatively, reckless, in that they subjectively knew that the information being conveyed to them by Mr Raubenheimer as set out below was material to the audit and the possibility of material misstatement in the 2013 annual financial statements of ABIL and African Bank, and they deliberately turned a blind eye to it, regardless of the consequences:

45.1.1 Mr Raubenheimer confirmed at a meeting on 10 October 2013 with the first and second respondents that he had sent an email to Mr Kirkinis on the previous day or the same day requesting permission to convey his concerns about impairment of the loan book in African Bank to Deloitte in writing. The email dated 10 October 2013 indicates that Mr Raubenheimer was of the opinion that ABIL's credit impairment was understated by R3 750 million as at 31 August 2013. In the email sent by Mr Raubenheimer to Mr Kirkinis, the amount of R3 750 million comprised of the following amounts:

(a) Understated general ledgers versus the cash flow model in the amount of R825 million

(b) *In duplum* accounts discounted at 0% in the amount of R2 045 million; and

(c) Change in impairment event (IBNR) in the amount of R1 123 million;

45.1.2 At the same meeting of 10 October 2013, the first and second respondents requested Mr Raubenheimer not to send the email which he had sent to Mr Kirkinis, to Deloitte, and advised Mr Raubenheimer that if he did send the email to Deloitte, this would limit Deloitte's 'wiggle room' in relation to the audit. The first and second respondents further warned Mr Raubenheimer not to destroy his relationship with Mr Kirkinis by sending the email to Deloitte. They advised Mr Raubenheimer that in the event that he sent the email to Deloitte, the first and second respondents would have been compelled to act on it as if it were a fraud report. The first and second respondents therefore acted dishonestly in dissuading Mr Raubenheimer from putting his various concerns in writing in order to avoid being compelled to fulfil their audit responsibilities.

45.1.3 An auditor is required to assess all available information, not suppress it. The abovementioned conduct of the first and second respondents as described in paragraphs 33.1 and 33.2 of the schedule of charges (see paragraphs 45.1.1 and 45.1.2 above) indicates that the first and second

respondents had succumbed to pressure, were not acting objectively and/or independently and acted in a dishonest manner.

45.2 Both the first and second respondents acted in concert with each other in relation to each identified element of dishonesty referred to in paragraph 33 of the schedule of charges (see paragraph 45.1 above).

Independence, Objectivity and Professional Scepticism

45.3 The following further factors were known to the first and second respondents and are evident from emails, discussions, submissions to the Myburgh Commission and the audit files of ABIL and African Bank for the year ended 30 September 2013:

45.3.1 The first and second respondents were aware that processing a higher impairment charge would impact on the following for ABIL and African Bank:

(a) breaches of debt covenants;

(b) exposing the banking market in general to systemic risk;

(c) failure of the rights offer;

(d) negative effect on the credibility of the bank;

(e) limiting access to funding with effecting liquidity;

(f) drop in the credit rating; and

(g) drop in the share price.

45.3.2 The signing of an unmodified audit opinion for ABIL and African Bank for the year ended 30 September 2013 was dependent on the board of ABIL and African Bank vetting and approving the collection initiatives supporting the additional cash uplift regarding the gap between the impairment provision and the general ledger;

45.3.3 The first and second respondents were aware that the abovementioned gap was not supported by the audit procedures performed;

45.3.4 The first and second respondents further indicated that the gap is irrelevant for the 30 September 2013 audit of African Bank and ABIL as long as it reduces to zero by the time that the annual financial statements are signed;

45.3.5 There is no sound basis in accounting or auditing for dismissing the gap as irrelevant if it reduced to zero subsequent to year end;

45.3.6 The views and evidence provided by Mr Raubenheimer specifically with regard to CD1 to CD3 loans were omitted from the audit file;

45.3.7 A prior year adjustment had already been processed with regard to the *in duplum* loan misstatement and the first and second respondents had been aware of this issue in prior years;

45.3.8 The planning section of the audit file for the audit of ABIL and African Bank for the year ended 30 September 2013 indicated that a comprehensive review of IFRS requirements (IAS 18 and IAS 39) would be performed, however this was not done;

45.3.9 There were also other indicators on the audit files, that the impairment provisions were not in line with IFRS, contained "much less than prudent" assumptions and practices and were potentially biased towards showing a much more favourable financial position than was indeed the case. Despite lengthy, but undocumented debate, these were not quantified and analysed, and were not properly taken into account in the formulation of the auditor's opinion; and

45.3.10 Mr Kirkinis had indicated in meetings with the first and second respondents that it would "sink" African Bank if Deloitte continued to hold its stated position as indicated in a submission to the Myburgh Commission. The first and second respondents were aware, alternatively should have reasonably been aware, that "sinking" ABIL and African Bank would be the likely outcome if higher impairment charges were processed; the resultant pressure led to an intimidation threat.

45.4 In relation to the issue of objectivity, independence and professional scepticism:

45.4.1 The first and second respondents accepted previous less than prudent judgements or estimates that were indications of bias and as a result this led to a self-review threat. A self-review threat arises if a current judgement relies on a previous judgement made by the same firm.

45.4.2 The level of partner continuity on the audit of ABIL and African Bank for the years ending 30 September 2011 to 30 September 2013 was high which led to a familiarity threat.

45.4.3 Despite safeguards, for example having a special quality control review partner in addition to a quality review partner, being put in place to manage the increased risk of the audit, these did not actively consider or prevent the threats of self-review, familiarity and intimidation.

45.4.4 The abovementioned threats of intimidation, self-review and familiarity resulted in bias and the undue influence of others to override sound auditing judgement which led to a compromise of the fundamental principles of objectivity and integrity contained in the Code.

45.5 Within the context of the above facts, the following ISAs and provisions of the Code were breached in the conduct of the ABIL and African Bank audits for the year ended 30 September 2013:

45.5.1 The first and second respondents failed to adhere to the fundamental principle of objectivity contained in section 120

of the Code and did not react appropriately in that they put pressure on Mr Raubenheimer to not put his concerns in writing;

45.5.2 The first and second respondents failed to eliminate or reduce threats to independence to an acceptable level as required by section 290.7 of the Code;

45.5.3 ISA 240, *The Auditors Responsibility to Consider Fraud in the Audit of the Financial Statements*, in that the first and second respondents failed to investigate responses from management that were inconsistent. The first and second respondents further failed to consider if the misstatements identified by Mr Raubenheimer were an indication of fraud and evaluate the implications for the audit;

45.5.4 ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, as the first and second respondents failed to comply with the relevant ethical requirements as outlined in paragraph 36.4 of the schedule of charges (see paragraph 45.4.4 above);

45.5.5 ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, as the first respondent failed to maintain an attitude of professional scepticism; and

45.5.6 ISA 220, *Quality Control for an Audit of Financial Statements*, in that the first and second respondents failed to remain alert for evidence of non-compliance with ethical requirements throughout the course of the audit engagement.

**Overview of the Response to the charges**

***Overview***

46 In an overview in response to the charges, the respondents focussed on three critical components that informed the presentation of the financial statements, the opinions expressed on them and the subsequent restatement of certain aspects of those financial statements in subsequent financial statements. The three areas were professional judgement, financial statement presentation and accounting estimates.

47 In relation to professional judgement, they make the point that *"differences in background, circumstances and context can affect the professional judgement of different individuals to the extent that they may arrive – legitimately and appropriately – at different outcomes at different times"*. Impacting on the 2013 audit in respect of ABIL and the 2013 and 2014 audits in respect of African Bank were the professional judgement of Mr Kirkinis and Mr Raubenheimer, being the pre-curatorship management, the 2013 audit team, including the first respondent, Mr Bierman, the Ellerines Holdings and Ellerines Furnishers engagement partner, and Mr Burra, the head of Deloitte Actuarial Quantitative Solutions (who did the impairment modelling), Mr Winterboer and Mr Raubenheimer,

representing post-curatorship management and the 2014 audit team, which included Mr Nunes, the then African Bank engagement partner.

48 In this context the following further observations were made:

48.1 Mr Kirkinis, later together with Mr Nalliah, had managed ABIL and African Bank successfully for nearly a decade.

48.2 The SARB required it to hold a higher capital base, reflecting the fact that African Bank and its risk appetite was not representative of traditional banks.

48.3 Mid- and long-term debt funding sources were financed at an interest rate corresponding to the increased risk.

48.4 African Bank provided loans to lower income, higher risk customers with a higher rate of contractual default.

48.5 This was exacerbated by the "monoline" nature of African Bank where loans were its only real product and there was no diversification benefit from other income streams.

48.6 African Bank, however, had a historical record of earning an adequate return on these loans, including a return on a significant portion of under- and non-performing loans.

48.7 African Bank continued to collect significant cash flows from loans that had been written off.

48.8 Mr Raubenheimer joined African Bank towards the end of 2012 from a traditional banking background, whilst the respondents performed audits of various financial institutions and Mr Burra had experience in performing analyses to support audit and other assurance work on various capital and credit risk models.

48.9 The curator is a former auditor of traditional banks and was differently placed to pre-curatorship management in that he was not responsible for certain assumptions that drove management's estimates in previous years, but saw first-hand when he joined African Bank that the loan book was not performing as well as had previously been estimated. This retrospective view, the respondents suggest, made it impossible for him to make an objective assessment of the estimation process that took place in the previous years.

48.10 Mr Raubenheimer had a professional judgement-based view that differed from other members of pre-curatorship management and which corresponded more closely with that of the audit team.

48.11 Nevertheless by the end of the 2013 audit, Mr Raubenheimer agreed with the credit impairment provisions as presented in the 2013 AFS, albeit that he would, like the audit team, have preferred provisions approximately R500m higher.

48.12 In so agreeing, he was influenced by the additional R2.5bn impairment provisions that the auditors required to be processed in response to their audit work.

49 In relation to financial statement presentation, the respondents refer to IAS 1 – *Presentation of Financial Statements.*

50 Paragraph 30 of IAS 1 states:

> *"Financial statements result from processing of large numbers of transactions or other events that are aggregated into classes according to their nature or function. A final stage in the process of aggregation and classification is the presentation of condensed and classified data, which form line items in the financial statements …"*

51 They repeat the point that a number of the charges relate to a single line item, "*net advances*", in the AFS. They then make the point that *"the audit conclusion on net advances forms the subject of an overall professional judgement, made in the context of the AFS as a whole"*.

52 In relation to accounting estimates, the respondents refer to ISA 540, paragraph 7 which defines management's point estimate as "*the amount selected by management for recognition or disclosure in the financial statements as an accounting estimate."*

53 Reference is also made to ISA 540, paragraph 4, which states –

> *"A difference between the outcome of an accounting estimate and the amount originally recognised or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements. This is particularly the case for fair value accounting estimates, as any observed outcome is invariably affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements."*

54 The respondents allege that the charges and the perspectives of both the curator and the drafter of the report upon which the charges are based, Mr Cameron-Ellis, are retrospective ones that do not adequately take into account the circumstances that prevailed at the time of the audit. They also make the point that –

> *"Bank audits – probably more so than any other audit – involve the exercise of significant professional judgement. They involve accounting estimates which are, by their nature, not only imprecise but subject to material variations depending on small changes and inputs and [which are] sensitive to the impact of singular subsequent events that may cause a dramatic change."*

55 They complain that through the disaggregation brought about by the separate charges, the reality of an overall professional judgement by management and subsequently by the auditor, are overlooked.

56 Reliance is also placed on the IFRS Conceptual Framework, QC15, which states -

> *"Faithful representation does not mean accurate in all respects. Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. In this context, free from error does not mean perfectly accurate in all respects. For example, an estimate of an unobservable price or value cannot be determined to be accurate or inaccurate. However, a representation of that estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate."*

57 They contend that the first respondent's assessment of the line item "net advances" in the 2013 AFS of African Bank met these requirements of faithful representation and that the audit work performed in that regard was reasonable.

58 The respondents then proceed to answer the allegations in the charge sheet on a charge by charge and paragraph by paragraph basis. These answers are summarised in those parts of the decision dealing individually with each of the charges below.

## THE EXPERT WITNESSES

### *The IRBA's expert witnesses*

59 The pro forma complainant led the evidence of two expert witnesses.

60 The first was Mr Cameron-Ellis. He is a registered auditor, chartered accountant (SA) and a certified fraud examiner. He has since July 2013 practised as an independent forensic accountant. He has an MPhil (internal audit) on forensic issues. He performed the primary role in investigating the matter and preparing the report on which the case for the pro forma complainant was founded. The report is entitled "*Investigation of the 2013 Audit of African Bank Investments Limited and African Bank Limited for Improper Conduct by the Auditor*" and is dated 19 January 2018.

61 The second expert witness called by the pro forma complainant is Ms De Beer. She is a qualified Chartered Accountant (SA) and holds a Masters Degree in taxation. She is also a Chartered Director (SA) and a professor in practice, being a part-time honorary appointment in the accounting department at the University of Johannesburg. She has served on the following committees and structures:

61.1 Investor Advisory Group of the Public Company Accounting Oversight Board in the United States of America, being the audit regulator in the United States;

61.2 The King Committee on Corporate Governance in South Africa and a member of the King IV Task Team;

61.3 Quality Control Assessment Committee of the Auditor-General of South Africa;

61.4 The Issuers Regulation Advisory Committee of the JSE;

61.5 The Financial Reporting Investigators Panel of the JSE;

61.6 The Governing Body of Chartered Director (SA) under the Institute of Directors of Southern Africa;

61.7 The audit committees of various entities, including the audit committee of Sasfin Bank Limited, in the capacities of chair, vice-chair and ordinary member;

61.8 The Consultative Advisory Group of the International Auditing and Assurance Standards Board, as chair from 2011 to 2015 after serving as an ordinary member from 2007 – 2011. This is a body of more than 30 international organisations such as the World Bank, Basel Committee, European Commission, International Monetary Fund, and others that give input on the strategic and technical agenda of the IAASB;

61.9 the Committee for Auditing Standards of IRBA;

61.10 The Financial Reporting Standards Council established in terms of the Companies Act, 2008.

62 She has not served as engagement partner or audit team member in the auditing of a bank, nor has she signed an audit opinion of any kind.

63 She prepared an expert report in which she set out her views on the first respondent's noncompliance with the Audit Act, the Rules and the Code of Conduct, the ISAs, and on the accounting, auditing and reporting issues raised in respect of each of the charges on the basis of a high level overview of the audit working papers.

***The respondents' expert witnesses***

64 The first expert witness called on behalf of the respondents was Mr Cohen. Mr Cohen holds BComm degrees majoring in law and accounting respectively, BComm Hons (Economics), MComm (Economics), a post graduate diploma in accounting, an advanced certificate in auditing and is a Chartered Accountant (SA) and a Chartered Financial Analyst. He is the founder and head, and has been since 2008, of Grey Matter, a consultancy and training business specialising in banking and financial instruments. The business has provided services to all of South Africa's major banks and many mid-tier ones and his specialist areas include financial instrument accounting, banking, credit risk, regulatory capital, derivatives, automation of financial accounting processes, excel and financial modelling and risk.

65 He is a previous member of the Treasury Advisor Group and has experience in the asset and liability management process and risk management processes of banks. He has lectured in management and financial accounting at the Wits Business School and is a member of the Association of Corporate Treasurers of South Africa.

66 He prepared an expert witness statement which formed the basis of his evidence. He also provided a supplementary witness statement providing an explanation of loss emergence periods.

67 He testified in relation to unsecured lending, IAS 39, impairment under IAS 39, the scope of judgement and discretion in the audit of impairments, individual and collectible impairment of performing and non-performing loans, the original effective interest rate, modelling, the treatment of impairment by the big four banks and peers.

68 The second expert witness called on behalf of the respondents was Mr Chidgey. He too prepared an expert witness statement or report. He holds a Bachelor of Economic Science in Law and Accountancy. He has been an associate of the Institute of Chartered Accountants of England and Wales since 1975 and a fellow of the Institute since 1980. He was a partner in BDO LLP (including its earlier named firms being Stoy Hayward and BDO Stoy Hayward) from 1990 until his retirement from the firm in 2013. He was a consultant and director there from 2013 to 2015. Since then he has been an independent consultant. Whilst an audit partner at BDO he was responsible for signing audit reports on clients regulated under the financial services legislation and was a technical partner responsible for the BDO technical accounting group from 1990 until 2008.

69 His major area of practice was the audit of entities in the financial services industry. This included banks and investment funds and brokers. He specialised in this area from 1998 to 2013. He has acted as audit partner on a number of UK registered banks, including UK-based subsidiaries of German, Bahraini, Israeli and Indian banks. He was the accounting expert on the team that valued

the shares in Northern Rock Plc, a large retail lender, for the UK Government after its collapse and worked with the expert team which produced a report on the audit issues relating to the failure of a large UK retail lender for disciplinary purposes.

70 He was also a member of the Urgent Issues Task Force of the UK Accounting Standards Board from 2003 to 2012 and has served on a number of professional Committees.

71 He testified on the ISAs from the perspective of bank audits in relation to a wide range of issues impacting on the charges in this matter, on the audit of impairments in African Bank in 2013 in the numerous respects relevant to the charges, on bias, scepticism and objectivity required by the standards in relation to the charges, and on the audit of going concern in the various respects raised by the charges.

***The IRBA's factual witnesses***

72 The pro forma complainant called three factual witnesses. The first was Mr Raubenheimer. With effect from 1 October 2012 until 28 February 2014, he was employed as the head of group credit by the Bank. Prior to that he had been employed by Nedbank and Absa respectively. At Absa he had served as head of retail credit initially and later as chief risk officer of the retail and business bank. With effect from 1 March 2014 he was appointed as group executive: credit at the Bank. During the initial period of his employment, he reported to Mr Roussos. His evidence focussed on his role in attempting to insist on higher levels of impairment than those preferred by senior management during the period

leading up to and during the 2013 audit. He also testified in relation to the circumstances giving rise to the tenth charge against the respondents.

73 The second factual witness called by the pro forma complainant was Mr Winterboer, who was appointed as curator to African Bank. He testified in relation to his objectives as curator, the experts that he consulted in the course of his curatorship, his engagement with Deloitte as auditors of the Bank, and particularly with Mr Nunes who was the engagement partner for African Bank in 2014.

74 He testified in relation to each of the issues in respect of which there was a restatement of the 2013 and 2012 financial statements, including the issues underlying each of the charges that were based on those restatements.

75 The third factual witness called on behalf of the pro forma complainant was Mr Natsas. He is a partner at PricewaterhouseCoopers. He testified regarding his engagements with the Bank. His first formal engagement with the Bank started in February 2013 when he was contacted by Mr Raubenheimer to assist him with work relating to the valuation of the Bank's post write-off recoveries book. During June 2014, as part of a wider engagement contract between PWC and the Bank he was requested by PWC to conduct interviews with management to understand their impairment accounting policies and impairment modelling methodologies under IAS 39. This resulted in the preparation of a memorandum, following which he gave input into an accounting opinion issued by PWC which dealt with accounting for fees receivable on loans, origination costs, in which CD band or bucket an impaired loss is incurred and how changes to the Bank's impairment model should be accounted for. He also testified in relation to his

agreement with the views expressed by the curator's team in the classification of various items as errors in the 2014 restatements of the 2013 AFS.

***The respondents' factual witnesses***

76 Both the respondents testified in their own defence. The first respondent's evidence, as was to be expected, canvassed the full gamut of the charges as well as the lead up to and the conduct of the 2013 audits of ABIL and African Bank and, where necessary, the audit processes in respect of other subsidiaries, particularly Ellerine Furnishers and Stangen. Apart from his testimony on the tenth charge, the second respondent testified also in relation to those aspects of the 2013 audit in which he was involved and which were relevant to the other charges.

77 The important components of their evidence are canvassed in the parts of the decision dealing specifically with the various charges.

78 The respondents called another four factual witnesses. The first was Mr Pinnock. He focussed on the series of difficult meetings that took place between him, the first respondent (and, to a certain extent, the second respondent) on behalf of Deloitte and, primarily, Messrs Kirkinis and Nalliah on behalf of the Bank. The main subject matter of these meetings was the appropriate level of impairments.

79 The next factual witness was Mr Burra. He is an actuary registered with the Actuarial Society of South Africa and has a BSc Degree in Actuarial Science from the London School of Economics. He joined Deloitte in 2002 and resigned as a director in 2015. Whilst a director at Deloitte, he led the credit modelling team

within the Financial Institutions Services Team known as Capital Markets or Actuarial Quantitative Solutions.

80 He testified on the role of the credit modelling team generally and in the 2013 audit in particular. He explained the concept of impairment modelling generally and as it applies to the Bank as well as the role of Capital Markets in the review of the Bank's impairment model. He also provided a review of the NPL and ML models in the 2009 to 2012 financial years. He testified on his role in relation to the particular audit issues arising in a number of the charges. The main issues on which he testified will be apparent from the discussion of the individual charges below.

81 The next factual witness called on behalf of the respondents was Mr Shipp. He is an audit partner in the Deloitte Financial Institutions Services Team and was admitted to the partnership in this division in 1999. He is currently the head of the Deloitte Banking Industry Group for Southern Africa. His specialist areas are in banking and corporate treasuries. He was appointed as engagement quality control review partner for African Bank during the years 2010 through 2014. In this role he was required to objectively evaluate the significant judgements the engagement team made and the conclusions reached in formulating the audit reports for ABIL and African Bank. He was not part of the engagement team performing the audit. This meant that he would generally not have interactions with the client, its staff and management. Rather he would assess the work performed by the audit team to consider whether he agreed with the conclusions reached by the team and whether they were sound.

82 In performing this role he would ordinarily look at select planning documents, significant risk areas and the evaluating and concluding documents such as the report to the audit committee.

83 His involvement was tethered to the level of engagement risk with the result that in 2013 and 2014 his involvement was, of necessity, much greater than in 2012.

84 His role also included ensuring the appropriate specialists were involved in the engagement and that their opinions were given sufficient consideration during the audit process.

85 He also gave evidence specific to the work done in relation to the 2013 audit and the specific meetings and interventions in which he was involved in this regard. He canvassed some of the specific contentious issues that formed the subject matter of some of the charges. He also dealt with his role in relation to the 2014 audit.

86 The fourth factual witness called on behalf of the respondents was Mr Lito Nunes, the Deloitte engagement partner for the 2014 audit of African Bank. He testified in relation to the history of his relationship with African Bank, including his having served as engagement partner for subsidiaries at African Bank in the early 2000's, engagement quality control review partner during 2006 and 2008 and advisory partner for African Bank during the period 2009 to 2013. He testified in particular on his appointment as engagement partner in 2014, including the background to his appointment and the approach to the 2013 audit. He focussed on the contentious accounting matters that had to be revisited during the 2014 audit for purposes of the restatements. He explained where his views coincided and where they diverged from the curator. He did so in respect of the various

matters that impacted on the charges in this regard. He also explained the formulation of the audit report, including the emphasis of matter which he included in his audit report in the 2014 AFS of African Bank. This and other aspects of his evidence are canvassed in the specific decisions on the charges.

**WEIGHT TO BE AFFORDED EXPERT EVIDENCE**

87 The legal teams for the respective parties devoted a considerable amount of attention to the weight to be afforded the evidence of the various experts. The respondents focussed on the IRBA expert witnesses' lack of expertise in the field of bank auditing. On this basis, they contended that the evidence of Mr Chidgey, with his extensive experience in the auditing of banks, should prevail over that of Mr Cameron-Ellis and Ms De Beer.

88 They also contended that the evidence of Mr Cohen should be preferred over that of the IRBA experts, because of his in-depth knowledge and broad experience in relation to accepted banking practice. Mr Cameron-Ellis's evidence was also criticised on the basis that he acted as investigator rather than as an independent expert and was biased inasmuch as he commenced his investigation with a suspicion of misconduct based on the press articles that he had read and was the originator of the charges. Reference in this regard was made to the criticism of the Supreme Court of Appeal of an expert witness said to have performed a similar function in *Pricewaterhouse Coopers Inc and others v National Potato Cooperative Limited and another.*[6]

[6] [2015] 2 All SA 483 (SCA).

89 The pro forma complainant acknowledged the lesser expertise of his expert witnesses in the field of bank auditing, but asserted the sufficiency of their other audit and accounting experience to provide a sound basis for their opinion evidence to be admitted and relied upon. He relied on the judgment of the English High Court in *Multiplex Construction UK Ltd v Cleveland Bridge UK Ltd* [2008] EWHC 2220 (TCC) to argue that the opinion evidence of highly experienced factual witnesses could also be taken into account in the adjudication of a matter where such witnesses had given evidence. In this regard, he pointed out that factual witnesses of this nature had testified on behalf of both the pro forma complainant and the respondents and it would be inappropriate for their opinion evidence to be ignored on the basis that they were called as factual witnesses.

90 He argued further that the pitting of the experts against each other would serve no useful purpose. What is required is that the entire body of evidence relevant to each charge, must be considered. This includes but is not limited to the expert opinions expressed in relation to each charge. The opinion evidence must in each instance be considered and the necessary weight attached, taking into account the witnesses' respective expertise in the context of the totality of the evidence.

91 The significance of the debate about the weight to be attached to the evidence of the respective expert witnesses is diminished in the present circumstances, where the adjudicative body includes persons with legal, auditing and accounting expertise. The combined experience of the four members of the Committee with auditing and accounting experience provides a pool of experience and expertise

that is not ordinarily available to a trial judge sitting alone. This includes one of the Committee members having served as the engagement partner in the audit of banks and other registered financial institutions in the course of his long career as an auditor. In these circumstances, the Committee is in a better position than a trial judge to evaluate audit-related evidence and less reliant on the expert witnesses. That does not mean, however, that the Committee has not given careful attention to the views expressed by the expert witnesses.

92 The extent to which the views of the particular experts have or have not held sway will be apparent from the reasoning in relation to each of the charges. That will tend to reflect a greater, but not an exclusive, reliance on the evidence of Mr Chidgey and Mr Cohen. We have relied upon the opinions of the various experts where and to the extent that they have been of "appreciable help" to the Committee.[7] That assistance has generally found to be present where an expert's process of reasoning or ability to articulate concepts clearly on the basis of his or her expertise has shed light on a contentious matter arising in the proceedings.[8]

93 Because of his role as investigator, we have treated the opinion evidence of Mr Cameron-Ellis with caution. However, he deserves acknowledgement for the role he played in gathering and presenting in a coherent manner the greater part of the body of evidence relied upon by the pro forma complainant.

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[7] *Pricewaterhouse Coopers Inc and others v National Potato Cooperative* above at para 97.

[8] See in this regard *AD and Ano v MEC for Health and Social Development Western Cape Provincial Government* (27428/10) [2016] ZAWCHC 116 (7 September 2016) at para 39 where Rogers J says:

> "*When faced with conflicting expert opinions, the court must determine which, if any, of the opinions to accept, based on the reasoning and reliability of the expert witnesses. The court must determine whether and to what extent an opinion is founded on logic or reasoning.*"

## THE LEGAL STANDARDS APPLICABLE TO IMPROPER CONDUCT

### *Onus of proof*

94 It is well established that onus of proof in proceedings before the Committee reposes in the pro forma complainant who must prove the case on a balance of probabilities. Moreover, the Committee has held that –

> *"The Committee will not lightly accept that an auditor will be guilty of dishonesty or other infringements of his or her professional rules. Convincing evidence is required."*[9]

### *Statutory context*

95 As appears from the introduction, disciplinary proceedings before the Committee are regulated by the Audit Act and by substantive and procedural rules made by the IRBA in terms of the Audit Act.

96 "Improper conduct" is defined in section 1 of the Audit Act as:

> *"any non-compliance with this Act or any rules prescribed in terms of this Act or any conduct prescribed as constituting improper conduct."*

97 Insofar as the definition includes noncompliance with the Audit Act, it would include noncompliance with section 44 of the Audit Act, quoted above.

98 The substantive rules pertaining to improper conduct have been quoted above, insofar as they form the basis for the charges in this matter. The range of conduct alleged to form the basis of the charges in this matter, which derive from rules 2.1, 2.4, 2.5, 2.6, 2.7 and 2.17, include –

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[9] *IRBA v Lourens* at para 69.

98.1 contravening or failing to comply with section 44 of the Audit Act with which it is the registered auditor's duty to comply (rule 2.1);

98.2 dishonesty in the performance of audit work or duties (rule 2.4);

98.3 failure to comply with auditing pronouncements (rule 2.5);

98.4 failure to comply with the requirements of the Code of Professional Conduct (rule 2.6);

98.5 failure to perform professional duties with "*such a degree of professional competence, due care and skill as in the opinion of the regulatory board may reasonably be expected*" (rule 2.7);

98.6 failure to perform professional services or duties at all (rule 2.7);

98.7 behaviour in a manner which tends to bring the auditing profession into disrepute (rule 2.17).

99 As was pointed out on behalf of the respondents, the charges in this case have been framed under and with reference to the rules. However, rule 2.1 refers back to the Audit Act, and in each charge in this matter where an infringement of rule 2.1 is alleged, the allegation is based on non-compliance with section 44 of the Audit Act.

100 What does, however, follow from the decision to frame the charges under the rules rather than directly under the Audit Act, is that the introductory paragraph of rule 2 comes into play. It includes the following qualifying provision:

> *"A registered auditor shall be guilty of improper conduct if such registered auditor <u>without reasonable cause or excuse</u> [the specific rules are then itemised.]"*

101 This would mean that, even in the case of a contravention of rule 2.1 on the basis of noncompliance with section 44 of the Act, the Committee would have to be satisfied that the alleged improper conduct was "without reasonable cause or excuse". The practical consequence of this would be that noncompliance with an auditing standard would not, in the context of the charges as framed, automatically give rise to improper conduct. Consideration would first have to be given to whether or not such conduct was "without reasonable cause or excuse".

***Case law***

102 The pro forma complainant and the legal team for the respondents referred the Committee to a number of cases. The respondents referred us to case law where the courts have dealt with applications for attorneys' names to be removed from the roll.[10] In those cases, for a removal from the roll to be warranted, serious misconduct in the form of dishonesty or gross negligence had to be established. The respondents also referred us to English cases decided under the legal regime governing the regulation of the auditing profession in the United Kingdom.

103 Particular attention was focussed on the case of *R (on the application of Baker Tilly UK Audit LLP) v Financial Reporting Council.*[11] That case was relied on as authority for the point that for there to be a finding of misconduct, there must be moral blameworthiness or deficient performance to an extent going beyond mere negligence. Plain negligence and carelessness would not suffice. Reliance was also placed on the decision on appeal in this matter, *Baker Tilly UK Audit LLP v*

[10] For example, *Jasat v Natal Law Society* 2000 (3) SA 44 (SCA); *Vassen v Law Society of the Cape of Good Hope* (1998 (4) SA 532 (SCA).

[11] [2015] EWHC 1398 (Admin).

*Financial Reporting Council.*[12] The judgment on appeal can be taken as suggesting that gross negligence must be present before there can be a finding of professional misconduct.

104 The pro forma complainant disputed that it was necessary to prove gross negligence before there could be a finding of improper conduct. He placed reliance on case law in the context of delictual claims against auditors or auditing firms.[13] On this basis he argued that negligence was a sufficient basis to establish improper conduct.

105 In the Committee's view, reliance on the case law referred to by both parties is of limited assistance. The English case law dealing with the regulation of the auditing profession is based upon that regulatory body's formulation of the requisite standards. Moreover, the argument gravitates towards the adoption of delictual concepts and standards in assessing professional misconduct. Delictual standards are employed by courts for the purposes of determining whether the consequences of financial or patrimonial loss should be shifted from one party to another, where a person or corporate body suffers harm or loss as a result of the negligent and unlawful conduct of another. The considerations that motivate a disciplinary enquiry are different and therefore require an approach to the interpretation of regulatory provisions consistent with their disciplinary purpose.

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[12] [2017] EWCA Civ 406.

[13] See for example *Thoroughbred Breeders Association of South Africa v Price Waterhouse* [1999] 4 All SA 69 (W); *Price Waterhouse Coopers Inc and others v National Potato Cooperative and Another* above at para 15; *Axiam Holdings Ltd v Deloitte & Touche* [2005] 4 All SA 157 (SCA).

106 In the Committee's view it is preferable to be guided primarily by the text, context and purpose of the particular statutory scheme under the Audit Act and rules referred to above, applying the recognised South African law pertaining to the interpretation of statutes.[14] In the Committee's view that approach will provide the requisite dividing line between conduct that falls either inside or outside of the area of legitimate concern of the regulatory authority for purposes of discipline and that is the approach that we apply in this decision. Without seeking to be exhaustive, context and purpose include the need to ensure, simultaneously -

106.1 the retention (some may say restoration) of a tradition of excellence in the South African auditing profession;

106.2 that practitioners in their audit work provide assurance that the users of audited financial statements in South Africa can rely on them with confidence, with all of the beneficial economic consequences that flow from that;

106.3 the protection of the dignity and professional reputation of the practitioner against unsubstantiated charges or complaints that lack the substance necessary to justify disciplinary sanction.

107 Both parties referred also to previous decisions of this Committee. Given that no system of precedent applies to its decisions, the Committee would not be bound by them, but they remain important and relevant considerations and we have treated them as such.

[14] *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 (4) SA 593 (SCA) at para 18; *Betterbridge (Pty) Ltd V Masilo And Others NNO* 2015 (2) SA 396 (GP) at para 8.

***"Without reasonable cause or excuse"***

108 There was debate about the meaning to be attributed to this qualifying provision in the introductory paragraph of rule 2. The difficulty which it poses is that it contemplates conduct which may technically infringe one of the listed substantive rules, but at the same time be excusable.

109 The respondents argued that guidance in this regard was to be found in the Committee's decision in the matter of *IRBA v WP.* That case also involved charges arising from a restatement. There the restatement was in respect of the 2009 AFS of a listed financial services company. The restatement resulted in the net profit after tax being reduced from R110m to R26.9m.

110 In a charge pertaining to the incorrect reflection of preference shares as equity instead of a financial obligation in the AFS, the Committee held as follows:

> *"Even if one proceeds on the assumption that the practitioner interpreted the agreement incorrectly, and interpreted and applied IAS32 incorrectly, it cannot be said that the practitioner acted without due care and skill.*
>
> *The Committee does not accept that the simple fact of an incorrect application of an accounting or auditing standard on its own and in every case, automatically translates into professional misconduct. Often it will. But regard needs to be had to the context and to the steps taken by the practitioner in seeking to interpret and apply the standard correctly."*

111 In acquitting the practitioner on this charge, the Committee took into account the complexity and lack of clarity in the wording of the preference share agreement, the fact that the auditor had identified the issue, grappled with it, taken it up with the technical department and documented his steps (save in respect of the obtaining of the opinion).

112 This decision of the IRBA is helpful in providing some guidance to the interpretation of the qualifying provision. At the same time, each case must be decided on the facts of the particular matter.

113 The respondents also referred to case law relevant to section 248 of the Companies Act No. 61 of 1973. That dealt with the circumstances where a director, officer or auditor of a company could avoid liability based on negligence if he or she acted honestly and reasonably. Again, given the different statutory setting, the Committee is of the view that this case law is of limited assistance.

114 The pro forma complainant contended for an interpretation of the clause that would embrace either a situation of a confession and avoidance, i.e where the respondent admitted the contravention of the rule but pleaded a reasonable cause or excuse in the form of a valid defence to the charge. The second interpretation contended for was that it was simply "*reinforcement of the principle that the standard for conviction is just that of a deviation from reasonableness, and gross reasonableness is not required*".

***Conclusion on the legal standards***

115 Taking into account the foregoing analysis, the Committee is of the view that the question of whether or not an auditor is guilty of improper conduct is to be determined with reference to the standard of the diligent auditor, exercising due care, skill and caution, as dictated by the contextual and purposive considerations underlying the statutory disciplinary scheme, and by the particular circumstances of the case.

**116** The qualifying clause *"without reasonable cause or excuse"* stands to be interpreted as supplementing and affirming the standard of the diligent auditor. Thus, if an auditor erred or overlooked something in circumstances where a diligent auditor might make the same mistake, notwithstanding having exercised due care, skill and caution, the relevant conduct would not constitute improper conduct. A standard of this nature is inherently flexible and would allow for the particular circumstances of an audit to be taken in account. Relevant circumstances might include:

116.1 the quantum, materiality and significance of the error or errors involved;

116.2 the extent of the audit work that was correctly done, yet failed to prevent the error or oversight;

116.3 the importance of the entity being audited with reference to the country's economy and the potential consequences that might flow from errors in its financial statements;

116.4 the potential harm to users of the financial statements as a result of the error; and

116.5 the risk status of the audit.

**117** It is neither necessary nor appropriate to provide a comprehensive list. That is the standard that we apply in the adjudication of the charges in this matter.

## SPLITTING OF CHARGES

118 The respondents contended that the charges were based on a substantial, impermissible splitting of charges. Particular attention was focused on charges four, dealing with management bias, and the second part of charge 10, dealing with independence, objectivity and professional scepticism. The respondents' ultimate submission was that *"[a]lthough spun out over ten charges, all of the charge sheet save for aspects of charges 8 and 9 consists of evidence pleaded for a single infraction, namely the issuance of an unmodified audit report on the 2013 AFS."*

119 Reference was made by both sides to case law pertaining to the splitting of charges in the context of criminal law and procedure. That does not in all respects sit comfortably with the nature of complaints of misconduct coming before this Committee. Nevertheless, in some respects it provides assistance.

120 At the heart of the problem recognised by the rule against the splitting of charges is that a person should not be convicted of, and punished separately for, two different offences on the basis of the same, single set of facts. In assessing the complaint of the respondents, it is important not to stray from that principle.

121 The correct approach to the problem was explained in the Supreme Court of Appeal's judgement in *Dlamini v S*[15] as follows:

> *[19]. Our courts have applied different tests to decide whether duplication has occurred. In S v Maneli, Streicher JA explained:*
>
> > *'One such test is to ask whether two or more acts were done with a single intent and constitute one continuous criminal transaction.*

[15] [2012] 2 All SA 569 (SCA).

*Another is to ask whether the evidence necessary to establish one crime involves proving another crime.'*

*[20] There is, however, no all-embracing formula. The various tests are mere guidelines – they are not rules of law, nor are they exhaustive. Their application may yield a clear result, but if not, a court must apply its common sense, wisdom, experience and sense of fairness to make this determination."*[16]

122 Applying this to the present charges, there is a very substantial overlap between the averments forming the basis of charge 4 and the second part of charge 10, on the one hand, and a number of the remaining charges, on the other. For reasons elaborated upon more fully in discussing those charges, we find that any conviction of the respondents in respect of them, would be unfair and would amount to a splitting of charges. We have therefore acquitted the first respondent on the fourth charge and the first and second respondents on the second part of the tenth charge, without further enquiry.

123 As for the balance of the charges, it must be remembered that the case is in the main about the <u>audit work</u> in relation to the 2013 financial statements. It is not a complaint about the financial statements in and of themselves. Where the financial statements are alleged to be defective, they are relevant insofar as the defects may evidence defective audit work. The fact that a single line item in the balance sheet may be misstated by what is ultimately a single amount, does not detract from the fact that it may be the sum of several distinct amounts, each associated with distinct audit work. If any such distinct piece of audit work pertaining to a distinct amount is flawed and amounts to an audit failure, it would justify a distinct and separate charge.

[16] Although this extract is from the minority judgment, this statement of the law was accepted as correct by the majority - see paras 54-55.

124 The Committee is satisfied that the charges <u>other than</u> charge 4 and the second part of charge 10 are, at their heart, based on distinct averments of distinct audit failures. Where there is overlap in the averments, this is in respect of secondary or background evidence. The nub of each of the remaining charges is different and there can be no complaint of splitting. The first part of charge 10 pertains to a distinct set of allegations pertaining to dishonesty. Charge 9 pertains to different audits in respect of different financial years. Charge 8 relates to the audit work required for and pertaining to the rights issue. Charge 7 relates to the audit work surrounding the going concern assessment. Charge 6 pertains to the audit work in respect of the impairment of a particular loan from African Bank to Ellerine Furnishers. Charge 5 relates to the audit work concerning the treatment of interest on impaired financial assets. Charges 1, 2 and 3 each involve distinct components of audit work in relation to the determination of an appropriate amount of impairment charges.

125 A strong indicator of the distinctiveness of the charges (other than charge 4 and the second part of charge 10), was the ease with which the presentation of each side's case could sensibly be divided up on the basis of the charges, through both the presentation of the evidence and argument. An unfair splitting would have rendered this impossible.

126 Accordingly, we are of the view that the complaint in respect of unfair splitting is unfounded insofar as it concerns the charges other than charge 4 and the second part of charge 10.

## AUDIT DOCUMENTATION AND EXTRANEOUS EVIDENCE

127 The respondents raised as a preliminary issue the question of audit documentation and how it impacted on the charges and the admissibility of evidence.

128 We deal with the issue below in the context of the particular charges where documentation failures are alleged.

129 One issue is whether the Committee may have any regard at all to audit evidence not appropriately placed and retained in the audit file at the time of the audit. We approach the matter on the basis that we may have regard to such evidence, but on a qualified basis elaborated upon in the discussion of charge 1.

130 The other issue pertains to whether a documentation failure can constitute improper conduct at all. We hold that it can. And it can, in appropriate circumstances, be serious. This is because documentation is so integral to the process of judgement-forming by an auditor and to enabling the auditor to account for his or her work, whether to his or his or her firm, client, professional regulators, other regulators, or the public. At the same time, we recognise that a minor documentation failure may well fall within the realm of an error which a diligent auditor might have made. That would not be improper conduct.

131 We now turn to the assessment of each of the charges.

## THE FIRST CHARGE

### Introduction

132 It is alleged in charge 1 that when the 2014 AFS for African Bank were prepared, they recorded a material restatement. The restatement related to a difference between the impairment model and the impairment provisions recognised in the 2013 AFS. This difference was referred to by the Bank and in the proceedings as "the gap". The impact of the restatement on the 2013 AFS was a downward adjustment of R656 million on pre-tax income.

133 The charge refers to the following facts known to the first respondent and evident from the audit files pertaining to African Bank for the 30 September 2013 financial year:

133.1 the final report submitted to African Bank's audit committee records that -

133.1.1 *"management discretion, being the difference between impairment model values and the GL is R825 million at September 2013"*;

133.1.2 additional audit procedures had been performed on collection initiatives which could produce an uplift of *"up to R825 million"*;

133.2 audit workpaper AB5450 indicated that -

133.2.1 two of the three cash uplift initiatives, could not be justified;

133.2.2 *"[a]s per our assessments the cash upliftments range between R261m and R516m"* and indicates that the average is R388,829,935; and

133.3 a reconciling item of R512 million relating to Stangen's insurance reserves was accepted without documenting procedures regarding its validity.

134 It is alleged further that the R656 million error was material and resulted in the misstatement of the AFS of ABIL and African Bank for the year ending 30 September 2013. The conduct of the first respondent pertaining to the error was in breach of ISA 200, ISA 220, ISA 230, ISA 330, ISA 450, ISA 500, ISA 700 and ISA 705.[17]

135 In his plea, the first respondent denies that the treatment of the gap in 2013 was incorrect. He states that management arrived at an estimate of the impairment provision by considering -

135.1 the answer yielded by the impairment model;

135.2 cash collections initiatives predicted to yield higher future cash flows, also referred to as cash uplifts or ACCIs;

135.3 improvements in credit underwriting metrics;

135.4 management's positive outlook on the economic environment, also referred to as the coverage effect;

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[17] The titles of the standards and the relevant paragraphs are set out below.

135.5 the nature of particular loan vintages which may or may not indicate future performance trends of the whole loan portfolio.

136 The first respondent pleads that the auditor's function is to apply professional scepticism in evaluating whether management's application is acceptable and yields a reasonable point estimate. He pleads that this is done by considering the best available evidence at the time and applying the auditor's own judgement and expertise.

137 He pleads that varying the model outcome in light of other discretionary factors is in line with industry practice. He points out that industry practice is typically conservative, i.e. recording an overlay as opposed to recording an underlay. He argues that underlays are not a concern, if they are supported by sufficient and appropriate audit evidence.

138 He pleads, based on estimation uncertainty,[18] that in 2013 he considered that, if the gap after adjustment for acceptable discretionary factors was less than 1 – 2% of gross advances, the gap did not give rise to a misstatement.[19]

139 He avers further that:

139.1 In his final 2013 report to the audit committee he inter alia reported that "We performed additional procedures on these collection

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[18] The first respondent argues that "*modelling of future cash flows on a vast portfolio of disparate loans worth billions of rands for up to ten years… is an inherently and irreducibly complex, uncertain and imprecise exercise*", and this results in "estimation uncertainty". He explains "estimation uncertainty" by referring to ISA 540 paragraph 7(a), which defines an accounting estimate as "*as an approximation of a monetary amount in the absence of a precise means of measurement.*"

[19] African Bank's gross advances for the 2013 financial year amounted to about R80 billion. On the first respondent's version, the gap, after taking into account the Stangen IBNR (R512 m) and the ACCIs (R825 m) amounted to about R222 million (R1,559 m – R825 m – R512 m). This equals about 0.3% of gross advances.

initiatives to assess the reasonability of this cash uplift ..... these initiatives could produce an uplift of up to approximately R825 million"

139.2 The first respondent admitted that audit working paper AB2013 5450 (which we will refer to as "AWP 5450") indicates -

139.2.1 that the insurance call centre initiative would produce cash uplifts of between R193 million and R430 million;

139.2.2 that he could not obtain sufficient evidence to justify the cash uplifts from the tracing project;

139.2.3 in relation to the changes in the Stangen insurance policies, these could not be correlated with their asserted present value quantified by management of R183 million;

139.2.4 a "coverage effect" of between R69 million and R86 million based on an expected improvement in economic conditions could be taken into account in filling the gap.

139.3 Subsequent to the preparation of AWP 5450, the audit team received additional evidence from management and performed additional work on the cash uplifts. This led to the conclusion that the cash uplift relating to the Stangen insurance policy changes could also be accepted. This formed the basis of the report to the audit committee.

139.4 When preparing Deloitte's submission to the Myburgh Commission, the first respondent became aware that the audit working papers had not been updated to reflect the subsequent work. At this time he

prepared, but did not file, an updated work paper based on his recollections of the 2013 audit. This audit working paper suggested that he could obtain sufficient audit evidence also to rely on the tracing project and the insurance policy changes.

139.5 In his partner memorandum in the audit file, the first respondent concluded that all three cash uplift initiatives could be accepted so that an additional amount of R550 million could be taken into account in filling the gap, excluding the additional R77 million that could be taken into account in respect of the coverage effect. This was supported by AWP AB2013 5421, being the ABL impairments overview memo prepared by Mr Mavuka.

139.6 The curator accepted in the 2014 AFS of African Bank that R500 million of the cash uplift initiatives could be accepted.

139.7 An amount of R512 million in relation to the Stangen IBNR was also taken into account to reduce the gap. The Stangen IBNR pertains to claims that, at financial year end, were yet to be made against Stangen, but arose from events that had already taken place. Taking this amount into account was justified with reference to an oral consultation by the second respondent with a Deloitte technical accounting expert, the outcome of which was that this IBNR could be taken into account in filling the gap.

140 He accordingly denies that he breached any of the ISAs referred to.

141 The areas of agreement on charge 1 as between the experts, including a summary of the main facts relevant to the charge, were recorded in their joint minute, as follows:

> *"1. Where an advance is impaired, IAS 39 requires the impairment provision being calculated as the difference between the carrying amount of the advance and the present value of the estimated future cash flows discounted at the original effective interest rate. Such calculation requires a bank to forecast such estimated future cash flows. A common mechanism that banks use to estimate future cash flows is to base these forecasts on historical cash flows recovered from similar loans or portfolios of loans.*
>
> *2. To the extent that historical cash flows do not reflect current or expected conditions, the output of a model that uses unadjusted historical cash flows will need to be modified in order to comply with IFRS.*
>
> *3. The practice of varying the model outcome in the light of other discretionary factors not reflected in historical observations but which factors affect expected cash flows, is in line with IFRS.*
>
> *4. These factors should be supported by reference to evidence relating to the effect of changes in circumstances which have occurred subsequent to the period reflected in the historical cash flows.*
>
> *5. At 30 September 2013 there was an initial gap between the impairment provision amount in the general ledger ("GL"), which was based on amounts processed through the year, and ABIL's impairment cash flow model amount. As at that date, the impairment calculated by the model exceeded the amount recorded in the GL by R1.559 billion.*
>
> *6. Management did not adjust for the initial gap and supported it by reference to, inter alia:*
>
> - *an amount of R512 million relating to the IBNR in the financial statements of Stangen. This was an insurance IBNR for claims where the Bank would be the ultimate beneficiary;*
> - *Cash uplift initiatives ("ACCIs")[20] in relation to a call centre and tracing projects, both of which were expected to improve recoveries, and insurance policy changes which were more favourable to the Bank; and*
> - *Management's positive outlook on the economic environment for the 2014 financial year based on economists' predictions at the time ("the coverage effect").*

[20] Standing for "additional cash collection initiatives".

*7. During the 2013 financial year, Stangen changed its accounting policies to recognise and raise an insurance IBNR provision; and in September 2013, Stangen raised an IBNR provision amounting to R550 million based on the valuation performed by their actuaries.*

*8. According to Mr Jordan's statement, management argued that R512 million of that amount could be taken into account to support the "underlay". Mr Crowther consulted with Mr Trevor Derwin, an IFRS specialist partner in the accounting technical department of Deloitte, on the conceptual basis of the support of the 'underlay' with this amount.*

*9. According to Mr Jordan's statement, the outcome of the consultation was that the Stangen IBNR could be taken into account to support the initial gap because it represented a provision made by Stangen for amounts that it would pay the Bank for losses for which the Bank had itself provided (through impairment provisions). The consultation and its outcome was not documented in the audit file.*

*10. According to Mr Jordan's statement, he also understood that Stangen had made certain changes in its claims policy which would enhance cash flows to the Bank in the 2014 financial year. Mr Jordan relied on the conclusion of the consultation as well as his understanding of the enhancement in cash flows flowing from the changes in the Stangen claims policy to consider management's conclusion to be reasonable that the amount of R512 million supported this component of the initial gap. This understanding was not documented in the audit file.*

*11. In respect of the ACCIs management produced a number of calculations to show their impact. According to Mr Jordan's statement the audit team carried out work on the ACCIs where they concluded that they could justify R672 million including a coverage effect. Subsequent to archiving the Bank's audit file he became aware that the archived work papers reflected a preliminary conclusion made during the course of the audit (version 2) and had not been updated to document the basis for this changed conclusion. Around the time of the Myburgh Commission, Mr Jordan prepared an updated work paper which reflected to the best of his recollection his conclusions at the time of finalising the 2013 audit which concluded that between R261 million and R677 million of ACCIs including a coverage effect of between R69 million and R86 million could be justified.*

*12. On 28 October 2013, Mr Mavuka sent Mr Jordan an email recording that management had provided additional information in regard to the three initiatives – changes in the insurance policy; the call centre; and the tracing initiative – and that they 'resulted in additional cashflows discounted over a ten-year period of R800 million'.*

*13. The 2013 final Audit Committee Report recorded that ACCIs 'could produce an uplift of up to approximately R825 million' and that*

*'this is an area of significant judgement affecting the group's financial results'.*

*14. The AFS of the Bank for the year ended 30 September 2014 recorded a restatement relating to the differences between the impairment model and the impairment provisions recognised in the 2013 AFS. The impact of this restatement on the 2013 financial year was a R656 million downward adjustment to the net advances line item in the statement of financial position, and the related impact on the statement of profit or loss.*

*15. The curator's downward adjustment to the net advances line item (R656 million) was lower than the size of the initial gap in 2013 (R1 559 million), because the curator considered that there was sufficient evidence present in 2013 to support cashflows relating to the Stangen IBNR and the ACCIs to that extent.*

*16. In preparing the 2014 AFS, the curator took into account a discretionary adjustment to his model, producing an 'overlay' of R100 million."*

***Adjustment of model forecasts***

142 Paragraph 62 of IAS 39 *Financial Instruments: Recognition and Measurement* provides in relevant part as follows:

*"In some cases the observable data required to estimate the amount of an impairment loss on a financial asset may be limited or no longer fully relevant to current circumstances. ... [A]n entity uses its experienced judgement to adjust observable data for a group of financial assets to reflect current circumstances (see paragraph AG89)."*

143 Paragraph AG89 provides in relevant part as follows:

*"Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. ... Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently."*

144 The respondents' expert, Mr Cohen, explained the operation of these provisions as follows:

> *"765. IAS 39 explicitly requires the reporting entity not to use historic experience as the sole basis for estimating impairment, and that doing so (sic) would ignore the extent to which current conditions diverge from those that prevailed historically. To link the preceding discussion with the relevant terminology in the charge sheet, to the extent that the bank's impairment is determined solely based on historic loss and recovery experience, then any adjustment to such historic experience would be considered a "model gap".*
>
> *766. Historic cash flows are used to forecast future cash flows and the likelihood of loans going into default. Using these historic cash flows and default rates, without adjustment, in order to forecast future cash flows would only be appropriate if the economic and operational environment during this historic period is the same as that in the present.*
>
> *767. Thus, if the economic environment deteriorates, the past cash flows will over-predict the future cash flows; and hence the bank would under-record impairment. It is thus necessary to make adjustments in order to reflect the current circumstances. This is referred to as a model overlay.*
>
> *768. In African Bank and Deloitte documents, an "overlay" is referred to as a judgemental adjustment to increase the impairment relative to that implied by the model; whereas an "underlay" is a judgemental adjustment to decrease the impairment relative to that implied by the model."*

145 The experts generally agreed that an underlay is not a common occurrence in the banking sector. Ms De Beer had never heard of an underlay[21] and regarded the concept as "*unique*".[22] Mr Chidgey said that banks typically "*take into account negative expectations more than positive expectations*". Mr Cohen agreed that "*an underlay is extraordinary and that it is overlays that one generally encounters.*"

[21] In her oral testimony, she said "*The first time I read the word, honestly, I thought it was a typo. I have never heard of the concept of an underlay.*"

[22] Further, she testified "*If you look at the document and the audit file, Mr Burra said the concept of an underlay is unique, which is certainly my experience too.*"

146 As much as underlays may be extraordinary, it was common cause that they are not prohibited and are permissible in principle provided that they are "*justified by sufficient appropriate evidence.*"[23] That disposes of the suggestion made at one point in the evidence of Mr Cameron-Ellis that there was something inherently dishonest in the presence of an underlay.

147 Another issue that should be dealt with at the outset is the pro forma complainant's criticism of the first respondent's audit work (or alleged lack thereof) pertaining to the journal entries effected during the course of the financial year that gave rise to the underlay or gap. That criticism finds no basis in the charge as formulated. The charge as formulated takes the gap as its starting point. The question raised by the charge is whether, as at the 2013 financial year end, the necessary audit work had been done, and sufficient appropriate audit evidence existed, to show that the gap or underlay represented a legitimate adjustment to the impairment figure generated by the financial model and did not amount to a misstatement.

148 As appears from the summary of the facts in the expert minute, in justifying the lower amount of the impairments brought about by the "gap" or underlay of R1.559 billion, management referred to three items, the Stangen IBNR, the additional cash collection initiatives or "ACCIs" and the coverage effect. It is the audit work relating to these items that forms the focus of the charge. In this regard the first respondent contended that -

[23] See the Joint Expert Minute at item 9 "*IFRS therefore permits either an "overlay" or an "underlay" to the model, provided the estimation yielded by the model (including such overlay or underlay) appropriately represents the present value of future estimated cash flows, and is justified by sufficient appropriate evidence.*"

148.1 the Stangen IBNR supported the underlay to the value of R512 million; and

148.2 the ACCIs, together with the coverage effect, supported the underlay to the value of R825 million,

and that together they justified the amount reflected in the general ledger and in the 2013 AFS of African Bank and ABIL.

149 We deal with the coverage effect as part of the ACCIs. First we consider the Stangen IBNR.

***The Stangen IBNR***

Introduction to the Stangen IBNR issue

150 It is unnecessary to repeat the factual summary contained in the expert witnesses' joint minute quoted above. The upshot of the factual developments referred to there is that, whilst the Stangen IBNR was taken into account in substantiating the gap in the preparation of the 2013 AFS, during the 2014 audit of the bank it was recognised that there was a substantial measure of double counting in doing so. This is because the cash flows generated by the insurance claims catered for in the IBNR would already substantially have been included in the data used for discounting future cash flows. The effect of the payments pursuant to the claims would therefore already be factored into the impairment calculation.

151 This formed the basis, in part, of the restatement in this regard, although the curator recognised a value of R216m in relation to the changes in the "grace

period" provision in the Stangen insurance policies.[24] The balance of R296m therefore represented the amount of the restatement in relation to the double counting.

The Derwin opinion

152 Whilst acknowledging that "*there was a measure of double counting as at 30 September 2013 of the insurance proceeds derived from Stangen credit life insurance policies*" the first respondent justified his conduct on the basis that he had requested the second respondent to obtain technical advice from Mr Derwin in the Deloitte technical accounting department, and Mr Derwin had confirmed *"that the Stangen IBNR could be taken into account to justify the 'gap' because it represented a provision made by Stangen for amounts that it would pay the bank for losses for which the bank itself provided (through impairment provisions). I relied on this conclusion to consider management's conclusion to be reasonable that the amount of R512m justified the 'gap' (by that amount)."*

153 The second respondent confirms the first respondent's request in this regard. He says that he discussed the matter orally with Mr Derwin in mid-October 2013. The questions he put to Mr Derwin were the following:

> *"58.1 whether the IBNR at Stangen might be taken into account as part of the impairment balance (coverage) at either or both the Bank and consolidated ABIL levels; and*
>
> *58.2 whether, if it must be taken into account in the impairment coverage for the Bank, a receivable should be recorded in its financial statements."*

[24] The "grace period" refers to the period within which a claim must be lodged in terms of the policy. This was extended. This must be distinguished from the ACCI that was based on an amendment to the Stangen policies whereby the waiting period before an insurance claim may be made pursuant to retrenchment was reduced from 3 months to 1 month. This is dealt with below.

154 In order to record the outcome of the consultation he refers to an exchange of emails that he had with Mr Derwin on which the first respondent was copied, on 17 October 2013.

155 At 13h21 on 17 October 2013, Mr Derwin addressed an email to the second respondent as follows:

> *"As discussed please find below a summary of our discussion on the insurance taken out in respect of death of the borrower.*
>
> *African Bank provides loans to clients. As part of the security in respect of the loan clients are required to cede a life policy to the bank. The policies are often entered into with an insurance company linked to the group. In this case the premiums are collected by the Bank and paid over to the insurer. On death the policy would form part of the deceased's estate but as a result of the cession would be collected by the Bank on behalf of the deceased borrower. The cash flows received under the insurance policy are therefore proceeds paid on behalf of the borrower. In assessing the cash flows for impairment purposes, the insurance proceeds should be considered as a cash flow arising from the borrower and not a separate cash flow to compensate for a loss suffered."* (emphasis added)

156 At 15h26 on 17 October, the second respondent addressed a letter to Mr Derwin, copying the first respondent, as follows:

> *"Hi Trevor.*
>
> *Can I expand a bit and have your comment on that please:*
>
> *[The second respondent then quotes verbatim the above-quoted second paragraph of Mr Derwin's email setting out his advice and then expands as follows]*
>
> *The resultant IBNR would be raised in the insurance company and no asset would be raised in the Bank. That implies that coverage for the nonperforming loans would be higher at a consolidated level than at a bank level."*

157 At 18h23 on 17 October 2013, Mr Derwin addressed an email to the second respondent, copying the first respondent, and saying:

> *"Hi Danie*
>
> *I am happy with what you have added."*

Interpretation of the Derwin opinion

158 Having regard in particular to the emphasised portions in the above email exchange, the question arises whether Mr Derwin's opinion did in fact support the stance that the Stangen IBNR could be used to substantiate the gap.

159 Ms De Beer testified in her evidence in chief as follows in this regard:

> *"there were two key initiatives ... , one being the Stangen IBNR provision. So Stangen, in the subsidiary books, actually started raising this IBNR provision, and the question was whether that could be used to fill the gap.*
>
> *So there is a cash flow shortfall or a default on a debtor's loan. It can be claimed from Stangen, which is really giving the insurance to fill default positions or non-payment positions of any of the debtors.*
>
> *There is quite a bit of working papers around that. There is also - there is a comment by Mr Jordan on one of the working papers, to say is this not potentially double-counting, because has the cash not already been brought into account in the future cash flow forecasting, a little flag there. And then there was an opinion obtained from the technical people at Deloitte, to give a view on that, whether you can use this Stangen IBNR provision to fill the gap.*
>
> *The way in which I read the technical opinion, it to me sort of says that you have to take that into account against the cash flows and you should not be creating a separate asset for that. Because remember you cannot really accounting-wise create an asset. Yes, you might get the cash flows in future, but you have to build that into your cash flow in your calculation of your IAS 39 provision."*

160 The working papers mentioned in her oral testimony were referred to in her witness statement as follows:

> *"38.24 AB3006 indicates a R1.21 billion 'GAP' in the NPL impairment as estimated versus the 'book value'. The worksheet tagged 'Sihlalo' as part of this Excel workbook indicates this R1.21 billion gap for NPL plus a R0.36 billion gap for ML, adding up to R1.57 billion described as 'Difference to be motivated'*

*38.25 Insurance reserves in Stangen of R0.12 billion and 'Additional insurance reserves in Stangen' of R0.15 billion are deducted applied (sic) to reduce the gap. Next to this there is a note that states, inter alia, 'We need to consider whether these reserves should be used to reduce impairments. <u>If previous claims were already included in the cash flows then are we not double counting</u>? If these were used to offset the impairments then they should be included in the IRR calculation. In general market practice is to either include fees in the IRR calculation or to raise a DAF. By raising a DAF and then offsetting against impairments just seems wrong. Probably need to check with Trevor in A&A."* (emphasis added)

161 Later in her evidence in chief, she says -

*"the way in which I read that opinion, I do not believe the opinion is wrong. I just think the opinion is potentially misinterpreted, because the opinion says that it should be accounted for in the cash flows and not the separate asset. So, but that is not what happened, it was sort of accounted for on both sides."*

162 When Ms De Beer was cross-examined about the points agreed on in the expert joint minute on this charge, she said -

*"MS DE BEER: So on paragraph 9 where we talk about the Stangen IBNR and a consultation with Mr Derwin which is not documented, just from an IFRS perspective, personally I just really battle with the concept that there is a provision in one legal entity and another legal entity has got the ability to access that provision.*

*Yes they will claim from Stangen in future if there are losses <u>but those have been worked into the cash flows so I think that is a point that I have made before and I just want to remind you of that point</u>. And it is as we have agreed, it is not documented on the audit files so it is difficult to interrogate it further.*

*... [the "grace period" change in the insurance policy is then referred to]*

*MR VAN DER NEST: Alright, three things. Firstly, whether it was included in the cash flows is one aspect. A second aspect is whether or not Mr Derwin was correct. You come to both together. As to whether or not Mr Derwin is correct, the point there is that there is an IBNR, it is in a separate legal entity, you are right.*

*It is a sister entity within the group, but the point is that the only beneficiary to those identified funds, is the bank. The fact that it lies in an IBNR is a collection of the amount which is to be paid to one entity and one entity only, the Bank. That is what underlies that.*

*Right. You say that the first that you saw of the benefit of these enhanced benefits and the context of the Stangen IBNR was in 2014. Mr Jordan's statement says he took it into account at the time. That is not recorded in the file, but he did take it into account and the panel will deal with that as they said.*

*MS DE BEER: Yes, and yes, agreed."*

163 This did not appear to the Committee to be a clear acceptance by Ms de Beer of counsel's proposition as to the correctness of the treatment of the Stangen IBNR or a renunciation of her interpretation of the opinion as precluding reliance on it. This much is borne out by her testimony the following day where the following exchange took place:

*"MR VAN DER NEST: …In 2014 two things were found, that in respect of the Stangen IBNR there in fact was double counting, because it had been reckoned into the cash flows already.*

*MS DE BEER: Yes, that was sort of the outstanding, hanging comment that we did not deal with yesterday.*

*MR VAN DER NEST: Yes, yes, yes, and Mr Nunes makes that finding. He says so therefore in the arithmetic 512 out, but he says … the grace period policy enhancement did in fact deliver value."*

164 In his witness statement, the second respondent explained his understanding of the appropriate accounting treatment of the item, following the email exchange, as follows:

*"62.1 At ABIL group level, the insurance policy between Stangen and the Bank would be eliminated as part of the consolidation process. From a consolidated perspective the group was self-insured. The loan remained external to the group and the risk in question (e.g. death or illness) should therefore be reported in terms of IAS 39 and incorporated in the quantification of impairment. Upon consolidation*

*the insurance IBNR, which is a liability recognised in accordance with the IFRS4 insurance standard, is therefore replaced by an IAS 39 impairment provision; and*

*62.2 The insurer (Stangen) in its own financial statements (before any consolidating entries to eliminate inter-company transactions at an ABIL level), had a liability (IFRS4 insurance IBNR) to the extent that an insured event (e.g. death) had already taken place at year end, but which event had not yet been reported as a claim. The Bank would be able to measure its impairment charge so as to incorporate higher cash recoveries due to the insurance pay-out. If the Bank chose to raise a receivable from the insurer rather than include it in the recoverable amount of the loan, the corresponding credit would be to credit Profit and Loss. My recollection was that, in terms of presentation, if the receivable is raised, it should be netted off against the impairment allowance and not shown as a separate asset. The amount receivable from Stangen should therefore be taken into account in assessing the adequacy of impairments at the Bank level. I did not consider the impact of this consultation on the impairment model."*

165 In his oral evidence, the second respondent testified as follows:

> *"So in a nutshell the answer was that the impairment, the right to the future cash flows, is a right of ABIL that they will get from Stangen, not from the individual customers, but they should* ***not*** *record that as a separate asset so it should be recorded as part of our loan and impairments balances and therefore it* ***can*** *be taken into account in assessing whether there are adequate impairments at a bank level as well."*
>
> (emphasis in the respondents' written submissions)

166 Subject to what we say below, the evidence of the second respondent thus supported the first respondent's interpretation.

167 The first respondent in his witness statement said that his understanding of the outcome of the consultation was that "*the Stangen IBNR could be taken into account to justify the 'gap', because it represented a provision made by Stangen for amounts that it would pay the Bank for losses for which the Bank itself provided (through impairment provisions).*"

168 In his oral evidence he said that what was fed back to him by the second respondent was that *"we were, the Bank was entitled to account for that as an asset and, but that would, to simplify that process we could recognise it as a negative impairment against the bank or at the bank."* (emphasis added)

169 After the hearing, the committee invited further written submissions from the parties in regard to the above email exchange and, in particular, on whether -

> *"6.1 Mr Derwin's advice, as recorded in the email exchange was, in effect, that the Stangen IBNR could not be taken into account to justify or reconcile the 'gap', particularly having regard to the words emphasised in the extract from the email above;*[25]
>
> *6.2 On the information available at the time, and in the absence of quantification of the enhancement referred to in paragraph 680.2 of the first respondent's witness statement, there was no basis for treating the R512m as an asset in African Bank for purposes of filling the 'gap' at 30 September 2013?"*

170 In response, it was contended on behalf of the first respondent that -

> *"The essential point is that the addition does not mean that Messrs Derwin, Crowther and Jordan considered that the cash inflows represented by the IBNR could not be taken account of in the impairment provisions of the Bank. I.e., the non-recordal of an asset in the Bank is not equivalent to (and is in fact the opposite of) the amount not being taken into account to reduce the impairment provision in the Bank. The contrary interpretation is not only unsupported by the evidence but would make a nonsense of the consultation and how it was used and relied upon by the audit team."*

171 It was also contended on behalf of the first respondent that the second respondent's interpretation coincided with that of the first respondent and neither was challenged by the pro forma complainant in cross examination. This is so and the pro forma complainant conceded as much. However, against that stands

[25] Here referring to the words emphasized in the second respondent's supplementation of Derwin's advice in the former's email.

the failure by counsel for the first respondent squarely to confront Ms De Beer in cross-examination on her stance that the opinion was correct but misinterpreted by the first respondent. Even if the cross-examination can be read as such a confrontation, it remained incumbent upon counsel to lead the first respondent's evidence with direct reference to, and in contradiction of, the evidence of Ms De Beer in this regard. He could also have lead the evidence of Mr Derwin to say what he meant. Neither of these took place.

172 It was also argued on behalf of the first respondent, quoting the IRBA experts in the joint minute, that they *"agreed that 'Mr Jordan was entitled to rely on the technical consultation'".* However, it is necessary to read the full paragraph from which this extract is taken to appreciate their stance:

> *"Mr Jordan was entitled to rely on the technical consultation and the variation of the Stangen insurance policies represented some level of expected cash flow to African Bank. However there is no evidence of reliance on the files and he did not follow up on these by checking to ensure that there was no duplication with the assumptions in the cash flow model or the ACCI's. No substantive work was done on the quantum of the cash flows, nor was the different way of calculating an insurance IBNR and PV of cashflows for IAS 39 taken into account. There was no documentation. The portion of the R512 million corrected by the curator in 2014 represented cashflows which did not exist (i.e. they did not represent additional cashflows not already reflected in the model). The curator appropriately adjusted this as a prior period error."* (emphasis added)

173 If one considers the totality of the evidence, the correctness of the interpretation of the opinion was not a settled issue amongst the experts.

174 What then to make of the evidence and the opinion of Mr Derwin? The reality of the situation is that -

174.1 African Bank would have accounted for the cash flows from all of its loans, including those debtors with insurance policies, in the normal course and would have included impairment provisions in respect of those loans;

174.2 The effect of a death and a claim on the insurance policy would have been to substitute the cash flows from the debtor with those of the insurance company, not to generate new ones;

174.3 African Bank would have had no claim against the proceeds of the insurance policy ceded to it, greater than what was already owed and accounted for in African Bank in respect of the insured;

174.4 In those circumstances, to treat the IBNR as a distinct set of cash flows to the tune of R512 million over and above what was already recognised by way of the indebtedness to it, was to recognise a new asset in the Bank;

174.5 This is so whether that new cash flow is accounted for as a reduction in impairments charges or otherwise;

174.6 Even if the second respondent's addition in the email that *"no asset would be raised in the bank"* is to be considered ambiguous, once read together with what Mr Derwin said in the email exchange, quoted immediately before the second respondent's addition, in particular that -

> *"The cash flows received under the insurance policy are therefore proceeds paid on behalf of the borrower. In assessing the cash flows for impairment purposes, the insurance proceeds would be considered as a cash flow arising from the borrower and not a separate cash flow to compensate for a loss suffered."*

the only reasonable interpretation of the opinion was that it was impermissible to recognise the insurance claim as a new and distinctive cash flow in the Bank;

174.7 The correctness of this interpretation is borne out by the fact that by the time of the hearing, the impermissible double-counting was common cause.

175 On a conspectus of the above evidence, Mr Derwin's opinion precluded using the Stangen IBNR as a basis for reducing the gap between the model and the GL and does not provide a justification for the first respondent's having approached the audit of the gap on the basis that he did.

Other flaws in the auditing of the Stangen IBNR

176 Even if we assume that we are wrong in our conclusion in the preceding paragraph and are bound to treat the opinion as supporting the first respondent's treatment of the IBNR, there are further issues to be considered.

177 The first additional issue is that it is common cause that there was a complete documentation failure in relation to the Derwin opinion. The second respondent explains the position as follows:

> *"I forwarded the email to Mr Mavuka, requesting that a member of the audit team record this on a formal technical consultation to be signed off by Mr Derwin. I did not follow up on whether this was done. I now know that it was not. Although not recorded in a working paper, the accounting treatment was in line with my understanding."*[26]

[26] The final email in the exchange bears out the second respondent's evidence in relation to the request for documentation. At 23h41 on 17 October 2013, he addressed an email to Mr Mavuka, copied to the first respondent amongst others, which read:

> *"Hi Brian. Can we get a consult doc done by one of the team members and signed off by Trevor please."*

178 Documenting of a technical consultation includes generating a written record of the nature and scope of the enquiry in respect of which the consultation takes place, agreement of the advice with the consultor, recordal of the advice and documentation of its implementation.[27] A documentation process of this nature is particularly important, because it ought to eliminate any room for miscommunication either in the briefing of the consultant or the giving of the advice.

179 Absent proper execution of that process of documentation, there can be no entitlement on the part of an auditor to rely on the advice given. To hold otherwise would allow for abuse of technical opinions in justifying misstatements in financial statements and erroneous audit work. Accordingly we find that, even if the Derwin opinion is to be interpreted as sanctioning the acceptance of the Stangen IBNR as a basis for reducing the gap, in the absence of an appropriate documentation process, the first respondent was not entitled to rely on it in order to resist a disciplinary complaint of erroneous audit work in that regard.

180 The second additional issue is that even if one takes the opinion as the first respondent reads it, given his own concerns about double counting recorded in the working papers and given the wording of the opinion, it remained incumbent upon him to do appropriate audit work to ensure that there was indeed no double counting.

181 In this regard, despite Mr Chidgey's support for the first respondent's interpretation of the Derwin opinion, he conceded both the need for that audit

[27] See the discussion of the relevant standards in relation to charge 3.

work and the first respondent's failure to undertake it. The cross-examination in this regard included, inter alia, the following"

> *"MR SYMON: … the first thing you would do as an auditor is when there is a contention that amounts of money will come in from the captive insurer in order to pay the claims, the first thing you would do is examine whether there is no element of double counting already. [the content of the audit work is then described]. I take it you are in agreement with me on that?*
>
> *MR CHIDGEY: I do not think it would be the first thing that I would do; the first thing I would do would be to establish that there was an amount in Stangen which was payable to me, then I would look at what the risk of that was. The risk of double counting and I would act accordingly."*

182 On the issue of whether the requisite audit work was done, the cross-examination included the following:

> *"MR SYMON: … to the best of my knowledge … there is no working paper which investigates this issue. There is nothing to suggest that this work was done.*
>
> *MR CHIDGEY: It - well, there are, there is a working paper …[intervenes]*
>
> *MR SYMON: This work was done, the one I am talking about.*
>
> *MR CHIDGEY: Sorry, the double counting work?*
>
> *MR SYMON: Yes.*
>
> *MR CHIDGEY: Ja, I would agree, there is no working paper on that."*

Conclusion on the Stangen IBNR

183 On all of these bases, the Committee finds that the first respondent's audit work was culpably remiss in relation to his allowing management to use the Stangen IBNR as a basis for reducing the gap.

184 The question then arises as to whether his conduct was remiss in relation to the full amount of R512m. The first respondent testified that he also relied in this context on the "grace period" amendments to the Stangen insurance policies for "comfort" and without quantifying them. This is not an appropriate basis upon which to audit an item of this nature. However, given that it was quantified and recognised by the curator in 2014 in an amount of R216m, and the balance of R296m represents the only quantification of the double-counting on the evidence before the Committee, we will recognise the amount of R216m as legitimately reducing the gap. In those circumstances, the first respondent's audit work is flawed insofar as it pertains to the balance of R296m of the R512m Stangen IBNR.

185 A final point that needs to be dealt with in relation to the Stangen IBNR is whether the R296m arising from the double counting was appropriately characterised as an error in the 2014 audit rather than a change in estimate. In this regard, the committee agrees with the pro forma complainant that an acknowledged double counting of cash flows giving rise to an understatement of impairment charges in the amount of R296m, cannot fairly be characterised as a change in estimate. This is so notwithstanding that Mr Chidgey supported the first respondent's stance in this regard.

***The ACCIs***

Introduction

186 The audit work pertaining to the ACCIs is best considered on the basis of a chronology of the relevant developments. We first set out the chronology of the audit work and then analyse it, first from the point of view of documentation and then from a substantive perspective. Although not an ACCI, we also deal with the coverage effect under this heading.

The 2012 financial year

187 Mr Jordan testified that in the 2012 financial year there was a R340m gap between the impairment provision in the general ledger and that suggested by the model. According to the first respondent, "*2012 was the first year that the Bank's management at my behest focussed on substantiating the 'gap' between the amount of impairments recorded in the GL and the estimate yielded by credit modelling. I was uncomfortable with it, because I considered it to be aggressive but – as I explain below - there are some theoretical justifications for it and, depending on the audit evidence presented, it may be justified.*"

188 In the executive summary of the Final Report to the Audit Committee on the 2012 Audit for ABIL, Deloitte recorded *"a decrease in management's discretionary factor of R340m to R212m".*

The lead-up to audit working paper AB 5450

189 At the commencement of the 2013 audit, the first respondent requested the audit team to challenge management extensively on the 2013 ACCIs. This was because he had noted that the gap had increased substantially over previous years. According to the first respondent, the gap that had emerged in 2013 "*had an impact on me in terms of just a sheer magnitude in quantum and also, as I indicated earlier, a patchy collection history, or ACCIs history in the Bank*".

190 The three ACCIs under consideration in 2013 were described in the relevant working paper as follows:

190.1 The insurance call centre:

> *"During the current financial year African Bank went on a new collections initiative. An insurance call centre was put into place where clients that are non-performing are contacted and information about their reason for non-payment is obtained from them and they are informed about the insurance that they may qualify for. If customers qualify for insurance they are then informed about the documentation they need to submit."*

190.2 The insurance policy changes:

> *"Towards the end of the prior financial year and during the current financial year there were a couple of insurance policy changes which included some of the following changes:*
>
> *- The waiting period for retrenchments was changed from 90 days to 30 days.*
>
> *- Retrenchment definition was broadened."*

190.3 The tracing project:

> *"During the current financial year African Bank introduced new individuals in the tracing division. The division was supposed to follow up on customers who had signed tracing packs and agreed to resume*

*making payments to their loans but did not make payments as agreed. T[en]*[28] *individuals were put in place to follow up on such collections."*

191 The coverage effect was a model adjustment for an anticipated improvement in the economy in the next financial year. This was based on forecasts from economists from FNB and Nedbank.

192 The first step taken in the audit was to interrogate the extent to which prior year ACCIs were successful. A work paper was prepared in this regard. The increase in call centre staff had been successful and was still present in 2013, whereas two other initiatives, though successful, were no longer present in 2013.[29] Seemingly, the working paper also gave preliminary consideration to the three new ACCIs, excluding the coverage effect. Only the insurance call centre was found acceptable at a value of R192,853,989.[30]

193 In the week of 30 September 2013, management presented to Deloitte fresh calculations of the ACCIs based on gross, undiscounted cash flows in order to fill the R1.5Bn gap. This version was seemingly also presented at meetings between Deloitte representatives and the senior management of the bank on 9 and 10 October 2013 by Mr Roussos. He contended that these initiatives could conservatively raise an additional R1Bn.[31]

194 The audit team rejected this on the basis that it was incorrect to use the gross cash flows to estimate the reduction in the impairment provision and that the cash flows should be discounted at the discount rate used for non-performing loans.

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[28] "Two" appears in the relevant spreadsheet, but other documents refer to ten.

[29] The so-called "Ellerines Collections Hub" and the so-called "Second Chance Loan".

[30] This is the "pre-version" in the spreadsheet summary of the various versions of the ACCIs referred to below.

[31] This is "Version 1" in the spreadsheet summary of the ACCIs below.

This version presented by management was not kept on the audit file because it was superseded by subsequent work.

195 On 16 October 2013, Mr Roussos addressed an email to the first respondent as follows:

> *"Further to our discussion last night I have extended the model to 10 years. I have also changed the decay to 1% and also change the insurance income to R7,5m per month.*
>
> *I have also attached a document that Marius prepared (Stangen) that may help substantiate the insurance cash flows. As you can see he is predicting an additional R20m per month (I have used R7,5m)."*

196 The first paragraph of the email pertains to the spreadsheet containing the next iteration of the ACCIs. In this iteration, both gross and discounted values were given for the three ACCIs and the coverage effect. The discounted values were as follows:

196.1 Insurance call centre: R263,602,091;

196.2 Tracing project: R111,583,318;

196.3 Insurance policy changes: R233,106,332;

196.4 Coverage effect: R93,931,410;

196.5 Total R702 223 151.

197 This iteration was made available in the hearing, but does not reflect any audit work.[32]

[32] This is "version 2 from Roussos" in the spreadsheet summary and formed annexure TMJ179 to the first respondent's witness statement.

198 The document referred to in the second paragraph of the email was a PowerPoint presentation that recorded "Insurance Recovery Drivers (Credit Life)". The first one relates to the insurance policy amendments and gives an annualised value of R90m which is based on an amount of R7.5m per month.

199 Reference is also made in this document to the "grace period" amendment of the policy term referred to above in the discussion of the Stangen IBNR. Here the estimated value of this amendment is given at R150m per annum.

200 Reference is also made to other ACCIs which are not relevant and were not taken into account in the process of filling the gap, but provide a reconciliation with the R20m per month figure mentioned in the email from Mr Roussos.

201 Neither the email nor the attachments were included in the audit file which the first respondent acknowledged to be an error.

Audit working paper AB 5450

202 Further communications must have taken place between the audit team and management, because the next document in the sequence is audit working paper "5450 Collections Initiatives V2". We will refer to it as "AWP5450". This reflects management's presentation of new, lower values for the ACCIs and the same value for the coverage effect, applying a discount rate of 36.8%.[33]

203 Management's contentions in relation to this version of the ACCIs, as recorded in the "Summary" tab of AWP5450 were as follows:

[33] It is referred to as "AWP 5450" in the spreadsheet summary.

Discount rate applied to cashflows **36.80%**

| | Gross cashflows | Discounted value |
|---|---|---|
| Insurance call centre | 745,645,376 | 192,853,990 |
| Tracing project | 262,729,016 | 85,754,694 |
| Insurance premiums | 525,464,707 | 182,954,397 |
| | 1,533,839,099 | 461,563,081 |
| Coverage affect | | 93,931,410 |
| **Total** | | **555,494,491** |

| | monthly | Annualised |
|---|---|---|
| insurance cashflows | 1.00% | 12% |
| tracing | 1.00% | 12% |
| ins claims | 1.00% | 12% |

204 The left-hand column is the gross cash flows. The right-hand column is the discounted cash flows. The reference to "Insurance premiums" is a misnomer and in fact refers to the insurance policy change.

205 The outcome of the audit process is recorded in AWP5450 as follows:

Below are the audit teams calculations of the expected discounted values of the cash uplifts. They were recalculated using the anticipated average data collected and actual data in the first month of the initiative.

Low end number (Insurance call centre) : This is the clients calculation of the present value of the cash uplifts. The clients numbers were used as they were more conservative than our low end numbers used in our calculation.

High end number (Insurance call centre) : The high end number was recalculated using average data collected from the client.

| | Low End | | High End | Average |
|---|---|---|---|---|
| Insurance call centre | 192,853,990 | | 429,869,140 | 344,405,951 |
| Tracing project | - | | - | |
| Insurance premiums | - | | - | |
| | 192,853,990 | | 429,869,140 | |
| Coverage affect | 68,794,902 | | 86,141,839 | |
| Total | | | | |
| | **261,648,891** | | **516,010,979** | |
| | **Average** | 388,829,935 | | |

206 As appears from the foregoing, the audit team accepted the insurance call centre initiative and the coverage effect, providing for cash upliftment ranging between R261m and R516m with an average of R388,829,935. They rejected the tracing project and the insurance policy changes initiatives.

207 The audit working paper provides the following explanation for the rejection of the tracing project in the "tracing" tab:

> *"As per discussion with supervisors in the division the collections arising from this initiative has (sic) not been appropriately monitored and there were no set targets for the collections, therefore there was no supporting information to support the impact that a new tracing division is supposed to have. Therefore we do not deem the initiative to be successful."*

208 The reason for the rejection of the initiative based on the insurance policy changes is confirmed by the first respondent's witness statement as being that recorded in the "conclusions" section of the "Summary" tab as follows:

> *"Stangen made insurance policy adjustment that resulted in changes in the waiting period for retrenchment insurance claims. In the data used no correlation could be found between the increase in retrenchment claims and the change in policy. Therefore the clients cash upliftment in relation to the insurance policy changes is not considered to be reasonable or substantiatied."*

209 The structure of AWP5450 shows the audit work that was done. The audit work done for the insurance call centre is reflected on its own tab, "Call Centre Insurance", which, in turn, is based on the forecasted cash flows provided by the client which appear in the next tab entitled "Call centre Ins cashflows – Client".

210 The tabs follow a similar structure in relation to the insurance policy changes with the audit work under the tab "Insurance Policy Changes" and the cash flows under "Ins Pol Changes – Client".

211 The first respondent pointed out a disjunct between the "Summary" tab and the audit work in relation to the insurance policy changes. Whilst the "Summary" tab rejects the insurance policy changes, the audit work on the "Insurance Policy Changes" tab in fact verifies an increase in the total amount of claims when compared with the corresponding months in the 2012 financial year. The average increase is an amount of R11,617,470.81 per month.

212 Here, the final analysis commentary at the end of the audit work tab reads as follows:

> *"From the above data it can be seen that there has been an increase in the number of retrenchment claims in the current financial year. As per discussion with the Stangen audit team members the increase is largely a result of the change in the waiting period for the retrenchments from 90 days to 30 days. We calculated an average monthly increase from the prior year of R11,617,470. The client has used an estimation of R7,500,000 monthly increase and applied a 1% … factor for a period of 120 months".*

213 The next tab is the "tracing" tab. This contains both the forecasted cash flows and the audit work on the same page and reflects the comment quoted earlier in rejecting this item.

214 The next tab is the "Coverage Penalty" tab, referring to the coverage effect. In relation to this tab, the audit work was done in a separate tab which lists the tick marks. Tick mark F in this regard reads as follows:

> *"These percentages are the client's expectation that the South African economy is going to improve … in the future.*
>
> *As per inspection of FNB in their bank reports from the August 2013 Deloitte market data the economy is expected to grow by 2.8% and 2.9% in the 2014 year from 2.7% in the 2013 year. Therefore the client's expectation of an improvement in the economy is therefore considered to be reasonable (sic).*
>
> *Therefore an improvement in the economic environment would result in customers having more disposable income to pay their debts. As a result the impairments in the NPL would be expected to be lower. At the same time the Bank would be able to take on better quality clients that would be able to service their debt obligations."*

215 The final tab is the "Tickmarks" tab, providing explanations for various items appearing in the tabs of the spreadsheet.

<u>Developments after AWP5450</u>

216 The first respondent says in his witness statement:

> *"The audit team performed further work on version 2 of the cash uplift calculation, based on the additional evidence received from management and concluded that the initiative in relation to the insurance policy written by Stangen could also be accepted, giving rise to version 3 of the ACCIs working papers. In this version, the audit team concluded that we could accept two of the three ACCIs and would reject the newest of the three initiatives. Even though the evidence indicated that it would be successful, the least amount of evidence was available for its justification. Version 3 indicated that accepting approximately R672 million in ACCIs (including coverage effect) would be justified."*

217 No document is provided to substantiate version 3.

218 The next iteration of the ACCIs is the "ABL Impairments Overview",[34] a document that is prepared during every audit and which develops over time. It may be that the date on the document of 14 October 2013 does not represent the date of its final iteration. The document is addressed from Brian Mavuka "to ABIL audit file". The document was included in the audit file.

219 The section dealing with *"Difference between GL and Impairment Model"* provides as follows:

> *"A difference of R825m was identified when comparing the impairment charge per the impairment model and the amount recorded in the GL.*
> ...
> *The difference is due to management discretionary factors which have been taken into, (sic) management believe that there have been [initiatives] which have been taken into account in the current year which will result in the collections increasing resulting in a lower impairment charge. The collections initiatives have been documented below.*
>
> ***Collection initiatives:***
>
> *In the current year the following initiatives have been implemented by management and they are of the opinion that this will result in additional cash flows of R500 million projected over the 120 months, the audit team has tested the assessments of these initiatives and we have documented the findings below:*

[34] It is referred to as the "Mavuka Impairment Memo" in the spreadsheet summary.

*...*

*1. Change in insurance policy [i.e. the retrenchment benefit] ...*

*In the current year management change the waiting period for retrenchment claims from a three month waiting period to a one month waiting period, this initiative started at the beginning of the year and has resulted in additional cash flows projected by management of R7.5 million, with a decay factor of 1%, over a period of 120 months. Management used a discount rate of 35.8%, this rate has been tested by the audit team and AQS and is the correct rate taking into account In Duplum accounts at the original effective interest rate. This initiative has resulted in discounted cash flows of R 198 million. Based on the audit work performed by the audit team in work paper <5450>, this initiative appears to be working, and has resulted an increase in collections (sic).*

*2. Insurance call centre*

*In the current year management hired additional staff in the call centre to work purely on insurance claims, the call centre agents call clients that are non performing to find out why they are not paying their accounts and if the reason for the non-payment meets the definition per the insurance contract to constitute a claim the agents assist the client to claim from Stangen and pay off their African Bank loan. This initiative has resulted in discounted cash flows of R187 million over 120 months, based on the audit work performed by the audit team in work paper <5450>. The initiative is still in its infancy; the audit team were able to trace actual balances produced by management and validate them.*

*3. Tracing project*

*African Bank has always had a tracing department, the tracing agents follow up and trace the client once the call centre has not been able to get the client to pay a PTP (promise to pay) or they can't get hold of the client. In the current year, 10 additional call centre agents were hired and this resulted in additional cash flows of R165 million, based on the audit work performed by the audit team in the work paper."*

220 Referring in his oral testimony to the "disconnect" between this document and AWP5450, he said *"I probably asked the team to update, certainly that work paper 5450, because I would have seen that. I would have made comments on it."*

221 As appears from the document, it accepts all three of the initiatives but attributes different values from those reflected in AWP5450.

222 The first respondent confirmed that the workings reflected in the impairment memorandum did not find their way into AWP5450, something Mr Mavuka would have been responsible for doing. Nor was the first respondent aware of the whereabouts of those workings.

223 On 27 October 2013 the first respondent addressed an email to Mr Mavuka under the subject line "Cash uplifts initiative" which reads as follows:

> *"Brian please complete and also provide me with prior year initiatives for the 2012 & 2011 and how successful these were or not."*

224 To that email Mr Mavuka responds on the next day, 28 October 2013, under the same subject line saying *"Please information requested below"* and provides the following information:

> *"Management provided us with additional information in terms of the following actions taken:*
>
> - *Change in Insurance Policy 'reduction in retrenchment period from three months to one month'*
> - *Insurance call centre dedicated insurance call centre staff dealing with bank insurance claims*
> - *Tracing Initiative, during the current financial year African Bank introduced new individuals in tracing division. The division was supposed to follow up on customers who had signed tracing packs and agreed to resume making payments to their loans but did not make payments as agreed."*
>
> *This three initiatives (sic), have resulted in additional cash flows discounted over a 10 year period of R800m.*
>
> *[Reference is then made to the 2012 and 2011 ACCIs]"*

225 In his oral testimony the first respondent confirms that this document too was not included on the audit file. His testimony in relation to the email exchange was as follows:

> *"If you reflect back on some of those dates that are in those emails, this is quite late in the process. In fact on the 25th is when I am drafting the audit committee document. He and I have been in discussions*

*prior to this. We had looked at the same documentation that you have just been to. We had been deliberating around where we are as a result of the additional information that management have given us. Whether we are now satisfied around the additional comfort that management has given us, whether we can accept those further impairment initiatives.*

*I ask him in this email, to reflect that in the structure that I give him … I said to him this is what we are looking to do in terms of structuring it into the document, based on our findings. Please can you complete and can you provide me with additional comments on the prior initiative and how successful they were.*

*I ask him in this email to reflect that in the structure that I give him …*

*He then responds in the chain of the email with the information requested, and populated.*

*MR VAN DER NEST: Now he gives you the outcome, the three initiatives have resulted in additional cash flows discounted over a 10 years period, of R800m. Does he give you a calculation that underlies that?*

*MR JORDAN: No, not in this email."*

226 In his witness statement, the first respondent goes on to say the following:

> *"The way in which Mr Mavuka arrived at this amount was by adding up the discounted value of the cash flows arising from the tracing project (R85.7m), the insurance premiums (R182.9m), the 'coverage effect' (R93.9m) and the high-end value of the insurance call centre (R429.9m). The total is R792.5m, leaving an immaterial difference with the amount of the 'gap' by that stage (R825m). (The R792.5m is consistent with the amount of R792m indicated in Mr Burra's roll-forward memorandum as the 'net shortfall on the coverage')."*

227 The next development in the chronology was the final report to the audit committee for the purposes of the meeting held on 29 October 2013. The relevant part of the report provides as follows:

> *"Management discretion, being the difference between impairment model values and the GL, is R825m as at September 2013. According to management this amount takes into consideration the initiatives introduced in the current year that is expected to have a positive impact on future cash collections.*
>
> *We performed additional procedures on these collection initiatives to assess the reasonability of this 'cash uplift'. If annualised, decayed and discounted over 10 years, the period the actual impairment models use, these initiatives could produce an uplift of up to*

*approximately R825m. It must be noted that these initiatives are still in their infancy but have already resulted in increased cash receipts.*

*Since management has applied similar discretion in prior years, we back tested actual cash collected in the current year to the cash flow predicted in the previous year model. This back test showed that there was a strong correlation at approximately 98%."*

228 The next event relevant to the ACCIs was Mr Raubenheimer's quantification of the gap in his 29 October 2013 presentation to the risk committee which read as follows in this regard:

> *"The year-end impairments have been finalised with the following outstanding issues that will be finalised in 2014.*
>
> - *Model gap to GL of R925m will be mitigated through collections initiative valued at R500m*
> - *The remaining model gap of R425m is reasonable considering potential model error."*

After completion of the audit

229 The next development in relation to this issue, which post-dated the audit, is recorded in the first respondent's statement as follows:

> *"At the time of assisting in the preparation of the Deloitte submission to the Myburgh Commission, I became aware that the work papers that had been included and archived in the Bank's audit file reflected a preliminary conclusion made during the course of the audit (version 2) and had not been updated to document the basis for this changed conclusion. In the circumstances, I concluded that it was not appropriate to amend the file by supplementing for this oversight. However, I prepared an updated work paper (version 3) which reflected my best recollection of my conclusions at the time of finalising the 2013 audit."*

230 Reference is then made to another spreadsheet which was prepared by *"a different team … who had been assisting me in compiling my Myburgh Commission statement, sometime probably late 2014… a year after the audit [was] conducted".* This team excluded Mr Mavuka who had resigned from the

firm at the end of October 2013. This spreadsheet still records a rejection of the tracing project initiative. When asked to explain this, Mr Jordan said that the document was incomplete and had not ultimately been placed before the Myburgh Commission.[35] It provided the following audited version of the ACCIs:

there was a significant increase in insurance claims as a result of the changes in the policies.

| | Low End | High End | Average |
|---|---|---|---|
| Insurance call centre | 192 853 990 | 408 833 434 | 300 843 712 |
| Tracing project | - | - | |
| Insurance premiums | - | 182 954 397 | 91 477 199 |
| | 192 853 990 | 591 787 831 | 392 320 910 |
| Coverage affect | 58 794 902 | 86 141 839 | 77 468 370 |
| **Total** | **251 648 891** | **677 929 670** | |

Analysis

231 In this regard:

231.1 The R677.9m figure in the table is based on the high-end figure;

231.2 The total of the average figures is not given in the table but would be R469,789,280;

231.3 The high-end figure of R677.9m derived by the auditors is higher than the total value asserted by management, recorded earlier in the same document, of R566,049,852.

232 The committee was referred to a second document prepared for purposes of the Myburgh Commission with a view to adding it to the audit file and re-archiving

[35] This is referred to in the spreadsheet summary as the "First Myburgh version" and was annexure TMJ182 to the first respondent's witness statement.

the file. This was cautioned against by Mr Mike Comber, Risk and Reputation leader at Deloitte, and not done.

233 This document starts with a cover memorandum dated 28 October 2014 from the first respondent to the "African Bank Limited 2013 Audit File" with the subject line "Addendum to the audit file". The opening paragraph reads -

> *"The purpose of this memo is to provide additional information with regards to the 2013 African Bank Limited .... The information presented in this memo was known to Deloitte prior to signing of the opinion (unless stated otherwise), but not documented as such in the audit file."*

234 It attaches four addenda. Addendum 1 bears the heading "Impairments GAP analysis". It provides the following revised gap analysis:

| NPL GAP | *<5415B> J226* | -1 544 |
|---|---|---|
| ML overlay | *<5415B> W201* | 105 |
| **GAP** | | **-1 439** |
| Stangen IBNR | *addendum 2* | 512 |
| **GAP less insurance reserves** | | **-927** |
| ACCIs | *addendum 3* | 700 |
| **1. Initial net unmitigated gap** | | **-227** |
| Add back Stangen IBNR | *addendum 2* | -512 |
| Insurance ACCIs | *addendum 2* | 27<br>0 |
| **2. Revised net unmitigated GAP** | | **-469** |

235 Alongside the item of R270m in respect of insurance ACCI's is a comment "*to update the Insurance with Nithia's email*". This is not explained. Below the table appears the following:

> *"1.**Initial Gap analysis for the 30 September 2013 audit:***
>
> *The final gap between the value recorded in the general ledger and the value calculated by the specific impairment model (both NPL & ML) was R1.439 billion. At the time this gap was reduced by offsetting the Stangen IBNR (refer addendum 2) and the ACCIs. The implication of this was a net unmitigated gap of R0.227 billion. This gap represented a difference of 0.27% of gross advances and was therefore within the tolerable level of model difference.*
>
> *2. **Gap analysis for period subsequent to the 30 September 2013 audit.***

*Subsequent to the African Bank audit performed and the signing of the 30 September 2013 financial statements new information came to light which suggested that the offset of the Stangen IBNR reserve against the gap in the Bank was done in error and should therefore be disregarded which increases the gap. In addition to this, additional insurance ACCIs ... was realised during the period which was not initially recognised in the calculation of the gap. Note that this is figure (sic) Deloitte received from management and has not yet been vetted or audited by Deloitte. This balance should be set off against the new gap.*

*The final calculated gap amounts to R0.469 billion which represents 0.558% of the gross advances. This difference is below the tolerable model variation of 1%-2% and can therefore be accepted as reasonable."*

236 It was pointed out by the first respondent in his oral evidence that this latter analysis bore some resemblance to Mr Raubenheimer's quantification of the gap in his 29 October 2013 presentation to the risk committee, referred to earlier.

237 Addendum 2 to the document then goes on to explain the error in relation to the Stangen IBNR as follows:

*"As a result of these known but not quantified cash flows we were of the view that the Bank could raise 'an asset' with a consequent reduction in the impairment model gap for these additional cash flows.*

*As these cash flows had not been fully quantified at 30 September 2013, we, with hindsight, erroneously attributed the entire insurance IBNR value to this estimate."*

238 It estimated the error in this regard as increasing the overall GAP by R230 - R250m.

239 Addendum 3 bears the heading "ACCIs".[36] It is dealt with in more detail in the analysis of the ACCIs below. It included the following table in respect of the ACCIs:

[36] This is referred to as the "Second Myburgh version Addendum 3 table" in the spreadsheet summary and formed annexure TMJ182.1 handed up during the hearing.

| | R million |
|---|---|
| Insurance call centre | 408 |
| Insurance premiums | 183 |
| Coverage effect | 86 |
| | 677 |

240 Addendum 4 contains a version of AWP5450, the "Summary" tab of which gives identical results to those in what we refer to as the first Myburgh version above. The figure of R700m for the ACCIs in the table in addendum 1 was presumably based on this version of AWP5450.

241 As a final chapter in the chronology, subsequent to the hearing, a number of queries were raised by the committee in relation to the quantification of the ACCIs and written submissions were invited from the parties thereon.

242 It emerged from this process that in relation to the insurance call centre ACCI average amount in the audit team recalculation in AWP5450, the figure of R344,405,951 was incorrect and should read R311,361,565. However, nothing turns on this as the average at the bottom of the table of R388,829,934 is correct.

243 Also in relation to the insurance call centre ACCI -

243.1 in the client tab providing the cash flows, the 1% decay factor was dropped from the cash flow calculations after the first 15 months. It was queried whether this did not give rise to a material reduction in the projected benefit and was a material error. In response to this, both parties raised the point that the issue had not arisen in the evidence. The committee accepts this and accordingly proceeds on the basis that no error arose from the dropping of the decay factor.

243.2 a query was raised by the Committee in relation to the activation rate relied upon and whether that similarly did not lead to an overstatement of the value to be attributed to the ACCI.

244 On this latter issue, the following submission was made on behalf of the first respondent:

> *"No charge was brought against Mr Jordan that he had inappropriately assessed the assumptions underlying any of the ACCIs, and as far as we are aware, this topic was not covered with him in oral evidence."*

245 The first respondent also disputed that the incorrect activation rate had been used, focussing on the extent to which the three-month actual experience of the implementation of the ACCI as tested by the audit team outperformed the Bank's model.

246 The concluding submission on behalf of the first respondent in this regard is as follows:

> *"Whilst our calculations show that the forecast cash flow arising from the insurance call centre was significantly higher, i.e. R533.038m as compared to what the client's model was forecasting of R426.869m, we do not contend for the additional amount to be taken into account in the respondent's favour as this was not interrogated or evaluated in*

*2013 and the audit team concluded on the effectiveness of this ACCI. Rather, the R426.869m is the value that should be considered as this was what was audited and considered reasonable by the audit team at that time."*

247 The question of whether the amount of R426.869m is the value that should be considered is dealt with below. However, in view of the submissions made, for the purposes of our decision, we will assume the correctness of the activation rate employed in AWP5450.

248 In relation to the insurance policy changes ACCI, the question was raised whether, having regard to the fact that the initiative commenced at the end of the previous financial year at 30 September 2012, the cash collection effect of it had not already been included in the monthly cash flow receipts data and therefore could not be relied on to reconcile the gap either at or all or to the extent that it was. Both parties were of the view that the cash collection effect of the insurance policy ACCI had not been included in the monthly cash receipts data for 2013 and that the ACCI was not flawed on this basis. The committee accordingly assumes the correctness of the stance of the parties and bases its decision on the assumption that this did not represent a flaw in its computation.

249 A similar query was raised by the Committee in relation to the tracing project ACCI which had commenced in July 2012. Again, both parties were of the view that the cash collection effect of the tracing project ACCI had not already been included for 15 months in the monthly cash receipts data. Again, the Committee accepts the stance of the parties and proceeds on the assumption that no such flaw in computation affected the tracing project ACCI. The question of whether

it was appropriately considered in the audit work pertaining to the filling of the gap will be adjudicated on the evidence led during the hearing.

Documentation analysis

250 It will be apparent from the foregoing chronology that there was a serious failure as far as documentation of audit work is concerned. Essentially, proper documentation of the audit work largely ceased from the time when version 2 of the AWP5450 was prepared. This much is not in dispute and was readily conceded by the first respondent both in his evidence and in written and oral argument.

251 The documentation failure is surprising because of, amongst other things, the first respondent's call upon his audit team to ensure thorough documentation in the course of the audit because of the likelihood of it becoming controversial, the first respondent's concern about the scale of the gap compared to previous years, his having called upon his audit team to be astute to challenge management in relation to it, the extraordinary nature of an underlay, the difficult circumstances in which the bank found itself and the identification by the first respondent of the risk of management's wish to understate impairments in the particular circumstances of the matter.

252 Having regard to the extent of the documentation failure, the size of the underlay and the importance of both the audit in general and this particular component of the audit, renders his documentation failure culpable as improper conduct, regardless of the substantive questions of misconduct raised by the charge.

Introduction to the substantive analysis

253 The first respondent sought to characterise the flaws in his work in relation to the filling of the gap as essentially being confined to a non-culpable documentation failure and nothing more. It was contended that the requisite audit work in relation to the gap was both sufficient and that it was readily apparent from the further documentation put up in evidence and his and the second respondent's oral testimony as to what took place.

254 The pro forma complainant insisted that the auditing failures extended beyond documentation and resulted in a misstatement of the 2013 AFS of ABIL and African Bank by reason of the failure of management to provide sufficient audit evidence to demonstrate that it was able to fill the gap, and the first respondent's failure either to insist on an increase in impairment charges or, failing that, to modify his audit opinion.

255 What was the gap that was required to be filled? This was agreed by the experts at R1.559Bn. We have found above that, of that gap, only an amount of R216m could be substantiated with reference to the Stangen IBNR. That leaves a gap of R1,343Bn which had to be filled by the ACCIs.

256 On none of the iterations of the value of the ACCIs was that gap filled. However, purely for the purposes of the analysis of the ACCIs, we will assume in favour of the first respondent and for this component of the decision only, that the full amount of the Stangen IBNR could be used in substantiating the gap. This would leave an amount of R1.047Bn that had to be filled by the ACCIs. The approach of the first respondent was that, to the extent that he could demonstrate that there

was sufficient audit evidence to justify a value of R825m being attributed to the ACCIs, the remaining R222m could be justified with reference to the auditor's tolerable range, notwithstanding that it was above materiality. Again, we will assume in the first respondent's favour that this is so.

Analysis of the spreadsheet summary

257 The pro forma complainant produced a spreadsheet which summarised the various iterations of the gap and its substantiation. The document is essentially based on the witness statement of the first respondent, the annexures to it and his oral evidence. The spreadsheet is helpful in depicting in a single numerical and chronological sequence, the various iterations of the evidence put up to substantiate the filling of the gap. The version of it that appeared in the pro forma complainant's heads of argument, with minor adaptations by the Committee, is as follows:

| | | Pre-version | Version 1 | Version 2 From Roussos / TMJ179 | AWP 5450 Version 2 | | Version 3 | Mavuka Impairment Memo | Mavuka Email | Explanation of Mavuka email | Presentation to Risk Comm | 2013 Report to the Audit Committee | First Myburgh version TMJ182 | | Second Myburgh version - Addend 3 Table TMJ182.1 | Second Myburgh version - Addend 3 Text TMJ182.1 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ON FILE | | ✓ | ✗ | ✗ | ✓ | | ✗ | ✓ | ✗ | ✗ | ✗ | ✓ | ✗ | | ✗ | |
| MANAGEMENT'S CALCULATION | **Gross cashflows** | | 1500 | 1553.8 | 1553.8 | | | | | | | | 1553.8 | | | |
| | **Discount rate** | | 0% | 25.70% | 36.60% | | | | | | | | 35.80% | | | |
| | **Call centre** | | | 253.6 | 182.9 | | | | | | | | 197.8 | | | |
| | **Tracing project** | | | 111.5 | 85.7 | | | | | | | | 87.6 | | | |
| | **Insurance policy changes** | | | 233.1 | 182.9 | | | | | | | | 196.6 | | | |
| | **Total ACCIs** | | | 608.2 | 461.5 | | | | | | | | 472 | | | |
| | **Coverage effect** | | | 93.9 | 93.9 | | | | | | | | 93.9 | | | |
| | **Total** | | | **702.1** | **555.4** | | | | | | **500** | | **585.9** | | | |
| AUDITOR'S CALCULATION | **Call centre** | 192.9 | | | 192.8 | 429.8 | Accepted. | 187 | | 429.9 | | Accepted | 192.8 | 408.8 | 408 | 237 |
| | **Tracing project** | [illegible] | | | [illegible] | | [illegible] | 164 | | 85.7 | | Accepted | [illegible] | | [illegible] | [illegible] |
| | **Insurance policy change** | [illegible] | | | [illegible] | | Accepted. | 198 | | 182.9 | | Accepted | 182.9 | | 183 | 183 |
| | **Total ACCIS** | 192.9 | | | 192.8 | 429.9 | | 549 | | 698.5 | | | 192.8 | 591.7 | 591 | 420 |
| | **Coverage effect** | | | | 68.7 | 86.1 | Unknown | 0 | | 93.9 | | | 68.8 | 86.1 | 86 | [illegible] |
| | **Total** | **192.9** | | | 261.5 | 515.9 | **672** | **549** | **800** | 792.4 | | **826** | 261.6 | 677.9 | 677 | 420 |
| | **Average** | | | | **388.7** | | | | | | | | **489.7** | | | |

258 The spreadsheet splits between management's calculation in the upper portion and the auditor's calculation in the lower portion of the document. It provides totals for the respective calculations by management and the auditors. It then also tracks the acceptance or rejection (as the case may be) of the ACCIs through the various iterations. Where a value range is provided in respect of any ACCI, averages are provided in the bottom row.

259 The following observations may be made by way of an overview of the spreadsheet:

259.1 It is only the Mavuka email and the first respondent's explanation of it, and the 2013 final report to the audit committee that might be considered to be sufficient to fill the gap on the assumptions recorded above.

259.2 With only two exceptions, the tracing project continues to be recorded as having been rejected in the iterations of the ACCIs throughout, including the iterations emanating from preparation for the Myburgh commission. The exceptions are the Mavuka impairment memorandum and the 2013 report to the audit committee.

259.3 If regard is had to the "total" row for management's calculations, none of them assert an ability to fill the gap as quantified by the first respondent, with the highest figure being that attributed to the Roussos version 2 at R702.1m.

260 We proceed to consider the main iterations of the ACCIs to see whether the gap was filled and, if so, whether the requisite audit evidence was provided.

Analysis of early versions

261 Clearly the "Preversion" based on undiscounted gross cash flows was correctly rejected by the first respondent.

262 There is no evidence that the version of the ACCIs which was emailed by Mr Roussos on 16 October 2013, using a discount rate of 25.7% and providing a total across all of the ACCIs of R702.1m, was audited.

Analysis of AWP5450

263 The next version is that represented by AWP5450, which records extensive audit work that was performed on the various ACCIs. Management's calculation relied on the three ACCIs and the coverage effect and applied a discount rate of 36.8% giving a total of R555.4m.

264 Pursuant to their audit work, the audit team rejected the tracing project and the insurance policy change. It accepted the insurance call centre ACCI.

265 Having regard to the Committee's acceptance that the matter is to be decided on the basis that the correct activation rate was used on the insurance call centre ACCI, we find that the requisite audit work was done and that the first respondent acted reasonably in accepting that ACCI in part substantiation of the gap. The question of whether that permitted the first respondent to proceed on the basis of the high-end value of the insurance call centre ACCI is dealt with below.

266 As far as the coverage effect is concerned, it is clear from AWP5450 that audit work was done. But was the work done sufficient and reasonable?

267 In the view of the Committee, the starting point in this regard ought to have been the economic fortunes of ABIL itself. In this regard, amongst other things -

267.1 On 4 March 2013, Moody's downgraded the Bank's global senior debt and deposit ratings by one notch to Baa3/prime-3, from Baa2/prime-2;

267.2 On 21 February 2013, first and second respondent attended the annual trilateral meeting with the BSD and the board of ABIL where the respondents highlighted Ellerines' poor results;

267.3 On 17 April 2013, Deloitte met with the BSD and, inter alia, highlighted the deterioration of cash collections, a matter of which Deloitte had become aware during the course of the 2013 financial year;

267.4 On 2 May 2013, ABIL issued a SENS announcement saying that they expected earnings for the six months ended March 2013 to decline by 25% to 28% compared to the six months to March 2012;

267.5 On 5 August 2013, ABIL announced to the market that it intended to raise share capital through a rights offer;

267.6 On 18 September 2013 ABIL issued a trading statement in respect of its results to 31 August 2013 in which they announced an expected increase in the impairment provision against NPLs and went on to point out that the operating environment in which both the retail and

credit businesses operated continued to prove challenging with little respite expected in the next year.

268 The reasoning of the audit team in accepting the coverage effect is set out in tick mark (f) quoted earlier. It is brief and generalised. There is no reference whatsoever to the well-documented, negative outlook within ABIL as referred to above. It accepts, in substantiation, reports from FNB and Nedbank economists of an increase in economic growth forecast for 2014 of between 0.1 and 0.2% above growth for the 2013 year. There is no record in the working paper of any attempt to critically examine whether this is a legitimate basis for substantiating this component of the gap. There is no attempt to contrast it with the negative outlook internally in ABIL.

269 Although the evidence of the first respondent and, to a lesser degree, Mr Chidgey supported the coverage effect, one must also take into account Mr Chidgey's comment that *"what the macroeconomic effects of economic growth are is probably something way beyond one paragraph in an audit file"*.

270 Taking into account the foregoing circumstances, the Committee finds that it was neither reasonable nor justifiable for the audit team and the first respondent to conclude that management was entitled to apply a coverage effect. In the circumstances, the coverage effect ought not to have been accepted and the high end and low-end totals in AWP5450 reduced accordingly.

271 On the other hand, AWP5450 presents a disjunct between the "Summary" tab in relation to the insurance policy change and the tab setting out the analysis of that change, "Insurance Policy Changes". Whilst the auditors at that stage rejected

this item in the "Summary" tab, the analysis showed a clear average increase in the monthly receipts by way of claims by retrenched persons and concluded as follows:

> *"Analysis*
> *From the above data can be seen that there has been an increase in the number of retrenchment claims in the current financial year. As per discussion with the Stangen audit team members the increase is largely as a result of the changes in the waiting period for the retrenchments from 90 days to 30 days. We calculated an average monthly increase from the prior year of R11 617 470. The client has used an estimation of R7,500,000 monthly increase and applied a 1% decay factor for a period of 120 months."*

272 In respect of this particular item, the committee accepts the first respondent's evidence that the necessary audit work is reflected in AWP 5450, but that there was simply a failure to update the "Summary" tab due to mere oversight. It is clear that audit work was done in this regard and the totals for the ACCIs analysed in this audit working paper ought to have been increased to take this into account. Given that the amount of R182,954,397 represents the net present value of cash flows based on the figure of R7.5m per month, which is lower than the average actual increases reflected in the analysis, it seems reasonable to accept this amount as reducing the gap.

273 The totals for AWP5450 ought therefore to have reflected the total low end and high end figures as follows:

273.1 Low end : 375,808,387;

273.2 High end: 612,823,537;

273.3 Average: 494,315,962.[37]

274 As we move beyond AWP5450 into the field of undocumented audit work, the committee notes that, whilst it would be unreasonable in a disciplinary hearing not to admit sound evidence of undocumented audit work, the evidentiary burden (not onus) cast upon an auditor relying on undocumented audit work must be that much greater. Not only should the evidence be reasonably convincing but, as far as possible, it should be objectively verifiable, even though it is not to be found in the audit file, and there should ideally be an explanation for the failure to document. This increased burden is appropriate because -

274.1 The standards are strict in requiring documentation;

274.2 Documentation is foundational to the auditing function and indispensable to forming sound judgements;

274.3 Properly documented evidence is contemporaneous and therefore not subject to the impact of the passage of time on the retention and recollection of evidence;

274.4 Without saying that it is a phenomenon of this matter, lightly allowing undocumented evidence of audit work creates the potential for abuse and after the fact, benevolent reconstruction; and

274.5 The facts outside the audit file generally fall within the exclusive knowledge of the auditor.[38]

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[37] Taking into account the correction of the average figure referred to earlier.

[38] *Gericke v Sack* 1978 (1) SA 821 (A) at 827; *Union Government (Minister of Railways) v Sykes* 1913 AD 156 at 173-4.

275 The next version of the ACCIs working papers is something that exists only in the form of an averment in the first respondent's witness statement where he described his version 3. At that stage, he says that the insurance policy changes initiative was found by the audit team to be acceptable. On this basis, he contends, accepting an amount of R672m in respect of the ACCIs, including the coverage effect, would be justified.

276 We have already found that acceptance of the coverage effect would not be justified. No breakdown is provided of the R672m. The appropriate figures for those reflected in version 3, if it existed, would have been those given above in AWP5450, which excluded the tracing project and ought to have excluded the coverage effect.

ABIL Impairments Overview Memorandum

277 The next iteration to be considered is the ABIL impairments overview memorandum prepared by Mr Mavuka. Although this document was included in the audit file, it purports to reflect the outcome of audit work but not the audit work itself. It refers as its basis for the audit work to AWP5450 but does not correlate with it.

278 As far as the insurance policy change initiative is concerned, it records discounted cash flows in an amount of R198m. This is inconsistent with the audit work in AWP5450 which only goes as far as to justify an amount of R182,954,397.

279 In relation to the insurance call centre, a figure of R187m is given which correlates with the low-end figure in AWP5450 of R192m.

280 As far as the tracing project is concerned, this is the first evidence of acceptance of that as an ACCI. The relevant paragraph in the memorandum reads as follows:

> *"African Bank has always had a tracing department, the tracing agents follow up and trace the client once the call centre has not been able to get the client to pay a PTP (promise to pay) or they can't get hold of the client. In the current year, 10 additional call centre agents were hired and this resulted in additional discounted cash flows of R164m based on the audit work performed by the audit team and work paper 5450."*

281 However, as we know, AWP5450 confirms rejection of the tracing project and, in the "tracing" and Summary" tabs, provided good reason for doing so. Given the absence of support for the tracing project in AWP5450,[39] its rejection in iterations of AWP5450 at the time of preparation for the Myburgh Commission, along with the absence of documentation or other evidence of audit work showing why the reasons for its rejection in AWP5450 had since fallen away, the committee is unable to find that the acceptance of the tracing project initiative in the Mavuka impairment memorandum (and the first respondent's reliance on it) was justified.

282 Taking the corrected figures for the insurance policy change initiative and the insurance call centre, this document serves only as limited evidence to support a total value for the two reasonable ACCIs of R376m.

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[39] Note that Mr Chidgey's comment on the audit work pertaining to the tracing project was as follows:

> *"Well, that was not the only thing on the audit file but if you look at 5450, the testing working papers certainly had incomplete conclusions on them and in one case tracing initiative it was – there was no work on it at all."*

<u>The Mavuka email</u>

283 The next iteration to be considered is that described as the Mavuka email.

284 The exchange of emails between the first respondent and Mr Mavuka on 27 and 28 October 2013, together with the evidence of the first respondent in his witness statement and his oral testimony are all set out above. The committee makes the following observations in regard to this evidence:

284.1 The email from Mr Mavuka to the first respondent insofar as it pertains to the 2013 audit is extremely terse. It consists of 7 lines of information inserted into the first respondent's email of 27 October 2013 to which he was replying. The relevant portion reads as follows:

> *"Management provided us with additional information in terms of the following actions taken:*
>
> - *Change in insurance policy: reduction in retrenchment waiting period from 3 months to 1 month.*
> - *Insurance call centre, dedicated insurance call centre staff dealing with bank insurance claims.*
> - *Tracing initiative, during the current financial year African Bank introduced new individuals in tracing division. The division was supposed to follow up on customers who had signed tracing packs and agreed to resume making payments to their loans but did not make payments as agreed.*
>
> *This (sic) three initiatives have resulted in additional cash flows discounted over a 10 year period of R800m."*

285 The email makes no reference to any audit work whatsoever. All that it records is the provision by management of "additional information" in relation to the ACCIs. There is no indication what the additional information consisted of. There is no indication of what steps were taken to verify or audit the information. There is not even a breakdown as to how the amounts are distributed between the three

different ACCIs. There is no reference to the coverage effect. There is no indication as to how the total moved from that or those reflected in AWP5450, which included the coverage effect, to the R800m reflected in the email. Nor does the email say how the problems identified in AWP5450 in relation to the tracing project had been overcome.

286 The first respondent in his witness statement gives a very precise breakdown of the amount each ACCI purportedly contributed to the R800m, which is lacking in the Mavuka email itself. Yet he provides no evidentiary basis in the witness statement for this breakdown. Nor is there any information provided as to why the first respondent or the audit team had a change of heart in relation to the tracing project.

287 The coverage effect returns to the calculation despite the fact that it is not referred to in the Mavuka email itself. This places in doubt the reliability of the purported explanation in the witness statement. Nor is any justification provided for its inclusion at the level of R93.9m, when the auditors' high-end figure for the coverage effect in AWP5450 is only R86m. The amount of R93.9m was the unaudited amount claimed by the client. In any event, we have not found any amount in respect of the coverage effect to be justified. There is also no apparent justification for the inclusion of the insurance call centre at its high-end value, when the Mavuka impairment memorandum included it at its low-end value.

288 In the circumstances, the explanation in paragraph 703 of the first respondent's witness statement, unsupported by any document, raises more questions than it answers.

289 The oral testimony given in this regard and quoted earlier is vague and contributes nothing to the shortfall in information. In particular, no inference can be drawn from this evidence of there having been any audit work done beyond AWP5450 to justify the amount claimed. Nor does the evidence support the R800m substantiation of the gap which the first respondent asserts.

2013 Final Report to the Audit Committee

290 The next iteration of the filling of the gap is the sum of R825m referred to in the report to the audit committee. The only portion that refers to audit work is that part which reads:

> *"We performed additional procedures on these collection initiatives to assess the reasonability of this 'cash uplift'. If annualised, decayed and discounted over 10 years, the period the actual impairment models is used, these initiatives could produce an uplift of up to approximately R825m. It must be noted that these initiatives are still in their infancy but have already resulted in increased cash receipts.*
>
> *Since management has applied similar discretion in prior years, we back tested actual cash collected in the current year to the cash flow predicted in the previous year model. This back test showed there was a strong correlation of approximately 98%."*

291 The first respondent was asked where Mr Mavuka had obtained the amounts that are referred to in this paragraph. The answer given was working paper 5450 and the first respondent went on to say:

> *"The underlying data is all contained in 5450 which is the primary source of the information. So leading up to this stage Mr Mavuka and I were in constant discussions not just on ACCIs or model differences but on other aspects of the impairment and the audit in general but he was the senior manager responsible for assisting me and Mr Burra and others in the conduct of the audit of impairments. So leading up to that stage – and I cannot remember the exact instances but would have been on telephonic conversations and he would have been in the audit room, if not the Saturday, the Friday before, having discussions around how we are concluding on ACCIs in general. (sic)"*

292 The reliance on the figure of R825m taken together with the oral testimony of the first respondent suggests that the figure of R825m derives from the Mavuka email. Indeed this email was exchanged in the context of the preparation of the 2013 report to the audit committee. All of the criticisms pertaining to the Mavuka email therefore apply equally to the reference to the globular sum of R825m in the report to the audit committee. The only evidence of audit work which correlates (in terms of methodology, not the amount of R825m) is AWP5450. Yet that clearly does not support the amount of R825m.

293 Nor is the reference to back testing of any assistance where –

293.1 We have not been referred to any evidence of such back testing; and

293.2 The initiatives were in their infancy.

294 Accordingly, the 2013 report to the audit committee does not provide a sufficient basis on which to infer that the requisite audit work was done and the audit evidence gathered.

Documents from Myburgh Commission preparation

295 The remaining evidence relied upon by the first respondent is that which arose from the abortive attempts to prepare updated audit working papers for purposes of the Myburgh Commission.

296 As a general comment on these versions, to the extent that they reflect work performed subsequent to the financial year end, they cannot be relied upon by the first respondent in his defence. In any event, none of them numerically filled the gap, as appears from the spreadsheet summary above.

297 Nonetheless, aspects of these post-audit versions are significant. Firstly, although the table in addendum 3 reflects the insurance call centre ACCI at R408m, the narrative immediately above it says that -

> *"[t]his initiative has resulted in discounted cash flows of R187/237 million over 120 months".*

298 Secondly, the tracing policy was rejected in each of the iterations of this further work. Addendum 3 to the second document documented this as follows:

> *"Based on the audit work performed by the audit team in work paper addendum 4, this initiative does seem to be working, however could not be substantiated due to the lack of evidence in tracking additional cash flows. Therefore it was considered not appropriate to take into account when calculating the total cash upliftments. Subsequent to this work paper and in discussion with head of collections (Roussos) we gained enough comfort on the merits of this initiative however considered it prudent and inconsequential not to update the work paper."*

299 The reference to "this work paper" we understand to be a reference to addendum 3, which was prepared after the audit and the 2013 financial year. Even if a reference to AWP5450 was intended, a discussion with management in which comfort was gained does not amount to proper audit work. The latter part of the extract is also contradicted by the earlier part.

300 Thirdly, in relation to the coverage effect, the following is documented:

> *"It does however include the so called coverage effect, which is not fully substantiated as it predicts that future impairment coverage will return to a normal cycle. This was on the understanding that current year coverage was high due to once offs, for example the in duplum adjustment. The impact of this coverage effect is not significant in the context of the overall ACCIs"* (emphasis added)

301 This suggests that the coverage effect was in fact also rejected even though it was included in the table in addendum 3 quoted above.

302 The first respondent's comments alongside the document bear out that this second Myburgh version was not complete.[40]

High end value version

303 One remaining iteration remains for consideration. The first respondent argued that it is possible to support the amount of R792.4m on the basis of AWP5450 as it stood at the time when it was documented on the audit file.

304 In making this argument, the first respondent relies on the high-end value of the insurance call centre ACCI at R429.8m. If this amount is to be preferred to the average and low-end values, regard must be had to the audit work that was done on this ACCI at the "*Call Centre Insurance*" tab. The approach of the auditors is described in that tab as follows:

> "1. *Obtained an understanding as to how the insurance call centre works from discussion held with Bibi Tilly (Manager: Outbound Calls) and Andre Bezuidenhout.*
> 2. *Obtained the collections statements and details of the accounts making up the collections from Andre Bezuidenhout.*
> 3. *Selected a sample of accounts from the listing and traced the insurance claims to the client's account to obtain assurance that the claims were correct.*
> 4. *Plotted a graph based on the client's actual call centre insurance collections and the projected collections.*
> 5. *Commented on the analysis.*"

305 There follows an analysis of the collections statistics obtained for the months of July, August and September 2013. For each worked month, information is provided as to the number of "*clients worked where documents expected*", the

[40] This is referred to as the "Second Myburgh version Addendum 3 text" in the spreadsheet summary and formed annexure TMJ182.1 handed up during the hearing.

number of "*clients docs received*", the number of "*accounts docs received*", the number of "*accounts paid*" and the total claims amounts paid. The result is as follows:

**Explanation of client docs**

**Clients Worked Where Docs Expected:** This is the number of clients contacted where documents are expected.

**# of Clients Docs received:** This is the number of clients documents received.

**# of Accounts Docs received:** This is the number accounts where documents are received. On average a customer has more than one loan product with African Bank

**Worked Month:** **2013/07**

| Clients Worked Where Docs Expected | # of Clients Docs Received | # of Accounts Docs Received | # of accounts paid | Claim Amounts Paid |
|---|---|---|---|---|
| 6,272 | 1,024 | 2,386 | 1,024 | -5,806,503.12 |

**Worked Month:** **2013/08**

| Clients Worked Where Docs Expected | # of Clients Docs Received | # of Accounts Docs Received | # of accounts paid | Claim Amounts Paid |
|---|---|---|---|---|
| 5,553 | 1,056 | 2,239 | 765 | -3,773,736.70 |

**Worked Month:** **2013/09**

| Clients Worked Where Docs Expected | # of Clients Docs Received | # of Accounts Docs Received | # of accounts paid | Claim Amounts Paid |
|---|---|---|---|---|
| 6,148 | 985 | 2,292 | 294 | -1,498,589.84 |

**Actual Insurance Claims Paid**

| Month | Claim Amounts Paid | | % of accounts paid over number of accounts Docs received. | Average Claim | MOM % Movement | Average Client Docs worked on |
|---|---|---|---|---|---|---|
| Jul-13 | 5,806,503.12 | | 43% | -5670 | | 6,272 |
| Aug-13 | 3,773,736.70 | | 34% | -4933 | -11.464% | 5,553 |
| Sep-13 | 1,498,589.84 | | 13% | -5097 | 10.715% | 6,148 |
| | | **Average** | **30%** | **-5,234** | **-0.3744%** | **5,991** |

306 This data was then analysed by way of a graph and a narrative as follows:

Graph Depicting Insurance call centre claims and projected claims

307 The narrative below the graph reads as follows:

> *"The projections are based on an expected monthly claim of 6000 accounts to be worked on by the insurance call centre in the first month. The client used an activation factor of 30% and an average claim of R4000. The client then applies a decay factor of 1% on the total claims on a monthly basis. The claims are not expected to be received in one month but over a period of four months with 10% expected to be received within 1 month of contact, 25% in the 2nd month, 35% in the 3rd month and 30% in the 4th month.*
>
> *The above graph was plotted using the clients expected monthly claims and the actual monthly claims received. It does not take into account that the claims are expected to be received over a period of 4 months.*
>
> *Over the three months that the insurance call centre has been in place the average number of accounts worked amounted to 5991. Which is more in line with what the client has used in their projections as the client*

*used 6000 as the number of clients to be contacted in the first month and applied a decay factor of 1% to the expectation.*

*We calculated an average claim of R 5234 per month and the client had an average claim of R4000. When looking at the month on month average claims we can see that the average claims are decreasing at an average rate of 0.3744%.*

*In the first month of the Insurance call centre being in place the claims received amounted to R 5 806 503.12. The actual collections are less than the clients projected collections of R 7 200 000 in the first month. Over a 3 month period the actual collections are significantly lesser than the projected claims collections."*

308 The upshot of the analysis done by the audit team is that the ACCI had, at the time of preparation of the working paper, not yet proven a success.

309 It was pointed out on behalf of the first respondent that the ACCI model was based on an assumed four-month collections recovery period in respect of work done in one month. This is borne out by a comment to this effect in the narrative quoted immediately above. If this was so, then the figure of R5,806,503.12 for the first month of July would also have exceeded the first three months predicted for collections arising from July forecast in the cash flows in the "Call centre insurance cash flows – Client" tab. This forecast amount for the first three months based on July work totals R4,680,000.

310 However, it appears that the actual collections data upon which the analysis was performed was not presented on this basis in the "Call Centre Insurance" tab because it includes the following explanation:

> ***"Collections tracking***
>
> *As per discussion with Andre Bezuidenhout (Collections: Insurance Call centre manager) the collections are tracked from the time that the*

> *customer is contacted up until they make payments. For instance the customer would be contacted in July and insurance would only make payment in August. <u>When insurance amount is paid in August the collection would be assessed as a collection that related to August.</u>"* (emphasis added)

311 This suggests that in the analysis section, dealing with actual collections, the cash received in each month is the total of the cash actually received and not received over a three-month period attributable to the work done in that month. That tends to support the negative analysis of lower than predicted collections in the "Call Centre Insurance" tab.

312 The net result is that AWP5450 does not in and of itself provide justification for the adoption of the high-end value for the insurance call centre. Moreover, there was a reluctance on the part of both parties to delve into the correctness of the calculations underlying the analysis, where the issue had not been explored in the evidence, which the Committee respected.

313 Reliance was, however, also placed on the oral evidence given by the first respondent in this regard. In his oral evidence, the first respondent was referred to the worked collections data on the "Call Centre Insurance" tab and then the following was put to him:

> *MR VAN DER NEST: Now I am instructed by people who know this way better than I, that if you populate July, which is month 10, with the actual information i.e. – line 10. Sorry line 10 which is the month of July, instead of taking those assumed numbers you put in the actual from that which occurred in July; i.e. number of accounts worked 6272, activation at 43% and average claim [5670] and with the decay factor of 1% it will give you close to or very close to the actual high end of the claim. I am just putting it to you.*
>
> *MR JORDAN: Yes that is correct.*
>
> *MR VAN DER NEST: Okay, and there is apparently a way you can do it on the model, but I have not the knowledge to do that. If we then go to the next tab, insurance policy.*

*MR JORDAN: And maybe just to clarify Mr van der Nest you would use those inputs, the tab 3, which is call centre insurance cash flow client, is as received from the client except for the highlighting and the inclusion of the tick mark 'k'. But this is a client prepared schedule. And if you look at the electronic version of this document you will see that in line 10, in other words, the July month, those are hard [coded] numbers. They do not reference to anywhere else in the document. It is an assumed start point. The team would have then had a different start point if they go back to actual.*

*Because remember that we said at the summary, that we would use actual data in order to validate whether management had the right information and so, if you use the actual data from the call centre insurance tab, in the middle of that is where you would then pick up the number that you are referring to. The actual average claim for July was 5670, the activation rate was 43% and the amount of the claim was R5.8m. And so if you go back and you populate that, in that role, you would come up with a higher number."*

314 The calculation was not performed, and in those circumstances reliance cannot be placed on this evidence.

315 In any event, even if the first three months suggested, contrary to the analysis recorded in the working paper, that the initiative was performing well, the committee is of the view that a diligent auditor would not, on the basis of the first three months of collections data, when the initiative was still in its infancy, perform the audit work on the basis of the high end value. Accordingly, AWP5450 does not justify the use of the high-end value for the insurance call centre.

316 Even if we had placed reliance on this evidence, it does not appear to bear out the high-end value claimed, when tested against the actual collections. If one -

316.1 assumes that the actual collections in the analysis in AWP5450 were received over a four-month period (relative to the month of the contact work) in the percentages referred to;

316.2 adjusts for the fact that only three months of collections data were available (so that the 30% forecasted collection in the fourth month is ignored); and

316.3 does the calculation referred to by Mr van der Nest and inputs into the tab "Call centre Ins cashflows-Client" containing the forecasted cash flows, the higher numbers referred to in the above evidence (6272 accounts, activation rate at 43% and claim average of R5670, adjusted to omit the 30% in the fourth month),

one derives a forecasted aggregate over the three months for the collections pertaining to the contact work in the first month, of R10,704,234. Yet the actual collections for those three months were R5,806,503. This suggests that the Insurance Call Centre ACCI was underperforming by some 46%.

317 The next amount which the first respondent contends can be substantiated with reference to AWP5450 is an amount of R85.7m in respect of the tracing project. As we have already pointed out, save for two instances in respect of which there is no evidence of proper audit work, the tracing project was rejected throughout. Nor was our attention drawn to any audit work that was done on this working paper, or anywhere else, to demonstrate that the thinking and information behind the initial rejection of the tracing project had fallen away. Moreover, the figure of R85.7m is the figure contended for by the client. It is not the product of any audit work.

318 The final figure claimed on the basis of AWP5450 is R93.9m in respect of the coverage effect. For the reasons given earlier, the Committee does not agree

that the coverage effect ought to have been taken into account at all. In any event, the audited range for the coverage effect in AWP5450 was a high-end value of R86,141,839 and a low end of R68,794,902. The figure of R93.9m is based on the unaudited amount asserted by the client and would not appropriately be relied on by an auditor, even if the coverage effect was validly to have been accepted.

Conclusion on the ACCIs

319 Having regard to the foregoing analysis, even if one were to accept in its entirety the Stangen IBNR as a contributor of R512m to filling the gap, there was by no means sufficient appropriate audit evidence, either on the audit file or apparent from the written and oral evidence presented in the hearing to justify the filling of the gap with the ACCI's, including the coverage effect. Notwithstanding the problems identified above in relation to the high-end value for the insurance call centre (which would, in turn, undermine the reliability of the average value), the Committee accepts that sufficient audit evidence was presented to accept the average figure for the insurance call centre ACCI at R311,361,565 and to accept the R182,954,397 figure advanced by the client in respect of the insurance policy changes. That gives a total of R494,315,962 as the contribution of the ACCIs to filling the gap, leaving an unfilled balance of R552,691,038, leaving out of account the audit failure on the Stangen IBNR.

320 If the audit failure on the Stangen IBNR is factored in, the unfilled balance is R848,684,038.

321 By the time the matter was argued, we did not understand the first respondent to contend specifically in relation to this charge that a gap of this order could be justified on the basis of the auditor's tolerable range.[41] However, we address this issue in case we are under a misapprehension in this regard.

322 The issue of the auditor's tolerable range is dealt with more fully in relation to charge 9 and we make reference there to the relevant standard, ISA 540. Suffice it at this juncture to point out the following:

322.1 Management's point estimate is defined in paragraph 7(d) of ISA 540 as the amount selected by management for recognition in the AFS as an accounting estimate. In the context of charge 1, this was the figure in the GL.

322.2 Paragraph 13(b) of ISA 540 requires that before getting to the application of a range, one must *"test how management made the accounting estimate and the data on which it is based"*. Management relied on the Stangen IBNR and the ACCIs, including the coverage effect, to arrive at their point estimate.

322.3 The foregoing analysis in relation to charge 1 shows that already at this stage of the application of ISA 540, both management and the first respondent fell short in the respects that we have identified. One would only be able to proceed to apply the range in terms of paragraph (d) of ISA 540 once one had audited management's process for arriving at a

---

[41] First respondent's rebuttal heads record as follows:

> *"Mr Jordan described the tolerable range in his witness statement in the context of in duplum; and we do so too, because that is the only charge to which it is central."*

point estimate, and found that it was reasonable. Here it was not, for all the reasons we have given in relation to this charge.

322.4 If we ignore paragraph 13(b) and assume that the first respondent was entitled to proceed directly to an application of paragraph 13(d) of ISA 540, paragraph 13(d)(i) of ISA 540 requires the auditor to do the following in developing a range:

> *"If the auditor uses assumptions or methods that differ from management's, the auditor shall obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate."*

322.5 No audit evidence was presented to us of any such process in relation to the gap that forms the subject matter of charge 1, other than what is set out above in the discussion of this charge. If we apply paragraph 13(d)(i) to that evidence, then a proper application of this paragraph of the standard would have led to the understanding that management's assumptions and methods in arriving at their point estimate were deeply flawed. That meant that the comparative exercise using an auditor's range as envisaged in paragraph 13(d) of ISA 540 could not get out of the starting blocks, because there were no "relevant variables" to form the basis of the comparison.

323 In any event, the first respondent's rebuttal heads make it clear that -

> *"[t]he tolerable range is not a device to justify errors. It is an auditing technique which ... is described in the audit standards, pertaining specifically to the auditing of account balances subject to estimation (i.e.*

> *advances or impairments), to assess whether a difference is an error (or misstatement) in the first place",*

and it is clear here that there were indeed errors in the attempts to fill the gap and the audit work related to that.

324 In the circumstances, the first respondent should have insisted that the Bank increase its impairment charges in the amount of R848,684,038. The first respondent did not do so and in those circumstances ought to have modified his audit opinion.

325 It should be borne in mind though that the amount alleged in the charge as the total unfilled gap was R656m. Our finding must therefore be confined to that amount.

***Audit work***

326 We turn to the ISAs that the first respondent is charged with breaching. In the hearing, the parties focused, appropriately, on the substance of the charges, rather than on precisely how each of the relevant auditing standards were or were not infringed. The approach was that if the substance of the charges was established, a conviction should follow, and if the substance of the charges was not proven, an acquittal should follow. Our written decision will reflect that approach. As a result, we will not dwell on the full details of the infringement of each ISA. We have nonetheless applied our minds to each of the ISAs separately for each charge to ensure that in proving the substance of the charge, there has been proof of an infringement of each ISA.

327 Paragraph 15 of ISA 200 *Overall Objectives of the Independent auditor and the Conduct of an Audit in Accordance with the International Standards on Auditing* requires that –

> *"[t]he auditor shall plan and perform an audit with professional scepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated."*

328 Paragraph 17 of ISA 200 requires as follows:

> *"To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion."*

329 For the reasons given above, the first respondent failed to maintain an attitude of professional scepticism and further failed to plan and perform the audit to reduce risk to an acceptable level as not all the cash uplift initiatives or reconciling items could be substantiated. He accordingly breached ISA 200.

330 Paragraph 17 of ISA 220 *Quality Control for an Audit of Financial Statements* requires that –

> *"[o]n or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the management team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued."*

331 For the reasons given above, the first respondent failed to ensure that there was sufficient appropriate audit evidence to support the conclusions reached on the difference between the impairment model and the impairment provision recognised in the AFS. He accordingly breached ISA 220.

332 Paragraph 5 of ISA 230 *Audit Documentation* provides –

> *"The objective of the auditor is to prepare documentation that provides:*

*(a) a sufficient and appropriate record of the basis for the auditor's report; and*

*(b) evidence that the audit was planned and performed in accordance with ISAs and applicable legal and regulatory requirements."*

333 Paragraph 6(a) defines *"audit documentation"* as –

> *"The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached."*

334 "*Audit file*" is defined in paragraph 6(b) as follows:

> *"One or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement."*

335 Paragraphs 8 to 10 then provide as follows:

*"Form, content and extent of audit documentation*

8. *The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:*
   *(a) The nature, timing and extent of the audit procedures performed to comply with the ISAs and applicable legal and regulatory requirements;*
   *(b) The results of the audit procedures performed, and the audit evidence obtained; and*
   *(c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgements made in reaching those conclusions.*
9. *In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:*
   *(a) The identifying characteristics of the specific items or matters tested;*
   *(b) Who performed the audit work and the date such work was completed; and*
   *(c) Who reviewed the audit work performed and the date and extent of such review.*
10. *The auditor shall document discussions of significant matters with management, those charged with governance, and others,*

> *including the nature of the significant matters discussed and when and with whom the discussions took place."*

336 For the reasons given above, the first respondent failed to document how the information referenced in paragraph 6.2 of the charge and AWP5450 in particular was addressed in forming a final conclusion. Indeed, on the first respondent's own version, there was a significant documentation failure in respect of most components of the audit of the gap between the impairment model and the impairment provision in the general ledger. This has already been canvassed above. As pointed out there, the documentation failure would have been sufficient to constitute misconduct, even if the other components of the charge had not been proven.

337 Paragraph 5 of ISA 330 *The Auditor's Responses to Assessed Risks* provides as follows:

> *"The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level."*

338 For the reasons given above, the first respondent failed to take into account all relevant evidence in forming an opinion. The evidence that the cash uplift initiative amount of R825m could not be fully justified or substantiated, was not taken into account by the first respondent. The first respondent further failed to resolve the contradiction between AWP5450 and the report to the audit committee. He accordingly breached ISA 330.

339 Paragraph 5 of ISA 450 *Evaluation of Misstatements Identified During the Audit* reads as follows:

> *"The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial."*

340 Paragraphs 11 and 12 of ISA 450 then provide as follows:

> "***Evaluating the Effect of Uncorrected Misstatements***
>
> *11. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. When making this determination, the auditor shall consider:*
>
> *(a) the size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and*
>
> *(b) the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, accounts balance or disclosures, and the financial statements as a whole.*
>
> *12. The auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they individually or in aggregate have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected."*

341 For the reasons given above, the first respondent failed appropriately to accumulate and assess the misstatement related to the difference between the impairment model and the impairment provision. He accordingly breached ISA 450.

342 Paragraph 6 of ISA 500 *Audit Evidence* provides as follows:

> *"The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence."*

343 For the reasons given above, the first respondent failed to obtain sufficient audit evidence to draw reasonable conclusions on the difference that existed between the impairment model and the general ledger. He accordingly breached ISA 500.

344 Paragraphs 16 to 18 of ISA 700 *Forming an Opinion and Reporting on Financial Statements* provide as follows:

> *"16. The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.*
>
> *17. If the auditor:*
>
> *(a) concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or*
>
> *(b) is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement,*
>
> *the auditor shall modify the opinion in the auditor's report in accordance with ISA 705.*
>
> *18. If financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, the auditor shall discuss the matter with management and, depending on the requirements of the applicable financial reporting framework and how the matter is resolved, shall determine whether it is necessary to modify the opinion in the auditor's report in accordance with ISA 705."*

345 For the reasons given above, the flawed audit work identified in this charge contributed to the first respondent's failure to modify the report on the AFS of ABIL and the AFS of African Bank for the year ended 30 September 2013 for the material misstatement referred to in paragraph 6.3 of the charge. He accordingly breached ISA 700.

346 Paragraph 6 of ISA 705 *Modifications to the Opinion in the Independent Auditor's Report* provides as follows:

> *"The auditor shall modify the opinion in the auditor's report when:*
>
> *(a) the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or*

*(b) the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement."*

347 The flawed audit work identified in this charge contributed to the first respondent's incorrectly issuing an unqualified audit opinion in respect of the consolidated AFS of ABIL and the AFS of African Bank for the year ended 30 September 2013 in circumstances where it was inappropriate to do so. He accordingly breached ISA 705.

***Conclusion***

348 In the circumstances, the committee is satisfied that the pro forma complainant has proven sufficient of the material averments in the first charge for a conviction. The committee accordingly finds the first respondent guilty of infringing disciplinary rules 2.1, 2.5, 2.6 (in respect of section 130.1(b)[42] of the Code), 2.7 and 2.17 on the basis set out above in respect of the first charge. Although all of these rules were breached, the conviction on this charge is a single, separate conviction for purposes of sanction.

[42] Section 100.5(b) and 130.3 deal with maintaining skill competence and skill at the required level, including continuing professional development. Insufficient evidence was presented to justify a conviction in this regard.

## THE SECOND CHARGE

### *Introduction*

349 The essence of charge two is that the impairment provision against performing loans in the 2013 AFS of ABL was materially insufficient as a result of management having incorrectly selected the point of impairment at CD4 instead of CD1.[43] In the result net advances were materially overstated.

350 The main elements of charge 2 are as follows:

350.1 African Bank's 30 September 2014 AFS indicate a material restatement. The restatement related to the definition of a loss event changing from CD4 to CD1. This was to align with market practice and the requirements of IAS 39, *Financial Instruments: Recognition and Measurement*. The cumulative impact was downward adjustments of R3,674 billion and R2,529 billion for the 2013 and 2012 financial years, respectively.

350.2 The restatement related to non-compliance with IAS 39 and by definition was an error.

350.3 The First Respondent knew that -

350.3.1 the impairment point had been identified as *"an issue of audit significance"*;

[43] CD stands for "contractual delinquency" and "CD1" would mean that a debtor had missed one monthly instalment due under the loan agreement. "CD4" would mean that a debtor had missed four monthly instalments. Four monthly instalments missed was regarded as a state of contractual default at the Bank.

350.3.2 African Bank's credit team initially identified a credit IBNR provision of R1,317 billion based on a CD1 impairment point and provided this to Deloitte during the audit;

350.3.3 A consultation memorandum[44] said: "*Therefore, given the loss event examples, a CD1 categorisation should be considered a loss event. However, if ABIL is able to provide evidence that categorisation as CD1 to CD3 does not impact the expectation of future cash flows - that is, CD1 to CD3 loans generally are recovered in future periods - then it would be appropriate to consider CD4 to be the loss event that triggers the recognition of impairmen*t." In this regard –

(a) the audit file does not contain documented procedures as to whether African Bank provided such evidence; and

(b) the rationale in the memorandum appears to equate eventual recovery of loans with impact on future cash flows.

350.3.4 On 11 October 2013, Mr Raubenheimer provided an audit team member with a summary of the 12-month PD[45] per CD bucket for June 2010 to August 2012. These indicated a consistent flow of accounts from CD0 to CD4, with around 60% of CD1 accounts moving to CD4, around 85% of CD2

[44] This being an opinion provided by the technical expert, Ms Ranchod.

[45] Probability of default.

accounts moving to CD4 and around 93% of CD3 accounts moving to CD4. The audit file does not document a consideration of this analysis.

350.3.5 In an email of 10 October 2013, Mr Raubenheimer asked Mr Kirkinis for permission to tell Deloitte that it was his view that the CD1 versus CD4 point of impairment resulted in an understatement of impairments of R1,123 billion.

350.4 The impact of the R3,674 billion error, relating to the definition of a loss event, on ABIL's consolidated AFS and African Bank's AFS was material and the AFS were therefore materially misstated. An unqualified opinion was therefore incorrectly issued in contravention of ISA 700 *Forming an Opinion and Reporting on Financial Statements and* ISA 705 *Modifications to the Opinion in the Auditor's Report*.

350.5 In this context, the first respondent breached ISA 200, ISA 220, ISA 230, ISA 330, ISA 540, ISA 500, ISA 700 and ISA 705.

351 The points raised by the first respondent in his defence in the plea may be summarised as follows:

351.1 He denies that IAS 39 required him to force management to adopt a so-called "point of impairment"[46] at CD1 and that this would have led to any change in the impairment calculation;

[46] The term "point of impairment" is used in quotation marks throughout the plea and the first respondent's witness statement seemingly to be consistent with the first respondent's stance that the point of impairment was never

351.2 *"[c]alculating an IBNR provision for impairment of loans in the category CD0 to CD3 in the way that African Bank did in relation to the 2013 AFS, was an IAS 39 compliant methodology";*

351.3 *"African Bank's colloquial description of CD4 as the 'point of impairment' or the 'loss event' was a misnomer since loans in the category CD0 to CD3 were also impaired, albeit on a portfolio basis";*

351.4 IAS 39 is based on an 'incurred loss' model and not on an 'expected loss' model where losses expected as a result of future events are not recognised in terms of the then applicable accounting framework;

351.5 The approach adopted by the big four banks in South Africa of adopting CD1 as the impairment point across most of their portfolios assumes that all credit losses which will be suffered on a delinquent loan result from the past event which give rise to the first missed instalment;

351.6 The approach adopted by African Bank in the 2012 and 2013 AFS assumes that -

351.6.1 only once a customer has cumulatively missed four or more payments, is it more than likely that a loss event or a series of loss events have occurred which would give rise to all future cash flow shortfalls on that loan;

---

selected as CD4, because an IBNR-type impairment was always applied from CD0. No finding contrary to this stance should be read into the omission of quotation marks in this decision, save where the context indicates otherwise.

351.6.2 for loans that were in CD0 to CD3, all credit losses associated with the loan were attributable to the event that had caused the missed payments if management had an expectation that the loan would move directly to CD4 over the shortest possible period;

351.7 By contrast, in the 2014 restatements of the 2013 AFS, African Bank (through the curator) adopted an approach that assumed that an increasing proportion of the credit losses associated with the loan is attributable to the events that gave rise to one, two or three missed instalments;

351.8 By adopting CD0 "dirty" as the impairment point in the 2014 AFS, the curator assumed that such losses are attributable to loss events that occurred up to 36 months ago, even though the customer has caught up its payments since that time, such that the customer was no longer a full instalment in arrears;

351.9 *"There is no more, or less, evidence available for any of these assumptions. Their validity is therefore a matter of professional judgement in the circumstances. The assumption adopted by the big four banks would result in larger impairment provisions without directly-observable objective evidence of the link between credit events and credit losses, while that followed by African Bank would result in less impairment provisions in the same circumstances … The fact that industry practice was to recognise a more conservative provision does not itself demonstrate that such a provision is*

*supported by evidence. It is not apparent to Mr Jordan what audit evidence would be available within any bank (or African Bank in particular) to assess the cogency of any of these assumptions.";*

351.10 It is for this reason that the first respondent adopted an approach which assessed the overall appropriateness of the level of credit impairment provisions. On this basis the overall levels of impairment in the 2013 AFS were *"appropriate, if less than prudent."*;

352 The management of ABIL and African Bank, consistent with the practice of a number of microlenders at the time, were of the view that CD4 was a more appropriate impairment point because African Bank's customers frequently missed instalments but generally then resumed regular payments with the result that the loan value was generally fully recovered (with added interest) even if over a longer period. One missed instalment did not necessarily indicate a loss event to which all future losses could be ascribed;

352.1 Globally, the inadequacies of ISA 39's incurred loss model have been recognised. In this regard the Financial Crisis Advisory Group noted in its report of 28 July 2009 that:

> *"difficulties in applying the [incurred loss] model – in particular, identifying appropriate trigger points for loss recognition – in many instances [have] delayed the recognition of losses on loan portfolios."*

352.2 These inadequacies are borne out by the fact that in 2018 IFRS9 was introduced, which is based on an expected loss rather than an incurred loss model;

352.3 The curator's approach over-estimated the losses suffered and historical experience indicates that both the old management's and the curator's estimates were materially different from what actually transpired;

352.4 Given that the appropriate impairment point *is "highly subjective and bedevilled by conceptual weaknesses in the incurred loss model*", it is a "*matter of considerable management judgement and discretion*" and that is why the first respondent did not insist on a change in the impairment point in 2013, given the overall appropriateness of levels of impairments as a result of the adjustments already processed in 2013;

352.5 *"The Bank's description of loans that were past due, up to three months, in the 2013 AFS clearly indicated that the impairment calculation in respect of those loans was different from the impairment calculation for loans in categories CD4 and above";*

352.6 The restatement of the 2013 AFS by the curator in the 2014 AFS was based on an impairment point of CD0, not CD1, which was even more conservative than the big four banks;

352.7 The first respondent admitted that the audit team during the planning stage of 2013 identified the impairment point as an issue of audit significance, but did so in the context of a risk that management could override African Bank systems to reflect loans that were in reality in the CD4 bucket or higher as loans that were in CD3 or lower;

352.8 The first respondent admitted that on or about 30 September 2013 Mr Raubenheimer presented a calculation to the audit team indicating that if CD1 was used as a definition of a loss event instead of CD4, credit impairment provisions for loans in the CD0 to CD3 brackets would be R1.317 billion. However, (a) this was contrary to the bank's credit impairment policy insofar as it classified loans as NPL before they had reached CD4, and (b) Mr Raubenheimer later indicated to a meeting of the risk committee on 29 October 2013 that he was satisfied with the levels of credit impairment recorded in the 2013 AFS, although he would have preferred about R500 million more;

352.9 The first respondent admits the consultation with the Deloitte technical accounting department (per Ms Ranchod) and notes that the audit working paper referring to it also records that ABIL justified its approach on the basis that CD1 loans are usually recovered and that it is only when they move to CD4 that recovery is no longer expected;

352.10 The first respondent admitted that this approach equated eventual recovery of the loans with impact on future cash *flows "which is an equivalent approach to arrive at the conclusion that little (if any) impairment is required where a loan is eventually recovered even if over a longer period*";

352.11 The first respondent admits that on 11 October 2013 Mr Raubenheimer sent an email to Mr Burra containing a graph summarising the 12-month PDs for loans in the CD0 to CD4 buckets

for loans which originated between June 2010 and August 2012 which indicated that –

352.11.1 between approximately 15% and 18% of loans in CD0 defaulted in accordance with African Bank's loss definition (ie over time moved to CD4);

352.11.2 between approximately 52% and 63% of loans in CD1 defaulted;

352.11.3 between approximately 77% and 85% of loans in CD2 defaulted; and

352.11.4 between approximately 90% and 96% of loans in CD3 defaulted.

352.12 The first respondent denied that consideration of this analysis was not documented in the audit file;

352.13 The first respondent questioned the appropriateness of calculating PD's over a 12-month period because this methodology inter alia assumed that all losses incurred in the next 12 months resulted from a single past event that had already occurred;

352.14 The first respondent admitted the despatch by Mr Raubenheimer of the email to Mr Kirkinis on 10 October 2013 but denied that either he or the second respondent were aware of it at the time. However, Mr Raubenheimer conveyed similar information to Mr Burra on a number of occasions before 10 October 2013.

352.15 Finally, the first respondent denied that the 2013 AFS of ABIL or African Bank were materially misstated or contained an error of the magnitude of R3,674 billion.

353 Unlike the position with the remaining charges, the experts were not able to arrive at an agreed summary of points upon which they were in agreement and points in respect of which they were in dispute. The reason for the failure to reach agreement is described by the Deloitte experts as follows:

> *"One fundamental reason why it became clear that it would be impossible to agree a single version of this document is that, in the view of the Deloitte experts, the charge is based upon an incorrect main premise. The main premise of the charge is that CD4 was used by African Bank as an impairment point and that loans less delinquent than CD4 were not impaired. That is not correct: CD4 was used as a calibration point, in common with market practice, and loans less delinquent than CD4 were impaired albeit on a basis that was not in all aspects consistent with market practice. The IRBA experts' analysis remains tethered to this main premise which gives rise to a number of subsidiary premises. The Deloitte experts have pointed out the incorrect nature of the main premise and, accordingly, consider it unnecessary to engage with all subsidiary premises."*

354 The Deloitte experts go on to record that:

> *"[a]t the heart of the disagreement between the IRBA experts and the Deloitte experts are the following key questions:*
>
> *2.6.1 whether or not impairment was recognised on loans in CD1-3;*
>
> *2.6.2 whether the fact that the 'impairment point' was described as being CD4 was inherently noncompliant with the IFRS and consequently whether the changes in the 'impairment point' to CD1 must have represented an error;*
>
> *2.6.3 the extent to which the use of historic cash flows inherently compensates for potential over-impairment arising from including the impact of future loss events; and*
>
> *2.6.4 whether sufficient audit work was performed in order to justify reliance on Ms Ranchod's consultation."*

355 On these points, the experts' competing stances were as follows:

355.1 On the first main point of disagreement –

355.1.1 the Deloitte experts view was that through the mechanism of the IBNR, a provision for impairment was made in respect of loans in the CD1 to CD3 buckets.

355.1.2 According to the IRBA experts, the IBNR provision did not cater for the impairment required on loans in the CD1 to CD3 buckets which had already experienced a missed payment as a loss event and which would not roll directly into CD4.

355.2 On the second main point of disagreement –

355.2.1 the Deloitte experts' view was that the change from CD4 to CD1 in the 2014 restatement, did not represent the recognition of impairments against loans that previously had no impairment recognised – rather, it represented creating a third category of loans in CD1 – 3 between the IBNR and the portfolio-specific impairment with the impact from a methodology perspective being primarily the removal of the loss emergence factor in the computation. This does not represent an error but rather a change in the manner in which an impairment is assessed and computed.

355.2.2 The IRBA experts insist that the restatement of R2.2 billion in respect of loans from CD1 to CD3 in 2014 reflected an error as defined in IAS8. The error was made because

African Bank did not appropriately consider the requirement of IFRS which required that a provision be made for loans that had experienced a loss event. Loans in CD1 to 3 had all experienced a loss event as they had at least one missed payment and this changed the expected cash flows. Loans with the status CD1 to 3 should have been subject to normal impairment provisioning, not an IBNR provision.

355.3 On the third main point of disagreement –

355.3.1 the Deloitte experts were of the view that an analysis of historical cash flow recoveries and loans will inevitably include the impact of all events that have in any way influenced cash collections over the full recovery period. As a result, where there is more than one loss event that takes place over such recovery period, the actual cash flow performance on historic loans will reflect the impact of more than one loss event. The impact of including second loss events results in deteriorated recovery patterns and this is not self-correcting with the passage of time or the addition of more data and its impact is to add a certain number of future loss events (and therefore to reduce expected recovery into the point in time estimation where such loss events are in fact required to be excluded).

355.3.2 In response the IRBA experts said that IAS 39 requires that once a loss event or any objective evidence of impairment

has occurred, expected future cash flows had to be discounted applying the original effective interest rate. Using historic cash flows to make this estimation arguably anticipates another loss event in the future. However, expected future cash flows by their nature call for judgement and recalibration from time to time, which, in turn, allows for correction over time. There was no specific evidence to suggest that CD4 actually confirmed a second loss event. If the concept of the second loss event is accepted, essentially what African Bank did is only to provide for impairment on loans which had experienced the second loss event or which were expected to experience a second loss event by not making any further payments before they reached CD4 (i.e. going directly to CD4). The effect was that loans which had experienced a first but not a second default or delinquency had zero impairment against them, which is not in compliance with IFRS.

355.4 In relation to the fourth main point of disagreement, the Deloitte experts were of the view that sufficient work had been done to justify reliance on the Ranchod opinion. The IRBA experts believed otherwise.

356 Part of the expert process, separate from the summary or precis (where no agreement was reached), involved a series of responses by the IRBA experts to questions posed by the Deloitte experts and recorded in spreadsheet format. In

respect of many of these questions, the experts were either in disagreement or any agreement reached was substantially qualified. However agreement, or qualified agreement was reached on the following items of significance (where there are qualifications, these are contained in the footnotes; the paragraph numbering does not reflect that in the original document):

356.1 *"Entities, including banks, implemented IAS 39 using diverging interpretations and practical applications."*

356.2 *"Banks (Deloitte experts' preferred term) / "certain lenders" (IRBA experts' preferred term) used their historical data in regard to a similar loan or portfolio of loans to estimate future cash flows. The historical data of cash flows may in the case of a single loan (and will, in the case of portfolios of thousands or millions of loans being tracked over a protracted period of time after initial default) incorporate the effect of more than one loss event."*

356.3 *"ABIL and the Bank's way of implementing the impairment rules of IAS 39 conformed in some ways and differed in some ways from that generally applied by the "big banks", both in 2013 and 2014. In relation to the Bank:*

356.3.1 *Both in 2013 and 2014, the Bank described loans in buckets CD0 to CD3 as 'performing loans' or portfolio specific impairment, which was consistent with banking practice and*

*was a function of those loans not yet having reached the defined point of 'default';*[47]

356.3.2 *In 2013, the Bank considered loans to be 'cured' (i.e. their CD classification reverted to CD0) if they had made three consecutive payments of more than 90% of the contractually required payments. In 2014 these loans were retained in CD0 but treated as CD0 'dirty' unless their last delinquency was more than 36 months ago;*

356.3.3 *In 2013, the Bank described loans in buckets CD4 to CD12 as "nonperforming loans" or NPLs. While describing CD4+ loans as NPLs was consistent with banking practice, "big banks" often wrote off loans earlier than CD12";*

356.4 *"In regard to impairment calculation methodology:*

356.4.1 *In 2013, the Bank did not separately recognise an IBNR and a portfolio specific impairment over advances in buckets CD0 to CD3. Instead, it recognised a portfolio (IBNR) impairment over advances in each of these four buckets.*[48]

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[47] IRBA experts : This description does not deal with whether the Bank considered "default" and "loss event" to be synonymous. In 2013 it did, in 2014 the "loss event" was defined as any default / non payment.

[48] IRBA experts : The purpose of the IBNR was to identify the provision needed if these loans had suffered a loss event which would cause it to go directly into CD4 without any further payments. The unrecorded event was this event, and not the already known defaults being in CD1, CD2, CD3 or CD dirty. The provision was collective and not per bucket.

356.4.2 *In 2013, the Bank calculated its IBNR provision over advances in buckets CD0 to CD3 by way of the following formula -*

*IBNR = Sum of advances in each bucket x roll rate for that bucket x flow LGD x LEF for that bucket.*

356.4.3 *The "roll rate" was calculated in a similar way to a PD insofar as it measured the possibility of a loan rolling to "default"; however it measured this probability over the period it would take such loan to sequentially roll directly to default given its current CD status.*[49]

356.4.4 *The value of the LEF differed across different CD buckets, increasing in size as the delinquency increased. In 2013, the Bank utilised an LEF of 7/30 (or 23.33%) for CD0, 37/60 (61.7%) for CD1, 67/90 (74.4%) for CD2 and 97/120 (80.8%) for CD3 in buckets CD0 "dirty" to CD3.*[50]

356.4.5 *In 2014, the Bank recognised an IBNR over bucket CD0 'clean', and a PSI*[51] *over advances in buckets CD0 'dirty' to CD3";*[52]

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[49] IRBA experts : *"Agreed. This ignored the fact that these loans had already experienced a loss event."*

[50] IRBA experts : *"The IRBA experts refer to 507.3 and 508 of TMJ's witness statement which describe how he understood the terms."* Committee comment: These LEFs are an approximation. In fact they were calculated differently across the different loan books, depending on the different loss emergence periods determined for each of the books. The Bank also used a different LEF for each loan bucket, although Deloitte did not do so in the auditing process. See further below.

[51] A PSI is a portfolio specific impairment.

[52] IRBA experts: *"This IBNR looked for events other than default. For CD0 clean it was R487 million, almost as big as the R585 million over the entire CD0-CD3 PL book in the prior year."*

356.4.6 *In 2014 the Bank applied an LEF for CD0 "clean" and no LEF for CD0 "dirty".*[53]

357 A final point of agreement between the experts is recorded in the Deloitte experts' recordal in relation to the second charge as follows:

> *"The IRBA experts and the Deloitte experts agree that delinquency (being non-compliance with repayment terms) represents an example of a loss event and that it would be incorrect not to perform an impairment assessment on portfolios of delinquent loans."*

***The relevant standard***

358 The adjudication of the second charge turns on the interpretation and application of IAS 39 *Financial Instruments: Recognition and Measurement*, which was the standard applicable at the time of the preparation of the 2013 and 2014 AFS. It has since been replaced.

359 The standard represents a document that must be interpreted according to the relevant legal principles governing interpretation. The dictum of Wallis JA in *Natal Joint Municipal Pension Fund v Endumeni Municipality* pertaining to the interpretation of documents, is relevant, particularly the following aspect of it:[54]

> *"Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence. Whatever the nature of the document, consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is*

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[53] IRBA experts : *"No LEF was needed for CD0 dirty - The event had already occurred."*

[54] 2012 (4) SA 593 (SCA) ([2012] 2 All SA 262; [2012] ZASCA 13) para 18.

*directed and the material known to those responsible for its production. Where more than one meaning is possible each possibility must be weighed in the light of all these factors. The process is objective, not subjective. A sensible meaning is to be preferred to one that leads to insensible or unbusinesslike results or undermines the apparent purpose of the document. Judges must be alert to, and guard against, the temptation to substitute what they regard as reasonable, sensible or businesslike for the words actually used."*

360 Paragraphs 58, 59, 62 and 63 are the most important paragraphs of IAS 39 for purposes of the second charge. We quote the relevant paragraphs verbatim, but set the provisions out and add emphasis in a way that facilitates interpretation:

***"Impairment and uncollectability of financial assets measured at amortised cost***

*58. An entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets measured at amortised cost is impaired. If any such evidence exists, the entity shall apply paragraph 63 to determine the amount of any impairment loss.*

*59. A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if,*

- *there is objective evidence of impairment*
- *as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and*
- *that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets*
- *that can be reliably estimated.*

*It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment.*

*Losses expected as a result of future events, no matter how likely, are not recognised.*

*Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the holder of the asset about the following loss events:*

*(a) significant financial difficulty of the issuer or obligor;*

*(b) a breach of contract, such as a default or delinquency in interest or principal payments;…*

*62 In some cases the observable data required to estimate the amount of an impairment loss on a financial asset may be limited or no longer fully relevant to current circumstances. For example, this may be the case when a borrower is in financial difficulties and there are few available historical data relating to similar borrowers. In such cases, an entity uses its experienced judgement to estimate the amount of any impairment loss. Similarly an entity uses its experienced judgement to adjust observable data for a group of financial assets to reflect current circumstances (see paragraph AG89). The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.*

*63 If there is objective evidence that an impairment loss on financial assets measured at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognised in profit or loss."* (emphasis added)

361 Having regard to the words "reliably estimated" in paragraph 59, and the emphasised portion of paragraph 62, a measurement process involving reasonable estimation applying professional judgement is contemplated by paragraph 63.

362 Paragraph 62 cross-refers to paragraph AG89, which also provides guidance in understanding the paragraphs referred to and how they must be applied:

*"Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. ... Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect and are directionally consistent with changes in related observable data from period to period ...The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience."*

363 The verb "estimate" is defined (in the present context) as –

*"To calculate approximately (the amount, extent, magnitude, position, or value of something).*[55]

364 Also of relevance is paragraph AG87 of IAS 39 which provides as follows:

*"For the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics that are indicative of the debtors' ability to pay all amounts due according to the contractual terms (for example, on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors). The characteristics chosen are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated."*

365 "Credit risk" is defined as -

*"The risk that a borrower will be unable to make payment of interest or principal in a timely manner.'*[56]

[55] American Heritage Dictionary of the English Language 5th edition.

[56] https://financial-dictionary.thefreedictionary.com/.

366 What becomes apparent on a conspectus of the relevant parts of IAS 39 is that the estimates that form the basis of impairment are to be compliant with the standard, which has at its heart an estimation that is reasonable in the circumstances. A businesslike and purposive interpretation of the standard will require that the impairment estimated serves the purpose of fairly presenting the financial position of the entity. That forms the obligation of management in reporting on impairment losses and it would also govern the auditing of management's reporting in this regard. That in turn forms the basis upon which the Committee must assess the first respondent's conduct in relation to the charge.

***Factual background***

367 The next step in the adjudication of this charge is to consider the factual background. Unless indicated otherwise, the chronology of events is based on the first respondent's witness statement. The chronology focuses solely on the main events that are relevant to the charge in question.

368 In a SENS announcement on 2 May 2013, ABIL announced that it expected earnings for the six months ended March 2013 to decline by 25% to 28% compared to the six months to March 2012. The announcement attributed these weakening results *inter alia* to lower yields in the Banking Unit even though loan advances had grown.

369 On 17 April 2013, the first respondent and Mr Burra met the BSD arising out of Deloitte's previous communication to the BSD of their concerns around impairments. The purpose of the meeting was for the BSD to explore the

impairments issues Deloitte may have to confront in the 2013 audit of ABIL and African Bank. The first respondent and Mr Burra highlighted the lack of conservatism of the bank's impairment policies and practices and the deterioration of cash collections. The first respondent *"outlined to the BSD the different loan books at the Bank (and the different audit approaches to each), the Deloitte approach to the audit of impairments (where we envisage compiling our own models in the 2013 year), deviations from market practice (such as the 'impairment point' and the 'emergence factor') and previous findings of the Deloitte impairment reviews."* Mr Burra spoke to the difficulties experienced in relation to credit impairment modelling.

370 On Saturday 26 April 2013, the first respondent received a call from Mr Nalliah who indicated that, unusually, Mr Sithole, then-chairperson of the audit committee, wanted Deloitte to perform a review in the form of a limited assurance assignment of the half year results. Previously, the first respondent had simply provided comments on the unaudited and unreviewed half year results. Mr Nalliah asked the first respondent to call Mr Sithole who *"indicated that he had concerns regarding the trend in collections and whether the impairment models were responding quickly enough to emerging trends"*. Steps were taken to arrange and commence a review, but a few days later, Mr Nalliah indicated to the first respondent that it was not necessary for Deloitte to perform the review.

371 An audit committee meeting was held on 9 May 2013. Those attending discussed the amount of the IBNR provision in the general ledger which at that time exceeded the amount as calculated by the model. The reason for this, according to management, was *"that Deloitte had agreed with management after*

*the 2012 audit that the methodology they had been using for several years to determine the IBNR provision was no longer appropriate for an institution the size of the Bank and that they had to refine it. In anticipation of a higher charge, management had started to set aside further provisions. It was for this reason that I also requested Mr Burra to look at the IBNR model more closely during 2013."*

372 According to Mr Raubenheimer, on 18 June 2013, he met at the offices of Deloitte with Mr Burra in preparation for the 2013 year end audit. Mr Raubenheimer shared his *"sense of unease with the way impairments were handled at the Bank and expressed [his] direct concern regarding this to him"* and also sought Mr Burra's assistance in this regard.

373 On 27 June 2013, the first respondent and another member of the audit team met with Mr Nalliah in order to discuss what Deloitte considered to be a number of areas of concern. The first item on the agenda under the heading "African Bank" was *"impairment of advances"*. The action items included *"follow up with Pravin [Burra] on progress from meeting with Gustav [Raubenheimer]."* The first respondent's recollection was that Mr Raubenheimer had reported to Mr Burra that *"there may be a shortfall of about R1 billion in the Bank's impairment provisioning as at that stage."*

374 On 31 July 2013, the first respondent met with Mr Nalliah. The matters discussed included:

> *"The fact that the Bank diverged from market practice in relation to loans between CD1 and CD3 and NPL write-offs. I encouraged Mr Nalliah to strive towards a further alignment of the impairment model to market practice in the current year. Mr Nalliah indicated to me that*

> *market practice was indicative but not prescriptive for the Bank, due to its different business model. I knew that the Bank had a different business model to the other banks in South Africa. I advised Mr Nalliah, however, that we would highlight the Bank's divergent practices to the underwriters during the due diligence process ... Mr Nalliah enquired as to the effective date of IFRS9 [which was to replace IAS 39] as it was intended to align with market practice when that occurred."*

375 In early August 2013, the first respondent met with Mr Roussos and a specific discussion was held on collection trends. The first respondent was concerned by the collection trends evident in the half-year results. Mr Roussos acknowledged that the environment was tough but indicated that there were encouraging signs of improvement. He described the drop-off in collections to mistakes the bank had made in moving the collection responsibilities from Ellerine Stores to the call centre.

376 On 5 August 2013, ABIL announced to the market that it intended to raise share capital through a rights offer underwritten by Goldman Sachs. These events prompted an elevation of the audit risk by Deloitte to "*much greater than normal*" during August 2013.

377 On 15 August 2013 the first respondent had a chance encounter with Mr Pinnock at the Bank's offices in Midrand. The first respondent informed Mr Pinnock that based on the previous year's experience as well as indications from collections trends in 2013 and preliminary audit planning and credit impairment modelling work, there would likely be a significant difference between the level of impairments with which Deloitte would be comfortable and what management would prefer. He also discussed the deteriorating credit quality, amongst other things.

378 Shortly thereafter Mr Pinnock was contacted by Mr Woollam, former chief financial officer of ABIL. Mr Woollam informed Mr Pinnock that he thought that the bank's impairments were too low and that the capital raising through the rights offer was critical because the bank was not profitable enough to absorb the rising credit losses.

379 The first respondent's thinking in this regard was documented in a memorandum to the Deloitte professional practice director dated 11 September 2013 setting out the risks present in ABIL which had led to the "*much greater than normal client risk*" assessment. The memorandum also set out the controls to mitigate the risks which included:

> *"The Risk and the Audit committee reviewed the financial performance of ABIL on a quarterly basis and make enquiries on the financial information. We will perform a detailed review of the impairment model and assess the adequacy of the impairments. We will increase our professional scepticism and will take a detailed look at the balances being audited especially in areas where we have previously found misstatements."*

380 Additionally, a special review partner, Brian Botes, was allocated to the audit and Geoff Pinnock, African Managing Partner: Assurance, would *"oversee the conclusions made on the file and of the risks mitigate"*. Based on these control measures, the first respondent assessed that *"the acceptance of ABIL as an audit client is justified"*.

381 The first and second respondents attended an audit planning meeting with Mr Nalliah on 13 September 2013. Although the primary purpose was to discuss timelines of the audit, they discussed the issue of impairments at some length. Mr Nalliah expressed the view that the poor cash collections of 2013 were an

aberration which should not be allowed to taint the Deloitte view on the appropriate levels of impairment.

382 On 16 September 2013, the first respondent convened a planning meeting of the full audit team. The first respondent highlighted, amongst other matters -

382.1 the risk that impairments might be understated because of the increased consumer indebtedness;

382.2 the need to place greater emphasis on inputs and controls around the changes to the models;

382.3 *"ABIL management may have wanted to manipulate the credit impairments as it involved significant management estimates. The desired outcome for this from management would be to keep the impairment as low as possible in order to improve profitability and the regulatory capital balance before rights issue and in the annual results."*

383 A few days before the Bank issued a trading statement on 18 September 2013, in respect of its results to 31 August 2013, the first respondent had several discussions with Mr Nalliah in which he conveyed, *inter alia*, that *"the level of impairments envisaged by executive management was significantly lower than was indicated by the impairment models and, when processed would decrease earnings by more than the 58% - 63% mentioned in the draft SENS."*

384 On 19 September 2013, Mr Burra addressed an email to the first respondent, copied to Mr Daniel Tenzer, a member of Mr Burra's team, which commented:

> *"I spent yesterday at African Bank. At this stage I am hopeful that we will be able to accept Gustav's estimate of the liabilities. There are still a number of boxes that need to be ticked but I am hopeful."*

385 Item 9 of the email read as follows:

> *"In addition there are a number of general issues that we need to discuss. These include:*
>
> - *The discount rate used on accounts with suspended or zero interest*
> - *The bucketing of loans between impaired and unimpaired, i.e. should CD1 to 3 be in IBNR or impaired."*

386 Around the time of the 19 September 2013 email, Mr Burra alerted the first respondent to the fact that Mr Raubenheimer had raised with him the issue whether CD1, not CD4, was the appropriate impairment point.

387 There were a series of meetings from 27 September 2013 through to the final audit committee meeting which dealt extensively with the issue of the appropriate level of impairments. These meetings will only be referred to where they focus specifically on the issue of the impairment of CD1 to CD3 loan buckets. These meetings took place between the first respondent, the second respondent (to some extent) and Mr Pinnock from Deloitte, on the one hand, and Messrs Kirkinis, Nalliah and Strauss from the Bank, on the other. At certain points they also involved the chairs of the audit and risk committees.

388 On 2 October 2013, the first respondent met with Mr Burra and Mr Tenzer from Deloitte. They discussed the possibility that the LGD used in management's current IBNR model was too low. *"We further discussed issues around the impairment point (i.e. whether the default should be considered at CD1 or CD4 and the application of the emergence period. This discussion was a direct*

*discussion of the debates around the IBNR model proposed by management. I noted that management (not the auditors) needed to propose an 'impairment point' and that we would then consider its acceptability."* This meeting was in preparation for a later meeting with executive management of the bank.

389 At 16h30 on 2 October 2013, the first respondent together with Ms Sangoni and Mr Burra met with Messrs Nalliah, Strauss and Raubenheimer. According to the first respondent "*we discussed inter alia the 'impairment point' as well as the length of the emergence period. Mr Raubenheimer expressed his view that these issues should be aligned with industry practice (which would increase impairment provisions as indicated by the model).*" The first respondent asked Mr Burra to record these scenarios in a spreadsheet to inform later discussions.

390 Directly after the 16h30 meeting, the first and second respondents together with Mr Pinnock met with Messrs Kirkinis and Nalliah from the Bank. They pointed out that Mr Raubenheimer had different views from Mr Nalliah regarding the proper level of impairment, with Raubenheimer suggesting a shortfall in the total figure for impairments of R4 billion. The Deloitte representatives conveyed that the bank had to present an agreed view to Deloitte. Amongst other things, the first respondent records in relation to the meeting that:

> *"Mr Kirkinis argued that he would strongly resist any attempts (such as advocated by Mr Raubenheimer) to change the impairment point or the length of the emergence period. That sort of inconsistency with previous years treatment was, in his view, unwarranted by the Bank's business model. He argued that such significant changes would lead to questions around management's ability, but also the viability of the rights issue. It was in this context that Mr Kirkinis made the remark that it would 'sink' the bank if Deloitte continued to hold its stated position, primarily because it would lead to a breach of the capital adequacy requirements.*

> *Mr Pinnock made it clear to Mr Kirkinis that Deloitte was prepared to take a firm stand on the issue of impairments …"*

391 After the meetings, at 6:59pm on 2 October 2013, Mr Burra sent an email attaching a numerical depiction of the various impairment scenarios discussed. The provision in respect of IBNR was reflected at R1.092 billion on two of the scenarios and R0.5 billion on the other two scenarios.

392 The first respondent and Mr Pinnock continued the discussions with Messrs Kirkinis and Nalliah on 3 October 2013. Mr Pinnock records the first respondent as conveying that *"Deloitte would be comfortable with a total provision of R2.3 billion made up as follows: base gap (R825m); cashflows (R500m); IBNR (R500m) and discount rate (R500m)."*

393 The first respondent also records at this meeting that in relation to the credit IBNR, management raised two areas of difference from the initial Deloitte estimates, *"which were informed by the 'advanced approach' Mr Raubenheimer proposed. These related to (a) the emergence period (with management contending that the emergence period used was less than that of the big four banks, as the Bank had a different business model); and (b) the impairment point (with management continuing its view that a 'loss event' was only indicated at CD4). Management undertook, however, to build a properly considered model that would incorporate their unique business circumstances and would also more closely align with general banking practice in the next financial year. Changes to the existing policies could then be made simultaneously with the preparation for the implementation of IFRS9 (which did away with the 'incurred loss model' and adopted the 'expected loss model')."*

394 At 6:12pm on 3 October 2013, Mr Nalliah sent to the first respondent an accounting paper prepared by Mr Ngobese of African Bank in which he set out his views regarding the identification of when advances are impaired in terms of IAS 39:

> *"IAS 39 does not stipulate that if there is a breach of contract then it certainly results in an impairment of the advance. This is left to the preparers of the financial statements as it is a judgement area.*
>
> *This is due to the fact that the extent of breach of contract determines whether the advance is impaired or not. For example, a breach of contract due to a missed payment may be due to a technical reason, eg a change in bank accounts or a personal reason such as a customer being in hospital on payment date and being unable to make the payment.*
>
> *The experience in African Bank shows that many customers who have defaulted on one or two payments catch up on their payments and are subsequently up to date. This is often due to a technical issue or a life event which is temporary.*
>
> *Hence African Bank has identified that customers at over contractual delinquency 3 (in effect have missed three cumulative instalments) show objective evidence of impairment. This is based on the experience of when customers actually start showing losses which indicated that the impairment loss is incurred as opposed to expected.*
>
> *In summary, IAS 39 is not explicit on when a loss event arises. This is left to preparers of financial statements to decide based on the specific circumstances of their business. African Bank has selected a specific number of missed instalments when it is of the view that a loss has been incurred. This is permitted by the accounting standards."*

395 Also on 3 October 2013, the first respondent and Mr Burra received an email from Mr Riaan Smit, who worked in Mr Raubenheimer's credit modelling team attaching two spreadsheets. The second of these summarised the differences between the bank's "finance team's" model for provisions against loans in CD0 to CD3 and that proposed by the bank's credit modelling team. Mr Raubenheimer's credit modelling team recommended an IBNR impairment provision for 2013 in respect of these loans of R1.347 billion versus the general ledger's provision of R224m.

396 On 8 October 2013, Mr Smit sent Mr Burra a further email, copying Mr Raubenheimer. The email dealt with certain IBNR scenarios that were under discussion. Attached to the email was a spreadsheet setting out four different IBNR scenarios as follows:

**Current PD and LGD as Per Finance Stipulation**

| | Exposure | PD | LGD | Impairment |
|---|---|---|---|---|
| 0 (IBNR) | 34 674 | 0.09% | 21.82% | 7 |
| 1 | 2 989 | 0.76% | 21.82% | 5 |
| 2 | 1 798 | 8.44% | 21.82% | 33 |
| 3 | 1 522 | 70.01% | 21.82% | 233 |
| | | Required | | 277 |
| | | IBNR on GL | | -224 |
| | | Gap | | 53 |

**Revised LGD %**

| | Exposure | PD | LGD | Impairment |
|---|---|---|---|---|
| 0 (IBNR) | 34 674 | 0.09% | 44% | 13 |
| 1 | 2 989 | 0.76% | 44% | 10 |
| 2 | 1 798 | 8.44% | 44% | 67 |
| 3 | 1 522 | 70.01% | 44% | 469 |
| | | Required | | 559 |
| | | IBNR on GL | | -224 |
| | | Gap | | 335 |

**Revised LGD % and Adjusted PDs**

| | Exposure | PD | LGD | Impairment |
|---|---|---|---|---|
| 0 (IBNR) | 34 674 | 0.05% | 44% | 8 |
| 1 | 2 989 | 0.40% | 44% | 5 |
| 2 | 1 798 | 7.00% | 44% | 55 |
| 3 | 1 522 | 73.00% | 44% | 489 |
| | | Required | | 557 |
| | | IBNR on GL | | -224 |
| | | Gap | | 333 |

**Gustav's Original Model**

| | Exposure | PD | LGD | Impairment |
|---|---|---|---|---|
| 0 (IBNR) | 34 674 | 0.05% | 44% | 8 |
| 1 | 2 989 | 28% | 44% | 374 |
| 2 | 1 798 | 51% | 44% | 403 |
| 3 | 1 522 | 84% | 44% | 563 |
| | | Required | | 1 347 |
| | | IBNR on GL | | -224 |
| | | Gap | | 1 123 |

397 These scenarios represented:

397.1 The finance department's model for the IBNR advanced by Mr Nalliah and Mr Strauss' department;

397.2 A scenario with a revised LGD percentage;

397.3 A scenario with both revised LGD's and slightly revised "roll rates"; and

397.4 A scenario described as "Gustav's original model", also known as the "advanced approach" to the IBNR. This was Mr Raubenheimer's original proposal which had not found favour with senior management. The approach in this scenario was to treat advances between CD1 and CD3 as based on a PD x LGD or portfolio specific impairment, without any emergence factor.

398 The finance department's scenario would only require an additional R53m impairments additional to those already reflected in the general ledger and the approach preferred by Mr Raubenheimer would have required an additional R1.123 bn impairments.

399 Of these scenarios, the first respondent rejected the first two on the basis that they contemplated an unacceptable roll rate directly from any of the CD0 to CD2 buckets into CD4 over a single month. It is also worth noting that -

399.1 scenario 3 also used the unacceptable roll rate directly from CDO to CD2 buckets into CD4 over a single month;

399.2 "IBNR" appears only alongside CD0 in each of the four scenarios.

400 Meetings continued between the Deloitte representatives and senior management on 9 and 10 October 2013. One of the topics of discussion was:

> *"Management's doubt about the further provisions Deloitte and Mr Raubenheimer recommended to the IBNR which primarily arose out of the higher LGD percentage used in the calculation (44% versus 21%) which, according to management did not accord with their 'experience' and where they have identified anomalies in the underlying data."*

401 On 11 October 2013, Mr Raubenheimer provided Mr Burra by email a summary of the 12-month PD per CD bucket for June 2010 to August 2012. This indicated a consistent flow of accounts to CD4 with around 60% of CD1 accounts moving to CD4, around 85% of CD2 accounts moving to CD4 and around 93% of CD3 accounts moving to CD4 over a 12-month period.

402 On 14 October 2013, the first respondent addressed an email to Mr Botes, copied to Mr Shipp, Mr Burra, the second respondent and Mr Tenzer, in which he answered various questions from Mr Botes *inter alia* as follows:

> *"I am meeting with Nithia (Nalliah) just now as he has an update on the IBNR accounting interpretation which he says we are wrong on. This is the argument about what IAS 39 requires vs implies. For the micro loan industry is 'impaired' determined at 1 month default or rather some later point? ABIL adopts the latter and discloses this in their policies in the integrated report. They are consulting EY on this."*

403 On 14 October 2013, the first respondent met with the BSD to discuss the progress on the audit of the bank. A range of matters were discussed including, in the first respondent's words, *"in relation to loans in the CD0 to CD3 buckets (IBNR), we were still working on finalising our position with management as there were lots of 'moving parts' and judgemental areas."*

404 On 15 October 2013, the first respondent forwarded Mr Ngobese's abovementioned accounting paper to Ms Ranchod in order to solicit her views on the three issues dealt with in his accounting paper. Mr Andrew van der Burgh, a manager in Ms Ranchod's department, compiled an email in response on the same day. In relation to the impairment point, it concluded as follows:

> *"**LOSS EVENTS (CD1 AND CD4)***
>
> *An impairment is only booked on a financial asset when a loss event has occurred that has an impact on the cash flows of the financial asset.*
>
> *Therefore CD4 may be identified as the loss event after which impairments are assessed. We would need evidence to show that CD1 to CD3 do not impact on the cash flows of the financial asset to support this."*

405 The first respondent points out further that he had requested Mr Tenzer to compile a document setting out how the bank made impairment provisions for CD0 to CD3 loans. This request was responded to by Mr Tenzer also on 15 October 2013.

406 Mr Tenzer's document included the following table:

| IBNR | Balance/Exposure | Impairment Rate | Impairment Prov% |
|---|---|---|---|
| **Ideal** | CD 0,1*<br>**CD1 depends on "significant difference" between PD(0) and PD(1)* | Probability of moving from "performing" to "impaired" status | Coverage in "impaired" buckets |
| **Actual** | CD 0,1,2,**3** | ABIL have no "impaired" status so we use the probability of going into NPL/default **over the emergence period.** | Old DI LGDs ≈ 20% |
| **Issue** | Definition Issue:<br>Can you really argue that the "risk" in CD0 is similar to the "risk" in CD3?<br>Counter argument:<br>Bank decides what qualifies as an "incurred event"… | Short emergence period leads to small probability of moving in short time.<br>Counter argument:<br>Bank chooses emergence period | • Should use actual coverage of **new to CD 4 accounts**<br>• 44 % seems right for this = Number from ABIL (Gustav) and Deloitte New to NPL, including large recoveries in June 2013, but it may not be correct to include these diagonals... We have checked the roll rate calc for mathematical accuracy, but need to confirm logic is sound. |

407 The first respondent describes Mr Tenzer's document as follows:

> *"The document explained the 'IBNR methodology' in particular how it differed from what Mr Tenzer described as the 'ideal', i.e. his interpretation of big banks methodology. The document flagged that ABIL's previous IBNR methodology embodied two incorrect assumptions, i.e. the regulatory coverage percentage for LGDs and the incorrect 'direct' roll rate to CD4. (Both of these matters were corrected in Mr Burra's IBNR model for 2013). The document further flagged that:*
>
> *599.1 Mr Raubenheimer indicated the correct LGD would be 44% which seemed right to Mr Tenzer. (This is the number ultimately used in Mr Burra's calculations before adjusting for in duplum); and*
>
> *599.2 Deloitte calculated stepped 'emergence periods' (or roll rates)[57] depending on whether the relevant loan was in CD0, CD1, CD2 or CD3. (These were also ultimately used in Mr Burra's calculation).*
>
> *Finally the document indicated that Mr Tenzer was sceptical that CD3 loans could be treated similarly to 'unimpaired' CD0 loans when the risk associated with them was much higher, but he indicated that there were two counter arguments, namely that*

[57] The first respondent's comment here is not quite correct. It is stepped roll rates that were calculated, not stepped emergence periods.

> *599.3 the bank's accounting policies dictated what was considered as an 'incurred event'; and*
>
> *599.4 the bank chose what the applicable emergence period was."*

408 On 15 October 2013 at approximately 14h30, Raubenheimer records a meeting with the second respondent, which canvassed amongst other things the issue of the point of impairment. He told the second respondent that:

> *"The point of impairment needed to move from CD4 to CD1, using a PD x LGD approach adopted by the other banks. PD should be calculated over 12 months and use the LGD for accounts that had just moved into NPL as the flow LGD which was 44%."*

409 Later on the same day, 15 October 2013, a meeting was held at the Bank where the first and second respondents and Mr Raubenheimer were present.[58] Mr Raubenhemier retained a flip chart that he used for purposes of his presentation that day, which was handed in as an exhibit. Raubenheimer records that they discussed his concern that the roll rates were very high and that, for this reason, he was concerned about the point of impairment. In this regard the -

409.1 probability of moving from CD3 to CD4 was 97%;

409.2 probability of moving from CD2 into CD3 was 92% and;

409.3 probability of moving from CD1 to CD2 was 37%.

410 These roll rates are depicted in the flip chart exhibit.

411 Also listed are the various impairment amounts that were being proposed by Raubenheimer at that time, including an additional amount of R900m in respect of the IBNR.

[58] There is a dispute as to whether or not Mr Pinnock was present.

412 On 16 October 2013, the first and second respondents together with Messrs Burra, Pinnock and Shipp held an internal meeting. In relation to the discussion of the IBNR, Mr Pinnock records the following:

> *"Mr Burra performed calculations on the IBNR calculation ... and the additional amount to be provided for, taking into account an amount of R225m already provided for, was expected to be approximately R300m."*
>
> and
>
> *"The IBNR amount still had to be finally determined".*

413 On 16 October 2013, Mr Burra sent to Mr Raubenheimer the then prevailing IBNR calculation. This took the form of a spreadsheet, exhibit 18.3. This presented three alternative scenarios:

413.1 an impairment of R224,541,751, being the finance department's assessment of the IBNR at that time (referred to as the "Base");

413.2 an impairment of R506,793,383, based on adjusted roll rates; and

413.3 an impairment of R994,377,266 based on adjusted roll rates and adjusted LGDs.

414 On the morning of 17 October 2013, the first respondent held a further internal meeting with Mr Burra, Ms Ranchod, the second respondent, Mr Shipp, and others. The primary purpose of the meeting was to discuss various accounting technical issues raised by the audit. These included the issue of the impairment point. This meeting, says the first respondent, was the genesis of the *"consultation paper on the 'impairment point'."*

415 The consultation paper was prepared by Ms Sarahan Zariffis, a senior manager in the Deloitte accounting technical department on the same day, 17 October 2013. The first respondent in his witness statement records having received it from Ms Ranchod on 24 October 2013, the date on which he signed off on it and placed it in the audit file. The consultation paper seems to have been furnished earlier than 24 October 2013 because it forms the subject matter of a telephone discussion between Mr Raubenheimer and Ms Ranchod on 23 October 2013.

416 The consultation paper characterises the question posed to the technical experts as follows:

> *"We have been asked to consider*
>
> - *Whether the IAS 39 requires / prescribes the recognition of an impairment loss at CD1 [generally adopted banking practice in SA]*
> - *Whether a change in the point of impairment [say from CD4 to CD3] will be regarded as a change in estimate or a change in accounting policy."*

417 The opinion is dealt with in more detail below but the thrust of the advice given was as follows:

> *"... given the loss event examples, a CD1 categorisation should be considered a loss event. However, if ABIL is able to provide evidence that categorisation in CD1 to CD3 does not impact the expectation of future cash flows – that is, CD1 to CD3 loans generally are recovered in the future periods – then it will be appropriate to consider CD4 to be the loss event that triggers the recognition of impairment."*

418 Later on 17 October 2013, the next in the series of meetings between Deloitte and executive management at the Bank took place. In relation to the IBNR the Deloitte representatives conveyed that they thought that the amount would be "*approximately another R300m*".

419 Also on 17 October 2013, the first respondent sent to Mr Pinnock and the second respondent an email enclosing an excel spreadsheet which set out the then current Deloitte estimate of required additional impairment provisions. Insofar as the IBNR is concerned, it included an amount of *"R228m for the "LGD correction i.e. management's calculation of correcting for the use of 21% LGD in the IBNR model raising it to 44%"*.

420 On 18 October 2013, the first respondent and Mr Pinnock, attended an informal board meeting of the Bank in order to explain their view with regard to the size of the impairments required in relation to the 2013 AFS. Mr Pinnock summarised the position as follows:

> *"The minutes record that the total amount relating to the in duplum adjustment was R2.2 bn, and that the board concluded that this impairment was required. The minutes further record that Mr Nalliah advised that he would check the calculation prepared by the Bank and by Deloitte in respect of IBNR. It was this component that led to a further R300m being required."*

421 The minutes then go on to record that:

> *"In the external auditors' view, the only matters outstanding are the review of the testing for impairment of the deferred tax asset in Ellerine Furnishers and the goodwill within ABL."*

422 On 22 October 2013, the first respondent and Ms Ranchod attended a meeting with Mr Ngobese in order to discuss IFRS compliance in relation to *inter alia "the 'impairment point' (CD1 versus CD4)"*. The first respondent records that executive management felt strongly that the impairment point should be retained [i.e. at CD4]. Deloitte seemingly advanced the position recorded in Ms Ranchod's opinion.

423 Notwithstanding the finalisation of the issue of the amount of the IBNR at board level on 18 October 2013, on 23 October 2013 Mr Raubenheimer had a discussion with Ms Ranchod pertaining to his concern about the point of impairment. That conversation was confirmed in an email addressed by Mr Raubenheimer to Ms Ranchod the same day, 23 October 2013, which reads as follows:

> *"Thank you very much for our opportunity to discuss our impairment situation with you this morning.*
>
> *My understanding of your position re our IBNR is as follows:*
>
> - *IAS 39 requires impairment only for realised and not expected losses.*
> - *IAS 39 has a fairly loose definition for an impairment-event. It does, however, suggest that accounts not keeping to their contractual obligations should be regarded as impaired if it is probable that these accounts will stop paying.*
> - *Although the roll rates from delinquency bucket 3 (accounts that are between 60 and 90 days past due) into default (90 days + past due) within 1 month is high (75%), this fact, per se, does not imply non-payment is probable. The reasoning behind non-payment not being regarded as probable is a result of the LGD for accounts in default being around 50% which implies the loss for accounts in bucket 3 is less than 50%."*

424 On 25 October 2013, ABIL issued a SENS announcement which, amongst other things, recorded the *in duplum* adjustment of R2.175bn and the increase in respect of the IBNR of R300m. The first respondent records in his witness statement that *"by the time of the SENS announcement, Mr Burra concluded as follows on the impairment model and work performed by the valuation team.*

| *IBNR (performing book)* | *Value R'Million* |
|---|---|
| *Base impairment estimated by Management* | *225* |
| *Update LGD to 56%* | *335* |
| *Update roll rates* | *594* |
| *Update day count adjustment* | *(637)*[59] |
| *Required IBNR* | ***517*** |

425 Management processed an adjustment to the IBNR provision. The final amount recorded in the GL and disclosed in the annual financial statements was R585 million.

426 The audit committee scheduled a meeting for 29 October 2013 to consider the annual results. For purposes of the meeting the first respondent and the audit team prepared the *"Final Report to the Audit Committee on the September 2013 Audit"*. In relation to the IBNR, the report recorded that:

> *"An additional amount of approximately R222m was booked to update the inputs in the IBNR model."*

and

> *"The group defines the impairment event as the moment a lender moves from CD3 to CD4. This is regarded as an allowable practice in terms of IAS 39. The IBNR was then calculated on the basis of advances moving into CD4 in one month. In this calculation PD and LGD rates used were incorrect and resulted in an additional R360m adjustment being made."*

427 Under the heading "Industry practices" appear the following (only the items relevant to the second charge are included):

> *"In terms of our overall assessment we need to make the following observations and recommendations:*

---

[59] The original erroneously omitted the brackets

| | *African Bank* | *South African big four banks 'industry'* |
|---|---|---|
| *Performing loan book* | *CD0 – CD3* | *CD0* |
| *Performing loan methodology* | *Balance (EAD)*RR*PD*LGD*[60] | *Balance (EAD)*RR*PD*LGD* |
| *Impairment threshold* | *CD4* | *CD1* |
| *Non-performing book* | *CD4 to CD12 (previously CD17)* | *CD1 to CD6* |
| *Non-performing book methodology* | *Cash flow simulations* | *PD*LGD* |
| *Default book (write-off)* | *CD13+ (previously CD18+)* | *CD3+ to CD6+* |
| *Default book methodology* | *Cash flow based* | *Cash flow based* |
| *Default book disclosure* | *Net* | |
| *Cash flow forecast period* | *120 months* | *60 months* |

428 This table, the first respondent sought to amend in various respects in the course of his oral testimony. This aspect is dealt with below.

429 Under the heading "Modelling observations and recommendations", the relevant parts read as follows:

> *"Our overall assessment of impairment models leads us to make the following observations and recommendations:*

[60] This is clearly in error and should have added at the end "*LEF"

| *Topic* | *Observation* | *Recommendation* |
|---|---|---|
| *IBNR* | *Management currently uses an emergence period of 7 days in calculating the IBNR impairment* | *The industry normally uses an emergence period of one month* |
| *Impairment threshold* | *The impairment point African Bank has selected is CD4.* | *While we recognise that microlending customers do typically miss a payment from time to time, we are nevertheless of the opinion that CD4 is less prudent. This has a significant impact on the IBNR calculation or performing book impairment levels (i.e. CD0 to CD3)"* |

430 A meeting of the risk committee followed after the meeting of the audit committee on 29 October 2013. The first respondent records that he requested Mr Raubenheimer and the other attendees of the meeting to confirm whether they considered the outcome on impairments to be appropriate. Raubenheimer's *"response was in the affirmative, although he stated that he would have preferred a buffer of R500 million (as would we)"*. On Mr Raubenheimer's version, he said:

> *"I did not confirm that I was satisfied with the levels of credit impairment at the meeting of 29 October 2013. On the contrary, I specifically advised that additional impairments are required. This was minuted in paragraph 3.10 (n) of this meeting's final minutes. On 18 July 2014, I addressed correspondence to Ms Goliath reminding her that the minutes of the risk committee meeting in 2013 did not reflect my reservations around the level of impairments. She subsequently sent me the final minutes which record my unhappiness."*

431 The auditor's report in the AFS of ABIL was signed by the first respondent on 6 December 2013 and in respect of African Bank, on 10 December 2013. The notes to the AFS of African Bank include the following relevant aspects:

*"1.8.4 **Impairment of financial instruments***

*1.8.4.1 **Assets carried at amortised costs***

*The company assesses at each reporting date whether there is objective evidence that an asset or group of assets is impaired.*

*[reference is then made to the wording of IAS 39 para 59]*

*When portfolio (collective) assessment of impairment is used, financial assets are grouped on the basis of similar credit characteristics which indicate the Borrower's ability to pay in accordance with the contractually agreed terms.*

*The company estimates the recoverable amount on a portfolio basis using portfolio statistics derived from past performance of similar financial assets, taking into account any changes to collection procedures and projected future market conditions.*

*The recoverable amount is the sum of the estimated future cash flows, discounted to their present value, using a discount rate that reflects the portfolio of advances' original effective interest rate. If the recoverable amount of the advance is estimated to be less than the carrying amount, the carrying amount of the advance is reduced to its recoverable amount by raising an impairment provision (through the use of a separate allowance account), which is recognised as an expense in profit or loss. A write-off is effected against the allowance account when the debtor is deemed to be partially or fully impaired and not recoverable.*

*In order to provide for latent losses in a group of loans that have not yet been identified as specifically impaired, an impairment for incurred but not reported losses is recognised based on historic loss patterns and estimated emergence periods. Groups of loans and advances are also impaired when adverse economic conditions develop after initial recognition, which may impact future cash flows."*

432 Paragraph 5 of the note to the AFS deals with and sets out the details of net advances and their computation, including the relevant impairment provisions. The notes go on to provide as follows:

*"The impairment provisions for gross advances are classified into two categories i.e. specific impairments and portfolio impairments (IBNR). The specific impairments provision of R9 981 million (2012, R9 669 million) is in respect of the non-performing loan book, while the portfolio impairments provision of R585 million (2012: R156 million) is in respect of the performing loan book. The portfolio provision covers losses actually incurred but not yet reported in relation to clients who may have already suffered stress in making contractual payments, but such information has not been formally conveyed to the company. The performing loan book does have arrears of up to three cumulative instalments which do not necessarily indicate that all these loans are*

*non-performing, in terms of the company's definition of non-performing loans."*

433 Note 5.1 of the African Bank AFS provides as follows:

*"5.1* ***Credit Risk***

***Credit Risk management***

*Credit risk refers to the risk that a counterparty will default on its contractual obligations, resulting in financial loss to the company. The company's primary focus is the underwriting of unsecured loans and accordingly, credit risk features as a dominant financial risk within the company. The credit risk management framework setting out the policies and procedures applied by the company is set out in the risk management review. These are disclosed in the ABIL annual financial statements.*

*...*

*The carrying amount of financial assets recorded in the financial statements, which are net of impairment losses, represents the company's maximum exposure to credit risk.*

5.1.1 Credit risk exposure

| Analysis of credit quality 2013 | Retail debit order Rm | Payroll Rm | Credit card Rm | Mining Rm | Ellerines Rm | Pay-down Rm | Total Rm |
|---|---|---|---|---|---|---|---|
| **Financial assets that are neither past due nor impaired** | 25 874 | 213 | 5 315 | 180 | 4 317 | 22 | 35 921 |
| *Low risk* | 11 002 | 56 | 2 075 | 63 | 1 014 | - | 14 210 |
| *Medium risk* | 10 518 | 123 | 1 587 | 101 | 2 222 | 22 | 14 573 |
| *High risk* | 4 354 | 34 | 1 653 | 16 | 1 081 | - | 7 138 |
| **Financial assets that are past due (up to 3 months) but not yet impaired** | 4 150 | 18 | 1 050 | 32 | 1 166 | 1 | 6 417 |
| *One instalment missed* | 1 938 | 8 | 581 | 16 | 537 | 1 | 3 081 |
| *Two instalments missed* | 1 186 | 5 | 256 | 9 | 338 | - | 1 794 |
| *Three instalments missed* | 1 026 | 5 | 213 | 7 | 291 | - | 1 542 |
| **Financial assets that are impaired** | 4 989 | 29 | 823 | 160 | 593 | 47 | 6 641 |
| *Carrying amount* | 12 372 | 121 | 1 786 | 332 | 1 832 | 179 | 16 622 |
| *Provision for impairment* | (7 383) | (92) | (963) | (172) | (1 239) | (132) | (9 981) |
| *Partially written off advances* | 686 | 8 | 390 | 42 | 185 | 10 | 1 321 |
| **Total credit exposure** | 35 699 | 268 | 7 578 | 414 | 6 261 | 80 | 50 300 |
| *Deferred administration fees* | | | | | | | 195 |
| *Incurred but not reported provision* | | | | | | | (585) |
| **Net advances** | | | | | | | 49 910 |
| **Reconciliation of allowance account** | | | | | | | |
| *Balance at the beginning of the year* | 6 644 | 109 | 737 | 248 | 1 761 | 170 | 9 669 |
| *Bad debt charge / (release) net of recoveries* | 4 881 | 40 | 914 | 187 | 2 926 | 93 | 9 041 |
| *Bad debt (write-offs) / rehabilitations* | (4 142) | (57) | (688) | (263) | (3 448) | (131) | (8 729) |
| **Balance at the end of the year** | 7 383 | 92 | 963 | 172 | 1 239 | 132 | 9 981 |

434 According to Mr Raubenheimer during March 2014 the Bank in its impairment provisioning removed the emergence factors for CDs 1, 2 and 3, giving rise to an

increase in impairments in the sum of R448m. He then reports the following developments in July 2014:

> *"136 After the PWC review of the Bank's accounting practices, it was considered that accounts that are in CD1 or greater should factually be classified as impaired.*
>
> *137 The impact as at July 2014 was approximately R2.062bn…*
>
> *138 PWC also recommended that accounts that had cured, accounts that had been previously delinquent and accounts with CDs > 0 < 1, all be classified as impaired."*

435 In the 2014 AFS for African Bank the curator's report includes the following:

> ***"Restatement of advances impairment methodology***
>
> *…*
>
> *Previously the Bank considered a 'loss event' to occur where an account had a CD status of 4 or greater (i.e. the account has four months of cumulative contractual delinquency). The Bank amended its definition of a loss event, in determining the level of impairments, to align with market practice and the requirements of IAS 39. A loss event is determined to have occurred once the account is in arrears, either partially or with the CD status greater than 1. In addition, certain accounts with a history of arrears are considered to have experienced a loss event and are considered to be impaired.*
>
> *[The report then deals with the use of the incorrect discounting rate as well as the modelling technique adopted by the Bank]*
>
> *As a consequence, the statement of financial position as at 30 September 2013 and 1 October 2012, as well as the statement of profit or loss for the year ended 30 September 2013 has been restated. The cumulative impact to the 2013 financial year was R3 674 million pre-tax (2012: R2 529 million).*
>
> ***IBNR emergence period***
>
> *As described above, an advance is considered to be impaired and impairment losses are recognised once there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the loan (a 'loss event'). The Bank provides for impairment losses on loans where it is aware of objective evidence that a loss event has occurred, for example where the loan is contractually delinquent. On a portfolio basis the Bank is aware that loss events have occurred (e.g. a borrower experiencing financial difficulty) however these loss events have not necessarily been reported to the Bank. These are called 'Incurred but not reported'*

*(IBNR) impairments. In calculating the IBNR impairment provision the Bank estimates an emergence period being the average time between the loss event (the borrower experiencing financial difficulty) and the loss being reported to the Bank (contractual delinquency). Previously the Bank used an emergence period of seven days which has now been amended to 30 days based on benchmark emergence periods used in the banking industry.*

*As a consequence, the statement of financial position as at 30 September 2013 and 1 October 2012, as well as the statement of profit or loss for the year ended 30 September 2013 has been restated. The cumulative impact to the 2013 financial year was R374 million pre-tax (2012: R278 million)."*

436 The 2014 AFS in respect of African Bank also included the following emphasis of matter:

*"We draw users' attention to the fact that on 10 August 2014 the Bank was placed under curatorship in terms of section 69 of the Banks Act, 1990, as amended by the South African Reserve Bank (SARB).*

*In order to execute the mandate and prepare the Bank for restructuring, the Curator has adopted a more conservative approach to accounting for the activities of the Bank and modified the impairment models and methodologies applied to the loan book. The critical accounting judgements and key sources of estimation uncertainty disclosed in Note 1.2 and in Note 48 relate to the estimates that require management's most difficult, subjective or complex judgements. In this regard International Accounting Standard 39 - Financial Instruments: Recognition and Measurement (IAS 39) is not prescriptive with regard to the definitions of certain key inputs to the credit impairment methodology adopted by the Curator. The restatements presented in the financial statements reflect the definitions and statistical techniques adopted by the Curator, which are not prescribed by International Financial Reporting Standards. The key definitions adopted by the Curator are those commonly applied by banks who are on the Advanced Internal Ratings -based Approach and hence apply credit risk measurement techniques proposed by the Basel frameworks. These definitions have been applied retrospectively. The credit impairments calculated and presented are extremely sensitive to the definitions adopted. Significantly different outcomes and allocations across the years being presented arise depending on the definitions of the key inputs applied in the credit impairment models."*

437 Against that backdrop, it is appropriate to consider the issues that arose in the adjudication of the charge.

***The complaint ultimately faced by the first respondent is not in the charge***

438 The first respondent contends that the charge ultimately pressed against him in the pro forma complainant's heads of argument was not pleaded *"in any way, shape or form"* in the schedule of charges. Charge 2, he argued, was a complaint based on the failure to impair loans in the categories CD1 to CD3 as a result of wrongly using CD4 as a point of impairment. The case in the heads of argument was that the formula and inputs for computing the IBNR were wrong, and that the impairment amount in the IBNR was too low.

439 The formulation of charge 2 in the schedule of charges follows that employed also in certain of the other charges. It takes as its starting point the restatements effected in the 2014 AFS and treats these as reflecting the errors in management's reporting in the 2013 AFS, and the correlative misconduct of the first respondent in not insisting on reporting in the manner adopted in the 2014 AFS.

440 Section 49(3) of the Audit Profession Act requires that the charge sheet inform the registered auditor of the *"nature and details of the charge"*. Rule 4.10.1 requires that the charge sheet set out the nature of the charges and rule 4.10.2 requires that it set out *"the relevant facts upon which the charges are based with sufficient particularity as to allow the respondent to plead"*.

441 In *Du Plessis v Independent Regulatory Board for Auditors and Others*,[61] Binns-Ward J laid down the requirements for a charge under these provisions as follows:

---

[61] [2017] 3 All SA 137 (WCC).

*"[104] … The Board's Counsel drew an analogy with the requirements for drawing a pleading in a civil case. Mr Marcus referred in this respect to rule 18(4) of the Uniform Rules, which in relevant part reads: 'Every pleading shall contain a clear and concise statement of the material facts upon which the pleader relies for his claim . . . with sufficient particularity to enable the opposite party to reply thereto'. In that connection, Counsel cited the judgement in Nel and others NNO v McArthur and others 2003 (4) SA 142 (T), at 146, in which Basson J emphasised the phrase 'with sufficient particularity to enable the opposite party to reply thereto' as the determining criterion for compliance.*

*[105] In my judgement the analogy was well-drawn for the purpose of explaining the object of the pertinent requirement of the Act and the related procedural disciplinary rule. The object is that the practitioner who is the subject of the disciplinary proceedings should know what he or she is alleged to have done by way of the alleged misconduct with sufficient particularity to know the case he or she is called upon to answer. That much is borne out in the wording of sub-rule 4.10.2 of the New Disciplinary Rules in particular. As remarked earlier, the requirement does no more than to articulate the rule of natural justice that is in any event applicable, which is founded squarely on simple fairness. The object of the provisions is not to introduce an undue degree of nicety or technicality in the formulation of charges.*

*[106] Consideration of the alleged incongruence between the charge and the basis for the conviction must also take place cognisant that the basis of the attack on the disciplinary committee's findings is also founded on an application of the principle of fairness. Any question falling to be determined by reference to what would be fair in the circumstances has to be approached with appropriate flexibility, astute to the peculiar circumstances of the given case; cf eg Joseph and others v City of Johannesburg and others 2010 (4) SA 55 (CC), at paragraph 56 [also reported at 2010 (3) BCLR 212 (CC) – Ed]. The approach of the appeal court in Coetzee, discussed earlier, exemplified this in a closely comparable context; cf also the remarks of Harms DP in National Director of Public Prosecutions v King 2010 (7) BCLR 656 (SCA) at paragraph 5, in respect of the fair trial rights enshrined in section 35 of the Constitution. It is appropriate to have regard to the rights and interests of both sides and also, if applicable, to the objects of the statutory provisions in the context of which the proceedings are being conducted or have taken place. This principle would also bear on the assessment of the materiality of any non-compliance with section 49(3) and/or sub-rule 4.10, should there be a finding that the provisions had not been complied with."* (emphasis added)

442 Broadly speaking, what is conveyed in the judgment is that the assessment of the charge is based on fairness to both sides, having regard to the context. Perfection in the formulation of the charge is not required. A good indicator of an acceptable formulation of the charge will be whether or not the respondent is given sufficient warning to be able to plead and adduce evidence pertinent to the charge in his defence.

443 Applying this approach, the court in Du Plessis -

443.1 acknowledged that the charge had been *"somewhat ineptly drafted"*;

443.2 took into account that the charge was accompanied by a bundle of all the relevant documentation and the complainant's detailed witness statement;

443.3 considered that on a purposive reading of the charge, it was obvious what the nature of the charge was;

443.4 considered whether the applicant had sufficient information to plead to the charge, without the need for her to have the *facta probantia*;

443.5 in relation to a complaint that she was misled by the charge into thinking that it was based on one premise, yet ultimately faced a charge on a different premise, the court took into account that -

443.5.1 in the conduct of the case, the second premise was canvassed in her evidence;

443.5.2 *"it was in fact the [respondent] herself who spontaneously first made reference to the December emails [forming the*

*basis of the alleged second premise] in her evidence in chief";*

443.5.3 The issue was fully canvassed in the heads of argument.

444 Also relevant in this regard is that the proceedings are administrative action under the Promotion of Administrative Justice Act No. 3 of 2000, so that the formality of pleadings is not required in the schedule of charges. Rather, fairness depends in terms of section 3(2)(a) of that Act, *"on the circumstances of each case"*.[62] With reference to the charge, a respondent is entitled to *"adequate notice of the nature and purpose of the proposed administrative action"* (section 3(2)(b)(i) of that Act).

445 Paragraph 9.1 of the schedule of charges reads *"[t]he AFS of African Bank for the year ended 30 September 2014 indicate a material restatement relating to a change in the definition of loss event (from CD4 to CD1[63]), in determining the level of impairments to align with market practice and the requirements of IAS 39."* From that sentence the following is clear as to the nature of the complaint:

445.1 A material restatement in the 2014 AFS points to a material error in the 2013 AFS;

445.2 The error pertained to the determination of the appropriate level of impairments;

[62] Per van der Nest AJ in *Dawood v Independent Regulatory Board for Auditors* (Unreported judgement of the Gauteng Division, Johannesburg dated 5 July 2019 under case no. 10837/2016) at paras 5, 6, 62 and 64.

[63] There is an obvious error in paragraph 9.1 of the charge where it says from CD1 to CD4, when the reverse was intended.

445.3 That determination in the 2013 AFS was not in alignment with market practice and the requirements of IAS 39;

445.4 The change that was effected in the restatement to bring about the correction was *"a change in the definition of a loss event from CD4 to CD1"*.

446 Paragraph 9.1 goes on to give the alleged quantum of the restatement. Nowhere is it suggested that there was no impairment in respect of the loans in the CD1 to CD3 buckets - misstatement is alleged.

447 Paragraph 9.2 of the schedule of charges makes it clear that the restatement was the result of an error involving non-compliance with IAS 39.

448 Subparagraphs 9.3.1 to 9.3.5 of the schedule of charges refer to five communications during the audit which, it is alleged, pointed to the need for the Bank to reconsider its adoption of CD4 as the point of impairment and to consider the need to change it to CD1. The first respondent would have been aware of four of the five communications.

449 In this regard it is important to bear in mind that -

449.1 The contemporaneous documentation emanating from the audit and the setting out above of the chronology of events in relation to this aspect of the audit, makes it clear that everyone involved, including the first respondent, described the Bank's approach to impairment of loans in the CD1 to CD3 category, and the related auditing work, with reference to where it located the point of impairment;

449.2 This is so notwithstanding the fact that everyone involved, including the first respondent, was fully conscious of the fact that the Bank applied an IBNR-based impairment to this category of loans - indeed the short-hand term for the Bank's impairment on these buckets, together with CD0, was frequently "the IBNR";

449.3 Everyone involved, including the first respondent, was aware that an IBNR impairment was <u>not</u> applied to loans in the categories CD4 and greater - instead a specific impairment (using a different formula) was applied based on the point of default having been reached and a determination of the loss consequent upon default only (i.e. excluding PD);

449.4 The first respondent would have known that shifting the point of impairment from CD4 to CD1 to avoid the misstatement of impairments alleged in the charge, would have required changing the basis for computation of the impairment for the loans in the CD1 to CD3 buckets;

449.5 Because the Bank, with the approval of Deloitte, had used an IBNR-type approach to the impairment of these loan buckets in the 2013 AFS, it was inevitably the Bank's IBNR and the manner in which it computed impairments, that was going to be subject to scrutiny in terms of the charge. That would have been obvious to the first respondent.

449.6 It would also have been obvious to the first respondent that everyone knew and accepted that some level of impairment was provided for by the Bank in respect of the CD1 to CD3 loan buckets. The debate was therefore never going to be about whether or not there was any

impairment at all, but rather about whether the amount of the impairment represented a misstatement.

449.7 The latter point is borne out by the fact that the discourse during the audit frequently used language which, taken literally, might suggest that if a point of impairment is adopted at CD4, no impairment at all is applied to categories CD1 to CD3. Even note 5.1.1 to the African Bank 2013 AFS, quoted in the factual background above, states the following in respect of loans in these categories:

> *"Financial assets that are past due (up to 3 months) but not yet impaired."* (emphasis added)

450 That all of this was clear to the first respondent, is apparent from the extent to which his plea (along with the factual and expert evidence and argument presented on his behalf) is devoted to defending precisely the issues that the first respondent now argues are not in the charge i.e. the formula and inputs for computing the Bank's IBNR provision.

451 There is another way of assessing the first respondent's complaint in this regard. The charge, viewed holistically, alleges a misstatement through the incorrect location of the point of impairment at CD4 (not CD1), with reference to IAS 39 and industry practice. The first respondent admits that the Bank's approach in this regard diverges from that of industry, but seeks to defend the charge on the basis of a plea that it effectively did locate the point of impairment at CD1 by impairing loans in the CD1 to CD3 buckets on the basis of an IBNR type impairment. Having raised that plea, scrutiny by the pro forma complainant of the defence raised was entirely appropriate. Scrutiny naturally included

examination of the formula and inputs for computing the Bank's IBNR provision and its computation.

452 Accordingly, there is no merit in the first respondent's complaint in this regard, particularly when tested against the criteria identified in *Du Plessis*. Even if we are wrong in holding that there was no change in focus or premise of the charge, the first respondent was extremely well-prepared to meet it and *Du Plessis* permits us to consider his innocence or guilt on the refocused charge.

453 It should be added that, having regard to the foregoing analysis, it was unnecessary and inappropriate for the first respondent to seek, during oral evidence and retrospectively, to correct his 2013 Final Report to the Audit Committee in a manner that purported to align more closely with his defence.

454 In essence, the first respondent defends the second charge on two broad bases.

454.1 The first is on the basis of the advice that was provided by Ms Ranchod that IAS 39 is to be interpreted so as not to require or prescribe the recognition of a loss event at CD1 if ABIL can provide evidence that categorisation in CD1 to CD3 does not impact the expectation of future cash flows;

454.2 The second is on the basis that in effect CD1 was recognised as the point of impairment because an IBNR impairment provision was applied to loans in the CD0 to CD3 buckets, and that provision was compliant with IAS 39. This is so notwithstanding that the IBNR-type impairment diverged in its approach from most in the industry.

455 We consider each of these defences in turn.

***The Ranchod opinion justified the Bank's approach***

456 As appears from the factual background summarised above, pursuant to an internal meeting held on 17 October 2013, the first respondent, by way of a technical consultation, sought an opinion from the Deloitte technical department on the question whether IAS 39 prescribed CD1 as the point of impairment. Although the opinion was seemingly prepared by Ms Zariffis and approved by Ms Ranchod, it came to be referred to in the proceedings as the Ranchod opinion and we will refer to it as such. She characterised the problem presented to her as follows:

> *"ABIL currently considers a loss event to have taken place, and accordingly raises an impairment loss, when the loan reaches CD4 – that is when four payments (not consecutively but cumulatively) have been missed. ABIL justifies this approach on the basis that CD1 loans are usually recovered, and it is only when they move to CD4 that recovery (of a majority of capital and interest/ fees) is no longer expected.*
>
> *...*
>
> *We have been asked to consider*
>
> - *whether the IAS 39 requires / prescribes the recognition of an impairment loss at CD1 (generally accepted banking practice in SA)*
> - *whether a change in the point of impairment (say from CD4 to CD3) will be regarded a change in estimate or a change in accounting policy."*

457 The opinion then refers to IAS 39 and goes on to say:

> *"Therefore, given the loss event examples, <u>a CD1 categorisation should be considered a loss event</u>. However, <u>if ABIL is able to provide evidence that categorisation of CD1 to CD3 does not impact the expectation of future cash flows</u> – that is, CD1 to CD3 loans generally are recovered in future periods – then it will be appropriate to consider CD4 to be the loss event that triggers the recognition of impairment.*
>
> *....*
>
> *IAS 39 does not have a prescriptive point at which impairments should be recognised. Therefore, the CD4 level would be considered appropriate <u>if it meets the criteria</u>, namely that there is a loss event in*

*that the loss event affects future cash flows. It would not be appropriate to include future losses in this assessment.*

*ABIL currently discloses that loans are considered non-performing once more than three consecutive payments have been missed. This represents an estimate of incurred losses. Should management conclude, and the audit team concur, that impairment data indicates that the point at which a loss event occurs has changed, this will be regarded as a change in estimate as it reflects a change in the profile of expected cash flows from prior years. This change should be recognised prospectively."* (emphasis added)

458 We agree with the pro forma complainant that the opinion is incorrect insofar as it suggests that the impact on future cash flows was to be tested by the recoverability of the debts in future periods. That is not what IAS 39 says. What is required is an impact on future cash flows that can reliably be estimated, not an assessment of whether or not the impact of the loss event is that the loan will not be recovered. That error would have been obvious to the first respondent as a banking auditor.

459 However, save for that, the Ranchod opinion is correct. In terms of IAS 39 paragraph 59, a loss event on its own is insufficient to trigger the duty to impair. To qualify for impairment, a loss event must have had an impact on the estimated future cash flows that can reliably be estimated. If not, impairment is not required. Further, notwithstanding Ms Ranchod's error in this regard, we will assume in first respondent's favour that an audit enquiry that established that loans in these categories are generally recovered in future periods, would bring him within the protective reach of the opinion.

460 The committee accordingly accepts that if the first respondent followed the advice in the opinion and established that ABIL was able to provide the required audit evidence for each of the three loan categories, it was appropriate that CD4

was retained as the appropriate impairment point. The opinion provided the first respondent with a clear way forward in resolving the issue.

461 There are insertions by the first respondent on the Ranchod opinion which, from the outset, cast doubt on whether he complied with the search for audit evidence that the opinion prescribed. Below the above extract from the opinion, the first respondent adds the following:

> *"TMJ, commentary: Our discussions with management reflect that the basis of determining the impairment event is affected by economic cycles, collection strategies adopted by ABIL and historical default rates. We have commented to management and the audit committee that based on the trends seen at ABIL, the impairment level of CD4 is less prudent than that found in the rest of the banking sector, although commonly followed by other microlenders in SA."*

462 This is problematic.

462.1 This commentary does not relate back to the wording of IAS 39, but instead to considerations not all of which are directly linked to the enquiry mandated by the standard.

462.2 More importantly for present purposes, the commentary does not record any intention to take on the task mandated by the opinion i.e. to search for audit evidence that future cash flows or recoveries are not impacted by first, second and third contractual delinquencies.

462.3 The second sentence of the commentary points to an acceptance by the first respondent of CD4 as an acceptable impairment level, albeit on the basis of a comment that it is less prudent than found elsewhere in the banking sector, without any further enquiry as required by the opinion.

463 The opinion ends with the following questions directed at, and answered by, the first respondent as follows:

> *"Is the nature and scope of, and conclusions resulting from, this consultation documented and agreed with the party consulted?*
> *Yes, the engagement partner has acknowledged this conclusion.*
>
> *Has the conclusion resulting from the consultation been implemented?*
> *Yes, the treatment of IBNR has remained constant with prior years."* (emphasis added)

464 These responses on the part of the first respondent are also problematic.

464.1 In relation to the first question, agreeing the nature and scope of, and the conclusions reached in the opinion, meant agreeing the need to conduct the search for the further audit evidence referred to earlier. Instead, all that the first respondent says is that he acknowledges the conclusions. Acknowledgement does not necessarily mean agreement.

464.2 In relation to the second question, implementation of the conclusion reached in the opinion clearly called for a response by the first respondent along the lines that the necessary audit evidence had been sought from ABIL, together with an indication of the result of that enquiry. Instead, the first respondent simply says *"yes, the treatment of IBNR has remained consistent with prior years"*. That is not what implementation of the opinion required.

464.3 Moreover, asserting consistent treatment with prior years is the antithesis of the required enquiry. What was being queried was whether there was a need to change the practice from prior years. Saying that the treatment

was the same reflects a fundamental misapprehension of the advice given.

465 There is a further difficulty in relation to compliance with the Ranchod opinion. As appears from the factual background, the opinion was prepared on 17 October 2013. Assuming in favour of the first respondent that the Ranchod opinion was provided to him on the same day that it was sought from and prepared by Ms Zariffis, on the very next day, the first respondent and Mr Pinnock had confirmed an IBNR impairment figure of approximately R300m based on an impairment point of CD4, not CD1. There is no evidence to suggest that all (or any) of the audit work required by the Ranchod opinion was carried out during the 24-hour period between delivery of the opinion to him and agreement with the board of the Bank that the IBNR impairment would be settled on that basis.

466 Even if the starting point for the audit work is taken from the date of Mr van der Burgh's email of 15 October 2013 (which was essentially to the same effect as the Ranchod opinion) there is similarly no evidence that the required audit work was conducted during the period 15 to 18 October 2013.

467 The first respondent relied in argument, as the basis for compliance with the audit work required in the Ranchod opinion, on the following testimony of the first respondent:

> *"... the team would then conduct various tests that supported the input into this impairment model, but also gave us a view – gave me a view around the general performance of the Bank in relation to cash performance. In other words, what was the environment, was there an adequate collection of outstanding debt in the market. And this particular work paper which you may refer to, indicated that for the performing loan book, the cash collection rate, in other words the cash per instalment varied over the year between 95 and 106%."*

468 His oral testimony in this regard was referenced to a working paper entitled *"Collection and Discount Rate Analysis".* The part of this working paper from which the first respondent derives these collection rates is that which gives the cash to instalment percentages during the 2013 financial year for the entire performing loan book for each month.

469 The difficulty with reliance on this audit work is that it includes CD0 loans along with CD1 to CD3 loans. Ranchod's opinion required a search for audit evidence in relation to CD1 to CD3 loans because the issue was whether the impairment point should be moved to CD1. CD0 loans were therefore irrelevant to the enquiry.

470 Reliance on this audit work might nevertheless be appropriate if CD0 loans represented a negligible component of the performing loan book. However, if regard is had to the summary tab in exhibit 18.3, the whole performing loan book amounted to 41,101,962,601 of which (if one totals all the CD0 books) CD0 amounted to 34,818,550,396. Thus CD0 represented 84.7% of the performing loan book. From that it is clear that the working paper relied on provides no real indication of the collection rates for the CD1 to CD3 loan buckets. Nor were we referred to any audit work that isolated the collection rates for the CD1 to CD3 loan categories.

471 The first respondent's responses to this in cross-examination were as follows (with the Committee's views following):

471.1 Nowhere does Ms Ranchod require a separate categorisation for CD1, CD2, and CD3 – however, she expressly refers to this category and she excludes CD0; in any event, this flows logically from her opinion; if at any

one of those points, it is apparent on the audit evidence that the delinquency does not impact future cash flows, the point of impairment should be located in the subsequent CD bucket.

471.2 Ms Ranchod *"could not make that proposition [i.e. checking cash flows at each of CD1 to CD3] because knowing IAS 39, it is not evident. It is not prescriptive in terms of how management need to categorise and classify the loan book to determine impairments"* – however, the first respondent placed reliance on the opinion in his defence; he cannot pick and choose those parts of the opinion that he prefers; in any event, identification of a point at which impairment must be effected is an enquiry dictated by IAS 39, notwithstanding that any particular segmentation of the loan book is not dictated by IAS 39; AG87 of IAS 39 does lay down criteria for segmentation and here there was in any event a logical reason to scrutinise cash flows relevant to the CD1 to CD3 loan buckets.

472 The audit enquiry called for by the Ranchod opinion would also have required a consideration of the audit evidence pertaining to the roll rates and PDs of loans in the CD1 to CD3 buckets, with reference to an outcome period long enough to see whether there were indeed loan repayments in future periods of the kinds she envisaged, notwithstanding the first, second and third delinquencies. We were not referred to any such analysis in response to Ms Ranchod's opinion.

473 Had that analysis been done, the roll rates and PDs experienced in the CD1 to CD3 buckets would have revealed that future cash flows were indeed impacted by first, second and third contractual delinquencies and that loans were not

generally recovered in future periods. The details of this analysis are covered in the next section of the decision.

474 An aspect not alluded to by the first respondent in his defence when cross-examined on this aspect of the charge, but mentioned by Ms Ranchod in her discussion with Mr Raubenheimer on 22 October 2013, is summarised by him in his email of 23 October 2013 as follows:

> *"Although the roll rates from delinquency bucket 3 (accounts that are between 60 and 90 days past due) into default (90 days + past due) within 1 month is high (75%), this fact, per se, does not imply non-payment is probable. The reasoning behind non-payment not being regarded as probable is a result of the LGD for accounts in default being around 50% which implies the loss for accounts in bucket 3 is less than 50%."*

475 The problem with this reasoning is that the LGD is the quantum of the loss upon default and is therefore relevant to the quantum of the required impairment. It has nothing to do with the probability of non-payment. It relates to the amount of the loss upon non-payment.

476 To the extent that the probability of default is below 50% in the CD1 and CD2 buckets (based on a 4-month outcome period - it is above 50% on a 12-month outcome period), that level of default still requires impairment when performing portfolio specific impairment. IAS 39 does not by any means exempt an entity from impairment because the cash flows of less than half of the loans (by value) in a segment will default. Nor did Ms Ranchod place any such limitation on the enquiry she required.

477 Applying the foregoing analysis to the advice given by Ms Ranchod, a point of impairment at CD4 was not justified with reference to observable evidence of the absence of impact (of delinquency) on cashflows or repayment, in loans in the

CD1 to CD3 buckets. The advice of Ms Ranchod therefore required that the first respondent insist on the adoption of CD1 as the appropriate point of impairment.

***Was the IBNR provision for impairment compliant with IAS 39?***

478 We turn to the third defence advanced by the first respondent to this charge. It raises the following questions:

478.1 Is an IBNR impairment in respect of CD1 to CD3 loans permissible in principle in terms of IAS 39?

478.2 If so, was the methodology underlying the IBNR impairment effected by the Bank compliant with IAS 39 and did it generate a reasonable estimate?

Is it permissible in principle?

479 It was common cause that IBNR stands for "incurred but not reported". The first respondent defined the concept in his witness statement as follows:

> *"There are two forms of IBNR that are relevant to the ABIL group: credit impairment IBNR and insurance IBNR. Insurance IBNR refers to a reserve (in financial years before 2013) or a provision (in the 2013 financial year, after a change in accounting policy) recorded in the reserves of the ABIL insurance entities. Credit impairment IBNR refers to an impairment provision raised on the PL book of the Bank. Both refer to loss events that have transpired, but have not yet been reported. In the context of PLs, it recognises the statistical effects of loss events that have taken place at the time of assessment, but which have not yet been notified or reported to the entity at the time of the assessment of the value of the PLs."*

480 The experts had qualified agreement on the definition of IBNR. They defined it as follows:

*"An IBNR (Incurred But Not Reported) impairment provision – often described as a portfolio provision or portfolio impairment – over advances in the CD0 bucket that had probably already experienced a loss event but not yet missed a payment and therefore could not be individually identified as impaired. The calculation usually takes the following form:*

*IBNR = EAD (or carrying value) x PD x flow LGD x LEF".*

481 Although the experts refer only to the CD0 bucket, it was common cause that in the 2013 AFS, an IBNR impairment was applied also to loans in the CD1 to CD3 buckets. The experts' competing views on the permissibility of an IBNR impairment have already been referred to in the introductory section of the decision on the second charge. At the heart of their differences lies the IRBA's contention that an IBNR provision in respect of loans in the CD1 to CD3 buckets is impermissible, because there have been between one and three loss events as contemplated in paragraph 59(b) of IAS 39, in the form of contractual delinquency. These loss events <u>have been reported</u> to the creditor and accordingly are not appropriately impaired by way of an IBNR.

482 The appropriate starting point in determining whether it is in principle permissible to use an IBNR provision in these circumstances, is IAS 39. Unfortunately, IAS 39 does not define or specifically regulate an IBNR-based impairment. However, it is clear that a contractual delinquency, even a single one, forms one of several loss events specifically identified in paragraph 59 of IAS 39. This much is common cause. In the event that such a loss event impacts on future cash flows, and the impact can reliably be estimated, impairment must follow.

483 The IRBA contends that the effect of an IBNR impairment, which is only to impair for unreported losses, is inherently at odds with paragraph 59, which requires an impairment for every loss.

484 In answer to this, the first respondent refers to the requirement of paragraph 59 that losses expected as a result of future events are not to be recognised. Impact on estimated future cash flows is assessed by referring to historical statistical data of the performance of similar loans. Use of that data will, unless something is done to exclude them, include losses that are the result of future loss events, not necessarily linked to the contractual delinquency in question. It is here that the first respondent asserts that the IBNR-type methodology provides a superior mechanism, because it does just that. It acknowledges the loss event, but strips out future losses not causally connected with it.

485 The only reference to an IBNR impairment in IAS 39 is to be found in paragraph AG90, which refers to the following example:

> *"As an example of applying paragraph AG89 [quoted above and dealing with collective evaluation of future cash flows for purposes of impairment using historical loss experience], an entity may determine, on the basis of historical experience, that one of the main causes of default on credit card loans is the death of the borrower. The entity may observe that the death rate is unchanged from one year to the next. Nevertheless, some of the borrowers in the entity's group of credit card loans may have died in that year, indicating that an impairment loss has occurred on those loans, even if, at the year-end, the entity is not yet aware which specific borrowers have died. It would be appropriate for an impairment loss to be recognised for these 'incurred but not reported' losses. However, it would not be appropriate to recognise an impairment loss for deaths that are expected to occur in a future period, because the necessary loss event (the death of the borrower) has not yet occurred."*

486 The pro forma complainant contends that this example confirms its view that an IBNR applies only to a loss which is unknown and unreported to the reporting entity. It could never apply to a loss event known to it. The first respondent argues that it is but one example, which cannot be extrapolated to exclude an IBNR's application to loans where there are up to three delinquencies.

487 The example in paragraph AG90 in our view points to a loss event which is statistically known, but not actually reported. It is not clear where this takes the debate, but it cannot be said conclusively to exclude the application of an IBNR impairment in the circumstances contended for by the first respondent.

488 On the other hand, and favouring the pro forma complainant, it is so that the words "incurred but not reported" do not fit comfortably with a segment of loans where there are between one and three known and reported delinquencies. The logic of its wording tends to suggest that it would be appropriate to the CD0 category where there are no reported losses, or as a supplementary form of impairment in the CD1 to CD3 categories, not an alternative form of impairment, again to deal with unreported but statistically known loss events in those loan buckets.

489 The first respondent and the Deloitte experts contend that IAS 39 is not specific as to the methodology that is employed to effect impairment, as long as it is based on, and compliant with, the relevant paragraphs of IAS 39. Whilst they recognise that the approach of the "big four banks" and others, which apply a portfolio specific impairment on CD1 to CD3 loans (based on the formula – Carrying Value x PD x LGD), is a legitimate and compliant one, so too is an IBNR-type impairment. In this regard, Mr Cohen said in his witness statement –

> *"The name attached to the impairment of these loans, whether it is PSI or IBNR, or some other name is of lesser importance. The key issue is to ensure that an impairment is recognised (whether individually or collectively) and that such impairment is reasonable."* (emphasis added)

and elsewhere in this statement -

> *"The extent to which using an IBNR for the early arrears book is acceptable, in my view, depends more on whether the total impairment is accurately estimated, rather than the nature of the detailed impairment model adopted. Numerous approaches may be acceptable, provided that they are capable of accurately estimating the impairment allowance in accordance with the standard's principles."* (emphasis added)

490 In support of the stance of the Deloitte experts in this regard, even Mr Raubenheimer, whose stance on the impairments (save at the end of the audit) was generally advanced by the pro forma complainant as being the correct one, seemingly based his impairment at the time when exhibit 18.3 was prepared (16 October 2013), for the CD1 to CD3 loan buckets, on an IBNR-type methodology, albeit using a different LEF from that which ultimately formed the basis of the impairment charges in the 2013 AFS.

491 In these circumstances, it is in the Committee's view unnecessary to reach a final decision on whether or not an IBNR-type impairment is permissible under IAS 39 for loans in the CD1 to CD3 buckets. We will assume that it is permissible. However, having regard to what Mr Cohen says, it would still be required that the methodology underlying the particular IBNR impairment effected by the Bank was compliant with IAS 39 and that it generated a reasonable estimate.

A compliant methodology generating a reasonable estimate?

492 The sequence of events relating to the application of the IBNR methodology to impaired loans in the CD1 to CD3 buckets has been set out above in explaining

the factual background and need not be revisited, save in the respects elaborated upon below.

493 The initial stance of the Bank in relation to the amount of the IBNR impairment for loans in the CD1 – CD3 buckets was as set out in the "DT Summary" tab (i.e. Deloitte summary) of the spreadsheet forming annexure 18.3 sent by Mr Burra to Mr Raubenheimer on 16 October 2013. That was described as the "Base" and was an amount of R224,541,751.

494 The spreadsheet then reflects two sets of adjustments that were effected to the finance department's base figure.

495 The first adjustment is that made to the roll rates. The base calculation applied roll rates on the basis of the probability of a delinquent loan moving directly from its particular CD bucket to default (ie CD4) over the period of a single month. Given that it is almost impossible to contemplate a scenario where this might happen in respect of the CD0, CD1 and CD2 loan buckets, the roll rate used was not justifiable. Moreover, the inevitably exceptionally low percentages derived for the roll rates gave rise to unrealistically low levels of impairment. Messrs Burra and Tenzer accordingly adjusted the roll rates to provide for sequential rolling through the successive buckets to the point where default or CD4 was reached. The percentage adjustments to which this gave rise are not aggregated for the totality of the loan books, but using the "Retail W/F" book as an example, the adjustments were as follows

*CD0 : 0.1% to 2.8%*
*CD1 : 0.5% to 34.49%*
*CD2 : 6.1% to 55.93%*
*CD3 : 77% to 77.03%*

496 The adjustment gave rise to an adjustment of the base figure to a total amount of R506,793,383. The adjustment in question was reasonable and appropriate.

497 The second adjustment pertained to the LGD percentage, which was increased to 44%. This adjustment was attributed by Mr Burra to management, but attributed by the first respondent to Mr Burra. The spreadsheet treats it as a Deloitte adjustment, but nothing turns on this. This percentage was then used uniformly across all of the books. Previously, the LGD figure had been mostly in the region of 20%, but varied across the different loan books.

498 Application of this adjustment gave rise, together with the adjusted roll rate, to a figure of R994,377,266. Again, there was no suggestion that that adjustment was not reasonable and appropriate.

499 Those figures incorporated, without adjustment, a loss emergence factor (LEF). The LEF applied is apparent from the "Cash_Value Date" tab in exhibit 18.3. They are based on an "emergence factor" (more correctly emergence period) expressed in a number of days as numerator over a greater "number of days" expressed as a denominator. In respect of each loan book (e.g. "Retail W/F", "Retail Montly" etc), a different loss emergence factor is applied depending on the particular payment patterns in that book. In addition, average LEFs for each of the delinquency categories are provided in exhibit 18.3 as follows:

*CD0 : 9 days / 30 days or 30%*
*CD1 : 40 days / 61 days or 65.57%*
*CD2 : 71 days / 92 days or 77.17%*
*CD3 : 101 days / 122 days or 82.79%*

500 In his oral testimony Mr Burra said that he and Mr Raubenheimer "agreed to disagree" on this calculation of the loss emergence factor. Mr Burra held the view that it should remain constant across all of the CD buckets (ie at 9/30 or 30% applying the average LEF in exhibit 18.3). Despite this disagreement, there was no attempt to record any difference of opinion as between Deloitte and Mr Raubenheimer at that stage. Thus there was no adjustment in the spreadsheet to accommodate this disagreement. The LEFs were left as set out above. Nor was any reference to a disagreement in this regard made in the covering email from Mr Burra to Mr Raubenheimer when sending him the adjusted spreadsheet.

501 The final iteration of the Deloitte stance in relation to the audit of the IBNR impairment for the CD1 to CD3 buckets is that reflected in the Deloitte African Bank Credit Impairment Review prepared by Mr Burra. According to the first respondent, this had become the Deloitte position by 25 October 2013 when a SENS announcement was made pertaining *inter alia* to the final impairment figures. Unfortunately, there is no spreadsheet corresponding with the further adjustments referred to in the credit impairment review.

502 The further adjustments reflected at this stage were as follows:

502.1 There appears to have been a further refinement of the roll rates because the adjustment required moved up to an amount of R594m;

502.2 The LGD was further adjusted from 44% to 56% to take into account the correction of the approach to the *in duplum* loans, giving rise to an adjustment of R335m;

502.3 On the loss emergence factor, Mr Burra on this occasion chose to make an adjustment using the emergence factor for the CD0 bucket, across all of CD1, CD2 and CD3. With reference to exhibit 18.3, discussed above, this would have meant applying the 9/20 or 30% factor, not just to CD0, but also to all of CD1, CD2 and CD3, without increasing the numerator and the denominator. In other words, he applied his preferred approach, upon which he had "agreed to disagree" with Raubenheimer. The effect of this adjustment was a reduction in the impairments of R637m.

503 The effect of this reduction, to a large degree cancelled out the increase in impairments flowing from the other two adjustments referred to above. Thus the adjustments called for by Mr Burra to the roll rates and LGD totalled R929m, but, after the reduction of R637m, left a net upward adjustment to impairments of only R292m. When added to the base figure of R225m, this gave rise, on Mr Burra's approach, to a total IBNR impairment required by Deloitte of R517m. That figure was less than the R585m impairment provision which was by then advanced by management.

504 There was no suggestion in evidence or otherwise that the upward adjustments to impairments in respect of the roll rates and the LGD were unreasonable. However, the significant downward adjustment in the amount of R637m arising from the application of a uniform LEF, formed the subject matter of discussion in the hearing. In his evidence in chief Mr Burra justified his approach as follows:

> *"My view, based on the accounting adoption at the time was that, if the account is unimpaired and in CD1, the seven days for post-payment for the account to become impaired, then the emergence factor remains seven days (sic) ... So I would have kept the 30% constant, where Mr Raubenheimer kept adding 30 days per month."*

505 His explanation in cross examination appeared to be that because loans in all of categories CD0 to CD3 were treated as unimpaired under the Bank's IBNR approach, and the only impairment that was being done was for unreported loss events, these would in each month only be events that could have arisen between the 23rd and 30th day of the month.

506 The matter was taken up further in questioning by the committee. The exchange in this regard is illuminating and therefore requires to be quoted in full.

> *"MR GRIFFITHS: [Indistinct – microphone not on] question about this emergence factor. I just want you to bear with me and then explain to me how this then worked. The seven day is derived from the payment pattern.*
>
> *MR BURRA: Correct.*
>
> *MR GRIFFITHS: Okay, and the theory is that if the man paid up to that point one can accept that everything is fine, and you need to look at this period that there was not a payment.*
>
> *MR BURRA: Correct.*
>
> *MR GRIFFITHS: Now the first thing is that payment pattern comes from the actual payments.*
>
> *MR BURRA: Correct.*
>
> *MR GRIFFITHS: It does not come from what the people had to pay, it is – I have looked at it, you can also look at it, it is the actual receipts they were paying.*
>
> *MR BURRA: Right.*
>
> *MR GRIFFITHS: And I just wanted to know whether you looked at – so it is basically driven by when the people want to pay, if in January they pay late then you going to have an effect of this. It is not what was due.*
>
> *MR BURRA: So if understand your point correctly it is the – it was derived from payments rather than from paid versus raised, what was due.*
>
> *MR GRIFFITHS: Ja, ja.*
>
> *MR BURRA: So the honest answer is I do not recall checking that. No.*
>
> *MR GRIFFITHS: But it can have an influence.*
>
> *MR BURRA: …[intervenes] it can.*
>
> *MR GRIFFITHS: On the number.*

*MR BURRA: Correct.*

*MR GRIFFITHS: But that is not the important thing. The thing is that, and the way I look at it, I am going to put it to you like that because that is the way I understand.*

*MR BURRA: Sure.*

*MR GRIFFITHS: The logic behind this. If I look at CD1 at the end of September 2013.*

*MR BURRA: Yes.*

*MR GRIFFITHS: There is this bucket.*

*MR BURRA: Correct.*

*MR GRIFFITHS: Now who is in this bucket? If I can ask the people in that bucket why are you here, what have you done wrong, why are you here, I would think, and I am just going to lead you, you must correct me where I am wrong. There were the people in there that paid that month but they were previously in CD1 so they remained in CD1.*

*MR BURRA: Correct.*

*MR GRIFFITHS: Do you agree with me?*

*MR BURRA: I agree with you.*

*MR GRIFFITHS: There could be one or two that was in CD2 or 3 the previous month, that made payment, three payments, more than one payment, and they came back to CD1 but they were very few.*

*MR BURRA: Correct.*

*MR GRIFFITHS: I would imagine that the biggest category will be people that were in CD1 and made one month payment and then remained in CD1 okay.*

*MR BURRA: Okay.*

*MR GRIFFITHS: But I would think that the biggest part, you have got to correct me if I am wrong, will be people that the previous month were in CD0 and did not make a payment. Now those people, when was their last payment?*

*MR BURRA: Two months ago.*

*MR GRIFFITHS: So this theory of seven days does not apply to them. I will just tell you that when you say you did not agree with Mr Raubenheimer with his 37 over 60.*

*MR BURRA: Yes.*

*MR GRIFFITHS: I think he had a good point there because the biggest chunk of people in CD1 would not have paid seven days ago. They may have paid, one further could ask these people why are you here.*

*MR BURRA: Yes.*

*MR GRIFFITHS: They may have paid seven days before the end of August, if they paid whilst they were in CD0.*

*MR BURRA: Yes.*

*MR GRIFFITHS: But they also could never have paid, …for two months they have not paid.*

*MR BURRA: Yes.*

*MR GRIFFITHS: As you have just said.*

*MR BURRA: Yes.*

*MR GRIFFITHS: But …those people that migrate from CD0 to CD 1, they are 37 days behind.*

*MR BURRA: There is some merit to your point.*

*MR GRIFFITHS: And it makes one heck of a difference.*

*MR BURRA: Yes.*

*MR GRIFFITHS: So and if you agree with me there it is this logic. What I am really after, I am not trying to accuse you of doing incorrect calculations but my experience of people in your positions, you have these discussions.*

*MR BURRA: Yes.*

*MR GRIFFITHS: And it is those discussions that we as auditors enjoy.*

*MR BURRA: Yes correct.*

*MR GRIFFITHS: Because we are challenging you people and we want to get to the correct logical answer of what needs to happen in your calculation.*

*MR BURRA: Yes.*

*MR GRIFFITHS: Have you had a [discussion],*[64] *you said that you have had a [discussion] on CD1 versus CD4, with Mr Jordan, have you had this kind of [discussion] on practical aspects of the IBNR, how does it work, with Mr Jordan?*

*MR BURRA: I think we had many.*

*MR GRIFFITHS: But you never – and can you then say to me why did you not agree with Mr Raubenheimer?*

*MR BURRA: I think the argument was not presented as cleanly as you present it now.*

*MR GRIFFITHS: But it is not presented.*

*MR BURRA: Yes.*

*MR GRIFFITHS: It is thinking logically what is happening.*

*MR BURRA: Yes.*

*MR GRIFFITHS: These things are not just calculations for the spreadsheet and whatever.*

---

[64] Mr Griffiths here used the word "calculation" , not "discussion", but he clearly meant and was understood to mean "discussion".

> *MR BURRA: Yes.*
>
> *MR GRIFFITHS: Your numbers that you reflect in your financial statements must be a reflection of what is happening in the business, not against you. I just want to know whether this logical checking of the logic that is behind the calculation happened."*

507 Apart from the illogicality identified by Mr Griffiths, there are additional anomalies arising from Deloitte's R637m reduction in impairments on the basis of Mr Burra's adjustment to the LEF.

508 Firstly, it was inconsistent with earlier stances adopted repeatedly in the 2012 financial year, in 2013 during the period preceding the audit and during the 2013 audit by both Mr Burra and the first respondent. The views conveyed by the first respondent and Mr Burra in these meetings and communications repeatedly voiced a concern from the Deloitte side that management were turning towards aggressive stances in relation to impairment, when this was inconsistent with industry practice and inappropriate to the circumstances. In his witness statement, specifically in the context of the IBNR, Mr Burra says:

> *"Deloitte were concerned with management's aggressive definition [of the impairment point]."*

509 In relation to the models he built, he said, in his oral testimony:

> *"They were consistently towards the lower end of any estimates I had come up with and that for me was worrying. [It] led me to suggest that they were being aggressive."*

510 Against this backdrop it is incomprehensible that at the end point of the audit, in consultation with the first respondent, Deloitte, through Mr Burra, effected what can only be described as an aggressive downward adjustment of impairments in the sum of R637m. Indeed, at this point, the overall figure for impairments advanced by Deloitte at R517m in respect of performing loans was more aggressive than that advanced by management at R585m.

511 Secondly, the stance of Deloitte was not supported by the main expert called on behalf of the first respondent on this question, Mr Cohen. Mr Cohen described with considerable care and clarity the manner in which an IBNR impairment is conceived and implemented. Moreover, he considered the approach of African Bank to be that based on a loss emergence factor where the numerator and denominator increase as one moves from CD0 to CD3. It was that version of the IBNR which he sought to defend in his witness statement, not the approach of Mr Burra. He describes African Bank's approach as follows:

> *"526. As outlined above, the denominator for CD0 was 30 days. In the case of a CD1, since the loss event may have occurred a month earlier than was the case for a CD0, the denominator also increases by a month (i.e. is increased by a further 30 days).*
>
> *527. The Loss Emergence Factor for a CD1 thus increases from 7/30 to 37/60, which represents 61.6% as opposed to 23.3%. The factor for a CD1 has thus increased by a significant proportion, namely by over 2.6 times that for a CD0 (61.6/23.3).*
>
> *528. The logic explained above for CD1 applies in a similar way for CD2 and CD3. Thus, both the numerator and denominator increase by 30 for each successive CD bucket. Thus, a CD2 will have a Loss Emergence Factor of 67/90 representing a Factor of 74.4%. This is 3.19 times greater than the Factor for a CD0.*
>
> *529. Similarly, for a CD3, the Factor is 97/120 representing a Factor of 80.8%. This is 3.47 times greater than for a CD0. It is clear that, as a loan becomes increasingly delinquent, the Loss Emergence Factor increases relative to that for a CD0, but at a decreasing rate as the number of months in arrears increases.*
>
> *530. Therefore, as the loan becomes more delinquent the loss emergence factor gets closer to 100%. A loss emergence factor of 100% is identical to removing the loss emergence factor entirely from the equation (as one multiplies the equation by 1); which is identical to saying the loss has emerged. This is consistent with arguing that losses emerge at CD4, and for this CD bucket, the loss emergence factor is 100%."*

512 A loss emergence factor computed on this basis does have an inherent logic to it. It recognises the need for substantially greater impairment as the loan

becomes increasingly delinquent and approaches default. However, once the adjustment was made by Mr Burra introducing a flat LEF, that logic was lost.

513 In his oral evidence Mr Cohen was unwilling to support Mr Burra's approach and expressed his disagreement with it, although he was unwilling to reject it as necessarily incorrect. He went on to say:

> *"I would and do prefer the logic that I explained, which is that each month an increased number of days has passed, in fact much like Mr Griffiths referred to in his question. In other words, when Mr Griffiths posed that question to Mr Burra, they arrived at what I think is a sensible – it sounded like a point of agreement, that the loss emergence factor would increase as delinquency increases."*

514 Even on the basis of the IBNR using an increasing numerator and denominator, Mr Cohen had considerable reservations about the employment by African Bank of an IBNR in their particular circumstances. He said -

> *"563. There is a concern with African Bank's computation of IBNR, relating to the rate at which accounts flow from early arrears through to CD4. By way of example, if 60% of CD1's flow through to CD4, then CD1's are more likely than not to default. This might be considered to imply that a missed payment is associated with a severe deterioration in the quality of the loans. Based on this high probability of default, and the ability to identify a delinquency (the missed payment) at the account level, the question becomes whether it is still justifiable to consider this loan 'not reported'.*
>
> *564. As stated earlier, the event that defines 'reported' is within the discretion of the reporting entity as the standard does not specify this issue in any detail. The high probability of moving to CD4 for CD1's does not necessarily change the appropriateness of the IBNR model. The association of a markedly higher PD with the occurrence of a missed payment cannot unequivocally be proven to be proof of causality - namely the event causing the missed payment is the same event causing the eventual default within 12 months. However, in my view, this causality is likely. In any event, the higher PD should be reflected in the model parameters."*

515 Thirdly, Deloitte's approach was at odds with that adopted by the Bank itself, not just Mr Raubenheimer. Thus in exhibit 18.1 which represented management's approach to the IBNR impairment at the end of the audit, the emergence factor remained almost identical to that which had been reflected on 16 October 2013 in exhibit 18.3, on this occasion at 7/30 in relation to CD0, 38/61 in respect of CD1, 69/92 in respect of CD2 and 99/122 in respect of CD3. Thus Deloitte's approach was more aggressive than that of management, not only in terms of the final IBNR impairment number but also in respect of the IBNR impairment methodology in respect of the LEF.

516 Fourthly, Deloitte's approach in this regard does not withstand a reality check when tested against the PDs for the buckets in question. As Mr Cohen pointed out in his evidence, a PD of 70% means that *"in a population of 100 loans, 70 of those loans will reach that default point"*. Obviously this needs to be adjusted by way of a weighting to take into account the value of each of those loans but the concept is nevertheless helpful for analysing the impact of Deloitte's approach.

517 To demonstrate the effect of this, assume that Deloitte applied a uniform LEF of 7 days / 30 days or 23.3% (which was the rule of thumb average used during the proceedings to illustrate the effect of the LEF adopted by Deloitte) across CD1 to CD3,

518 If one then takes the PDs calculated by Mr Raubenheimer and sent to Mr Burra on 11 October 2013, based on a 12-month outcome period, the PDs were 60%, 85% and 93% for CD1, CD2 and CD3 respectively. Applying Mr Cohen's simplified explanation of the PD, and assuming 100 equal loans in each of the CD buckets –

518.1 In CD1, despite the fact that 60 of the 100 debtors are destined to default, only 14 of the loans are impaired (i.e. 23.3% of 60).

518.2 In CD2, despite the fact that 85 of the 100 debtors are destined to default, only 20 of the loans are impaired (i.e. 23.3% of 85).

518.3 In CD3, despite the fact that 93 of the 100 debtors are destined to default, only 22 of the loans are impaired (i.e. 23.3% of 93).

519 The argument against this that is advanced by the first respondent is that a 12-month outcome period would include a significant number of losses expected as a result of future events, contrary to IAS 39. There are at least two answers to this:

519.1 IAS 39 requires a reasonable estimate. Imperfection is inherent in estimation. It can therefore be accepted that there would be some element of expected losses intruding into the data sets used for measuring the impact on future cash flows, without infringing the standard. All the more so where a 12-month outcome period has become widely used by industry.

519.2 As observed by Mr Cohen, the particularly high roll rates and PDs at African Bank point to higher probabilities of a causal link between the contractual delinquencies (or their underlying cause) and the future losses manifesting during the 12-month period.

520 Assuming the criticism of a 12-month outcome period is founded, then to address this one may consider the issue from the perspective of a 4-month outcome period as represented in exhibit 18.3. This would ensure a much higher

correlation between the early stage delinquencies and incurred rather than expected losses.

521 We have performed the simple exercise of calculating the average and weighted average roll rates for the different loan books in respect of the CD1, CD2 and CD3 buckets off exhibit 18.3. Because the averages and weighted averages are so similar, we give only the weighted average PDs as follows:

521.1 CD1, 25%

521.2 CD2, 45.8%

521.3 CD3, 69.9%

522 Applying the assumed uniform LEF of 23.3%, what that means is that, despite the fact that –

522.1 25% of loan value in CD1 will not be repaid, only 5.8% in loan value is impaired;

522.2 45.8% of loan value in CD2 will not be repaid, only 10.7% in loan value is impaired; and

522.3 69.9% of loan value in CD3 will not be repaid, only 16.3% of loan value is impaired.

523 This represents another serious logical flaw in the IBNR methodology adopted by Deloitte.

524 Fifthly, the claim that the IBNR would strip out losses expected as a result of future events, was not demonstrated with reference to either the African Bank

IBNR or the Deloitte version of it. There is no obvious logical correlation between a formula that aims to subject to impairment a group of unreported losses in the preceding 7 (or 37 or 67 or 97 days), and the stripping from historical cash flow statistics used for estimating future cash flows, losses attributable to future events.

525 Mr Cohen does not seem to make this claim in respect of the African Bank version of the IBNR. When he discusses an IBNR that will separate future losses from incurred losses, he says -

> *"In order to separate future losses from incurred losses, the PD needs to be apportioned between these two components. This is done by estimating what portion of the defaults taking place within the next 12 months will be due to past loss events that have not yet manifested in a default … and what portion are due to future loss events that have not yet manifested in a default … The loss emergence factor is used for this purpose."*

526 This does not accord at all with the manner in which either African Bank or Deloitte determined the loss emergence factor. The African Bank LEFs were determined by taking the day in the month when half of the total value of instalments paid that month was reached. The balance of the days in the month then represented the loss emergence days for CD0, with additional days then added to the numerators for the later buckets, and denominators based on (approximately) the number of days in one, two, three and fourth months.

Conclusion on the IBNR methodology and computation

527 In the circumstances, the methodology used by Deloitte in the auditing of the IBNR impairment in respect of loans in the CD1 to CD3 buckets adopted by Deloitte was not reasonable. Viewed from the perspective of IAS 39, the

application of the uniform loss emergence factor in the manner that it was done, had the consequence that loans in respect of which there was objective evidence of impairment as a result of one or more loss events after initial recognition, were not impaired to the extent that they should have been, despite the fact that the loss events impacted on estimated future cash flows and that impact could reliably be estimated.

528 The question remains, however, whether the estimate emanating from the flawed methodology adopted by Deloitte was inaccurate to an unreasonable and material degree.

529 It is clear that the assertion in the charge that the error was of the order of magnitude of R3.674 bn was patently incorrect. However, it is clear from Deloitte's own calculations that the order of magnitude of their error was R637m. This is substantially in excess of materiality and did not give rise to a reasonable estimate of impairments in respect of the CD1 to CD3 loan buckets.

530 As was conceded in the first respondent's heads of argument, absent the downward adjustment of R637m, the impairment for the CD1 to CD3 loan buckets would have been R1.265 billion, a number fairly close to the R1.137 bn originally proposed by Mr Raubenheimer. Manifestly, that represented a reasonable estimate of the impairments.

531 The first respondent argues that he should not be held responsible for this because he *"used Mr Burra as his expert to test the LGDs and PDs and the emergence factor used in the calculation of the impairment over the early stage delinquencies"* .... and *"was accordingly entitled to rely - and did rely - on Mr*

*Burra's calculation / verification of the accuracy and the usage of the LGD, PDs .. and the LEF in the calculation of the 2013 IBNR."*

532 The Committee does not accept that the first respondent can avoid responsibility on this basis for the following reasons:

532.1 It is clear from Mr Burra's evidence in response to the questions from Mr Griffiths that the first respondent was at all times involved in the decision-making process around the LEF;

532.2 He was acutely aware of the issues pertaining to the use of the LEF and had in his 2012 Report to the Audit Committee pointed out that *"management uses an emergence period of 7 days in the IBNR impairment calculation, whereas market practice is 1 month"*;

532.3 As appears from the factual background set out above, the emergence period had been a specific point of concern discussed by the first respondent during the course of the audit;

532.4 The very substantial reduction in impairments contemplated by the R637m reduction in the IBNR impairment must have been a matter of particular concern for the first respondent. As engagement partner he would have been fully entitled to prevent Mr Burra from making the adjustment and to have a deciding say in relation to the parameters used in the IBNR impairment calculation.

532.5 Mr Burra points out the following in the introduction to the 2013 Deloitte Credit Impairment Review:

*"The Capital Markets review team specifically focus on the calculation aspects of the impairment calculation and explicitly do not provide assurance with regard to the underlying data and accounting treatment. ...*

*Our review focussed on the logic of Management's calculation and the back testing of the results arising. The business logic and compliance with any relevant accounting standards is strictly out of scope."* (emphasis added)

The question of compliance with IAS 39 was the first respondent's responsibility, not Mr Burra's, and this required him to take the final decisions in relation to the parameters used in the IBNR credit impairment methodology. It was up to Mr Burra to perform the calculations on the basis of the parameters provided.

533 In the circumstances, it is the first respondent who must accept responsibility for the R637 m error in the auditing of the IBNR impairment provision.

534 Had the first respondent required Mr Burra to calculate the impairment provision for loans in the CD1 to CD3 buckets either on the basis of a CD1 point of impairment for purposes of a portfolio specific impairment (Balance x PD x LGD) or on the basis of an IBNR provision with a rising LEF as contained in exhibit 18.3, he would have been in a position either to insist that management provide for impairments on the basis of a reasonable estimate or to modify his opinion.

***Audit work***

535 We turn to the ISAs that the first respondent is charged with breaching.

536 Paragraph 15 of ISA 200 *Overall Objectives of the Independent auditor and the Conduct of an Audit in Accordance with the International Standards on Auditing* requires that –

*"[t]he auditor shall plan and perform an audit with professional scepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated."*

537 Paragraph 17 of ISA 200 requires as follows:

> *"To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion."*

538 The first respondent failed to maintain an attitude of professional scepticism and further failed to plan and perform the audit so as to reduce risk to an acceptable level in that he failed to take into account relevant evidence relating to the point of impairment and the related issue of the appropriateness of the use of a LEF, including the use of incorrect parameters in the calculation of the LEFs. He accordingly breached ISA 200.

539 Paragraph 17 of ISA 220 *Quality Control for an Audit of Financial Statements* requires that –

> *"[o]n or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the management team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued."*

540 For the reasons given above, the first respondent failed to ensure that there was sufficient appropriate audit evidence to support the conclusions reached relating to the point at which the loans become impaired for purposes of a portfolio-specific impairment, including the related issue of obtaining the audit evidence called for in the Ranchod opinion. He accordingly breached ISA 220.

541 Paragraph 5 of ISA 230 *Audit Documentation* provides –

> *"The objective of the auditor is to prepare documentation that provides:*
>
> *(a) a sufficient and appropriate record of the basis for the auditor's report; and*
>
> *(b) evidence that the audit was planned and performed in accordance with ISAs and applicable legal and regulatory requirements."*

542 Other provisions in ISA 230 give more detailed effect to that objective.

543 There were documentation shortcomings in relation to the audit work relevant to this charge. In particular, in response to the Ranchod opinion the first respondent was required both to perform and document the audit work stipulated in it. He did neither. In relation to the documentation failure, he breached ISA 230.

544 Paragraph 5 of ISA 330 *The Auditor's Responses to Assessed Risks* provides as follows:

> *"The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level."*

545 For the reasons given above, the first respondent failed to take into account all relevant evidence in forming an opinion regarding the point of impairment and the related issue of the appropriateness and computation of the loss emergence factor. He accordingly breached ISA 330.

546 Paragraph 6 of ISA 500 *Audit Evidence* provides as follows:

> *"The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence."*

547 For the reasons given above, the first respondent failed to design and perform audit procedures to obtain sufficient appropriate audit evidence to draw

reasonable conclusions regarding the point at which loans become impaired and the related issue of the appropriateness and computation of the LEFs. He accordingly breached ISA 500.

548 Paragraph 6 of ISA 540 *Auditing Accounting Estimates, including Fair Value Accounting Estimates, and Related Disclosures* provides as follows:

> *"The objective of the auditor is to obtain sufficient appropriate audit evidence about whether:*
>
> *(a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognized or disclosed, are reasonable; and*
>
> *(b) related disclosures in the financial statements are adequate,*
>
> *in the context of the applicable financial reporting framework."*

549 Paragraph 21 of ISA 540 reads as follows:

> ***"Indicators of possible management bias***
>
> *21. The auditor shall review the judgements and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias. Indicators of possible management bias do not themselves constitute misstatements for the purposes of drawing conclusions on the reasonableness of individual accounting estimates."*

550 For the reasons given above, the first respondent failed to obtain sufficient evidence to support the conclusion reached that there was compliance with the relevant paragraphs of IAS 39 identified above. Further, the first respondent failed to consider management bias in their judgements and decisions in the making of accounting estimates pertaining to impairment provisions in respect of early delinquency loans. He accordingly breached ISA 540.

551 Paragraphs 16 to 18 of ISA 700 *Forming an Opinion and Reporting on Financial Statements* provide as follows:

> *"16. The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.*
>
> *17. If the auditor:*
>
> *(a) concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or*
>
> *(b) is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement,*
>
> *the auditor shall modify the opinion in the auditor's report in accordance with ISA 705.*
>
> *18. If financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, the auditor shall discuss the matter with management and, depending on the requirements of the applicable financial reporting framework and how the matter is resolved, shall determine whether it is necessary to modify the opinion in the auditor's report in accordance with ISA 705."*

552 The flawed audit work identified in this charge contributed to the first respondent's failure to modify the report on the AFS of ABIL and African Bank for the year ended 30 September 2013 for the material misstatement emanating from the incorrect application and computation of the LEFs. Further he failed adequately to evaluate the qualitative aspects of the entity's accounting practice regarding the point of impairment and the related issue of the appropriateness and computation of the LEFs, gave rise to a material misstatement. He accordingly breached ISA 700.

553 Paragraph 6 of ISA 705 *Modifications to the Opinion in the Independent Auditor's Report* provides as follows:

> *"The auditor shall modify the opinion in the auditor's report when:*

> *(a) the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or*
>
> *(b) the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement."*

554 The flawed audit work identified in this charge contributed to the first respondent's incorrectly issuing an unqualified audit opinion in respect of the consolidated AFS of ABIL and the AFS of African Bank for the year ended 30 September 2013 in circumstances which gave rise to a material misstatement. He accordingly breached ISA 705.

***Conclusion***

555 In the circumstances, the committee is satisfied that the pro forma complainant has proven sufficient of the material averments in the second charge for a conviction. The committee accordingly finds the first respondent guilty of infringing disciplinary rules 2.1, 2.5, 2.6 (in respect of section 130.1(b) of the Code), 2.7 and 2.17 on the basis set out above in respect of the second charge. Although all of these rules were breached, the conviction on this charge is a single, separate conviction for purposes of sanction.

## THE THIRD CHARGE

### *Introduction*

556 The essence of the second charge is that the first respondent allowed African Bank to use an incorrect discount rate to determine the present value of estimated future cash flows for non-performing loans. The discount rate was incorrect because origination fees were not included in the calculation of the original effective interest rate (the "OEIR"). This was allowed despite the first respondent having identified the discount rates relating to the discounting of loan books as a specific area of emphasis in the audit planning documents.

557 IAS 39 paragraph 63 specifies that "*if there is objective evidence that an impairment loss measured at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows…discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition).*"

558 IAS 39 paragraph 9 says that the calculation of the OEIR "*includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see IAS 18 Revenue), transaction costs, and all other premiums or discounts.*"

559 It is averred further in the schedule of charges that, apart from comparing the discount rate utilised for discounting impaired loans with those of the prior year, no further procedures were performed to determine that the rate complied with the requirements of IAS 39. The error that forms the subject matter of the charge

is alleged to have resulted in a R2,3 billion over-valuation of the loan book. As the AFS were not amended for this misstatement, the first respondent incorrectly issued an unqualified opinion, in contravention of ISA 700 and ISA 705. It is alleged that the first respondent also breached ISAs 200, 220, 230, 330, 500 and 540.

560 In his plea, the first respondent does not deny that he dealt with discount rates in the audit planning documents. He admits that the Audit Strategy Document prepared in February 2013 for the ABIL / African Bank audit committee, identified the discount rates relating to the discounting of loan books as an area of emphasis.

561 The first respondent expands on his admission by explaining that the Audit Strategy Document was a preliminary document. He says that a subsequent document - *the Risk Assessment and Audit Plan – Provision for Impairments* ("Risks Assessment and Audit Plan") – did not indicate the use of incorrect discount rates as a significant risk.

562 Insofar as the charge sheet alleges that IAS 39 requires that impaired loans be discounted at the OEIR, the first respondent:

562.1 admits that IAS 39 requires that impaired loans be discounted at the OEIR;

562.2 admits that the discount rate used by ABIL / African Bank excluded the origination fee from the calculation of the OEIR.

563 The first respondent asserts that excluding the origination fee in the calculation of the OEIR is not contrary to industry practice in South Africa. He says that this

is because banks generally calculate the OEIR using their loan book accounting systems, which charge the origination fee at inception.

564 He pleads that an accurate calculation of the OEIR can only be done individually per loan. He says that because banks calculate impairment on a portfolio basis, the OEIR can only be calculated on a weighted average basis.

565 He pleads further that he obtained technical advice that showed that it may be appropriate to exclude the origination fee from the OEIR calculation for out of term cash flows. This treatment was justified with reference to paragraph AG6 of IAS 39. The first respondent obtained his technical advice from Deloitte's IFRS specialist, Mr Trevor Derwin. He relied on this advice.

566 The first respondent relied on his consultation with Mr Derwin to conclude that the Bank could calculate the OEIR for impaired loans outside their contract terms, without including the origination fees. However, in preparing the 2009 AFS, management excluded the origination fees when calculating the OEIR for all impaired loans, not just out of term loans.

567 The first respondent raised this approach with management in his management letter in 2009. Management's view was that it was not possible to identify in and out of term loans using a model applied to a portfolio. The first respondent accepted this *"practical limitation"*, on the basis that a significant proportion of the cash flows related to non-performing loans were likely to be out of term.

568 The first respondent denies that using the incorrect interest rate when discounting the impaired loan book, resulted in it being overvalued. He denies that the impaired loan book was overvalued by R2.3 billion. He argues that the

calculations are flawed, based on incorrect assumptions and are gratuitously overstated.

569 The first respondent admits that the audit file shows that the discount rate used for discounting impaired loans was compared to the previous year. He however disputes that no further procedures were done to verify the OEIR's compliance with IAS 39. The first respondent supports this contention by citing paragraph 4.4.7 of Mr Cameron-Ellis' forensic report as recording that there were documented procedures. He also presents examples of other work that was performed to test for compliance with IAS 39. He says:

569.1 Audit working paper AB2013 5433, has a SAS code that shows how the Bank computed the OEIR for impairment. He says that by reviewing this code, an experienced auditor will be able to determine that that impairment model calculated the effective rates in the way management thought appropriate.

569.2 The audit team compared the September 2013 SAS code to the August 2013 SAS code to ensure appropriate adjustments related to impairment.

570 Other than the admission set out above, the first respondent denies all other allegations related to charge 3.

571 The areas of agreement on charge 3 as between the experts were recorded in their joint minute, as follows:

> *"1. IAS 39 requires using the original effective interest rate (EIR) to discount estimated future cash flows to their present value when quantifying loan impairments.*

2. *Under IAS 39, the calculation of the effective interest rate 'includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts.'*
3. *The higher the EIR on a loan, the higher the impairment that would be recorded on that loan, in the event that a "loss event" occurred which would have an impact on future cash flows. Furthermore, the higher the EIR on a loan, the greater the subsequent revenue recognised as part of the interest recognition after that point.*
4. *Where the original EIR is too low, the initial impairment will be understated, and subsequently too little interest income related to the impairment unwind will be recognised in the remaining periods. On an aggregate basis, whether or not the original EIR is understated, the impact on the statement of profit or loss will be identical over the full term of the recovery period in question. On a year on year basis, however, there will be differences in the financial position and results of the entity.*
5. *The interest rate used by ABIL and the Bank in 2013 to discount estimated future cash flows on impaired loans excluded the effect of the initiation fee.*
6. *In 2009, management of ABIL / the Bank prepared an accounting paper that presented a basis for excluding the effect of the initiation fee from the calculation of the EIR to be used to discount estimated future cash flows for impaired loans that were outside of their original contractual terms. The accounting paper referred to paragraph AG6 of IAS 39 in support of this conclusion.*
7. *In response to this accounting paper, and during the 2009 audit, Mr Jordan held a technical consultation with Mr Derwin. Mr Jordan relied on this consultation in concluding that ABIL and the Bank could appropriately calculate the original EIR in relation to 'out of term' cash flows on impaired loans using a discount rate that excluded the effect of the initiation fee.*
8. *In 2009, management excluded the effect of the initiation fee from the calculation of the original EIR used to discount cash flows for impaired loans, regardless of whether such cash flows were in or out of term.*
9. *This was on the basis that management was of the view that it was neither feasible nor practicable to distinguish between 'out of term' and 'in term' cash flows when impairment is determined using a model applied to a portfolio, since that would entail distinguishing between individual loans.*
10. *Based on his witness statement Mr Jordan accepted that this was a practical limitation of management's impairment model and assessed the impact on the 2009 audit.*

> 11. *The audit team estimated that the impact of this exclusion in relation to 'in term' cash flows as R27 million in 2009 and included R20.3 million of this on the error schedule as the R27 million was considered to be a "worst case" scenario.*
> 12. *Mr Jordan relied upon both the technical opinion and the quantification of the effect of excluding 'in term' cash flows in 2009, which indicated it was immaterial, and the fact that a significant proportion of the cash flows associated with non-performing loans were likely to be 'out of term.'*
> 13. *The 2011, 2012 and 2013 … audit files carried forward and documented that the rate used excluded the initiation fee for both in-term and out of term loans. [I]t was impracticable to determine discount rates separately for loans that were within or outside of their contractual terms. These files did not include the technical opinion but did note that the out of term rate was used for in-term loans for practical purposes. The amount on the error schedule was also not carried forward to subsequent years."*

572 The experts addressed the issue of reliance on technical consultation. In this regard:

572.1 IRBA's experts referred to ISA 220. They highlighted paragraphs 14, 15 and 18. Paragraph 18 deals with consultation. It requires the engagement partner to *"be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted*". They argue that even if the technical opinion was accepted in 2009, it should have been revisited each year, especially from a materiality perspective, because it was recorded as a risk in each of those years.

572.2 Deloitte's experts referred to paragraph 34 of ISQC1. It requires firms to design policies and procedures to provide reasonable assurance that (a) appropriate consultation occurs on difficult matters; (b) the

nature, scope and conclusions of consultations are documented and are agreed by both the advice seeker and the advisor; and (c) the conclusions reached are implemented. They argue that the first respondent had no reason not to rely on Mr Derwin's advice as he is a highly experienced and senior expert and that, because there were no changes in the facts between 2009 and 2013, the first respondent did not need to consult again.

572.3 The competing stances of the experts in relation to the quantum of the error were also set out in the minute. Mr Cameron-Ellis accepted that the calculations ought to be based on actual cashflow curves, as opposed to the estimated curves relied on my him, along with a weighted average. Implicit in this was an acceptance that his figure of R2.3 billion was not correct. However, he contended that the weighted average used by Mr Cohen in arriving at his figure of R489 million was flawed on the basis that the percentage weightings used for certain "buckets" did not make sense.

***Factual background***

573 According to the first respondent, during 2009, management of the bank through Mr Reynold Ngobese, Group Financial Manager, prepared an accounting paper that presented a basis for excluding the origination fees from the effective interest rate to be used to discount expected cash flows for impaired loans that were outside of their original contractual terms. Mr Ngobese argued as follows:

> *"Paragraph 63 of IAS 39 requires that where there is objective evidence of an impairment loss, the amount of the loss is the difference between the carrying amount and the present value of*

*estimated future cash flows discounted at the financial asset's original effective yield (i.e. the effective interest rate computed at initial recognition).*

*When the effective yield is calculated at inception of the loan it is based on the loan running to the end of its original contracted term and not another estimate.*

*The loans and advances that the Bank and Ellerines have made are carried at amortised cost. In terms of paragraph 63 of IAS 39 the calculation of any impairment loss is the difference between the carrying amount and the present value of estimated future cash flows. Thus when calculating the carrying value of an impaired loan as required by paragraph 63 of IAS 39, the yield attributable to the origination fees is included in the 'original effective interest rate' although the advance may well be outside the original contractual term (which is often the case for ABIL group impaired loans.)*

*We are of the view that this is not the intention of the standard as it produces a result which in effect misstates the value of the impaired advance. This is supported by the following application guidance to the standard:*

*Paragraph AG6 IAS 39 dealing with effective interest rates states:*

> *'When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument.* ***However, a shorter period is used, if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate.****'*

*The above, in our opinion, supports our interpretation that the origination fees which are charged in relation to the original contractual term, may be included only in the contractual term for the purposes of calculation of the effective interest rate. If the higher rate derived by using the origination fee in the calculation beyond the contractual term is used, it would imply that the origination fee is charged with reference to the expected term of the loan as opposed to the contractual term. This clearly is factually incorrect as ABIL charges the origination fee with reference to the contractual term …*

*Paragraph AG84 of IAS 39 states that where a loan, receivable or held-to-maturity investment has a variable interest rate, the discount rate for measuring an impairment loss is the current effective interest rate determined in the contract.*

*For ABIL advances there are in effect two rates – one for during the contractual term and one for outside of the contractual term."* (The bold emphasis is that of Mr Ngobese. The underlining emphasis is that of the Committee and is explained below)

574 The first respondent understood the paper to argue that *"because origination fees are 'charged in relation to the original contractual term', they should only be included in the original effective interest rate for impairment purposes if the loan is still within its original contractual term."* (his emphasis)

575 During 2009, the first respondent consulted with Mr Trevor Derwin an IFRS specialist in the Deloitte technical department to consider the accounting paper prepared by the Bank. In this consultation, Mr Derwin confirmed that the Bank's position was appropriate. A consultation document in this regard was placed on the audit file for 2009. According to the first respondent, Mr Derwin also sent by email on 28 October 2009 a draft opinion similar to the consultation document on the file. This draft opinion is discussed further below.

576 The consultation document in the audit file for 2009 is entitled – *"ACCOUNTING MEMORANDUM IN CONNECTION WITH THE DETERMINATION OF EFFECTIVE INTEREST RATES."* The document starts off with a description of the "transaction", refers to the fees, interest and charges that make up the total yield that African Bank receives for cash loaned or advanced to customers, refers to the relevant IFRS and concludes by endorsing the approach indicated by Mr Ngobese as that followed by the Bank, namely the inclusion of the origination fee only for in-term cash flows and not for out-of-term cash flows.

577 The first respondent in his original witness statement goes on to say that

> *"256 I relied on this consultation for the conclusion that the bank could appropriately calculate the original effective interest rate in relation to the out of term cash flows or impaired loans without reference to the origination fees.*
>
> *257 Notwithstanding Mr Ngobese's technical paper, for the purposes of determining impairment, management did not*

*apply an original effective interest rate including origination fees to cash flows within the original contractual term of impaired loans and an original effective interest rate excluding origination fees to loans to cash flows that were outside the original contractual terms. Instead, management excluded the origination fee in relation to the calculation of the original effective interest rate for all impaired loans (for impairment, not revenue recognition purposes)."* (his emphasis)

578 In the report to management for the year ended 30 September 2009, Deloitte said the following:

> ***"Issue identified***
>
> *In terms of IAS 39, management should apply different discount rates to in term and out of term NPL portfolios in relation to the treatment of origination (initiation) fees. However, management has informed us that it is neither feasible nor practical to distinguish between the in term and out of term loans, given the complexity involved in separating the NPL portfolios on the loan-by-loan basis. As a result, management has taken a decision to apply a reduced discount rate (by eliminating the origination fee component) to the entire NPL portfolio (regardless of term); a practice which we view as not in accordance with IAS 39.*
>
> ***Impact***
>
> *It is estimated that the impact of the above treatment is likely to have maximum effect on the impairment charge of R27 million in the current year.*
>
> ***Recommendation***
>
> *We recommend that the group refines its data on the NPLs to enable it to accurately distinguish between in term and out of term loans for purposes of applying different discount rates used in the impairment calculations.*
>
> ***Management comments***
>
> *This is not as simple as made out by Deloitte as a NPL whilst still in term at year end will have some of its future cash flow projections remaining in term and the balance out of term. This means that the discount rate and application of IAS 39 would, on Deloitte proposal, have to be done at an individual loan level rather than the current portfolio basis. Given that we have more than one million loans in NPL this is not a practical solution as this is not an exact science to determine impairment provision (sic).*
>
> *We will continue to determine impairment provisions on a portfolio basis and therefore continue to use an indicative average rate rather than use separate rate for in term and out of term (sic).*
>
> ***Person responsible***

*Nithia Nalliah (Group Finanical Direct)*

***Date of implementation***

*N/A"*

579 Management in these comments refers to the approach as being *"the Deloitte proposal"*, whereas it was in truth communicated by Mr Ngobese as being the Bank's existing practice. Presumably no date is given for implementation because management were unwilling to implement anything in this regard.

580 In his witness statement, confirmed in his oral testimony, the first respondent went on to describe his reaction to management stance as follows;

> *"260. This impracticability argument appeared reasonable and the effect small. We therefore did not raise further concerns about it. Given that the quantification in 2009 indicated a number that was a fraction of materiality, the loan book would have had to have grown manifold for it to have become a material issue.*
>
> *261. The 2011, 2012 and 2013 audit files carried forward and documented the conclusion of the 2009 technical consultation and the conclusion that it was impracticable to determine discount rates separately for loans that are within or outside their original contractual terms. The matter also remained on management's radar screen and was reported on an annual basis to the risk committee as a factor that may influence impairments."*

581 The first respondent also confirmed in oral evidence that in the audit planning documents in each of these years he signalled that management's approach was an audit risk.

582 As will appear from the extract from Mr Jordan's witness statement above, in the 2013 financial year, the matter was dealt with in the same manner as in the 2010 to 2012 financial years. Whilst the matter of the discount rates used was raised in the Audit Strategy Document prepared in February 2013, the subsequent Risk

Assessment and Audit Plan – Provision for Impairments, did not indicate the use of incorrect discount rates as a significant risk.

583 The discounting rate for purposes of impairment calculations is dealt with at various points in the 2013 AFS of African Bank. The following examples will suffice.

584 In the notes to the AFS dealing with financial instruments and their subsequent measurement, the section dealing with the treatment of loans and receivables includes the following:

> *"Advances are classified as loans and receivables and are measured at amortised cost using the effective interest rate method, less any impairment losses through the use of an allowance account whereby the amount of the losses are recognised in profit or loss. Origination fees and monthly service fees that are integral to the effective interest rate are capitalised to the value of the loan and amortised to profit or loss over the contractual life of the loan using the effective interest rate method."*[65] (emphasis added)

585 The effective interest rate method is then described as follows:

> *"The effective interest rate method is a method of calculating the amortised cost of the financial asset or liability and of allocating interest income over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash receipts/payments (including all fees that form an integral part of the effective interest rate) through the expected life of the financial asset/liability or, where appropriate, a shorter period."*[66]

586 To the extent that it was common cause that origination fees are not included at all in the original effective interest rate, these and other similar paragraphs of the AFS do not correctly represent their treatment.

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[65] At para 1.8.3 on p 28.

[66] At para 1.8.3.1 on p 29.

587 Origination fees are specifically dealt with in the notes to the AFS dealing with revenue as follows:

> *"**Origination fees on loans granted***
>
> *These fees are charged upfront, are capitalised into the loan, and are primarily based on the cost of granting the loan to the individual. In accordance with IAS18 Revenue, these origination fees are considered an integral part of the loan agreement and therefore recognised as an integral part of the effective interest rate and are accounted for over the shorter of the original contractual term and the actual term of the loan using the effective interest rate method."* (emphasis added)[67]

588 The approach seemingly identified in this paragraph of the AFS refers to that put forward by Ngobese in his memorandum and accepted by Mr Derwin as the basis for his opinion. Again, to the extent that it is common cause that this approach was not followed by management, because of the alleged inability to distinguish between in term and out of term loans, this paragraph of the AFS also does not correctly represent the position.

589 Against this factual background, the adjudication of this charge resolves itself into four distinct questions:

589.1 Was the Derwin memorandum correct?

589.2 If not, was the first respondent nevertheless entitled to rely on it?

589.3 If so, was the Derwin memorandum correctly implemented?

589.4 If the first respondent is found incorrectly to have relied on the Derwin memorandum, or incorrectly to have implemented the Derwin memorandum, what was the quantum of the error?

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[67] At paragraph 1.13.2 on page 34.

***Was the Derwin memorandum correct?***

590 The stances of the respective experts on the correctness or otherwise of Mr Derwin's opinion were set out in the expert joint minute as follows:

> *"<u>IRBA EXPERTS</u>*
>
> *1.1 The manner in which the original EIR was applied was not in compliance with IFRS. It should have included the effect of the initiation fees for all loans. It is completely outside the principle of the effective interest method of calculating amortised cost which in these circumstances requires the same interest rate to be used at all times in order to achieve its aims. Mr Cameron-Ellis provided a worked example illustrating the effect of using rates other than the original Effective Interest Rate Method on the value of loans, impairment costs and interest revenue when cash flows move from in-term to out-of-term and how this does not achieve what the effective interest rate method intends. …*
>
> *<u>DELOITTE EXPERTS</u>*
>
> *1.2 Mr Coppin has subsequently reviewed this opinion and agrees with Mr Derwin's view that under IAS 39 it is possible to exclude initiation fees from the calculation of EIR for out of term cash flows. For in term cash flows the EIR should include the initiation fees."*

591 In oral evidence, Mr Cameron-Ellis maintained his view as recorded in the joint minute. Ms De Beer, however, appeared to relinquish her stance under cross examination when she said:

> *"I agree that the original effective interest rate, when the original effective interest rate, you obviously would not recognise those cash flows out of term, because they will not happen. And you receive the initiation fee upfront and then it is blend into the cash flows as they become due. And then after the term, there are no initiation fees, so in calculating an original effective interest rate, it is obviously excluded from the cash flows (sic)"*

592 When it was put to Mr Cohen by the proforma complainant's counsel that he did not understand Mr Cohen specifically to endorse Mr Derwin's opinion in his witness report, Mr Cohen said:

> *"I find this a very difficult issue to wrap my mind around. I am going to say to you, I am uncertain. I am uncertain whether that is a correct opinion, or an incorrect opinion. I think it is debatable."*

593 He went on to explain his uncertainty. Mr Chidgey's evidence regarding the correctness or otherwise of the Derwin opinion can be gleaned from the following extract from this evidence on the point:

> *"I do not think I have said there that it is wrong or that he has misconstrued it. I think what I said is that I would probably take a different view, whether, but as part of my general introduction I think I said the difference, and if I did not I will say it now, [that] different accountants can look at these things and come to different views on it. So it is not necessarily wrong, it is a different view."*

594 Mr Coppin did not, in the end, come to give oral evidence in support of the view recorded in the joint minute.

595 Paragraph 63 of IAS 39 provides in relevant part as follows:

> *"If there is objective evidence that an impairment loss on financial assets measured at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition)."* (emphasis added)

596 The words "original" and "at initial recognition" are significant. *Prima facie*, the method advanced by Mr Derwin would involve a different interest rate excluding the origination fee from the point at which cash flows fall outside the contractual period of the loan. That does not involve computation at initial recognition. It involves computation at the end of the contractual term. Nor would it be the original rate.

597 Also relevant to understanding the inclusion of the origination fee is the definition of *"effective interest rate"* in paragraph 9 of IAS 39 which is as follows:

> *"The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument ... but shall not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate ..., transaction costs and all other premiums or discounts.*
> *"*

598 Mr Ngobese, Mr Derwin and the first respondent however rely on paragraph AG6 of IAS 39 and in particular the following portion:

> *"When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate."*

599 It is trite that South African law requires a contextually based and purposive approach to the interpretation of documents.[68] A consequence of that approach is that any provision in a document must, amongst other things, be interpreted in the context of its surrounding provisions and the document read as a whole. As counsel for the pro forma complainant pointed out, the above extract from paragraph AG6 of IAS 39 leaves out of account the balance of the paragraph, which goes on to read as follows:

> *"This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortisation period is the*

[68] *Natal Joint Municipal Pension Fund v Endumeni Municipality* above at para 18.

> *period to the next such repricing date. For example, if a premium or discount on a floating rate instrument reflects interest that has accrued on the instrument since interest was last paid, or changes in market rates since the floating interest rate was reset to market rates, it will be amortised to the next date when the floating interest is reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (i.e. the interest rates) is reset to market rates. If, however, the premium or discount results from a change in the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates, it is amortised over the expected life of the instrument.*"

600 In other words, the exception contemplated by paragraph AG6 of IAS 39 involves the circumstances where there is a re-pricing of the loan facility to market rates during the course of its contractual term (*"before the expected maturity"*). This is not the circumstance that is contemplated in the class of loans advanced by the Bank and dealt with in the AFS. Generally these were fixed interest loans and the period in which Derwin and the first respondent sought to justify exclusion of the origination fee was after maturity, not before. The last sentence emphasised in the extract above also makes it clear that the exception contemplated by paragraph AG6 is a narrow one.

601 Moreover, the interpretation contended for by Mr Derwin and the first respondent has the consequence that out of term cash flows on an impaired loan are discounted at a lower discount rate (because the origination fee is excluded) with the result that they are attributed a higher value than in term cash flows. It also has this illogical consequence.

602 It is significant that with neither Mr Derwin nor Mr Coppin having come to testify in support of the former's opinion. No expert witness on either side was willing to

support it unequivocally (save to the extent that this might be inferred from the evidence of Ms De Beer).

603 In the circumstances, we find that the opinion of Mr Derwin was incorrect. IAS 39 left no room for the exclusion of the origination fee in respect of out of term cash flows on impaired loans in respect of the loan book of African Bank.

***Reliance on the Derwin memorandum***

604 The next question to be answered is whether, notwithstanding the incorrectness of the Derwin memorandum, the first respondent was justified in relying on it. This question must be answered with reference to the relevant standards.

605 We start with ISQC1: *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance Related Services Engagements.* It provides in relevant part as follows:

> *"Consultation*
>
> *34. The firm shall establish policies and procedures designed to provide it with reasonable assurance that:*
>
> *(a) appropriate consultation takes place on difficult or contentious matters;*
>
> *(b) sufficient resources are available to enable appropriate consultation to take place;*
>
> *(c) the nature and scope of, and conclusions resulting from, such consultations are documented and are agreed by both the individual seeking consultation and the individual consulted; and*
>
> *(d) conclusions resulting from consultations are implemented."*

606 Paragraph A38 of ISQC1 provides as follows:

> *"Effective consultation on significant technical, ethical and other matters within the firm or, where applicable, outside the firm can be achieved when those consulted:*

- *Are given all the relevant facts that will enable them to provide informed advice; and*
- *Have appropriate knowledge, seniority and experience, and when conclusions resulting from consultations are appropriately documented and implemented."*

607 ISA 220: *Quality Control for an Audit of Financial Statements* provides in relevant part as follows:

> *"Consultation*
>
> *18. The engagement partner shall:*
>
> *(a) take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters;*
>
> *(b) be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm;*
>
> *(c) be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted; and*
>
> *(d) determine that conclusions resulting from such consultations have been implemented."*

608 Paragraph A21 of ISA 220 is similar to paragraph A38 of ISQC1.

609 If the consultation was consistent with these standards, then it would be reasonable for the first respondent to have relied upon it, whether or not it was correct. Taking the two standards together, consultation that is compliant with the relevant standards would require the following:

609.1 All the relevant facts must be provided to enable informed advice to be given.

609.2 The consultation must take place with an appropriately knowledgeable, senior and experienced person.

609.3 The consultation must be *"appropriate"*. That contemplates at least that it addresses the factual scenario posed and the question asked in relation to the factual scenario. It must do so in a clearly set out, logical and reasoned manner. However, it need not be elaborate.

609.4 The nature and scope of, and conclusions resulting from, the consultation must be agreed between the person seeking the advice and the person who is consulted.

609.5 The nature and scope of, and conclusions resulting from the consultation must be appropriately documented.

609.6 The conclusions resulting from the consultation must be implemented.

610 We assess compliance with each of these below. Compliance must be tested with reference to the relevant documentation. In this regard, there is a complication in that two sets of documents were provided by the first respondent. The first document consists of a four-page document to which is attached a five-page appendix, being Mr Ngobese's accounting paper.

611 The document is entitled *"ACCOUNTING MEMO IN CONNECTION WITH THE DETERMINATION OF EFFECTIVE RATES"*. It begins with a heading *"DESCRIPTION OF TRANSACTION"* and a sub-heading *"Effective Discount Rate"*. There is then a paragraph describing the loan business of African Bank and the charges that are debited in respect of loans advanced to customers. The

manner of determination of the various fees and charges is then described in two paragraphs.[69]

612 Then follows under the heading *"APPROPRIATE ACCOUNTING PRINCIPLES"*, a recitation of the relevant portions of IAS 39, including paragraph AG6 (in full) as well as IFRS7. The document then proceeds directly to the statement of the author's opinion as follows:

> *"APPLICATION OF APPROPRIATE ACCOUNTING PRINCIPLES*
> *In determining the effective interest rate to be applied to the Loans and Receivables, certain of the abovementioned charges would be included together with the interest charged. Where these charges relate to a period which may be less than either the contractual loan period or the expected repayment period, they may be included in the effective interest rate over the shorter period. This may apply for example where the contractual period is less than the expected repayment period and when the charges may not be re-levied after the initial period. In this case the original effective interest rate determined would include the effect of the charges but would be adjusted to reflect the fact that these charges are not included after the period to which they do not relate. In the subsequent period the only adjustment will be to remove the effect of the charges from the effective interest rate as any other adjustments would not be permitted."*[70]

613 The first document makes no express reference to the appendix that follows it. It does, however, in the initial part, reflect in brief, summarised form, the fact base presented in the Ngobese accounting paper. It is neither signed, nor dated, save for a handwritten audit working paper reference on the first page, *"AB 2009 3283"*. There is no name on the document at all. "Appendix 1", being the

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[69] There is then reference to a separate issue in respect of which advice was sought pertaining to "partial write off of impaired loans".

[70] The final paragraph deals with the other issue on which advice was sought.

Ngobese accounting paper, is similarly unsigned, undated and devoid of any reference to the author's name.

614 As appears from the extract from the first respondent's witness statement, he referred also to a second document. It is described in his witness statement as *"a draft opinion in this regard that is similar to the consultation document on the file"*. This was contained in, or attached to, an email addressed to him by Mr Derwin on 28 October 2009. The email was not put up but the draft opinion was. This version of the document is dated 3 October 2018 and is expressly addressed to the audit committee of African Bank Investments Limited for the attention of *"David Gibbon, Chairman: Audit Committee"*. The subject line describes the document as an opinion rather than a memorandum. In this document there is an introduction which does not appear in the first document. The introduction reads as follows:

> *"This report is in response to your request to assist you in evaluating the appropriate application of International Financial Reporting Standards ('IFRS') to the transaction described below.*
>
> *This report is solely for the internal use of management and the board of directors of African Bank Investments Limited (ABIL) and should not be distributed or communicated to third parties other than the group auditors, with our prior written consent. No party other than those to whom it is addressed may rely upon this report for any purpose whatsoever.*
>
> *This opinion is prepared in accordance with the engagement letter issued to you and is subject to the terms and conditions provided therein. The opinion has been based on the opinion prepared by management which has been attached as appendix 1."*

615 From that point the document is word-for-word identical to the first document, save for a single reference to ABL having been changed to ABIL. The opinion is set out in identical terms. However, inserted at the end of the document are three further sections under three headings, namely, *"DISCLOSURE"*, *"EXCLUSION*

*OF LIABILITY"* and *"CONCLUDING COMMENTS"*. These paragraphs contain standard precautionary provisions. The document then, unlike the preceding document, ends as follows:

> *"Should you have any queries please do not hesitate to contact Trevor Derwin.*
>
> *Yours faithfully*
>
> *Deloitte & Touche*
>
> *Per Trevor Derwin*
>
> *Partner"*

616 Although here referring to Mr Derwin, the document does not bear his signature. Another feature of this second document is that all of the pages from the second page onwards, including appendix 1, bear an electronic watermark with the word in large capital letters "draft".

617 This second document is a little more structured and better formatted than the first document. However the Committee's view is that we must base our decision on the first document, because the date on the second document does not correspond with the date of the email referred to in the first respondent's witness statement (i.e. it is dated 3 October 2018, not 28 October 2009), it is not in the audit file, bears no audit working paper reference and is, for the most part, marked as a draft. In any event, the substance of the second document, when it comes to the opinion expressed, is identical to the first.

618 <u>The first requirement</u> emanating from the relevant standards, is that all the relevant facts be provided. For the 2009 audit, this was done by the furnishing of the Ngobese accounting paper and presumably an oral explanation of the problem given by the first respondent to Mr Derwin. We accept that the provision

of the Ngobese paper together with an oral explanation from the first respondent was sufficient for that year.

619 However, as is clear from the factual background, there was an important factual development subsequent to the furnishing of the opinion. That was that management made it clear that they were not going to follow what Ngobese had said was the practice of the Bank in relation to the computation of the effective interest rate. Nor were they going to follow the approach which the opinion suggested was compliant. From that moment the fact base changed in an important respect. Despite this change in the fact base, the opinion continued to be relied on without being revisited in the 2010, 2011, 2012 and 2013 audits. But for those audits, the fact base was materially different. No reliance could be placed on the opinion without the new fact base having been drawn to Mr Derwin's attention and him having been requested to update his opinion. He was not asked to do so. In those circumstances, the 2009 opinion no longer satisfied this requirement of the standards for purposes of the subsequent financial years.

620 The second requirement, that the consultation must take place with an appropriately knowledgeable, senior and experienced person, was satisfied.

621 The third requirement is that of appropriateness. As pointed out in relation to the first requirement, the opinion might have been based on the correct facts in 2009, but was not based on the correct facts from that year onwards, including in 2013. Leaving this aside, a substantial flaw in the memorandum is that it contains no reasoning providing a logical link between the setting out of the facts and the relevant standards, on the one hand, and the arrival at a conclusion on the other. It does not explain how the latter part of paragraph AG6 of IAS 39, seemingly

overlooked by Mr Ngobese, is to be applied in the circumstances of African Bank's loan book. It does not seek to explain how paragraph AG6 is to be reconciled with the other paragraphs of IAS 39 in the context of African Bank's loan book. The memorandum accordingly does not satisfy the requirement of appropriateness.

622 The fourth requirement is that the outcome of the consultation must be agreed between the person seeking advice and the person giving it. By that must be contemplated a process whereby the opinion emanating from the consultation is considered, discussed between the two persons concerned and agreement reached that the advice answers the question asked, and does so in a reasonable and persuasive manner. There was no reference by the first respondent to any such process of agreement in his witness statement. However, in cross-examination the following exchange took place:

> *"MR SYMON: ...It is the number one duty of an auditor to be independent, to be objective and to be sceptical and ensure that before you sign an audit report you are yourself satisfied with what is conveyed to you whether it is by a technical expert or not.*
>
> *MR JORDAN: And Mr Symon, that was the exact exercise that I discharged in 2009. Armed with information that I got from management, understanding that I may have ... limited knowledge around IAS 39, I did exactly what an auditor is expected to do. I asked for a much ... more experienced technical accountant ... Mr Derwin to provide me with his views. He did not have to agree with management, the fact that he did agree with management is something that I supported. As a result that is what I conveyed in the audit files from 2009 onwards."*

623 That is the highwater mark of the first respondent's compliance with this requirement. The audit files to which he refers were not, however, shown to include any process of agreement as contemplated by the standards. In the

present context, the process of agreement would have required that the first respondent draw Mr Derwin's attention to the absence of any logical reasoning in arriving at the conclusion set out in his memorandum. He ought to have required Mr Derwin to address that, whereupon it could be recorded that his reasoning process and conclusion had been understood and agreed upon. There is no evidence that any such process took place.

624 Had that process been properly followed, the flawed nature of the conclusion would likely have become apparent and the consultation abandoned or the conclusion changed. It is significant in this regard that the first respondent in the 2009 audit took the understatement of impairments resulting from his estimate of the effect of excluding the origination fee, to the "schedule of overs and unders". This suggests that the first respondent was, already at that time, not convinced of the reliability of the Derwin memorandum.

625 The effective discount rates applied to in and out of term NPLs as well as the effect of a reduced discount rate applied to an entire NPL portfolio was identified as a key audit risk in the audit strategy document and a significant risk in the audit planning meeting minutes as well as the audit planning memorandum in the 2013 audit working papers. This too suggests a lack of conviction on the part of the first respondent that the Derwin memorandum could be relied on, particularly in 2013.

626 Accordingly we are not satisfied that there was compliance with the fourth requirement.

627 The fifth requirement is that the consultation process is properly documented. As pointed out above, the Derwin memorandum and the appendix are devoid of

any reference to author or date (save for the AWP reference) and are not signed. More importantly, there is no documented reasoning process. There is no documented process of agreement between advisor and advisee. The documentation requirement was thus not satisfied.

628 The sixth requirement is that the conclusions reached in the consultation process are implemented. This is discussed in the section that falls under the next heading.

629 There is a further reason why the first respondent could not reasonably rely on the Derwin memorandum. The amount in respect of impairment charges in the income statements and the amount for net advances in the balance sheets in the 2013 AFS of ABIL and African Bank, leave the effect of the origination fee out of account completely in the determination and application of the effective interest rate. The first respondent cannot therefore claim reliance on the Derwin memorandum, when the income statement and balance sheet did not reflect that approach. The highly unsatisfactory consequence was that all of the notes to the 2013 AFS of African Bank and ABIL that suggested that the origination fee was included in the effective interest rate (in any respect), were misleading and incorrect.

630 In all the circumstances, the committee is not satisfied that the relevant requirements of ISQC1 and ISA 220 were complied with. In those circumstances, the first respondent was not entitled to rely on the memorandum from Mr Derwin. It does not shield him from the complaint of flawed audit work in relation to the omission of the origination fees from the computation of the original effective interest rate.

***Was the Derwin opinion correctly implemented?***

631 Given our findings that the opinion expressed in the Derwin memorandum was incorrect and that first respondent was not entitled to rely on it, it is not strictly necessary to pursue the further enquiry as to whether his opinion was correctly implemented (i.e. the sixth requirement). For the sake of completeness, we nevertheless do so.

632 As appears from the factual background, the stance of management was that it was impossible to distinguish between in-term and out-of-term loans and cash flows and that for that reason, the origination fee would not be included in the original effective interest rate at all.

633 It was argued on behalf of the first respondent that his acceptance of this stance on the part of management was reasonable, particularly having regard to the estimation in 2009 that the numerical impact was well below materiality. The question of the quantum of the impact is dealt with separately below.

634 In the view of the committee, the first respondent's acceptance of management's stance that the calculation was impractical, was not reasonable for the following reasons:

634.1 As appears from the emphasised portions of Mr Ngobese's accounting paper quoted earlier, it was presented on the basis that the Bank was in fact already including the origination fee in the effective interest rate, but doing so only in respect of in-term cash flows and not in respect of out-of-term cash flows. It was not Deloitte's proposal. Yet there is no evidence that the first respondent challenged management on the basis

that this was not a Deloitte proposal, but information conveyed by the Group Financial Manager about an existing practice of the Bank.

634.2 During his evidence in chief, Mr Raubenheimer was asked whether there was "*sufficient information in the books and records over the years to have ascertain[ed] which loans are in and out of term, and to which you could or could not apply different interest rates if you wanted to apply different interest rates?*"[71] His response was "*yes, there are sufficient information to determine both those aspects (sic).*"

634.3 The first respondent's contention, that it was impractical to do so was not put to Mr Raubenheimer. Nor was he cross-examined or contradicted on his assertion that it was possible to separate in- and out-of-term loans and cash flows.

634.4 Ms De Beer also correctly made the point that if some sort of calculation could be done in 2009, there was no reason for it not to be done in subsequent years.

634.5 Mr Chidgey highlights that in 2009, Mr Jordan had recommended to management "*that they sort their data out so that they can do the calculation in future*". Although Mr Chidgey goes on to say that at face value, management's impracticality response was reasonable, the fact of the matter is that the passage of four years between 2009 and the 2013 audit meant that there had been more than enough time for management to adjust its systems to enable the required calculation to be done.

[71] See line 22 on page 5035 of the Final Transcript.

635 To the extent that the first respondent places reliance on industry practice being to exclude the origination fee, he did not provide any independent evidence to support this contention. Nor did any of the other witnesses give evidence to this effect.

636 In the circumstances, the committee does not accept that, even if it had been correct, the Derwin memorandum was correctly implemented or applied by the first respondent. In truth, it never was implemented.

***Quantum***

637 As appears from the joint minute, Mr Cameron-Ellis conceded that his calculation of the impact of the omission of the origination fee, as being in an amount of R2.3 billion, was incorrect. Mr Cohen calculated the cumulative impact in 2013 of the omission of the origination fee from the effective interest rate, to be R489 million for the aggregate of the NPL and ML books. That amount is well above audit materiality and accordingly provided a basis upon which the auditors report in the AFS ought to have been qualified where the error was not corrected.

638 The following submission was made in the respondents' heads of argument:

> *"It is important to note that both Mr Cameron-Ellis' and Mr Cohen's calculations were done across both in-term and out-of-term cashflows, so that they do not take into account Mr Derwin's opinion. In other words, should the Committee conclude that Mr Jordan was entitled to rely on Mr Derwin's opinion relating to out-of-term cashflows, but should not have permitted the Bank to apply the practicability argument in relation to in-term cashflows, then the effect would be much smaller than that estimated by Mr Cohen of R489 million."*

639 Given that the Committee has concluded that the first respondent was not entitled to rely on Mr Derwin's opinion, the circumstances contemplated by this

paragraph do not arise. In any event, if the first respondent seeks to assert that *"the effect would have been much smaller than that estimated by Mr Cohen of R489 million"*, it was incumbent upon him to adduce evidence to show what that amount was. He did not do so.

***Audit work***

640 We turn to the ISAs that the first respondent is charged with breaching.

641 Paragraph 15 of ISA 200 *Overall Objectives of the Independent auditor and the Conduct of an Audit in Accordance with the International Standards on Auditing* requires that –

> *"[t]he auditor shall plan and perform an audit with professional scepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated."*

642 For the reasons given above, the first respondent did not apply professional scepticism in dealing either with the Derwin memorandum, or with management's assertion that it was impractical to distinguish between in-term and out-of-term loans and cash flows. He accordingly breached ISA 200.

643 Paragraph 17 of ISA 220 *Quality Control for an Audit of Financial Statements* requires that –

> *"[o]n or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the management team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued."*

644 As a consequence of the first respondent's failure to deal appropriately with the consultation process with Mr Derwin, he failed properly to satisfy himself that sufficient appropriate audit evidence had been obtained to support the conclusion that origination fees could be omitted from the calculation of the effective interest rate for purposes of determining the impairment charges for the 2013 AFS. He accordingly breached ISA 220.

645 Paragraph 5 of ISA 230 *Audit Documentation* provides –

> *"The objective of the auditor is to prepare documentation that provides:*
>
> *(a) a sufficient and appropriate record of the basis for the auditor's report; and*
>
> *(b) evidence that the audit was planned and performed in accordance with ISAs and applicable legal and regulatory requirements."*

646 Other provisions in ISA 230 give more detailed effect to that objective. In the respects explained above, the first respondent failed properly to document the consultation process with Mr Derwin. He accordingly breached ISA 230.

647 Paragraph 6 of ISA 500 *Audit Evidence* provides as follows:

> *"The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence."*

648 The first respondent failed to design and perform procedures to obtain sufficient appropriate audit evidence to draw reasonable conclusions on the determination and application of the effective interest rate in the audit of the bank's compliance with IAS 39. He accordingly breached ISA 500.

649 Paragraph 6 of ISA 540 *Auditing Accounting Estimates, including Fair Value Accounting Estimates, and Related Disclosures* provides as follows:

> *"The objective of the auditor is to obtain sufficient appropriate audit evidence about whether:*
>
> *(a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognized or disclosed, are reasonable; and*
>
> *(b) related disclosures in the financial statements are adequate, in the context of the applicable financial reporting framework."*

650 The first respondent failed to obtain sufficient appropriate evidence to support the conclusion that the determination of impairment charges was in compliance with IAS 39.

651 Paragraphs 16 to 18 of ISA 700 *Forming an Opinion and Reporting on Financial Statements* provide as follows:

> *"16. The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.*
>
> *17. If the auditor:*
>
> *(a) concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or*
>
> *(b) is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement,*
>
> *the auditor shall modify the opinion in the auditor's report in accordance with ISA 705.*
>
> *18. If financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, the auditor shall discuss the matter with management and, depending on the requirements of the applicable financial reporting framework and how the matter is resolved, shall determine whether it is necessary to modify the opinion in the auditor's report in accordance with ISA 705."*

652 For the reasons given above, the flawed audit work identified in this charge contributed to the first respondent's failure to modify the report on the AFS of ABIL and African Bank for the year ended 30 September 2013 for the material misstatement emanating from the failure to include the amount in respect of origination fees in the original effective interest rate. He accordingly breached ISA 700.

653 Paragraph 6 of ISA 705 *Modifications to the Opinion in the Independent Auditor's Report* provides as follows:

> *"The auditor shall modify the opinion in the auditor's report when:*
>
> *(a) the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or*
>
> *(b) the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement."*

654 The flawed audit work identified in this charge contributed to the first respondent's incorrectly issuing an unqualified audit opinion in respect of the consolidated AFS of ABIL and the AFS of African Bank for the year ended 30 September 2013 in circumstances where the material misstatement emanating from the incorrect calculation and application of the effective interest rate gave rise to a material misstatement. He accordingly breached ISA 705.

***Conclusion***

655 In the circumstances, the committee is satisfied that the pro forma complainant has proven sufficient of the material averments in the third charge for a conviction. The committee accordingly finds the first respondent guilty of infringing disciplinary rules 2.1, 2.5, 2.6 (in respect of section 130.1(b) of the

Code), 2.7 and 2.17 on the basis set out above in respect of the third charge. Although all of these rules were breached, the conviction on this charge is a single, separate conviction for purposes of sanction.

**THE FOURTH CHARGE**

656 The essence of the fourth charge is that the first respondent did not appropriately consider management bias in relation to the audit of the 2013 AFS of ABIL and African Bank.

657 The part of the charge setting out the facts upon which it is based, is divided into three parts. In the first part, paragraph 15.1 of the charge (see paragraph 33.1 above), it is alleged that a number of "factors" were known to the first respondent. Eleven such factors are listed. These are dealt with in more detail below.

658 In the second part, paragraph 15.2 of the charge (see paragraph 33.2 above), it is alleged that the 2013 AFS of ABIL and African Bank were compiled without taking into account certain "*amounts and issues which indicate that bias was not appropriately considered*". Seventeen such alleged *"amounts and issues"* are then listed. Again we discuss these in more detail below.

659 In the third part, paragraph 15.3 (see paragraph 33.3 above), it is alleged that, within the context of the "*above facts*" as set out in paragraphs 15.1 and 15.2, the following ISAs were reached in the conduct of the 2013 audits of the AFS of ABIL and African Bank:

659.1 ISA 200 *Overall Objectives of the Independent Auditor in the Conduct of an Audit in accordance with International Standards and Auditing;*

659.2 ISA 240 *The Auditor's Responsibility to Consider Fraud in the Audit of the Financial Statements*;

659.3 ISA 540 *Auditing Accounting Estimates, including Fair Value Accounting Estimates and Related Disclosures;* and

659.4 ISA 700 *Forming an Opinion on Financial Statements.*

660 Again, the details are explored further below.

***First part of the charge (paragraph 33.1 above)***

661 The "factors" that are alleged in the first part of the charge are as set out below.

662 The factor in paragraph 15.1.1 (see paragraph 33.1.1 above) is that management bias was identified as a significant risk in the calculation of the loan impairment provisions. This is not in dispute. However, it is significant that the calculation of the loan impairment provisions also forms the subject matter of charges 1, 2, 3, 5, 6 and 9.

663 The factor in paragraph 15.1.2 (see paragraph 33.1.2 above) is that the first respondent communicated in the final report to the audit committee on the September 2013 audit, that the boards of African Bank and ABIL were required to formally sign off on the ACCIs. This measure was to compensate for the gap between the impairment model and the general ledger, although audit procedures indicated that two of the three ACCIs could not be substantiated. This alleged "factor" pertains directly to the factual basis for charge 1.

664 The factor in paragraph 15.1.3 (see paragraph 33.1.3 above) is that the first respondent did not obtain or document a proper understanding of the IFRS

requirements and the relevant account estimates relating to loans and receivables. These averments are relevant also to charges 2, 3, 5, 6 and 9.

665 The factor in paragraph 15.1.4 (see paragraph 33.1.4 above) is that the report to the audit committee indicated that the first respondent was concerned about the governance processes around credit impairment and modelling. This is relevant also to charges 1, 2, 3 and 9.

666 The factor in paragraph 15.1.5 (see paragraph 33.1.5 above) is that *"strong indicators of bias were evident from the work papers, either these were merely labelled as 'less than prudent' estimates or judgements in the working papers and final report to the audit committee."* The estimates and judgements referred to include those contemplated in charges 1, 2, 3, 5 and 9 (at least).

667 The factor in paragraph 15.1.6 (see paragraph 33.1.6 above) is that the first respondent *"failed to document point estimates, or a range of estimates (except those developed by the auditor's expert which were exceeded) to assess whether the identified 'less than prudent' estimates and judgements resulted in misstatements."* This refers to conduct also forming the subject matter of at least charges 1 and 9.

668 The factor in paragraph 15.1.7 (see paragraph 33.1.7 above) is that the first respondent failed to recognise that bias may be present because of the familiarity of preparing estimates in a certain way, despite the fact that a prior year error had already been identified. This is relevant at least to charges 3 and 9.

669 The factor in paragraph 15.1.8 (see paragraph 33.1.8 above) is that the first respondent did not document discussions of significant matters with management and *"suppressed information provided to him by Mr Raubenheimer at the time that may have indicated a contrary view regarding the adequacy of the impairment provisions".* This also forms the subject matter of the charges where documentation is part of the complaint, i.e. at least charges 1, 2, 3, 6 and 9 and, in relation to the alleged suppression of information, charge 10.

670 The factor in paragraph 15.1.9 (see paragraph 33.1.9 above) is that the first respondent *"failed to document his consideration of the use of the 7-day emergence period in the impairment model instead of a 30-day emergency period."* This conduct is also relevant to charge 2.

671 The factor in paragraph 15.1.10 (see paragraph 33.1.10 above) is that the first respondent accepted methodologies relating to impairment provisions that were not in accordance with industry norms as set out in the final report to the audit committee. This conduct is relevant also to at least charge 2.

672 The factor in paragraph 15.1.11 (see paragraph 33.1.11 above) is that the first respondent *"failed to properly consider and document his assessment of the impact of third party payments in the estimation of future cash flows."* This conduct is, in part, relevant also to charge 1.

673 Thus all of the "factors" alleged also form, to a greater or lesser degree, conduct forming the subject matter of other charges faced by the first respondent.

***The second part of the charge (paragraph 33.2 above)***

674 The *"amounts and issues which indicate that bias was not appropriately considered"* include the following allegations -

674.1 A R656 million error relating to the differences between the impairment provisions and the impairment models. This alleged error is relevant also to charge 1.

674.2 A R3,674 billion error relating to the definition of a loss event. This alleged error is relevant also to charge 2.

674.3 An estimated R2,3 billion overvaluation of the impaired loan book arising from discounting impaired loans at the incorrect discount rate. This overvaluation is relevant also to charges 3 and 9.

674.4 An estimated R600 million overvaluation of the impaired loan book arising from the inclusion of receipts on behalf of the third parties in the estimated future cash flows. This is relevant also to charge 1.

674.5 A R510 million error arising from the loan valuation model over-forecasting cashflows in a slowing economy.

674.6 A R83 million overvaluation arising from the 0.5% gap between the expert's model's range and management's model for the NPL book.

674.7 A R218 million overvaluation arising from the 0.7 cents difference between the expert's model and the African Bank model for the memorandum ledger (partially written off) book or ML book.

674.8 A R700 million further provision required on post-default advances.

674.9 A R300 million further provision for the *in duplum* component of the IBNR provision.

674.10 The issue of whether the projected cash flows from "cured loans" were properly estimated.

674.11 The effects on estimated future cash flows of premiums paid to Stangen after default.

674.12 An estimated R500 million overvaluation difference from industry norms arising from performing the cash forecast over 120 months instead of 60 months.

674.13 An estimated R1.992 billion overvaluation difference from industry norms because industry wrote off debt at CD6 instead of CD12.

674.14 A R374 million overvaluation difference to industry norms arising from the use of the 7-day emergence period instead of the industry norm of 30 days in the calculation of IBNR. This is also relevant to charge 2.

674.15 The recoverability of the R750 million deferred tax asset in Ellerines. This is also relevant to charges 6, 7 and 8.

674.16 The doubtful debt allowances in African Bank's tax calculations.

674.17 The R81 million impairment in the Ellerines Holdings trademarks.

675 From the foregoing it is apparent that the averments forming the basis of the second part of the charge in paragraph 15.2 in some respects overlap with other

charges and in other respects represent fresh allegations of incorrect audit work in the conduct of the September 2013 audit.

***The third part of the charge (paragraph 33.3 above)***

676 The third part of the charge refers back to the first two parts and it is then averred that within the context of the "above facts" as set out in paragraphs 15.1 and 15.2, the ISAs listed earlier were breached. The breaches are alleged as follows-

676.1 ISA 200 is alleged to have been breached on the basis that the first respondent failed to maintain an attitude of professional scepticism in that he failed to identify that bias was present despite the fact that it had been identified as a significant risk regarding the loan provisions. This is relevant also to charges 1, 2, 3, 5, 6 and 9.

676.2 ISA 240 is alleged to have been breached on the basis that the first respondent failed to review current and prior year account estimates for bias and to evaluate whether or not this represented a risk of misstatement due to fraud. This is relevant also to charge 9.

676.3 ISA 540 is alleged to have been breached in that the first respondent failed to obtain sufficient appropriate audit evidence to support the conclusion that management had appropriately applied the requirements of IFRS relevant to accounting estimates and failed to identify and respond to management bias evidence in estimates. This is relevant also to charges 1, 2, 3, 5, 6 and 9.

676.4 ISA 700 is alleged to have been breached on the basis that the first respondent failed adequately to evaluate indications of bias in management's judgements when determining whether the AFS of ABIL and African Bank for the year ended 31 September 2013 were prepared in all material respects in accordance with IFRS. This is relevant also to charges 1, 2, 3, 5 and 9.

677 Thus, once again, each of these paragraphs alludes either completely or substantially to conduct which also forms the subject matter of one or more other charges, particularly as identified in paragraph 15.1 and with a focus on accounting estimates. The most important accounting estimates were those pertaining to the impairment charges in respect of the various loan books.

***Analysis***

678 A evaluation of the first respondent's conduct in relation to the charges requires in respect of the whole of paragraph 15.1, the whole of paragraph 15.3 and part of paragraph 15.2 of the schedule of charges, an evaluation of conduct that also forms the subject matter of other charges. The effect of that is immediately to create a risk of the first respondent either being convicted twice in respect of the same conduct, or of being acquitted and convicted in respect of the same conduct.

679 The effect of the overlap of paragraphs 15.1 and 15.3 in their entirety with other charges and the partial overlap in respect of paragraph 15.2 means that the only self-standing part of the charge is that contained in certain of the sub-paragraphs of paragraph 15.2.

680 The difficulty for the pro forma complainant is that paragraph 15.2 does not stand on its own. The logical sequence of the charge is that:

680.1 The first respondent was aware of the factors listed in paragraph 15.1.

680.2 The 2013 AFS of ABIL and African Bank were compiled without taking into account the *"amounts and issues which indicated that bias was not properly considered"* in paragraph 15.2.

680.3 On the basis of both 15.1 and 15.2 the first respondent was guilty of breaching the four ISAs referred to in paragraph 15.3.

681 If paragraph 15.1 and 15.3 are removed from the equation because of the overlap with other charges and the need to avoid the first respondent being convicted twice in respect of the same charge (or convicted in respect of conduct upon which he has been acquitted in another charge), the logical structure of the charge falls away.

682 In those circumstances, the Committee is of the view that, notwithstanding that there are some components of paragraph 15.2 that are not canvassed by other charges, a prosecution on charge 4 cannot be justified.

683 The problem is compounded by the fact that there are allegations of failure properly to address management bias also in –

683.1 paragraph 9.5.5 of charge 2 (see paragraph 29.5.5 above);

683.2 paragraph 9.5.7 of charge 2 (see paragraph 29.5.7 above);

683.3 paragraph 24.4.4 of charge 7 (see paragraph 39.4.4 above);

683.4 paragraph 35.9 of charge 10 (see paragraph 45.3.9 above);

683.5 paragraph 36.1 of charge 10 (see paragraph 45.4.1 above); and

683.6 paragraph 36.4 of charge 10 (see paragraph 45.4.4 above).

684 That too creates the potential for the first respondent either to be convicted twice in respect of the same conduct or to be convicted in respect of the conduct alleged in one charge, but acquitted in respect of that conduct in another charge.

685 None of this would be fair to the first respondent.

***Conclusion***

686 In the circumstances, the first respondent must be acquitted in respect of the fourth charge.

## THE FIFTH CHARGE

### *Introduction*

687 The essence of the fifth charge is this. IAS 39 and IAS 18 require that interest on impaired financial assets be recognised at the rate of interest used to discount future cash flows for the purposes of measuring the impairment loss. ABIL and African Bank instead partially or fully suspended interest recognition on loans in arrears for more than six months. The net impact of this was to understate interest revenue and the credit impairment charge by at least R3 billion. This in turn significantly misrepresented the inherent risk of the loan book and had the consequence that the AFS of African Bank and ABIL were materially misstated.

688 Although the first respondent identified management override, suspension of interest and non-compliance with IFRS as potential fraud risks, it was apparent from the audit file that these risks were not adequately addressed during the audit. As the AFS were not amended for this misstatement, an unqualified audit opinion was incorrectly issued. In the circumstances, the first respondent breached ISAs 200, 220, 230, 240, 330, 500, 540, 700 and 705.

689 The essence of the first respondent's defence is as follows:

689.1 The "technical interpretation" on which the charge is based is "plausible";

689.2 The accounting policy followed by ABIL and African Bank was disclosed in its AFS, was known to users and would not have affected the user's judgement since the bottom-line effect of the policy was zero;

689.3 The practice of suspending interest was a purely technical issue and caused no material misstatement in the AFS;

689.4 The practice was commonly followed by South African Banks and a number of international banks;

689.5 It was done consistently from one financial year to the next so that no misleading impression could be given of trends in the bank's revenue for the 2013 financial year;

689.6 The practice of suspending interest was adopted because IAS18 paragraph 29 required that revenue should only be recognised if *"it is probable that the economic benefits associated with the transaction will flow to the entity";*

689.7 The SARB regulations under the Banks Act, 94 of 1990, provide that *"[w]hen an account is classified as doubtful, unless particular circumstances prevailing to the relevant obligor dictate otherwise, interest shall no longer be accrued or accrued interest shall be impaired."*

689.8 The bank partially or completely suspended interest on loans that were more than six months in arrears (CD7+);

689.9 The practice did not significantly misrepresent the inherent risk of the loan book because the bottom line effect on the AFS was zero and because the inherent risk of the loan book can only be established by comparing trends in the credit impairment charge on a year to year basis and these are unaffected by whether interest is suspended or not;

689.10 The figure of R3 billion in the charge is vastly overstated – in truth, the understatement is between R86 million and R270 million and, in the context of ABIL and African Bank's AFS these amounts are not material;

689.11 Any breach of the ISAs referred to was denied.

690 It is helpful at this point to set out verbatim the main accounting standards that are relevant to this charge.

691 IAS 39 *Financial Instruments: Recognition and Measurement* paragraph 93 provides as follows:

> *"Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss."*

692 IAS 18 *Revenue* paragraph 18 provides as follows:

> *"Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity. In some cases, this may not be probable until the consideration is received or until an uncertainty is removed."*

693 IAS 18 paragraph 29 provides as follows:

> *"Revenue arising from the use by others of entity assets yielding interest, royalties and dividends shall be recognised on the bases set out in paragraph 30 when –*
>
> *(a) it is probable that the economic benefits associated with the transaction will flow to the entity; and*
>
> *(b) the amount of the revenue can be measured reliably."*

694 IAS 18 paragraph 30(a) requires that -

> *"Interest shall be recognised using the effective interest method as set out in IAS 39".*

695 IAS 18 paragraph 35(b)(iii) states that an entity shall disclose –

> *"[t]he amount of each significant category of revenue recognised during the period, including revenue arising from …interest".*

696 The following was agreed between the expert witnesses in relation to this charge:

> *"1. For loans that are still reflected in the lending systems of the Bank, these systems continue to charge revenue to the borrowers' accounts. These systems continue to do so for loans that are both impaired and unimpaired until such time as those loans are removed entirely from the lending system.*
>
> *2. IAS 39 requires the recognition of interest on loans at the original effective interest rate (OEIR) on the carrying amount of the loan. This is part of the effective interest method.*
>
> *3. Suspension of interest involves passing adjustments for accounting purposes to partially or fully counteract this recognition of interest revenue recorded by the lending systems.*
>
> *4. The Bank suspended the recognition of interest revenue on loans on which more than six instalments were missed (CD6+). The Bank disclosed this in its stated accounting policy.*
>
> *5. Suspension, once it occurred for a loan, was initially partial in nature. This meant that the majority of interest on the loan was suspended, namely 90%; and therefore interest amounting to 10% of the Rand value of the contractual interest continued to be recognised.*
>
> *6. At a later stage of delinquency (CD12+), suspension became complete, meaning that no interest was recognised on the loan in question.*
>
> *7. 100% of the contractual interest was recognised on loans with status CD0 to CD6.*
>
> *8. In the scenario that the suspension of interest results in a misstatement of interest income hence revenue, it also results in offsetting misstatement of the impairment charge. These have no*

*or a very immaterial impact on the bottom line. The effect of these two possible understatements could result in the two individual disclosable numbers in terms of IFRS, namely revenue and the impairment charge, being materially misstated. It is this possibility that is the main issue in dispute.*

9. *The practice of suspension of interest had no effect on the calculation of the future estimated cash flows and the original effective interest rate both of which are the two key inputs into calculating the impairment charge.*

10. *It was not documented in the audit file why CD6+ was the appropriate point at which interest was to be suspended.*

11. *Suspension of interest is a common banking practice. It is not the practice of suspending interest that is the issue it is the quantum of interest recognised in the Income Statement".*

697 It emerges from the areas of agreement between the experts that the issues in dispute on this charge are narrower than the heads of argument on each side suggested.

698 As a starting point it is not in issue that the bank suspended 90% of the interest on loans in the doubtful category (CD 7 – CD12) and completely suspended interest for loans in the loss category (CD 13+).

699 It is also not in issue that IAS 39 paragraph 93 was not complied with. However, the first respondent defends the charge on the basis that it is a "technical" non-compliance that does not give rise to any misstatement in the AFS.

700 It does not appear to be seriously in issue that suspension of interest does take place in international banking practice. This much was conceded by Mr Winterboer and was testified to both by Mr Cohen and Mr Chidgey. The approach which was adopted by the Bank is known in international practice as the nil interest method and the approach advanced by the pro forma complainant

is referred to as the net interest method. The issue is not so much the practice of suspending interest, but rather the question of the appropriate presentation in the AFS.

701 It is also not in dispute that there was full disclosure of the practice. The "Interest Income" note to the 2013 AFS of ABIL and African Bank disclosed this accounting policy as follows:

> *"In instances where a loan is in arrears for greater than six months, an assessment is made regarding the recoverability of the loan or group of loans and if necessary, based on available evidence at that date, the accrual of interest from that date is partially or fully suspended and not recognised in profit or loss until recovery is highly likely or actually recovered."*

702 The audit file documented the rationale for suspension of interest as follows:

> *"This is in line with IAS 18 paragraph 18 which states that 'revenue should only be recognised when it is probable that economic benefits associated with the transaction will flow to the entity (when a loan has reached CD7 it will be less likely that economic benefits will flow to the entity)"*

703 The first respondent in his witness statement summarised his approach as follows:

> *"To sum up, although accounting standards required the recognition of interest revenue on impaired loans based on the carrying value of the loan, net of impairment, as a proxy some banks (including the Bank) suspended the recognition of interest revenue on loans that had reached a particular classification in default. The audit team and I were aware of this and that it was a practice applied in the banking industry in South Africa.*
>
> *In any event, I was not concerned about the appropriateness of the Bank's policy of suspending interest, because the suspension of interest has no impact on the net profit of the Bank. Furthermore, its impact on the calculation of the key performance ratios disclosed by ABIL would not be significant. My impression was that every bank analyst knew that banks suspended interest and this was clearly disclosed in the accounting policies of the Bank. The practice could*

> *not have impacted their judgement. Further, the practice does not impact on any significant metric; for instance, the Bank's risk-adjusted income – which is a critical item indicating profit and loss – is not affected by the set-off between interest income and impairment."*

704 An issue which should also be disposed of at this point is that, whatever criticism there may have been of the first respondent's audit work in this regard, the charge does not pertain to the point of default at which interest was suspended. It flows from this that the absence of audit work on this issue cannot form part of the evidence taken into account against him.

705 Against that background we turn to the evaluation of the points raised by the first respondent in his defence.

***Users of AFS not affected***

706 Mr Cameron Ellis contended in his evidence that users of the AFS would be affected by a presentation of interest on the basis of the nil interest method. His point was:

> *"You've got to consider the effect on the ratios of the entity. Here you have got a very key ratio. It is the interest income versus the loan book. That an analyst can actually look at and see how risky that loan book is. If you understate the interest, you understate the risk inherent in the book."*

707 Mr Jordan disputed this on the basis that the policy did not impact on any risk-adjusted income number on the income statement and on the basis that there was disclosure in the notes. This practice was well known in the industry and the necessary adjustments were made.

708 The Deloitte experts in the expert minute argued that analysts would assess the risk attached to a loan book with reference to other "more meaningful metrics"

than interest income. This does however amount to a concession that at least one of the metrics for assessing risk is affected by the method of presentation selected by the first respondent, albeit a less significant one in their estimation.

709 Whilst it may be that the risk inherent in the AFS in this respect was overstated by Mr Cameron Ellis, the contention advanced on behalf of the first respondent does not affect ultimately whether there was noncompliance with IAS 39.

710 Also relevant in this regard is paragraph 18 of IAS1 that states:

> *"An entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material."*

711 Paragraph 20 of IAS1 gives details of the disclosure required when there is a departure from IFRS in order to ensure fair presentation, but there was no suggestion that this was such an instance.

712 On balance, the Committee is of the view that the first respondent's contention that users of the AFS would not be affected is valid. However, this does not justify a departure from the requirements of IAS 39 and does not provide a defence to the charge.

***No bottom-line effect***

713 It was also the first respondent's contention that users of the financial statements would be unaffected because of the fact that the nil interest approach had no bottom-line impact. In the income statement, the reduction in revenue from the suspension of interest would be matched by a corresponding reduction in impairment charges. Accordingly, there was no bottom-line impact.

714 Ms De Beer countered that the impairment charges were an important disclosure item in the AFS, as was revenue and its disclosure. The effect of the first respondent's approach would be that *"you [now] have two important numbers that are understated in the financial statements"*.

715 The Deloitte expert's view in the expert minute was that *"since interest and suspense had no net effect on the profit of the bank this would not manipulate the results in a meaningful way, assuming that was actually the intention. Because the suspension point was held consistently at CD6+ across 2009 – 2014, it was not manipulated or used in any way to show a favourable result."*

716 As far as the balance sheet is concerned, it was contended in argument by the pro forma complainant that:

> *"904. The African Bank approach created a conceptual disjuncture between the balance sheet and income statement. African Bank continued to take into account cash flows being generated from CD7+ upwards when computing impairment for purposes of calculating net advances on the balance sheet. This meant that there was a sufficiently high probability that the cash flows would in fact be generated or they would not have been included in net advances.*
>
> *905. However the generation of the cash flows from the same loans was regarded as insufficiently probable to merit their recognition as revenue. This inconsistency between the treatment of the cash flows from the same loans for balance sheet as opposed to income statement purposes is of concern."*

717 To the extent that this might suggest that African Bank's practice in relation to the suspension of interest impacted on the balance sheet in any way, this is not correct. The practice had no impact at all as far as presentation in the balance sheet of either African Bank or ABIL is concerned.

718 However, the difficulty with the first respondent's "no bottom-line impact" argument is that it runs against –

718.1 IAS1 para 32, which states that -

> *"[a]n entity shall not offset assets and liabilities or income and expenses unless required or permitted by an IFRS."*

No IFRS permitting the offset in this instance was drawn to the committee's attention; and

718.2 IAS18 para 35(b), quoted above, which requires disclosure of –

> *"the amount of each significant category of revenue recognised during the period, including revenue arising from interest;"*

and

718.3 ISA 450 para 11 which requires that –

> *"The auditor shall determine whether uncorrected misstatements are material, <u>individually or in aggregate</u>."*

and

718.4 ISA 450 paras A13 and A 14, which provide as follows:

> *"A13. Each individual misstatement is considered to evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions, account balance or disclosure, if any, has been exceeded.*
>
> *A14. If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. For example, if revenue has been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses. It may be appropriate to offset misstatements within the same account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate."*

719 Accordingly, the “no bottom-line effect” argument is not a satisfactory answer to the complaint of a breach of IAS 39 and is not a defence to the charge.

***SARB regulations***

720 The first respondent also relies as a component of his defence on the SARB regulations issued in terms of the Banks Act, 94 of 1990, which provide, in relevant part, that *“[w]hen an account is classified as doubtful, unless particular circumstances prevailing to the relevant obligor dictate otherwise, interest shall no longer be accrued or accrued interest shall be impaired.”* (emphasis added)

721 As appears from the underlined portion of the regulation, the regulation does permit of an approach to the AFS which is capable of being strictly in compliance with IAS 39, i.e. where both accrued interest and the corresponding impairment charges are recognised.

722 Accordingly this too does not excuse a breach of IAS 39 or provide a defence to the charge.

***Suspension of interest is a widespread banking practice***

723 Mr Jordan testified that it was widespread banking practice to suspend interest. In particular, in his witness statement he said that *“from my own experience and anecdotally, I am aware that at least two of the four big banks suspend interest on at least some of their portfolios.”*

724 In response to this, the pro forma complainant introduced into evidence a series of extracts of AFS published by various other banks.

725 The First Rand AFS state its policy as follows:

> *"From an operational perspective, the group suspends the accrual of contractual interest on non-recoverable advances, subject to certain curing assumptions. However, in terms of IAS 39, interest income on impaired advances is recognised based on the original effective interest rate."*

726 In the notes to the AFS, the note entitled "Interest and similar income" includes an item *"unwinding of discounted present value on non performing loans"*.

727 The Nedbank AFS explain that:

> *"Interest on specifically impaired loans and advances is determined for the period for which the loan and advance was classified as specifically impaired. The amount is calculated by multiplying the discounted expected recovery by the effective interest rate for the specifically impaired loan and advance. The interest on specifically impaired loans and advances reflects the unwinding of the time value of money for the expected discount recovery. Interest on specifically impaired loans and advances does not represent the contractual interest that has been earned on the outstanding balance of a loan advance."*

728 The Standard Bank AFS describes its interest income policy as follows:

> *"When financial assets have been impaired, interest income continues to be recognised on the impaired value based on the original effective interest rate."*

729 Therefore provision is made for "*unwinding a discount element of credit impairments for loans and advances*" in the income statement and a corresponding *"discount element recognised in interest income"* and a "*group specific impairments"* in the notes to the AFS.

730 The Capitec AFS describe its interest income policy as follows:

> *"Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss interest income is recognised using the rate of interest used to discount the future cash flows for the purposes of measuring the impairment loss."*

731 In the footnote to the net interest income note it is specified that *"included in interest income is R72.8 million … with respect to interest income accrued on impaired financial assets."*

732 The Bayport[72] AFS[73] in the accounting policies section under the heading *"Interest income"*, which in turn is under the heading *"Revenue recognition"*, provide as follows:

> *"In instances where a loan is in arrears and no qualifying payment has been received in the last six months, an assessment is made regarding the recoverability of the loan or group of loans and, if necessary, based on available evidence at that date, the accrual of interest from that date is suspended and not recognised in the statement of comprehensive income."*

733 When cross-examined about these AFS, Mr Cohen appeared to accept that five of the six banks recognised interest on impaired loans and differed in their approach from Bayport. However, Mr Cohen sought to distinguish the first four banks on the basis of their having different business models from African Bank. Only two of the examples were of a similar business type to African Bank and those were Capitec and Bayport. Between those, each had diametrically opposite approaches. He accepted that Bayport's approach was similar to that of African Bank but did not accept that the approach was wrong. He characterised the five banks recognising interest on impaired loans as being at the opposite end of the conservatism spectrum to Bayport and African Bank.

734 Mr Cohen also testified as follows:

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[72] *Bayport Securitisation (RF) Limited.*

[73] For the 15 months ended 31 December 2014.

> *"So the realistic question is not whether or not a bank should suspend interest, they do. The question is given that they suspend interest, what must we do, because IAS 39 has its own rules on accounting for interest on loans that are impaired, and that is the location of this debate. So I did see in some of the documents, and I do not know if it was Mr Cameron-Ellis' report or the charges themselves, but they seem to say that the suspension of interest is not in compliance with IAS 39. You will correct me if it does not say that. That to me is a fundamental misunderstanding because suspension happens, it is factually true. The question is whether suspension of interest can co-exist with what IAS 39 says, and I am saying to you it does and it can."*

735 Both the first respondent and Mr Chidgey referred to a discussion by the IAASB on the issue of suspension of interest and the nil interest versus net interest approaches. Mr Chidgey's evidence in this regard was as follows:

> *"There was a discussion …about disclosure of, presentation of the interest line in the income statement and … it referred to what goes on at the moment, but the context was IFRS9, which is the new standard, and they were discussing whether the net method is used or the nil method and the nil method is where effectively interest is offset against the impairment provision and not showing any interest line in relation to impaired loans.*
>
> *I think as part of the discussion that I think it was generally agreed that most banks used the nil method rather than a net method."*

736 He went on to testify that in relation to the 2013 audit of ABIL and African Bank he did not consider the suspension of interest to be a "high-risk area". He justified this on the basis that it is a method employed by a large number of banks and because "*if interest is brought into the income statement on one line it will be impaired through the impairments adjustments on the line below.*"

737 If regard is had to the debate at the IAASB meeting which was held during 2012, it records the following on this issue:

> *"Many Board members noted that the net interest approach is consistent with current requirements in IAS 39. The same Board members noted that calculating interest revenue on the net carrying amount more faithfully represents economic yield of the expected cash flows because the contractual effective interest rate is reduced by the unwind of the impairment allowance. Other changes to the*

*estimate of the impairment allowance would be presented separated in the credit loss line item.*

*However, other Board members noted that the net interest approach is unduly complex. An entity would be required to identify a subset of financial assets and their related impairment allowances and apply the effective interest rate to the net amount, something which is not required under the nil interest approach.*

*One Board member, outlining the simplicity of the nil interest approach, noted that banks are currently applying the nil interest approach as a proxy to the net interest approach. He noted that banks often stop accruing interest instead of adjusting the effective interest rate.*

*Many Board members noted that banks which have found the proxy of the nil interest approach to be materially accurate would likely apply a similar approach after the new proposals come into effect. These Board members were concerned with prescribing a nil interest approach, however, as they believed the approach comingled the unwind of the present value of expected cash flows with other impairment losses. They expressed concern that the nil interest approach would understate interest revenue."*

738 On the one hand, the debate provides support for the first respondent's contention that the practice of suspending interest and the use of the nil interest method as a proxy for the net interest method, is widespread. On the other hand, it also provides support for the stance of the pro forma complainant that the net interest approach is in fact the one that is compliant with IAS 39 and not the nil interest approach.

739 Turning to the pro forma complainant's witnesses, the evidence of Mr Natsas, which was relied upon by the first respondent, was as follows:

*"MR GRIFFITHS: You also talked about earlier about stopping interest on an account. In your experience is there a correlation between when a write-off and when a stop interest, what is your experience on that in this environment?*

*MR NATSAS: Chair, so my experience has been that this – what they call 'suspension of interest'.*

*MR GRIFFITHS: Yes.*

*MR NATSAS: Is a term that is widely used within the banking context. And it is normally applied when an event of default is reached. So,*

*default in this case being CD4. Banks would say, I need to now suspend interest. They do this in a number of ways. But ultimately each and every way should hopefully give the same result, otherwise there is something wrong with their calculation. So if I expand on that, you can either raise the interest that is due to you and impair it, because the cash is the cash, you know what you are going to get. So, if I tell you I do not know what the cash I am going to get, it is not going to change over time. If you keeping on adding interest it ...[intervenes]*

*MR GRIFFITHS: But it obviously affects income in the income statement?*

*MR NATSAS: That is correct. So that is exactly where the issue is and therefore you know many people ignore this point of this default and there are various definitions on doing it. But it does effect, like you say, it affect income statement disclosure, interest versus impairment. It may also affect the impairment when you are calculating impairments, you have to discount those recoveries using the original effective interest rate. So obviously the more you shift it closer to – when you are going to get the cash, the less of that discounting impact you have within your balance sheet impairment number. So in summary, it effects line items quite a bit depending on how you treat it.*

*MR GRIFFITHS: That is what I would have expected, if my policy is that I write-off in CD7, 8, 9 whatever. That is the point that I stood on. So, but I stop adding interest, because then just to keep those two lines persisting, keeping the impairment and the interest income in line. That is why I am actually asking the question. But if the two are dealt with separately, or there is no correlation between – because if you write-off, then it goes out of your balance sheet number of advances. So the reader of the financial statements then – you know, can calculate what is the interest that you charge on your book. But if those things are not in sync, then you cannot actually do that. I was wondering whether there is some policy that would stop interest when we write-off, or is it not the case?*

*MR NATSAS: Ja Chair, so then there vary in practices. I mean, let us cover a few examples if you do not know. So, let us assume a default that mentions CD6 in your modelling. But when it comes to the non-performing loan book, you just write everything off. So to your point, because you are writing off almost even before you have reached default, you are taking the full impairment, you are not recognising interest that you would have, until that default point and then you are also not recognising impairment. I think that is the point you are trying to raise.*

*MR GRIFFITHS: That is the point.*

*MR NATSAS: I am trying to imply that, with my experience, suspension of interest actually happens when you get to that CD4 default definition. That is when you stop raising interest. But obviously if we are writing off things too late, it actually will not affect the interest*

*suspension line. Because remember from the moment they had default – let us say they had default at four, and you write-off at ten, from four until ten, one of the ways to do it is, you do not raise – you raise interest and impairment, you impaired it, until you get to that write-off point, that is one way to treat it.*

*MR GRIFFITHS: I think I understand what you are saying. So if you stop interest, interest suspension at CD4, but you do impairment calculations up to CD10, as an example, you in fact going to have a number in your balance sheets, a debtors account that there is no credit interest for in the income statement.*

*MR NATSAS: Ja. Now we are getting to ...[intervenes]*

*MR GRIFFITHS: In my mind it is a bit of a mismatch.*

*MR NATSAS: It depends on how you disclose it. As I said, there is mismatching practices, and our first line is try to clarify all of this. Because one would – I do not want to go into it. But ultimately, nett/nett.*

*MR GRIFFITHS: Ja.*

*MR NATSAS: If you are not going to get it, it should not be there. And that is what it is trying to do. You recognise it when you impair, or you do not recognise it because you were not going to get any.*

*MR GRIFFITHS: I am obviously talking IAS 39.*

*MR NATSAS: Yes, yes. So, I think that is important. Under IAS 39 vary in practices. There is actually an International Accounting [Standards] Board paper that deals with some of these principles that describes the variation in how banks treat the topic you are discussing now.*

*Our first line has clarified it and there is much more alignment, but I can understand the reason you are asking the question."*

740 Although the transcript of the evidence is not a model of clarity, it does indeed tend to provide support for the first respondent's contention that the suspension of interest is widely applied and that there are varying practices in the implementation of IAS 39 in this regard.

741 As far as Ms De Beer is concerned, she accepted under cross-examination that *"the fact that you suspend interest does not automatically mean that you contravene IFRS. ... You do need to make sure that you are still in compliance with IFRS and that your suspension point is appropriate."*

742 The evidence of Mr Winterboer was as follows:

> *"MR SMIT: Am I correct to say that it is banking practice that interest is suspended from a specific point forward?*
>
> *MR WINTERBOER: That is correct and I think that most banks in South Africa would do that.*
>
> *....*
>
> *MR SMIT: You are comfortable that was in compliance with IFRS?*
>
> *MR WINTERBOER: Yes, I believe so and I think most of the banks in South Africa do."*

743 It has been demonstrated by the first respondent through the above evidence that there is support for his view from both the witnesses for the pro forma complainant and the witnesses for the defence.

***Quantum***

744 The first respondent's heads of argument go on to make the following submissions:

> *"725. Mr Cohen testified that one cannot form a view whether the practice of suspending interest is or is not in compliance with IFRS without quantifying its effect and without understanding it in the context of other adjustments which potentially counteract the impact of suspension.*
>
> *726. Suspending interest can be a proxy for applying the method prescribed by IAS 39 AG93. The reason why this may be so is that there are two offsetting impacts of suspending interest rather than mechanically applying IAS 39 AG93:*
>
> *726.1 In respect of early stage delinquent loans (CD0-CD6), interest will not yet have been suspended. For these loans, 100% of contractual interest is therefore recognised. This amount exceeds the IAS 39 requirement in terms of which the interest rate is multiplied by the reduced (impaired) carrying amount - a percentage rate applied to a*

*reduced carrying amount would generate lower interest. Interest is thus overstated for these loans.*

*726.2 In respect of later stage delinquent loans, interest will be partially or fully suspended (partially suspended for CD6+ to CD12; fully suspended for CD12+). For these loans, little or no contractual interest is therefore recognised. This amount may fall below the IAS 39 requirement of interest computed on the impaired carrying amount. Interest is thus understated for these loans.*

*727. Which of the above two effects will predominate depends on a number of factors and thus cannot be known in the absence of quantification."*

745 Both Mr Chidgey and Mr Winterboer provided support for this approach.

746 It is alleged in the charge and initially testified to by Mr Cameron-Ellis that the amount of the understatement of interest (and impairment charges) was approximately R3 billion. However, Mr Cameron Ellis admitted to an R1,134 billion error in the calculation.

747 Based on a calculation by Mr Cohen, the first respondent's experts were of the view that, rather than there being any understatement of revenue (and impairment charges) there was an overstatement of some R8 million. If Mr Cohen's figure is correct it would show that the nil interest method did indeed operate as a proxy for the net interest method in this case.

748 However, the IRBA experts were of the view that the interest rate used by Mr Cohen in arriving at this figure was too low in comparison to the 37% used to impair the debtors book and the 40,22% used by Mr Cohen for the OEIR in charge 3. Their view is that using either 37% or 40.22% will show that there was a material understatement, contrary to what is suggested by Mr Cohen.

749 At the end of the cross examination of the first respondent, an exhibit was put up containing, amongst other things, a fresh quantification of the alleged

misstatement arising from the suspension of interest. This used an interest rate of 36.8% and arrived at a figure of R2,812 billion, close to the original figure of R3 billion which was conceded as being based on a substantial error.

750 The Committee has considered both this quantification and that of Mr Cohen.

751 Mr Cohen's methodology was to calculate an overall interest rate based on the gross advances and the gross interest charged during 2013. The interest rate calculated by him and used in his expected interest earned calculation was lower than that calculated by Mr Cameron Ellis

752 Mr Cameron-Ellis applied the average discount rate used by the impairment model as at the end of 2013 to calculate his expected interest earned for the year ended 30 September 2013. His interest earned calculation was therefore based on forward looking information whereas Mr Cohen's calculation was based on historical information.

753 None of the two calculation methods were shown to be without merit or incorrect in principle.

***Conclusion***

754 In the absence of a demonstrably superior quantification methodology by one witness over the other as to what the interest earned should have amounted to under the net interest method, taken together with the weight of the evidence suggesting that the nil interest method is widely applied and may operate as a proxy for the net interest method in compliance with IAS 39, the Committee is not satisfied that the pro forma complainant has acquitted himself of the onus of showing on a balance of probabilities that the first respondent was guilty of

misconduct in auditing the disclosure of interest income on impaired advances in compliance with IAS 39 by ABIL and African Bank in the 2013 AFS.

755 In reaching this finding, the Committee should not be seen as endorsing the nil interest approach. Compliance with IFRS is in our view more likely to be achieved if the net interest approach is followed. Had the pro forma complainant been able to show that –

755.1 even where interest is suspended by a bank, presentation in the AFS is usually on the basis of recognising interest on impaired loans with a corresponding amount included in both the revenue and the impairment charge items on the income statement; and

755.2 Mr Cohen's quantification was clearly wrong,

the outcome may well have been different.

756 In these circumstances, it cannot be found that the first respondent was in breach of the ISAs referred to.

757 The first respondent is accordingly acquitted on the fifth charge.

## THE SIXTH CHARGE

### *Introduction*

758 The sixth charge pertains specifically to the audit work (or lack of it) and its documentation (or lack of it), in relation to a loan from African Bank to Ellerine Furnishers (Pty) Ltd. Ellerine Furnishers was a subsidiary of Ellerines Holdings Limited, which was, in turn, a subsidiary of ABIL. The balance of the loan at the end of the 2013 financial year was R493 million.

759 The essence of the charge is that IAS 39 required African Bank to determine whether there was any objective evidence that the Ellerine Furnishers loan should be impaired. Even though Ellerine Furnishers was in significant financial difficulty, no specific work was documented regarding its potential impairment. In this context, it is averred that the first respondent breached ISAs 200, 220, 230, 330 and 500 in that –

759.1 No specific work was documented on the loan, despite recoverability being identified as risk.

759.2 The first respondent failed to ensure that there was sufficient appropriate audit evidence to support the conclusions reached regarding the recoverability of the loan.

759.3 The first respondent failed to document how the information regarding the recoverability of the loan was addressed in forming a final conclusion.

759.4 The first respondent failed to consider all relevant evidence in forming an opinion regarding the impairment of the loan.

759.5 The first respondent failed to obtain sufficient appropriate audit evidence to draw reasonable conclusions regarding recoverability of the loan to Ellerine Furnishers.

760 The essence of the first respondent's defence as set out in his plea is that –

760.1 Various audit procedures regarding Ellerine Furnishers indicated that the entity was solvent although under considerable pressure.

760.2 Ellerine Furnishers solvency indicated that the loan was recoverable.

760.3 The audit procedures relating to the solvency and going concern status of Ellerine Furnishers during its audit, constituted sufficient audit work for purposes of verifying the recoverability of the Ellerine Furnishers loan for purposes of the African Bank audit.

760.4 The charges do not allege that the loan was <u>not</u> recoverable.

760.5 Although the curator fully impaired the loan in the 2014 annual financial statements, he did not re-state the 2013 annual financial statements of African Bank in this regard.

760.6 The fact that paragraphs 21.5.1, 21.5.2, 21.5.3 and 21.5.5 of the schedule of charges all refer to <u>recoverability</u> of the loan rather than impairment of the loan, which is referred to only at 21.5.4, suggests that no criticism can be directed at the first respondent for focussing on recoverability rather than impairment.

760.7 The first respondent documented the risk that the loan could be impaired, as well as the audit procedures to be conducted in that regard, in the African Bank audit working papers.

760.8 The first respondent conducted audit procedures in ABIL at a group level, indicating that Ellerine Furnishers would be solvent, those procedures being –

760.8.1 procedures reflected in the ABIL working papers in relation to the existence of the deferred tax asset within Ellerine Furnishers; and

760.8.2 procedures in the Ellerine Furnishers working papers in relation to its going concern status.

760.9 The first respondent was aware of repayments and re-advancements in respect of the loan during 2012 and 2013 which indicated that management expected that future cash flows would be received in repayment of the loan.

760.10 The audit team inspected the Ellerine Furnishers account payment profile for the 11 months ended 31 August 2013, as reflected in the African Bank audit working papers during the risk assessment process, and

760.11 Accordingly the first respondent denied that he was guilty in respect of the charge.

***Factual background***

761 The factual background to this charge, briefly, is that in 2007, ABIL decided to acquire Ellerine Holdings (Pty) Ltd. Ellerine Furnishers was one of its subsidiaries. The effective date of the acquisition was 1 January 2008. The rationale behind the acquisition was apparently to add to the critical mass in African Bank's traditional customer base and advances book, to open new areas for growth and to integrate the financial services activities of the two businesses. Upon acquisition, African Bank granted Ellerine Furnishers an inter-company loan facility.

762 The business model of Ellerine Holdings at the time of the acquisition was to sell merchandise on credit with the furniture operating as a form of security. After acquisition by ABIL, the business model was changed. Ellerine Furnishers sales force provided both merchandise credit and unsecured loans as agents of African Bank.

763 In 2010, African Bank acquired the financial services activities of Ellerine Furnishers. Most of the inter-company loan was settled at this point. African Bank then started to conduct business in African Bank kiosks in the Ellerine Furnishers stores. Ellerine Furnishers in turn stopped its credit sales and became a cash retailer whilst receiving a "value share" from the bank for the referral of loans to the bank, for credit life insurance products obtained from Stangen, and for the use of the in-store kiosks.

764 The value share payments took the form of a base fee together with various commissions.

765 The inter-company loan took the form of a treasury loan facility limited to 25% of African Bank's capital and reserves (when taken together with other related party funding), as prescribed by the Banks Act, No. 94 of 1990. Amounts due to Ellerine Furnishers by way of value share could be set off against the amounts due under the loan facility. African Bank disbursed an amount of R840 million to Ellerine Furnishers during the 2009 financial year in terms of the loan facility. The outstanding balances on the loan were R30 million at the end of 2010, R190 million at the end of 2011, R459 million at the end of 2012 and R493 million at the end of 2013.

***The parties contentions***

766 The focus of the debate in relation to this charge became the correctness or otherwise of the first respondent's failure to insist on impairment of the Ellerine Furnishers loan. The pro forma complainant insisted that impairment under IAS 39 was triggered by a loss event in the form of Ellerine Furnishers acknowledged financial difficulties in 2013. The first respondent contended that the audit work done in the assessment by its component auditor, Mr Bierman, of Ellerine Furnishers as a going concern (albeit with an emphasis of matter) was sufficient to confirm the recoverability of the loan and remove any need for impairment.

767 It was agreed between the experts and became common cause in the proceedings that the financial difficulties of Ellerine Furnishers as at 2013 constituted a loss event. However, it was contended in the heads of argument on behalf of the first respondent that:

> *"IAS 39 requires the identification of a loss event as a 'trigger' for an impairment calculation. If a loss event has occurred, then it must be established whether 'that loss event (or events) has an impact on the*

> *estimated future cash flows of the financial asset or group of financial assets that can reliably be estimated'. Once the trigger, the impact and the possibility to reliably estimate the impact are present, then 'the amount of the loss is measured as the difference between the assets carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate'."*

768 If a loan is expected to be fully recoverable, said the first respondent, then the present value of the cash flows at the original effective interest rate would equal the book value because the loan would continue to earn interest at the original effective interest rate. This would exclude any basis for impairment. Based on the audit work done in Ellerine Furnishers, the solvency of Ellerine Furnishers confirmed the full recoverability of the loan. And everyone was agreed that the audit work of Mr Bierman on the solvency of Ellerine Furnishers was acceptable.

769 In any event, the first respondent argued further, even if it could be said that there was an impact on estimated future cash flows, impairment was only required by IAS 39 where the future cash flows "*can be reliably estimated*". This was not possible in respect of a loan of this nature with no fixed repayment terms and with it being repayable upon demand.

770 The pro forma complainant disputed this, insisting that impairment was called for, given the difficult financial circumstances of Ellerine Furnishers, and that a mechanism for estimation of the future cash flows, even if difficult, could have been found.

771 The expert witnesses aligned with the parties that called them on this issue, although none chose to offer a mechanism for estimation of the impact on future cash flows.

772 The charge as formulated does not in fact require us to answer the "to impair or not to impair" question. Instead, the complaint pertains to the insufficiency of the audit work and its documentation.

773 We accordingly turn to the complaints in regard to the audit work conducted.

***Agreement between the experts***

774 An appropriate starting point in this analysis is what was agreed between the expert witnesses.

774.1 *"No documentation whatsoever about the terms of the loan was included in the audit file."*

774.2 *"The ABIL audit files contained key working documents extracted from the Ellerine Furnishers audit file. These included the Ellerine Furnishers board minutes of 22 October 2013 approving initiatives to return to profitability to support the recognition of the deferred tax asset, the 2014 Ellerine Holdings Limited budget presentation, the auditor's assessment of the recognition of the deferred tax asset and detailed workings thereon."*

774.3 *"The audit report accompanying the Ellerine Furnishers standalone set of financial statements for 2013 [which was finalised and issued after the African Bank set] included an emphasis of matter paragraph in respect of the material uncertainties in relation to the going concern status of Ellerines. That the audit report would include an emphasis of matter paragraph was stated in the 30 October 2013 report to the audit committee."*

774.4 *"The recoverability of the loan to Ellerines was identified as a normal risk in the related party audit programme of African Bank."*

***The documentation complaints***

775 In paragraph 21.5.1 of the schedule of charges it is alleged that the first respondent *"failed to maintain an attitude of professional scepticism and further failed to plan and perform the audit to reduce risk to an acceptable level <u>in that</u> no specific work was documented on the R493m loan to Ellerine Furnishers despite recoverability being identified as a risk."* (emphasis added)

776 The words *"in that"* indicate that the nub of the charge is the absence of documentation of specific audit work pertaining to the loan, despite recoverability being identified as a risk.

777 ISA 200 *Overall Objectives of the independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* includes the following provisions dealing with documentation:

778 Paragraph 16 of ISA 200 requires that –

> *"The auditor shall exercise professional judgement in planning and performing an audit of financial statements."*

779 Paragraph A27 of ISA 200 then elaborates as follows:

> *"Professional judgement needs to be exercised throughout the audit. <u>It also needs to be appropriately documented</u>. In this regard, the auditor is required to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgements made in reaching conclusions on significant matters arising during the audit. Professional judgement is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient appropriate audit evidence."*

780 These paragraphs align with the complaint in paragraph 21.5.1 of the schedule of charges pertaining to a failure adequately to document audit work.

781 ISA 230 is the standard dealing specifically with audit documentation. Paragraph 5 of ISA 230 provides as follows:

> *"Objective*
>
> *5. The objective of the auditor is to prepare documentation that provides:*
>
> *(a) a sufficient and appropriate record of the basis for the auditor's report; and*
>
> *(b) evidence that the audit was planned and performed in accordance with ISAs and applicable legal and regulatory requirements."*

782 Paragraph 6(a) defines *"audit documentation"* as –

> *"The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached [terms such as 'working papers' or 'work papers' are also sometimes used.]"*

783 "*Audit file*" is defined in paragraph 6(b) as follows:

> *"One or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement."*

784 Paragraphs 8 to 10 then provide as follows:

> *"Form, content and extent of audit documentation*
>
> *8. The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:*
>
> *(a) The nature, timing and extent of the audit procedures performed to comply with the ISAs and applicable legal and regulatory requirements;*
>
> *(b) The results of the audit procedures performed, and the audit evidence obtained; and*
>
> *(c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgements made in reaching those conclusions.*

> 9. *In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:*
>
> *(a) The identifying characteristics of the specific items or matters tested;*
>
> *(b) Who performed the audit work and the date such work was completed; and*
>
> *(c) Who reviewed the audit work performed and the date and extent of such review.*
>
> 10. *The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place."*

785 The question of the sufficiency of the audit work is dealt with below. In relation to that charge, the defence is that the audit work done in Ellerine Furnishers as a fellow group company pertaining to its turnaround plan, the deferred tax asset and its going concern status, was sufficient for purposes of the African bank audit in relation to the Ellerine Furnishers loan.

786 Assuming for the moment that the first respondent is correct regarding the sufficiency of the audit work in Ellerine Furnishers, in the Committee's view a professional judgement pertaining to reliance on the audit work in Ellerine Furnishers (in order to conclude that there was no need to impair the Ellerine loan) ought nonetheless to have been documented in the African Bank audit file specifically. This would be required in terms of paragraphs 8(c) and 9 of ISA 230 as well as paragraph A27 of ISA 200. The reliance on the audit work in Ellerine Furnishers was in itself a professional judgement exercised during the African Bank audit and ought to have been appropriately documented as part of the African Bank audit documentation.

787 Mr Chidgey conceded as much in his evidence saying:

*"The conclusion that there was no need ... to make an impairment provision in relation to the loan ... should be a conclusion on the file of the company where the loan is sitting to that effect... Whether the working papers to support it are there, I think is less of an issue."*

788 The committee agrees. But we go further. A conclusion that there was no need to make an impairment provision in relation to the loan from the perspective of African Bank, was no simple matter. A conclusion alone would not satisfy the provisions of ISA 200 and ISA 230 referred to above. Paragraph 8(c) requires not only documentation of the conclusion but also the documentation of *"significant professional judgements made in reaching [the] conclusion."* Paragraph A27 of ISA 200 is to similar effect. That calls for the documentation of the reasoning process of the auditor in arriving at a conclusion.

789 The factual circumstances that prevailed at the time of the audit meant that the assessment of the need or otherwise for impairment required the exercise of significant professional judgements. Although Ellerine Furnishers, the debtor, was assessed on a going concern basis, the audit opinion of Mr Bierman in respect of Ellerine Furnishers included the following emphasis of matter:

*"Without qualifying our opinion, we draw attention to note 34 to the annual financial statements. The loss incurred by the company of R828.9 million (2012: R276.1 million), along with other matters, indicate the existence of material uncertainties which may cast significant doubt on the company's ability to continue as a going concern. The directors have a plan to ensure that the entity will be a going concern as referred to in note 34."*

790 Note 34 of the notes to the annual financial statements of Ellerine Furnishers for 2013 reads as follows:

***"Going concern***

*The annual financial statements have been prepared on the basis of accounting policies applicable to a going concern. This basis presumes that funds will be available to finance future operations and*

*that the realisation of assets and settlement of liabilities, contingent obligations and commitments that will occur in the ordinary course of business.*

***Profitability***

*The company has incurred an after tax loss of R 828 911 287 (2012: R 276 118 064). The directors have prepared a forecast that indicates a trading loss before taxation for the 2014 financial year. However, a turnaround strategy has been put into place which includes a number of internal as well as other initiatives. This has been done in conjunction with African Bank Investments Limited, the ultimate holding company and African Bank Limited, a fellow subsidiary, to ensure that profitability of the company is restored in the medium term.*

*The estimated tax loss available for set off against future taxable income Is R 2 283 657 982 (2012: R 1 121 700 964).*

*A deferred tax asset of R 722 617 674 (2012: R 425 744 829) has been recognised on the statement of financial position.*

*The deferred tax in note 7 refers to the details of the turnaround strategy.*

***Liquidity***

*The company has borrowing facilities with African Bank Limited and four of the major banks. African Bank Investments Limited has initiated a number of actions in order to secure the funding facilities that the company requires over the next 12 months.*

*This includes obtaining approval to issue guarantees to the funders of the company from ABIL shareholders in terms of resolution 2 - General authority to provide financial assistance in terms of section 45 of the Companies Act. To date no objections have been received regarding this resolution.*

***Solvency***

*It is the intention of the EHL Group to restructure the ownership of certain of its subsidiaries. This will result in the company being the ultimate shareholder of the Group's insurance companies that will result in a further increase in the share capital of the company. This restructuring was approved in principle by the Financial Services Board.*

*To the extent that the company may require additional share capital, Ellerine Holdings Limited has agreed to further capitalise the company as and when the need arises during the financial year to September 2014, subject to Ellerine Holdings Limited passing a solvency test at such time.*

***Conclusion***

*The company will remain a going concern, based on the strategies and steps to be implemented."*

791 The significant doubt recorded in the emphasis of the matter as to the ability to continue as a going concern, was compounded from the perspective of African Bank by the facts that:

791.1 The deferred tax asset could only be realised at a point when Ellerine Furnishers returned to profitability;

791.2 The deferred tax asset was not going to generate any cash or improve the liquidity position of Ellerine Furnishers until such time as it moved out of a loss-making situation, and the loss making was predicted to continue for the 2014 financial year;

791.3 As appears from note 34 to the Ellerine Furnishers annual financial statements for 2013, the conclusion as to Ellerine Furnishers going concern status was heavily based on the willingness of African Bank to continue funding Ellerine Furnishers;

791.4 The outstanding balance on the loan was in a significant amount, well above materiality;

791.5 Interest was payable on the loan, so that too had to be factored into the assessment.

792 These are just some of the circumstances that would have to have been dealt with and documented in the reasoning process in concluding that, despite these circumstances, there was no need to impair the loan.

793 In the circumstances, the pro forma complainant has proven the averments –

793.1 in paragraph 21.5.1 of the schedule of charges, i.e. that no specific work was documented on the loan to Ellerines, despite recoverability being identified as a risk; and

793.2 in paragraph 21.5.3, namely the failure to document how the information regarding the recoverability of the loan was addressed in forming a final conclusion.

794 In paragraph 21.5.2, it is alleged that the first respondent breached ISA 220 in that the first respondent *"failed to ensure that there was sufficient appropriate evidence to support the conclusions reached regarding the recoverability of the loan."*

795 ISA 220 deals with quality *control for an audit of financial statements.* Paragraph 17 provides as follows:

> *"On or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued."*

796 Absent any documentation whatsoever in the African Bank audit file pertaining to the Ellerines loan, this obligation could not have been complied with by the first respondent with reference to the audit of African Bank. The Committee is accordingly satisfied that the averment in paragraph 21.5.2 of the schedule of charges has also been proven.

***The sufficiency of audit evidence complaints***

797 In paragraph 21.5.4, it is alleged that the first respondent breached ISA 330 in that he *"failed to take into account all relevant evidence in forming an opinion regarding the impairment of the loan to Ellerine Furnishers."*

798 In paragraph 21.5.5, it is alleged that the first respondent breached ISA 500 in that he *"failed to obtain sufficient appropriate audit evidence to draw reasonable conclusions regarding the recoverability of the loan to Ellerine Furnishers."*

799 ISA 330 deals with the *auditor's responses to assessed risks.* Paragraph 26 provides as follows:

> *"The auditor shall conclude whether sufficient appropriate audit evidence has been obtained. In forming an opinion, the auditor shall consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements."*

800 ISA 500 deals with *"Audit Evidence"*. Paragraph 6 provides as follows:

> ***"Sufficient Appropriate Audit Evidence***
>
> *6. The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence."*

801 Paragraph 5(b) defines *"appropriateness of audit evidence"* as:

> *"The measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based."*

802 Paragraph 5(c) defines *"audit evidence"* as:

> *"Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information."*

803 Paragraph 5(e) defines *"sufficiency of audit evidence"* as:

> *"The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence."*

804 Paragraph A1 of ISA 500 reads, in relevant part:

> *"Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. <u>It may, however, also include information obtained from other sources</u> ..."* (emphasis added)

805 It does not give, as an example of *"other sources"*, audits done on other group companies, but the committee accepts that the first respondent was entitled in auditing African Bank to make use of the audit work done in Ellerine Furnishers by Mr Bierman, the component auditor responsible for that audit. All the more so because the first respondent was the engagement partner at group level for ABIL.

806 Moreover, it must be accepted that the audit work performed by Mr Bierman was appropriately and correctly done because this much was conceded by the pro forma complainant's witnesses. Part of Mr Bierman's audit work included the assessment of Ellerine Furnishers as a going concern and as being solvent, albeit with an emphasis of matter.

807 The question remains, however, whether that audit work was sufficient for purposes of the auditing of African Bank in relation to the recoverability of the Ellerines loan.

808 The pro forma complainant's expert witnesses contended that the audit work done in Ellerine Furnishers was not, on its own, sufficient audit work for the

purposes of the African Bank audit in respect of the Ellerines loan. The first respondent, on the other hand, contended that:

> *"The only issue that needed to be considered was whether there was an ability by Ellerines to pay [the loan] back and that ability would have been subject to the going concern, the solvency, the liquidity of Ellerines. So once we concluded that Ellerines was a going concern despite the material uncertainty [expressed in Mr Bierman's audit opinion], our view was that the recoverability of the loan was confirmed."*

809 As appears from the extract quoted from the evidence of Mr Chidgey above, he supported the view of the first respondent in this regard.

810 The pro forma complaint's experts, on the other hand, advanced the following contentions, as recorded in the expert minute:

810.1 *"The recoverability of inter-company loans, in general, and hence the loan to Ellerines by implication, was identified as a risk in the related party audit programme of African Bank."*

810.2 *"Consideration of the overall going concern status (solvency and liquidity) of Ellerine Furnishers at a company level was insufficient for purposes of assessing the valuation of the debtor in African Bank."*

810.3 *"The uncertainties in respect of Ellerines going concern implied [that] there were uncertainties regarding the recoverability of the loan".*

810.4 *"Ellerine Furnishers was an individually significant debtor of African Bank above the audit materiality level."*

810.5 *"The success of Ellerine Furnishers turnaround strategy was strongly dependent on the ability and willingness of African Bank to grant*

*further facilities on the back of already relaxed repayment arrangements and with no security against the debt."*

811 The pro forma complainant's experts also contended that the loan ought to have been impaired pursuant to IAS 39. As pointed out above, the committee is of the view that the formulation of the sixth charge does not raise this as a distinct issue that must be adjudicated, one way or another, to arrive at a finding of innocence or guilt on the charge. Whether or not the loan should ultimately have been impaired, the question is whether the audit work was correctly done in the sense of ensuring that the work done was properly documented, that there was sufficient appropriate audit evidence to draw reasonable conclusions regarding recoverability, and that all relevant evidence in forming an opinion on impairment was taken into account.

812 Having considered the competing evidence and argument, the Committee is not satisfied that the pro forma complainant has proven, on a balance of probabilities, that

812.1 there was insufficient, appropriate audit evidence generated in the audit of Ellerine Furnishers to make the assessment that the loan was recoverable and need not be impaired in the AFS of African Bank;

812.2 the evidence was not properly considered and taken into account for purposes of the audit of the Ellerines loan in African Bank.

813 In arriving at this conclusion, the Committee has taken into account *inter alia* the following -

813.1 the failure of the witnesses for the IRBA to put up evidence to show that any impact on estimated future cash flows in repayment of the loan could reliably be estimated, as required by IAS 39;

813.2 Mr Cameron-Ellis confirmed several times that the audit work done on the deferred tax asset and going concern was sufficient to support the conclusions in Ellerine Furnishers;

813.3 He said that there were a number of “different things” that had to happen in order to get Ellerine Furnishers back to profitability, and that all the variables that needed to be considered were taken into account;

813.4 Mr Cameron-Ellis also affirmed in response to a question from Mr Sooklal, that the work that was done at Ellerine Furnishers, was adequate to state that Ellerine Furnishers was solvent;

813.5 Mr Bierman’s tests showed that Ellerine Furnishers would be a going concern for the foreseeable future;

813.6 ABIL had successfully raised R5,3bn from a rights issue.

814 In the circumstances, the proforma complainant has not proven the insufficiency of audit evidence component of the charge as set out in paragraphs 21.5.4 and 21.5.5.

***Does the documentation failure amount to misconduct?***

815 The question which must then be considered is whether the allegations proven in respect of the sixth charge, which focus on a failure of adequate

documentation of audit work, are sufficient to constitute misconduct on the part of the auditor. The heads of argument submitted on behalf of the first respondent in this regard include the following submissions:

> *"... the question then arises as to what the consequences are of documentation imperfections. At most, we submit, they constitute a self-standing breach of the audit standards, which may or may not – depending on how serious they are considered by the Committee – constitute a species of (much) less serious improper conduct under the Rules. Particularly for a "first offender" or where the failure is isolated, we submit that a documentation imperfection should not be considered improper conduct deserving of the opprobrium attaching to that term."*

816 One should not understate the importance of documentation of audit work. Audit work is based on the gathering of sufficient audit evidence to support conclusions in relation to whether financial statements are misstated by reason of fraud or error, and the exercise of professional judgements in relation to the audit evidence. The Committee agrees with the submission on behalf of the respondents that the absence of documentation in the audit file does not mean that the audit work was not done. However, the process of documentation has the following benefits:

816.1 It provides a record of the reasoning of the auditor and its evidential basis for a range of potential users of that information, including the entity audited (which may use it to improve its accounting, reporting or governance), a regulator such as IRBA which reviews or investigates an audit for a reason relevant to its statutory mandate, and the auditor or audit firm, which may use it when a new engagement partner takes over the audit, when it is necessary in conducting an audit to compare the position in the preceding financial

year and when it is necessary for the auditor or audit firm to defend itself in civil or disciplinary proceedings;

816.2 In an age when corruption is rife in the public and private sector, documentation of audit evidence and work ensures greater accountability;

816.3 Most importantly, the process and discipline of documentation improves the quality of the exercise of professional judgement during the audit, through the mental process that it demands; and

816.4 It facilitates the overall assessment that is required to be done by an auditor immediately prior to the signing of the audit opinion.

817 Given that the following circumstances, namely –

817.1 The audit was appropriately classified at the outset by Deloitte as involving much greater than normal risk;

817.2 The progress of the audit and the evidence emanating from it, confirmed the correctness of this classification;

817.3 The debtor was in severe financial difficulty, with an emphasis of matter included in the audit opinion in respect of the debtor company by the same firm of auditors;

817.4 The amount of the loan was significant and well-above materiality;

817.5 The documentation failure was complete rather than partial – there was nothing in the audit file pertaining to the audit work in respect of the loan;

817.6 The first respondent was concerned with the audit of a bank and reliable information pertaining to the financial health (or otherwise) of banks is central to maintaining the stability of a country's financial system,

the Committee is satisfied that the documentation failure is sufficiently serious to constitute misconduct.

***Conclusion***

818 In the circumstances, the Committee is satisfied that the pro forma complainant has proven sufficient of the material averments in the sixth charge for a conviction. The Committee accordingly finds the first respondent guilty of infringing disciplinary rules 2.5, 2.6 (in respect of section 130.1(b) of the Code) and 2.7 on the basis set out above in respect of the sixth charge. Although all of these rules were breached, the conviction on this charge is a single, separate conviction for purposes of sanction. Whilst the documentation failure amounted to misconduct, it was not such as to bring the auditing profession into disrepute as contemplated in rule 2.17.

**THE SEVENTH CHARGE**

***Introduction***

819 The essence of the seventh charge is that the first respondent issued an unmodified audit report in the annual financial statements of both ABIL and African Bank for the year ended 30 September 2013 in circumstances where there was a material uncertainty relating to their going concern status. This required disclosure in the annual financial statements of both ABIL and African Bank. Because this was not disclosed in the annual financial statements, the first respondent was obliged in terms of ISA 570 *Going Concern* to express a qualified or adverse conclusion in accordance with ISA 705 *Modifications to the Opinion in the Independent Auditor's Report*.

820 The bases alleged for the material uncertainty regarding going concern are –

820.1 the material uncertainty regarding the ability of Ellerine Furnishers to continue as a going concern;

820.2 the funding requirements for its turnaround strategy, which would impact on the cash reserves of ABIL and African Bank;

820.3 the absence of detailed cashflow projections of the funding requirements to implement its turnaround strategy in the audit files;

820.4 the concentration risk of advancing funds to Ellerine Furnishers instead of individual bank clients; and

820.5 the alleged misstatement of impairments in the annual financial statements of ABIL and African Bank for the year ended 30 September 2013 in the respects alleged in charges 1, 2, 3 and 4;

820.6 the misstatements referred to in the other charges would have had a material impact on the capital adequacy requirements of African Bank and its ability to raise additional funding.

821 The first respondent however failed to modify the report on the annual financial statements of ABIL and African Bank and he accordingly failed to comply with ISA 570.

822 The first respondent's plea to the seventh charge may be summarised as follows:

822.1 The major factor affecting a bank's status as a going concern is liquidity.

822.2 The turnaround strategy of Ellerine Furnishers and the alleged misstatement of impairments did not impact directly on the liquidity of ABIL or African Bank. The turnaround strategy was more or less cash neutral vis-à-vis both ABIL and African Bank.

822.3 Funding was unlikely to be affected because the over-subscription of the rights offer showed the capacity to raise the requisite funding, even if a larger amount had been required. Hence the going concern status of ABIL or African Bank depended on the underwriting of the rights offer and not on any specific level of impairment.

822.4 The audit working papers show a consideration of these issues and specifically liquidity under stress-tested scenarios.

822.5 Even if there was a material uncertainty about the going concern of ABIL or African Bank, the audit would never have unfolded so as immediately to require a modification of the reports - the first respondent would first have had to engage with the SARB, which would, in all probability, have placed African Bank in curatorship 10 months earlier. This is borne out by the fact that the SARB had already initiated Project Phoenix which monitored ABIL and African Bank, particularly in regard to liquidity.

822.6 On this basis, the allegations in the charge were denied.

823 Significant consensus was also arrived at in relation to the seventh charge amongst the expert witnesses. The respects in which they were in agreement are recorded in the expert minute as follows:

> *"1. The audited financial statements of ABIL and the Bank for the period to 30 September 2013 were prepared in accordance with the going concern principle and did not indicate any uncertainties in this respect. Mr Jordan signed the audit reports on these statements on 6 and 10 December 2013 respectively. These reports contained no reference to a material uncertainty in respect of going concern.*
>
> *2. The SARB would most likely, not have permitted Deloitte to issue a modified audit report in respect of ABIL or the Bank and would have, instead – in circumstances which otherwise would have required such a modified audit report – placed the Bank in curatorship or made some other form of regulatory intervention.*
>
> *3. There was material uncertainty regarding the ability of Ellerine Furnishers to continue as a going concern as at 30 September 2013, which was disclosed in its own 2013 AFS, inter alia by including an emphasis of matter in the audit report signed by Mr Bierman on 31 January 2014.*

*4. The existence of a modified audit report at a subsidiary level does not automatically require a modification to the audit report at a group level.*

*5. At the time of concluding the Bank and the ABIL audits in early December 2013, the Deloitte ABIL group audit team considered that, Ellerine Furnishers would continue as a going concern despite a possible material uncertainty in that regard at the level of Ellerine Furnishers.*

*6. The dispute regarding the impact of Ellerine Furnishers on the going concern assessment of ABIL and the Bank … relates to whether additional credit risk in relation to the intercompany loans with the Bank (both the original loan and the new loan arising from funding the Ellerine book) was appropriately taken into account in the stress testing of the Group's cashflows for liquidity purposes.*

*7. Additional cash requirements to fund the Ellerine Furnishers turnaround strategy had been considered by Deloitte in their going concern assessment (which included stress testing of the cash flows) of ABIL and the Bank. A portion of the facility was operational, and a portion was to be … lent to Ellerine's customers (instead of as in the past to African Bank customers). This second category and how it was dealt with is the subject of the charges.*

*8. The more significant consideration of the two criteria of solvency and liquidity, affecting a bank's status as a going concern is generally liquidity. In the case of a bank, capital adequacy is also important.*

*9. Charge 7 also alleges that there was a material uncertainty on going concern because the statement of financial position of the Bank was overstated in respect of the loan impairments ('the disputed impairments') which are the subject of charges 1, 2, 3 and 4 and these had not been considered as part of the Deloitte going concern assessment.*

*10. Impairments are a non-cash item and these disputed impairments would have no direct effect on liquidity although they would have an effect on the extent of the Bank's solvency and its ability to meet its capital adequacy requirements.*

*11. Even if the disputed impairments were reflected in the original 2013 AFS, both ABIL and the Bank would have remained solvent*

*12. The SARB had implemented a project called "Project Phoenix" in or about May 2013, of which Mr Jordan was not aware, to monitor, in particular, the liquidity of ABIL and the Bank.*

*13. During October 2013, the SARB retrospectively condoned a breach of the capital adequacy requirements of the Bank.*

*14. The rights offer, which was fully underwritten on 31 October and which closed on 6 December 2013, was oversubscribed. It raised R5 billion of new funding which had improved the group's capital."*

824 Based on these areas of agreement, the experts were of the view that the only remaining issues in dispute were the following:

824.1 *"Whether additional credit risk arising from the fact that Ellerine (sic) was interposed between the Bank and the Borrower was properly considered by Deloitte in considering whether there were material uncertainties in relation to the going concern."*

824.2 *"Whether the 'disputed' impairment provisions which form the basis of charges 1, 2, 3 and 4 should have been taken into account in assessing whether there were material uncertainties in relation to going concern."*

***Disputed impairment provisions***

825 In regard to the second of the above points in issue, it was submitted in the summarised argument on behalf of the first respondent as follows:

> *"12. It is not appropriate to consider further hypothetical impairments that form the subject of other charges in relation to an auditor's professional conduct in forming an opinion on the going concern of the bank. It would amount to assuming Mr Jordan was aware of those instances of alleged misconduct, and the splitting of convictions.*
>
> *13. An auditor does not ask, and is not required to ask: what would be the outcome of the going concern assessment if the financial statements are wrong? The correctness of the relevant amounts disclosed in the financial statements, once they have been audited, are appropriately assumed for the purposes of the going concern assessment."*

826 The committee agrees. Were the committee's findings in relation to charges 1, 2, 3 and 4 to form a component of the decision-making process in finding the first respondent guilty of charge 7, the first respondent would be convicted and

punished in respect of the same conduct twice. For a conviction on this charge to be sustained, it was incumbent upon the pro forma complainant to show distinctive misconduct in the auditing process pertaining to the going concern assessment, leaving out of account the misconduct alleged in the first four charges.

827 In any event, this component of the charge is in the committee's view disposed of by the matters agreed in paragraphs 10 and 11 of the list of items on which the experts were in agreement on the seventh charge, i.e:

827.1 Impairments are a non-cash item so the disputed impairments would have no direct effect on liquidity although they would have an effect on the extent of the Bank's solvency and its ability to meet its capital adequacy requirements.

827.2 Even if the disputed impairments were reflected in the original 2013 annual financial statements, both ABIL and the Bank would have remained solvent.

828 Insofar as the capital adequacy requirements are concerned, these had in any event been relaxed by the SARB to accommodate the difficulties faced by ABIL and African Bank.

***Other considerations relevant to going concern***

<u>Pro forma complainant's contentions</u>

829 As recognised by the pro forma complainant in his written heads of argument, what remains then of the seventh charge pertains primarily to the "*first*

*respondent's failure properly to appreciate the cash flow implications on African Bank in having to fund Ellerine Furnishers, and the concentration risk".*

830 At the outset we point out that this component of the misconduct alleged against the first respondent becomes difficult to distinguish from that to which the sixth charge relates, pertaining to the audit work in relation to the Ellerine Furnishers loan. Nonetheless it is assumed in favour of the pro forma complainant that the conduct complained of in this charge is distinct from that referred to in the sixth charge and capable of sustaining a conviction.

831 In examining the narrower enquiry emanating from the process of engagement between the experts, the pro forma complainant, in argument, focussed on the audit work in relation to, and circumstances of, Ellerine Furnishers. The pro forma complainant assessed the position from what he described as the primary, secondary and tertiary levels, corresponding with Ellerine Furnishers, African Bank and ABIL.

832 In evaluating the position from <u>the primary level</u>, i.e. in relation to Ellerine Furnishers, the pro forma complainant drew attention to the following:

832.1 The emphasis of matter paragraph in the audit report accompanying the Ellerine Furnishers standalone financial statements for 2013 in respect of the material uncertainties in relation to its going concern status. In this regard Mr Bierman had emphasised that Ellerine Furnishers depended on the support of African Bank and ABIL.

832.2 Ellerine Furnishers deteriorating financial circumstances were "explicitly chronicled" in the Ellerine Furnishers AFS of 2013, suffering

an operational loss of just over R1 billion, having current liabilities exceeding current assets and with the circumstance that without the deferred tax asset (DTA), it was insolvent.

832.3 The DTA could only be taken advantage of when Ellerine Furnishers moved into a profit-making position.

832.4 The quality of the Ellerine Furnishers loan book was worse than that of African Bank.

833 With reference to the turnaround plan for Ellerine Furnishers, the pro forma complainant referred to the following:

833.1 The gloomy picture painted in a budget prepared by Ellerine Holdings on 9 September 2013.

833.2 The doubts expressed in the DTA audit working papers to the effect that "*[w]hilst we are satisfied with the overall recoverability of the deferred taxation asset based on the forecast received, we believe that the assumptions and judgements used are much less conservative than what we see at other clients*".

833.3 A series of critical comments in the DTA audit working papers regarding management's major assumptions regarding projected revenue increases in Ellerine Furnishers, projected reductions in operating costs and the anticipated enhanced value share from ABIL and the group's insurance entities.

834 On this basis it was contended that the first respondent ought not to have relied on the turnaround strategies or the DTA in assessing the financial viability of Ellerine Furnishers.

835 The pro forma complainant criticised the fact that the audit working papers of Ellerine Furnishers did not provide a detailed cash analysis, both in respect of the existing loan facility which, said the pro forma complainant, Ellerine Furnishers had already overdrawn, as well as its other funding requirements (to fund Ellerine Furnishers' payaways in respect of its loans to its customers). This meant that the audit working papers of Ellerine Furnishers did not state how much money was required going forward to sustain the various initiatives. Further, the pro forma complainant argued that most of the strategies "*involved a sacrifice by African Bank which it could ill-afford and which would inevitably sink it further into financial crisis*".

836 The pro forma complainant referred also to the concentration risk relating to Ellerine Furnishers (i.e. the enhanced risk allegedly arising from African Bank shifting from providing loans itself to multiple borrowers, to providing funding to Ellerine Furnishers to enable it to provide loans to multiple borrowers, resulting in the indebtedness to African Bank being that of a single debtor rather than multiple debtors with diverse risk profiles).

837 It was contended that the concentration risk was neither taken into account nor subjected to any stress tests, nor considered in the liquidity analysis.

838 In regard to the secondary level, i.e. the liquidity analysis from the perspective of African Bank, the pro forma complainant made the following submissions:

838.1 The pro forma complainant acknowledged that in 2013, working papers were prepared with regard to the going concern assessment of African Bank's liquidity position.

838.2 However he criticised this aspect of the audit in the following respects–

838.2.1 the analysis does not separately include the cash flows that would be advanced to and received back from Ellerine Furnishers;

838.2.2 the cash outflows only addressed funding in terms of the Ellerine Furnishers loan for three months – no scenario was envisaged where Ellerine Furnishers would require more than this, which turned out to be the case;

838.2.3 no stress scenario addressed the risk that repayment of loans to Ellerine Furnishers by their customers would not be used to repay African Bank;

838.2.4 the conclusion that the group is a going concern was expressly described as being on the basis that "*key to its success is a successful rights issue being underwritten by Goldman Sachs*", with the first respondent agreeing in evidence that the group's ability to survive as a going concern was on the basis of the successful rights issue.

838.3 It was acknowledged that a sensitivity analysis had been performed considering the impact of various cashflows, stress tested from

August 2013 to November 2014 and, apart from the dependence on the rights issue, these identified that successive 10% increases in disbursement of payaways would have a negative cash impact by November 2013, and a further stress test involving a 10% decrease in receipts would result in a marked negative impact from July 2014.

839 The first respondent's audit work was also criticised on the basis that the cashflow analysis preceded the details of the turnaround plan formulated for Ellerine Furnishers and was not updated to reflect these various initiatives. The first respondent disputed this.

840 The pro forma complainant acknowledged that there were other relevant audit working papers, including a liquidity forecast, a liquidity analysis calculation, a financial analysis, an audit working paper entitled "Going concern – information prepared by the entity", two going concern evaluation maps and a further audit working paper entitled "Going concern considerations". These were all criticised on the basis that they failed to assess:

840.1 The funding requirements placed on ABIL to implement the turnaround strategy of Ellerine Furnishers; and

840.2 The concentration risk.

841 In relation to <u>the tertiary level</u>, i.e. viewed from the perspective of ABIL, the pro forma complainant made the following submission:

> *"Whilst what the first respondent says is true, i.e. that whatever debt Ellerine Furnishers owed to African Bank would be set off 'in the wash' as it was consolidated up towards ABIL, it did not make a difference as the real issue is that this affected African Bank and the collapse was within African Bank. The fault lay with the cashflows of African*

*Bank and it was the bank's inability to continue to fund Ellerine Furnishers which caused the problem."*

842 On the basis of the foregoing analysis, the pro forma complainant submitted that there was a material uncertainty as to the ability of both African Bank and ABIL to continue as going concerns, which required disclosure in their annual financial statements. Absent such disclosure, the first respondent was required by ISA 570 to express a qualified or adverse conclusion. In failing to do so he was guilty of misconduct.

The first respondent's contentions

843 On behalf of the first respondent, it was pointed out that, whilst it is common cause that there was material uncertainty regarding the ability of ABIL and African Bank to continue as going concerns absent a rights issue, the question is whether the commitment of the SARB, and Goldman Sachs to the rights issue, culminating in a final underwriting agreement being signed with Goldman Sachs on 31 October 2013, eliminated the material uncertainty.

844 The first respondent focusses on the following as having ensured the continued going concern status of ABIL and African Bank:

844.1 The fact that the rights issue was fully underwritten, thus ensuring that ABIL and African Bank would be recapitalised in an amount of approximately R5.5 billion, less fees and costs, thus increasing its equity and regulatory capital and restoring its liquidity.

844.2 The proceeds of the rights issue were materially in excess of ABIL's needs as determined by the going concern evaluation of the cashflow forecasts.

844.3 The SARB and Goldman Sachs both made bridging facilities available to ABIL for the period up to the consummation of the rights issue.

844.4 The SARB demonstrated extensive support for the bank, including condoning a temporary breach of its capital adequacy requirements.

844.5 ABIL and African Bank would have had enough cash to carry on their business in the normal course for the next financial year given any reasonable liquidity scenario, even when stressed in various ways to account for lower roll rates resulting from loss of market confidence or any other factor.

844.6 The bank could always improve its liquidity position by decreasing payaways (in other words, advancing less cash loans to customers).

844.7 Additionally the successful rights issue would encourage continued rolling of current funding instruments and new over-the-counter funding instruments being written.

845 It was further pointed out on behalf of the first respondent that:

845.1 ABIL and the bank audit teams prepared a detailed going concern analysis in the audit working papers;

845.2 The first respondent obtained guidance on the going concern concept and the audit impact in relation to distressed banks from the Basel Committee on Banking Supervision and the Sharman Panel – Implementation Consultation Paper.

845.3 The first respondent followed international best practice by encouraging management to take proactive steps to address the difficult position in which the bank found itself, without prematurely modifying his audit report which would have resulted in the immediate demise of the Bank.

846 The first respondent goes on to address the particular components of the charge pertaining to his alleged failure properly to take into consideration the financial difficulties in Ellerine Furnishers in various respects.

847 In relation to the allegation that the turnaround strategy of Ellerine Holdings and Ellerine Furnishers required funding that would have a significant impact on the cash reserves of ABIL and African Bank, the following submissions were made:

847.1 In response to Mr Cameron-Ellis' report in its unamended form, the first respondent had pleaded that the Ellerine Furnishers turnaround strategy was essentially cash neutral, from the perspective of both African Bank and ABIL. This was because, whilst previously African Bank would advance cash to customers, following the turnaround strategy, such advances would be made via advances to Ellerine Furnishers who would, in turn, make the advances to customers, with Ellerine Furnishers ultimately obliged to repay the funds advanced by African Bank.

847.2 Mr Cameron-Ellis amended his report in response to this so as to focus the complaint in this regard on the failure to consider the concentration risk (referred to above) of advancing funds to Ellerine Furnishers instead of to individual bank clients.

847.3 Mr Cameron-Ellis conceded that the audit work done on the deferred tax asset and the going concern of Ellerine Furnishers was sufficient and acceptable.

847.4 Mr Cameron-Ellis conceded that the first respondent's audit work on the expected liquidity position of ABIL and African Bank over the following year was *"of a quality that is different to the type of work that was done on the impairments. There is quite a bit of attention to detail. There is a lot of consideration of different scenarios etc."*

847.5 Mr Cameron-Ellis conceded that only a very small portion of the net advances figure in ABIL was lent by the retail unit, Ellerine Furnishers.

847.6 Mr Cameron-Ellis conceded that adequate stress tests were performed on ABIL's liquidity.

847.7 Mr Cameron-Ellis conceded that the stress tests included a full drawdown of the facility the bank made available to Ellerine Furnishers over a three- month period.

847.8 Ms De Beer conceded that one could reach the conclusion that ABIL and African Bank were going concerns but averred that the audit work in this regard had not necessarily been documented correctly (which is not part of the charge).[74]

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[74] The relevant part of the transcript reads:

> "The impact of Ellerines might not have been stress tested enough in this, and all of those are factors that need very thoughtful comment because it is a difficulty identified in the audit, and how do you then get to a conclusion that the group and the company is a going concern.
>
> <u>So I am not saying that you should not have got into that conclusion</u>, it is just in light of all of these really difficult issues, you needed to do a lot of documenting." (emphasis added)

848 In relation to the criticism regarding the audit work done on the recoverability of the DTA, the following were the main submissions:

848.1 Mr Jordan did rely and was entitled to rely for purposes of the risk in relation to the deferred tax asset from the group's position, on the extensive audit work done by Mr Bierman as component auditor for Ellerine Furnishers and the first respondent was in fact involved with Mr Bierman in that work.

848.2 There were several iterations of the forecasts relevant to the DTA and Mr Bierman only signed off on these once properly satisfied by management. The Ellerine Furnishers turnaround strategy was not primarily an attempt to justify the deferred tax asset but sought to extract value from Ellerines Furnishers in changing the product, and in changing some of its processes.

849 In relation to the auditing work done on the funding requirements of Ellerine Furnishers, the following submissions were made on behalf of the first respondent:

849.1 In Mr Chidgey's assessment, the risk of any future financing needs of Ellerine Furnishers were fully considered.

849.2 The liquidity analysis in the bank dealing with Ellerine Furnishers turnaround strategy was appropriately and fully documented in the audit working papers – in this regard, tick mark {h} in the relevant audit working paper set out the analysis of loans disbursed and credit card disbursements on a monthly basis and concluded as follows:

> *"As a result of this the cashflow forecast appears to be overstating the cashflow by R315 million, which would have a negative impact on the liquidity position of ABIL.*
>
> *In conclusion treasury management is being conservative in their cashflow forecast and is appropriate in terms of assessment of the liquidity of the bank (sic)."*

849.3 Accordingly, the funding of the loans to Ellerine Furnishers was going to extend from 1 October 2013 and was fully reflected in the payaways line item in the Bank's liquidity analysis.

849.4 Other than the future drawdowns on the Ellerine Furnishers loan and the funding of the loan business by Ellerine Furnishers, the turnaround strategy did not require any further cash from African Bank.

849.5 Accordingly, the liquidity analysis dealt fully with any cash requirements of the turnaround strategy.

850 Mr Chidgey explained the going concern assessment as amounting essentially to an assessment of budgets and cash flows produced by management. He testified that he had reviewed the going concern analysis prepared by the audit team, noted no deficiencies in the going concern work that was done and considered the cash requirements to implement the turnaround strategy of Ellerine Furnishers to have been sufficiently and appropriately tested.

851 As far as the concentration risk was concerned, the following submissions were made on behalf of the first respondent:

851.1 The experts agreed that, in truth, the risk in relation to the Ellerine Furnishers loan was a credit risk rather than a concentration risk.

851.2 Whether a bank funds credit operations in divisions or in separate companies, as many banks do, does not change the underlying nature of the risk.

851.3 The issue of the "concentration risk" thus resolves itself into the same question as that pertaining to charge 6, namely whether the Ellerine Furnishers loan was recoverable and did not pose a distinct threat to the going concern status of either ABIL or African Bank.

851.4 The stress tests took into account a full drawdown on the Ellerine Furnishers loan up to its limit of approximately R800 million and under those circumstances the Bank would remain solvent and liquid.

***Analysis***

852 It is important to bear in mind in considering this charge that, unlike charge 6, the focus of the charge is not compliance with those auditing standards concerned with obtaining sufficient appropriate audit evidence and its documentation, but rather on the objective fact as to whether or not there was indeed material uncertainty as to the going concern status of ABIL and African Bank. If there was, then there was a breach of ISA 570 *Going Concern*.

853 The focus in the evidence and in argument on the quality of the audit work done in relation to the going concern analysis was therefore, to some degree, misdirected. All the more so where it was common cause between the parties that, absent the funding that would be generated by the rights issue, there was indeed material uncertainty as to the going concern status of both ABIL and African Bank.

854 The charge therefore, as correctly observed by counsel for the first respondent, resolves itself into a single question – did the rights issue provide sufficient liquidity to ensure that ABIL and African Bank could continue as a going concern in the ensuing financial year, without any material uncertainty as to its ability to do so. It is that to which we now turn.

855 Paragraph 2 of ISA 570 provides in relevant part as follows:

> *"**Going Concern Assumption***
>
> *2. Under the Going Concern Assumption, an entity is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations or has no realistic alternative but to do so… When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity would be able to realise its assets and discharge its liabilities in the normal course of business."*

856 Paragraph 6 of ISA 570 provides in relevant part as follows:

> *"Responsibilities of the Auditor*
>
> *6. The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern."*

857 Paragraphs 17 to 20 of ISA 570 provide, in relevant part, as follows:

> *"**Audit Conclusions and Reporting***
>
> *17. Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor's judgement, material uncertainty exists relating to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgement, appropriate disclosure of the nature and implications of the uncertainty is necessary for … a fair presentation of the financial statements."*

***Use of Going Concern Assumption Appropriate but a Material Uncertainty Exists***

*18. If the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:*

*(a) adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and*

*(b) disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, and, therefore that it may be unable to realise its assets and discharge its liabilities in the ordinary course of business.*

*19. If adequate disclosure is made in the financial statements, the auditor shall express an unmodified opinion and include an emphasis of matter in the auditor's report to:*

*(a) highlight the existence of material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and*

*(b) draw attention to the note in the financial statements that discloses the matters set out in in paragraph 18.*

*20. If adequate disclosure is not made in the financial statements, the auditor shall express a qualified opinion or adverse opinion, as appropriate, in accordance with ISA 705. The auditor shall state in the auditor's report that there is a material uncertainty that may cast significant doubt upon the entity's ability to continue as a going concern."*

858 It is apparent from this extract that a material uncertainty exists when there is a potential event or events or there is a condition or conditions, the likelihood of which, along with the magnitude of their potential impact, require disclosure for there to be fair presentation.

859 Simply put, the condition and likelihood which was to be assessed was that ABIL and African Bank would run out of cash to fund their operations. Viewed from this perspective, the concluding paragraph of the list of issues upon which the experts were in agreement, leaves no room for any conclusion other than that

any material uncertainty was indeed removed by the rights issue. The relevant paragraph reads -

> *"The rights offer, which was fully underwritten on 31 October [2013] and which closed on 6 December 2013, was oversubscribed. It raised R5 billion of new funding which had improved the group's capital adequacy ratio and resolved any regulatory, solvency or liquidity issues."*

860 Against that agreement between the experts, the level of likelihood of ABIL and African Bank running out of cash required by paragraph 17 of ISA 570, is absent.

861 In addition, as pointed out on behalf of the first respondent, the SARB and Goldman Sachs had both made bridging facilities available to ABIL for the period up to the consummation of the rights issue and the SARB had, in addition, demonstrated extensive support for the bank, including condoning a temporary breach of its capital adequacy requirements.

862 Another component of the points of agreement between the experts was that *"the SARB would most likely, not have permitted Deloitte to issue a modified audit report in respect of ABIL or the Bank and would have, instead – in circumstances which otherwise would have required such a modified audit report – placed the Bank in curatorship or made some other form of regulatory intervention."* That too seems to create an obstacle in the way of the probability assessment required by paragraph 17 of ISA 570.

863 The pro forma complainant placed reliance on the following dictum of the Supreme Court of Appeal in the matter of *Axiam Holdings Ltd v Deloitte & Touche*:[75]

[75] 2006 (1) SA 237 (SCA).

*"[21] Whether the representation by silence alleged in this case does fall within the section's terms depends on whether there was a duty to speak. In other words the duty relied on for there having been a representation will be the same duty relied on for the allegation of wrongfulness.*

*[22] As to the existence of that duty, a court apprised of all the factors and circumstances referred to in Minister of Law and Order v Kadir at 318H - I could find, on the framework of the allegations made in the particulars of claim, and on final evaluation, that the defendant's ignorance of its negligent report is no bar to concluding that it bore the alleged duty. It must be remembered that we are dealing with a situation where the legal convictions of the community could well consider it unacceptable that an auditing firm which issued a seriously negligent report should escape the legal duty to speak with care concerning that report simply because it was, possibly even negligently, ignorant of the negligence of its report. And what is more, in circumstances in which the latter negligence was something it ought to have known of. Reliance on the case of Universal Stores Ltd v OK Bazaars (1929) Ltd is misplaced. Two factors distinguish that case. One is that the wrongful conduct in ignorance of which the alleged representation occurred was that of the representor itself. It could well be the conclusion on trial that the representation compounds the negligence of the earlier audit and report. The second factor consists of the statutory provisions of s 20(9)(b)(ii)."*

864 As pointed out on behalf of the first respondent, that case turned on section 20(9)(b)(ii) of the Public Accountants' and Auditors' Act 80 of 1991. It concerned a delictual claim in circumstances where it was alleged that an auditor had conducted an audit and prepared a bank's annual financial statements, which statements significantly misrepresented the bank's financial position by indicating a net profit before tax of R29 m plus whereas the company had actually suffered a loss of almost R78 m. This happened because the respondent had failed to include a bad debt of approximately R69 m in the income statement. The amount was reflected as goodwill. Two companies relied on the financial statements in acquiring shares in the bank. They suffered a loss. The appellant took cession of their right to recover damages and brought a delictual claim on the basis of the auditor's failure to warn them of the deficient audit report. The

Supreme Court of Appeal upheld their right to claim. The case is distinguishable from the present matter both on the facts and on the basis of the legal questions in issue in these proceedings. It takes the matter no further.

***Conclusion***

865 In the circumstances, the committee finds that IRBA has failed to prove that there was a material uncertainty relating to the going concern status of ABIL and African Bank which would have required disclosure in the AFS for the year ended 30 September 2013. In the circumstances there was no obligation on the first respondent in terms of ISA 570 to modify his report on the AFS of ABIL and African Bank on account of any going concern uncertainty.

866 In view of the foregoing, the Committee finds that the pro forma complainant has failed to prove the averments underlying the seventh charge and accordingly acquits the first respondent on this charge.

## THE EIGHTH CHARGE

### *Introduction*

867 The eighth charge pertains to the failure by the first respondent to modify the independent reporting accountant's report on the reviewed interim financial information of ABIL for the eleven-month period ended 31 August 2013. The report was issued by the first respondent, in relation to a rights offer circular published in November 2013.

868 The essence of the charge is that there was material uncertainty regarding the going concern status of ABIL as at 31 August 2013, and that there was inadequate disclosure of this fact in the financial information. On this basis it is averred that the first respondent failed to comply with ISRE 2410 in that he failed to modify his conclusion on the financial information of ABIL as at 31 August 2013. The first respondent should have issued either a qualified or an adverse conclusion because of the non-disclosure of the material uncertainty.

869 The essence of the first respondent's defence as set out in his plea is that –

869.1 The assumption in the charge that there was a material uncertainty around the going concern status of ABIL until the rights offer closed on 6 December 2013, was incorrect.

869.2 Goldman Sachs and ABIL concluded an underwriting agreement on 31 October 2013.

869.3 The rights offer was fully underwritten by Goldman Sachs, in terms of the underwriting agreement.

869.4 Prior to 31 October 2013, and prior to the underwriting agreement being concluded, there was material uncertainty over whether ABIL would raise the required funds to maintain its going concern status

869.5 The first respondent had concluded, prior to 31 October 2013, that he would only be able to sign an unmodified audit report on the annual financial statements of ABIL and African Bank for the year ended 30 September 2013, if the rights issue was fully underwritten by Goldman Sachs.

869.6 The conclusion of the underwriting agreement on 31 October 2013, with the rights issue being fully underwritten, removed any material uncertainty over the ability of ABIL to raise the required capital and continue as a going concern.

869.7 The first respondent was therefore able to issue an unmodified reporting accountant's report on 31 October 2013, on the financial information as at 31 August 2013.

870 The factual background to this charge, briefly, is that the financial position and financial performance of African Bank and ABIL deteriorated during 2013.

871 On 4 March 2013, Moody's downgraded the Bank's global senior debt and deposit ratings by one notch to Baa3/Prime-3, from Baa2/Prime-2. The accompanying announcement stated that the downgrade reflected "*Moody's assessment of the risks associated with (1) the continued challenging operating conditions in South Africa's unsecured lending market, which will likely weigh on*

*African Bank's financial performance; and (2) the bank's concentrated wholesale funding profile, which is susceptible to market disruptions."*

872 At the end of May 2013 (and unknown to the first respondent) the SARB launched "Project Phoenix" to monitor the financial health of African Bank more closely.

873 The Bank was having difficulty rolling existing funding and attracting new funding, which had a negative impact on its liquidity. This was noted by the SARB, which granted a temporary relaxation of African Bank's capital adequacy requirements in October 2013.

874 On 5 August 2013 ABIL announced on SENS that it intended to raise up to R4 billion in capital through a rights offer underwritten by Goldman Sachs. The rights offer was later increased to R5.5 billion.

875 On 31 October 2013, ABIL concluded a final underwriting agreement with Goldman Sachs in terms of which the rights offer was fully underwritten by Goldman Sachs.

876 The rights offer circular was issued on 11 November 2013, and it contained the reporting accountant's report signed by the first respondent.

877 The charge pertains to the reporting accountant's report on the financial information as at 31 August 2013, included in the rights offer circular.

878 The focus of the debate in relation to this charge became the correctness or otherwise of the first respondent's failure to issue a modified reporting accountant's report. The pro forma complainant insisted that there was material

uncertainty that cast significant doubt on ABIL's ability to continue as a going concern. The material uncertainty was not disclosed in the financial information. This, according to the pro forma complainant, should have resulted in a qualified or adverse conclusion in terms of ISRE 2410.

879 The first respondent contended that the conclusion of the underwriting agreement between Goldman Sachs and ABIL resulted in the material uncertainty being removed and the going concern of ABIL being restored. The pro forma complainant disputed this for reasons elaborated upon below.

880 The following facts, *inter alia*, were agreed to between the experts and became common cause to the proceedings:

880.1 The first respondent issued an unmodified review report on the interim financial information of ABIL for the 11 months ended 31 August 2013.

880.2 The report was dated 31 October 2013.

880.3 The reviewed interim financial information formed part of the documentation related to the ABIL rights offer.

880.4 The reviewed interim financial information did not contain any reference to any material uncertainties related to the going concern of ABIL.

881 What was not agreed amongst the experts was whether a material uncertainty relating to going concern existed as at 31 October 2013 and if it was therefore appropriate for the first respondent to have issued an unmodified review

conclusion at that date, on the interim results for the 11 months to 31 August 2013.

***The parties' competing contentions***

882 Mr Cameron-Ellis, in his evidence in chief, sums up the disagreement by stating that the uncertainty turns on when the success of the rights issue is ensured: is it when the underwriting agreement is signed, or when the rights offer is finally concluded?

883 It was contended by the pro forma complainant that the success of the rights offer was only known on 6 December 2013, the date on which the rights issue closed. The pro forma complainant argues that when the first respondent signed the unmodified review report on 31 October 2013, there was not yet a successful rights issue.

884 In support of this contention the pro forma complainant refers to the following: the first respondent had admitted to the Myburgh Commission that he would not be prepared to sign an unmodified opinion on the audit of ABIL and African Bank for the year ended 30 September 2013 until the rights issue had gone to market and been successful. The pro forma complainant contends that the first respondent waited until 6 December 2013 before signing the audit opinion of ABIL, this being the date of the closing of the rights issue. This, according to the pro forma complainant, is the date on which the material uncertainty was removed, and not before.

885 The pro forma complainant therefore contends that if certainty was only to be attained on 6 December 2013, there must still have been a material uncertainty on the part of the first respondent on 31 October 2013, the date on which he signed the unmodified review report on the interim financial information as at 31 August 2013. The pro forma complainant contends that the first respondent's insistence that there was no material uncertainty at 31 October 2013 is without a sound basis.

886 The first respondent contends that what Deloitte conveyed to the Myburgh Commission was that he was not willing to sign the financial statements until the rights issue was successful. By success, he meant securing the underwriting agreement.

887 The problem with this debate is that it focuses on the subjective state of mind of the first respondent. The first respondent's state of mind is of little relevance. The question is whether on the information before him as an auditor, objectively, there was a material uncertainty as to the going concern status of ABIL and African Bank. It is to that question that we now turn.

888 The audit working papers containing the going concern considerations and evaluation indicate that much reliance was placed on the finalisation of the underwriting agreement. There the following is recorded:

> *"...The PRICING and the FIRM UNDERWRITING was signed on the 30 October 2013 by Goldman Sachs and ABIL management. This places us in a position to determine that the rights issue is very likely to take place, with approximately a 10% chance of withdrawal by Goldman Sachs..."* and
>
> *"Goldman Sachs has signed the pricing and firm underwriting documentation re-emphasising their commitment to the*

> *transaction and the rights issue is more likely than not to take place…We do not see an indication that they will not be able to raise this funding."*

889 The first respondent reiterated this during his evidence in chief. He stated that he took comfort from the work done by Goldman Sachs, and that he did not believe Goldman Sachs would support an underwriting for a rights issue that they did not believe would be successful. He was of the view that there was a very high probability (90%) that the rights issue would be a success.

890 The pro forma complainant countered this by pointing out that the underwriting agreement was subject to various provisions which, if breached, would allow Goldman Sachs to withdraw before the rights issue occurred. Included in those provisions was the obligation on the part of ABIL for accurate financial reporting. The underwriting agreement also contained warranties related to, *inter alia*, disclosures and financial records.

891 The existence of these provisions and warranties, argues the pro forma complainant, renders the underwriting agreement conditional and means that there was no certainty that the rights issue would be successful.

892 The pro forma complainant points to the circular nature of the situation: the underwriters were relying on the review of the financial information by the first respondent, to obtain comfort that they could proceed with the underwriting agreement. The first respondent, in turn, relied on the underwriting agreement when issuing an unmodified review report, on the basis that the material uncertainty was removed, and the capital raise was guaranteed.

893 Mr Chidgey noted that the issue of circularity was common with underwriting and other funding agreements. During his evidence in chief he testified that, provided the underwriting agreement is signed before the review report, there is no circularity. The material uncertainty no longer exists once the underwriting agreement has been signed. The review report can then be signed without a material uncertainty.

894 Ms De Beer, however, testified that the material uncertainty regarding going concern was not removed by the fully underwritten rights issue. She added that the underwriting agreement does not take away the auditor's responsibility to disclose information about the material uncertainty, and that the auditor should consider the impact on users of the financial information.

895 Mr Chidgey did not agree with Ms De Beer's view that the material uncertainty which existed before the underwriting agreement was signed, needed to be disclosed in the interim financial statements which were the subject of the review report. He argued that this is not a requirement in the accounting standards.

896 Coming back to the conditionality, or otherwise, of the underwriting agreement, the pro forma complainant makes the case that, because of the provisions and warranties contained in the agreement, it is conditional and thus its existence does not remove the material uncertainty. The pro forma complainant makes specific reference to the following warranties included in Schedule 1 to the underwriting agreement:

*"1. The Rights Issue Documents*

*1.1. None of the Rights Issue Documents contained (or will contain) any untrue, inaccurate, incomplete or misleading statement of a material factor omitted (or will omit) to state a material fact necessary in order to make the statements therein, in light of the circumstances under which they were (or will be) made, true, accurate and not misleading. All statements, forecasts, estimates and expressions of opinion, belief, intention and expectation contained in the Rights Issue Documents, at the time made, are fairly and honestly given, expressed or held and have been made on reasonable grounds after due and proper consideration and are reasonable based on facts known to the Company.*

*1.2. There are no facts or considerations known or which could on reasonable enquiry have been known to the Company which are not disclosed in the Rights Issue Documents and which by their omission would or might reasonably be considered to:*

*(a) be likely to affect the import of the information contained therein in any material respect; or*

*(b) make any statement therein (whether of fact or opinion) inaccurate or misleading in any material respect; or*

*(c) invalidate or qualify in any respect any assumption made in support of any statement therein (whether of fact or opinion) to any material respect; or*

*(d) be material for disclosure to Goldman Sachs in relation to the Rights Issue or potential purchaser of or subscriber for New Ordinary Shares.*

*2. Disclosure*

*2.2. So far as the Company is aware, there is no information which the Company is required by the JSE Listings Requirements to publish, whether to correct a misleading impression as to the market in or the price or value of the Ordinary Shares or to avoid behaviour which could constitute market abuse or which is otherwise relevant to the JSE in considering the Rights Issue, including the Listings.*

*3. Financial Records*

*3.1. The Accounts have (except as therein disclosed) been prepared in accordance with International Financial Reporting Standards consistently applied, the Companies Act and the JSE Listings requirements and give a true and fair view of the financial position as at, and the profits and losses and cash flow of the Group as at the end of, each relevant financial period and of the profit or loss and cashflow of such period and:*

*(a) …*

> *(b) proper provision or, as appropriate, disclosure in accordance with generally accepted accounting principles and practice (on the basis on which the Accounts have been prepared) has been made for Taxation payable by each Group Company."*

897 The pro forma complainant contends that these warranties and provisions invalidate the position held by the first respondent that the success of the rights issue was all but guaranteed. The pro forma complainant consequently holds that Goldman Sachs could withdraw from the underwriting agreement if the conditions were breached or warranties not met. Therefore, *"the First Respondent could not derive comfort as to the going concern being resolved by a conditional Underwriting Agreement, knowing as he did that there were controversies relating to the level of impairment in the audit"*.

898 Mr Chidgey and the first respondent both testified that rather than being unusual, such clauses were standard in underwriting agreements, and would rarely be used by underwriters to avoid their obligations. Mr Chidgey testified that the underwriting agreement in question is not dissimilar from the ones that he has seen during his career. Mr Chidgey does not believe that too much emphasis should be ascribed to the conditions and warranties.

899 To further emphasise that these conditions were not such as to create material uncertainty, the first respondent refers to the letter from Goldman Sachs to the Registrar of Banks advising of the increase in the rights offer to R5.5 billion. The letter, signed by the Chief Executive Officer, reads as follows:

> *"As discussed, Goldman Sachs International (GSI) acknowledges that it has increased the standby underwriting agreement with African Bank Investments Limited (ABIL) dated 5 August 2013 (Stand-by Agreement)*

*to ZAR 5.5 billion. Under this agreement GSI has agreed to underwrite a rights issue by ABIL of ZAR 5.5 billion subject to customary terms and conditions."*

***Analysis***

900 In the charge sheet, at paragraph 27.5, it is alleged that the first respondent *"failed to comply with ISRE 2410 as he failed to modify the report on the reviewed financial information of African Bank for the 11 months ended 31 August 2013 in circumstances where there was inadequate disclosure relating to going concern."*

901 ISRE 2410 *Review of Interim Financial Information performed by the Independent Auditor of the Entity* includes the following provisions:

> ***"Going Concern and Significant Uncertainties***
>
> *"55. ...*
>
> *56. If adequate disclosure is made in the interim financial information, the auditor should add an emphasis of matter paragraph to the review report to highlight a material uncertainty relating to an event or condition that may cast significant doubt on the entity's ability to continue as a going concern.*
>
> *...*
>
> *59. If a material uncertainty that casts significant doubt about the entity's ability to continue as a going concern is not adequately disclosed in the interim financial information, the auditor should express a qualified or adverse conclusion, as appropriate. The report should include specific reference to the fact that there is such a material uncertainty."*

902 The decision tree envisaged in ISRE 2410 with respect to reporting on a material uncertainty related to going concern is as follows:

902.1 Is there a material uncertainty related to the entity's ability to continue as a going concern?

902.2 If NO: no emphasis of matter or modification of conclusion is required.

902.3 If YES: has this been adequately disclosed in the interim financial information?

902.3.1 If YES: include an emphasis of matter paragraph in the review report.

902.3.2 If NO: express a qualified or adverse conclusion in the review report.

903 It is common cause that the review report issued by the first respondent did not contain an emphasis of matter paragraph, nor did it express a qualified or adverse conclusion. The question of whether or not a material uncertainty existed related to the going concern of ABIL at 31 August, therefore remains to be addressed.

904 Having considered the competing views, the Committee is satisfied that there was no material uncertainty related to ABIL's ability to continue as a going concern as at 31 August 2013, as confirmed by the following:

904.1 The rights issue was fully underwritten by Goldman Sachs, in an underwriting agreement concluded on 31 October 2013.

904.2 Mr Chidgey confirmed the conditions contained in the underwriting agreement to be standard in agreements of this nature.

904.3 This view was underscored by the CEO of Goldman Sachs, who expressed the commitment of Goldman Sachs to the underwriting

agreement, in a letter to the SARB wherein he referred to "*customary terms and conditions*".

904.4 The conditions were not of a kind that rendered Goldman Sachs' commitment to the underwriting of the offer open to any significant doubt.

904.5 It is significant that from 31 October 2013 until the closing of the rights offer on 6 December 2013 there was no attempt by Goldman Sachs to renege on its undertakings in the underwriting agreement.

904.6 The experts agreed in relation to charge seven that *"[t]he rights offer which was fully underwritten on 31 October and which closed on 6 December 2013, was oversubscribed."* (our emphasis). Although that pertains to charge 7, it is not appropriate for the Committee to disregard that factual agreement when it comes to the deliberation of another charge that raises similar issues. Against that shared conclusion of the experts that the rights offer was "fully underwritten", there is little room for arguing that the underwriting agreement had built-in uncertainty.

905 Subject to the further analysis below, the Committee is for these reasons satisfied that the conclusion of the underwriting agreement, and not the conclusion of the rights issue, is the point at which the material uncertainty was removed. In the circumstances, the reporting accountant's review report did not have to be modified and the correct conclusion was recorded in the independent reporting

accountant's report on the reviewed interim financial information of ABIL for the eleven-month period ended 31 August 2013.

906 The pro forma complainant advanced two further arguments to sustain a conviction on the eighth charge. The first respondent contends that these are not relevant to or canvassed in the charge as formulated in the summary of charges.

907 The first argument deals with the adequacy or otherwise, of the audit work performed on the going concern assessment for the review period ended 31 August 2013, and the documentation of that work. The pro forma complainant contends that there was no specific going concern work documented on the rights issue working papers.

908 The first respondent has pointed out that the audit work for year ended 30 September 2013 was done at the same time as the work for the rights issue, and that most of the documentation can be found in the audit working papers for the 30 September 2013 period. He referred to several working papers in the audit file for the year ending 30 September 2013, dealing with going concern. However, his contention remains that the matter of working papers is not the subject of this charge.

909 The Committee is of the view that the formulation of the eighth charge does not raise the issue of documentation as a separate matter. Accordingly, any shortfall in the documentation of the audit work done and professional judgements made, cannot form the basis for any conviction on this charge.

910 The pro forma complainant also alleged, through the evidence of Ms de Beer, that the prospectus was misleading in setting out the reasons for the rights offer. The prospectus states the following under the heading: "Reasons for the rights offer":

> *"The board of directors and executive management are of the opinion that ABIL's capital base needs to be strengthened in anticipation of the new Basel III phased capital requirements and to provide additional confidence to funders with regard to the various factors discussed above. The board of directors further believes it is appropriate to increase the buffer available by raising capital through the rights offer to absorb credit losses at the levels currently being experienced, and to proactively strengthen the capital base, all of which will provide ABIL the financial flexibility it needs to support the business growth prospects. In particular, the company is seeking to achieve the following objectives through the rights offer.*
>
> *Supplement the existing capital base with high quality capital…*
>
> *Provide additional capital protection against any deterioration of the South African economy…*
>
> *Support loan book growth…*
>
> *Provide a fair and transparent market solution to raise capital…"*

911 The pro forma complainant argued that the wording in the prospectus creates an impression that the reason for the capital raise is to grow the business, and that no mention is made of the material uncertainty related to going concern.

912 Mr Chidgey agreed, under cross examination, that the prospectus does not make any disclosure of the fact that ABIL would have a going concern issue if it were not for the rights issue. However, he noted that the rights offer circular indicated more "bad" reasons than "good" reasons for requiring the extra funding.

913 The question raised is what the responsibility of the first respondent is in relation to the information in the prospectus and the circular. The pro forma complainant contends that the first respondent should ensure that the prospectus does not contain inaccurate statements, and that the disclosures in the prospectus and circular should align with the interim financial information. The pro forma complainant cites paragraph 36 of ISRE 2410:

> *"The auditor should read the other information that accompanies the interim financial information to consider whether any such information is materially inconsistent with the interim financial statements."*

914 The first respondent argued that the business of ABIL and its risks were adequately detailed in the circular. The first respondent, however, points out that the disclosures in the prospectus and the circular are the responsibility of the directors. The first respondent also contends that the disclosures in the prospectus and / or circular are not the subject of this charge.

915 The eighth charge as formulated in the schedule of charges does not raise the issue of the first respondent's responsibilities in relation to disclosures in the prospectus. The charge focuses entirely on the issue of material uncertainty as to the going concern status of ABIL in the report. There is no reference to the prospectus. Nor is there any reference to paragraph 36 of ISRE 2410. The Committee is confined in its adjudication to what is set out in the charge.

***Conclusion***

916 In view of the foregoing, the Committee finds that the pro forma complainant has failed to prove the averments underlying the eighth charge and accordingly acquits the first respondent on this charge.

## THE NINTH CHARGE

### *Introduction*

917 The ninth charge pertains to the alleged failure by the first respondent to modify the audit opinion on the AFS of ABIL and African Bank for -

917.1 the years ended 30 September 2009 to 30 September 2012, on the basis that the accounting treatment of the *in duplum* loans was not in accordance with the provisions of IAS 39;

917.2 the year ended 30 September 2013, on the basis that the disclosure of the restatements related to *in duplum* in the AFS for that year, was misleading and does not meet the requirements of IAS 8.

918 It is asserted in this charge that IAS 39 required African Bank to discount future cash flows for loans that had reached the *in duplum* stage, at the original effective interest rate. African Bank had erroneously set the interest rate on such loans to zero. The impact of the *in duplum* errors for each of the years 30 September 2009 to 30 September 2012 was material, resulting in the AFS for each of those years being materially misstated. For those years an unqualified opinion was incorrectly issued, in contravention of ISA 700 and ISA 705.

919 The AFS for the year ended 30 September 2013 indicate that a material restatement related to the impairment methodology for *in duplum* loans was made. It is asserted in the charge that the first respondent failed to detect that the disclosure of the prior period error was incorrect, and not in accordance with IAS 8. Accordingly, a qualified or adverse audit opinion for the year ended 30 September 2013 should have been issued, in terms of ISA 710.

920 In the context of the above, it is alleged that the first respondent breached ISAs 200, 220, 230, 320, 450, 700, 705 and 710.

921 The essence of the first respondent's defence as set out in his plea is that –

921.1 ABIL and African Bank held the view that the *in duplum* rule was unique to South Africa and that IAS 39 did not cater for *in duplum* loans. They therefore applied a zero percent discount rate to *in duplum* loans, instead of the original effective interest rate as required by IAS 39.

921.2 Management of African Bank resisted the application of IAS 39 in respect of *in duplum* loans, despite the first respondent flagging the issue of non-compliance with IAS 39.

921.3 For the years 2009 to 2012, management did not perform calculations of the impact of a possible adjustment related to *in duplum*. Their credit impairment models lacked the sophistication to estimate accurately the impact of *in duplum* on impairment provisions. The audit team performed tests to assess the possible impact of such an adjustment. The type of tests included reasonability tests, a sensitivity analysis and a trend analysis. The results of the tests were not accepted by management.

921.4 The first respondent did not insist on an adjustment being made in respect of *in duplum* and accepted management's estimates of the overall level of provisions as reasonable. Although he did not agree with management's accounting treatment of the *in duplum* loans, he

concluded that an adjustment would not be material in the context of the overall loan book of African Bank.

921.5 The first respondent did take into account the error related to the zero discount rate for *in duplum* loans in formulating his audit opinions for the years 2009 to 2012, and concluded that the overall level of credit impairment provisions was not materially misstated.

921.6 Management built and ran more sophisticated credit impairment models in 2013 to quantify the effect of the proposed *in duplum* adjustment, at the first respondent's request and insistence. The model indicated an *in duplum* adjustment that was significantly higher than the results of the audit tests of the previous years. This was attributed, in part, to the deterioration of the Bank's loan book in 2013. The effect of the *in duplum* adjustments for the 2012 and 2011 financial years was also quantified, resulting in a restatement of the prior years' results.

921.7 At the insistence of the first respondent, and against considerable and continued resistance from management, African Bank changed its provisioning methodology in 2013 to discount all forecasted cash flows at the original effective interest rates.

921.8 An informed user would not have been misled by the disclosure of the restatements in the AFS of 2013. It is clear that if a restatement of a prior period is disclosed, the error must be material to the prior period. The disclosure met the requirements of IAS 8. IAS 8 does not require

that the restatement be described as an error; only its nature and quantification needs to be disclosed.

921.9 The disclosure of the prior period error was adequate, and the audit opinion on the AFS of ABIL and African Bank did not have to be modified in that regard.

922 The factual background to this charge, briefly, is that the AFS of ABIL and African Bank for the year ended 30 September 2013 reflect a correction for a material misstatement related to a change in the loan provisioning methodology.

923 The impact of the change on the financial statements for the year ended 30 September 2012 was as follows:

923.1 A decrease in net advances of R1 330 million

923.2 A decrease in after tax retained earnings of R957 million

924 Note 43.6 of the 2013 AFS of African Bank, under the heading "Change in the loan impairment provisioning methodology" described the position as follows:

> *"In terms of the NCA, once a credit agreement goes into arrears, a credit provider is not permitted to raise interest, fees and charges in excess of the total outstanding amount of the balance determined at the time that the first arrears occurred and for so long as the arrears subsist. ABIL has applied this requirement consistently across all its portfolios when defaulting loans reach the "in duplum" threshold (threshold loans). For the purposes of calculating the impairment provisions against the non-performing and written off loans on a portfolio basis, accounting standard IAS 39 Financial Instruments: Recognition and Measurement does not have an alternative treatment for situations where no interest and fees are permitted to be charged and requires the application of the effective interest rate of the loans determined at origination for purposes of the present value calculation. ABL historically applied a lower weighted average effective interest rate to calculate the present value of impaired loans, taking into consideration the fact that no interest or fees were*

> *permitted to be charged on the threshold loans. As a result of the growth in the threshold loans over time, the difference between the two provisioning methodologies has cumulatively become material for the financial year 2013. The company has therefore changed its provisioning methodology to discount all forecast cash flows at the original effective interest rates."*

925 IAS 39 requires that the loan provision be determined by discounting the cash flows at the original effective interest rate. The relevant paragraphs of IAS 39 are as follows:

> *"58. An entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets measured at amortised cost is impaired. If any such evidence exists, the entity shall apply paragraph 63 to determine the amount of any impairment loss.*
>
> *....*
>
> *63. If there is objective evidence that an impairment loss on financial assets measured at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognised in profit or loss."*

926 For the years 2009 to 2012, the loans that had reached the *in duplum* threshold were discounted at zero percent, and not at the original effective interest rate. Despite this, the first respondent issued unqualified audit opinions for both ABIL and African Bank for all the years in question, viz. 2009 to 2012.

927 The following was agreed to between the experts and became common cause in the proceedings –

927.1 An error in the financial statements, which is disclosed in a subsequent period, does not in and of itself, indicate a deficient audit in the prior year.

927.2 The issue of *in duplum* and the zero percent discount rate was identified as a risk in the audit working papers in 2009, and in every subsequent year up to and including 2013.

927.3 Between 2009 and 2012 ABIL and African Bank applied a blended rate when calculating loan impairments, which was a weighted average of the original effective interest rate on loans that were not *in duplum*, and zero percent on *in duplum* loans.

927.4 This treatment of *in duplum* loans was not in compliance with IAS 39, which requires the original effective interest rate to be used. This non-compliance with IAS 39 in respect of the *in duplum* loans was an error.

927.5 The first respondent did not insist that management should adjust their loan impairment provision for the years 2009 to 2012.

927.6 A correction for *in duplum* for the years 2009 to 2012 would have involved an estimation of the amount, as the Bank's models did not separately estimate the future cash flows of the *in duplum* loans. However, a high-level correction during these years could have resulted in a more accurate result.

927.7 The impairment provisions were increased during 2013 as a result of the correction of the treatment of the *in duplum* loans, whereby these were no longer discounted at a zero rate.

927.8 The AFS for ABIL and African Bank for 2013 contain a restatement relating to the increased provisions for the *in duplum* loans.

927.9 The impact of the *in duplum* correction on the prior years was calculated and shown in the AFS for 2013 as an after tax decrease in retained earnings of R957 million as at the end of 2012, and a decrease in net advances in 2012 of R1 330 million.

927.10 The first respondent had quantified the potential error in 2009, 2010 and partially in 2011; no estimation was performed for 2012. In each of the years that it was quantified, the estimates exceeded materiality.

927.11 Where a material error is identified, it has to be adjusted for. The auditor cannot do nothing – he has to adjust for the error, even if it is imprecise and an estimate.

927.12 The audit files for 2009 to 2012 did not contain sufficient documentation on how the auditor considered and concluded on the *in duplum* error and the risk of the overall misstatements of the impairments in the AFS for those years

927.13 ISA 230 requires that the basis for the auditor's report should be supported by sufficient and appropriate documentation. However, if an aspect is not documented, it does not necessarily mean that it was not considered or that no audit work was done.

927.14 The use of the word "error" is not a requirement of IAS 8 when a prior year adjustment is disclosed in the AFS.

928 There remained a number of areas of disagreement, in relation to whether the full correction in respect of *in duplum* was an error, or whether a portion could be regarded as a change in estimate; the auditor's response to the error in the financial years from 2009 to 2012; the wording of the prior year restatement in the 2013 AFS; the appropriateness of the auditor's conclusion on the acceptance of the *in duplum* treatment from 2009 to 2012 and whether a restatement due to an error indicates an inadequate audit in the prior periods.

***The parties' contentions on the treatment of in duplum loans from 2009 to 2012***

929 We turn now to the first part of the charge, namely the treatment of the *in duplum* loans for the years 2009 to 2012.

930 It was contended by the pro forma complainant that the adjustment required in respect of the *in duplum* error for each of the years from 2009 to 2012 was material, and that this fact as well as the amount, was known to the first respondent.

931 In support of this contention the pro forma complainant referred to the 2013 *"ABL impairments overview memo"* which formed part of the audit working papers for 2013. This memo details, *inter alia*, the restatements required in respect of the *in duplum* adjustment as follows:

931.1 2009: R666 million

931.2 2010: R266 million

931.3 2011: R753 million

931.4 2012: (R355 million).

932 The cumulative effect of these amounts on the net advances was a decrease of R1 330 million, which is the restatement recorded against the 2012 net advances figure, in the 2013 AFS.

933 The pro forma complainant further contends that the first respondent was aware that there was a breach of IAS 39 for each of the years 2009 to 2012 and that he had quantified the error, but that he had failed to properly address it in the working papers. In addition, contends the pro forma complainant, the first respondent failed to communicate the amount of the error to the audit committee and did not require management to adjust the AFS for the error.

934 In this regard the pro forma complainant points to the following concessions made by the first respondent during cross examination:

934.1 That the practice of discounting *in duplum* loans at 0% was in contravention of IAS 39.

934.2 That he had for years been advising management that the treatment of the *in duplum* loans was contrary to IAS 39.

934.3 Further concessions made as explained under the specific years below, in relation to the first respondent's communication to the audit committee and to management.

935 In response to the first respondent's argument in his plea that the Bank's models were not sophisticated enough to calculate accurately the impact of the *in duplum* misstatement, the pro forma complainant refers to the evidence from Mr Cohen, an expert witness for the first respondent. Mr Cohen testified that whilst in

practice it may be difficult to separate the loan book between *in duplum* and non *in duplum*, it can be proxied in some way.

936 In addition to the defences offered by the first respondent under the respective years below, two other aspects that the first respondent put forward in support of his contention that the *in duplum* error would not result in a material misstatement, are:

936.1 The back tests performed indicate that the cash flows predicted by the models were substantially correct.

936.2 Post write-off recoveries were not taken into account in the models; thus there was some conservatism built into the models.

937 The evidence and arguments in respect of each year, from 2009 to 2012, are dealt with in the following paragraphs.

938 With respect to the 2009 financial year, the pro forma complainant referred to various items of evidence which it was contended lend support for the case that a quantifiable adjustment was possible and required to have been made to ensure that *in duplum* loans were correctly impaired at the original effective interest rate rather than zero percent.

938.1 He referred to the working paper containing the sensitivity analysis performed by the Deloitte credit modelling experts, which reflects the *in duplum* difference at R530,763,409, made up of R354,745,320 for the NPL retail book and R176,018,089 for the ML retail book.

938.2 The first respondent confirmed the amount of R530 million as being the estimated *in duplum* amount for 2009 in both his evidence in chief and under cross- examination.

938.3 Attention was drawn to the working paper containing the 2009 "overs and unders" calculations which reflects a similar amount, R532 million, in respect of the *in duplum* issue, described as *"for the sensitivity analysis for calculation of in duplum for the worst case scenario"*. This working paper shows that the amount of R532 million was "*not processed*".[76] The pro forma complainant contends that no reasoning was provided in the working paper for the fact that the *in duplum* error was not processed.

938.4 The 2009 "overs and unders" schedule in the working papers is a summary of the misstatements for the year, and this is the schedule which is used to report misstatements to the audit committee. This schedule, the pro forma complainant notes, is similar to the "overs and unders" calculations working paper referred to in paragraph 938.3 above, yet does not contain the R532 million misstatement in relation to *in duplum*.

938.5 Mr Chidgey agreed under cross examination that the amount of R532 million from the "overs and unders" calculation was not recorded on

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[76] It should be noted that the amount of the 2009 *in duplum* error as a result of applying the 0% discount rate, is referred to as R530 million and R532 million at different times during the evidence and in the working papers. It is understood to be the same amount, possibly with rounding differences. For consistency, the amount of R532 million will be referred to in the rest of this document where a particular figure is not referred to in the evidence.

the "overs and unders" schedule, although went on to contend that *"it was up to management to make that calculation"*.

938.6 The pro forma complainant contrasts this omission with the following misstatement amounts that have been carried over from the "overs and unders" calculation to the "overs and unders" schedule – amounts that are considerably smaller in quantum than the R532 million *in duplum* error. The amounts referred to as carried over were R70.5 million, R10 million, R20.3 million, and R94.5 million.

938.7 The issue in relation to *in duplum* loans is dealt with in the body of the 2009 report to the audit committee. The relevant paragraphs from the report in this regard read as follows:

> *"The Group has a significant number of advances that exceed the in duplum threshold where the arrears amount exceeds the outstanding capital balance when the account went into arrears. The interest rate and yield on these loans is set at zero owing to the fact that no other fees and charges are permitted until the arrears amount is cleared.*
>
> *The Group maintains the discount rate to be applied against these loans at zero, the new effective interest rate of the loans. This decision is based on the premise that an in duplum loan will no longer generate interest revenue for the Group and therefore the yield should be reduced to represent that fact. In addition it is management's view that in duplum is a contractual feature of credit agreements (in terms of the NCA) and therefore warrants an adjustment to the original effective interest rate.*
>
> *We differ with management on this aspect in that an in duplum loan rate is not accounted for at its original effective interest rate as required by IAS 39. Further IAS 39 states that the original effective interest rate should not incorporate future credit losses.*
>
> *The impact of in duplum is significant for the Group. Notwithstanding the difference in opinion above we are satisfied with the overall level of impairments."* (emphasis added)

938.8 The pro forma complainant questioned why the amount of the error in respect of *in duplum* was not brought to the attention of the audit committee, particularly in light of the fact that the first respondent had stated in the report that "*the impact of in duplum is significant for the Group*".

938.9 A comparison was drawn between the amount of the *in duplum* error of R532 million, with the audit materiality of African Bank for that year, of R111 million, noting how much greater than materiality it is. This should have resulted in an adjustment in 2009, and should also have been reported to the audit committee.

938.10 In further support of the contention that the *in duplum* adjustment for 2009 was a significant amount requiring adjustment to the AFS, it was pointed out that the 2013 calculations which resulted in the prior year adjustment, reflect the *in duplum* impact as at the end of the 2009 financial year as R666 million.

938.11 Mr Cameron-Ellis testified in his evidence in chief that the *in duplum error* was a known error, and a known non-compliance with IFRS. This, testified Mr Cameron-Ellis, should have been adjusted for in the AFS.

939 The first respondent answered these contentions as follows:

939.1 The first respondent stated during his evidence in chief that the sensitivity analysis was performed at his request. However, he argued that the sensitivity analysis was a less accurate form of

assessment, and he could therefore not be certain of the numerical accuracy of the *in duplum* error.

939.2 During cross examination the first respondent repeated his view that the results of the sensitivity analysis was an accounting estimate, and that the impact of the calculation in 2009 would not fall outside the "auditor's range".

939.3 The first respondent conceded during cross examination that during 2009 he had reported to the audit committee that the impact of *in duplum* was serious and that there was a risk of material misstatement if not addressed.

939.4 The first respondent also conceded during cross examination that the *in duplum* error of R532 million was not included in the "overs and unders" schedule, and that the amount was not reported in the report to the audit committee in 2009. The first respondent however referred to an email communication sent to the audit committee in 2010, wherein reference is made to a discussion about the *in duplum* error in 2009, and an amount of R510 million is referred to in this regard. The first respondent therefore believes that the amount of the *in duplum* error was verbally communicated to the audit committee in 2009, although he could not recall this fact precisely.

939.5 The first respondent also pointed to the fact that he had reported the *in duplum* problem to management in the 2009 Deloitte management report. In the report the discount rate applied to the *in duplum* loans

is flagged as being in contravention of IAS 39. The report records the impact of this as follows:

> *"The impact on impairment figures (assuming all other inputs remain unchanged) is significant and is likely to cause differences (to management's estimates) in our assessment of the level of impairments in forthcoming financial years."*

939.6 The first respondent reiterated his view, during cross examination, that an adjustment in respect of the *in duplum* error was not required in 2009, as his overall conclusion was that the impairments for 2009 were fairly stated. In support of this, the first respondent referred to his witness statement wherein he had indicated an offset of two amounts (R114.5 million overstatement related to the PL book and R70.5 million understatement related to the NPL book[77]), resulting in a net overstatement of the loan loss provision of R44.1 million. This, argued the first respondent, was not material and hence did not require adjustment.

939.7 Counsel for the first respondent emphasised the difficulties faced by management in 2009 arising out of the significant adjustments that had to be made to accommodate a judgment that had been handed down pertaining to the *in duplum* rule under the National Credit Act. This had included having to effect refunds to customers.

939.8 It was pointed out that management in fact applied a discount rate that was a weighted average of the original effective interest rate on loans

[77] It is noted that although the first respondent had initially attributed the R70.5 million to the *in duplum* error in his witness statement, he corrected this during his evidence in chief, to attribute it to the NPL book, as was reflected in the "overs and unders" schedule and Appendix I to the report to the audit committee.

not *in duplum* and the zero percent interest rate on loans that were. This approach, although admittedly in breach of IFRS, was based on a view honestly held by management.

939.9 Counsel for the first respondent emphasised the real difficulty faced in attempting in these circumstances to quantify the extent of the *in duplum* error.

939.10 The 2013 retrospective calculation of the in duplum error of R666 million could not be used to extrapolate backwards in time because it was based on the 2013 impairment model.

940 With respect to the 2010 financial year, the pro forma complainant drew attention to the following.

940.1 Although Deloitte had flagged the *in duplum* issue as a risk in 2010, this matter was not adequately dealt with in the audit working papers, nor was it adequately reported to the audit committee.

940.2 The first respondent had testified to the fact that the *in duplum* issue remained a risk in 2010, and that Deloitte had attempted to quantify the effect again in 2010.

940.3 Several documents in the 2010 audit working papers indicate that the *in duplum* issue is a risk to be dealt with during the 2010 audit.

940.4 Reference was made to the working paper “African Bank July 2010 review file note”, which records figures of R350 million and R340.7 million for the *in duplum* error on the NPL and ML books respectively,

totalling R690.7 million. It was noted that these figures had been calculated on only parts of the NPL and ML books, and the pro forma complainant argued that the amounts may well have been higher if all categories of the loan book were taken into account.

940.5 These figures also appear in the October 2010 credit impairment memo prepared by the credit modelling team at Deloitte. With respect to the *in duplum* understatement on the NPL book of R350 million, the pro forma complainant drew attention to the following statement in the credit impairment memo:

> *This amount has not been taken to the schedule of misstatements due to the difference of opinion between management and ourselves. It will however continue to be reported to the Audit Committee as an area of disagreement with management.*

940.6 The narration in relation to R340.7 *in duplum* error on the ML book states that this amount will be reported to the audit committee.

940.7 Reference was made to the 2010 schedule of "overs and unders" which formed part of the report to the audit committee, setting out the misstatements for the 2010 year. The pro forma complainant points out that the *in duplum* error was not reflected on this schedule. This fact was conceded by both the first respondent and Mr Chidgey.

940.8 The pro forma complainant further points out that the schedule of "overs and unders" instead reflects an amount of R724 million in respect of the undervaluation of the ML book as a whole. Under cross examination, the first respondent argued that the R340.7 million was

included in the R724 million. Counsel pointed out, however, that there is no audit evidence for this.

940.9 The pro forma complainant referred to the following communications to the audit committee in 2010 on the issue of *in duplum*:

940.9.1 A memo dated 8 November 2010 from the first respondent to the audit committee, in response to queries raised by the audit committee. The amounts of R350 million and R347 million are recorded in this memo as the misstatements of the loan provisions in respect of *in duplum*.

940.9.2 The report to the audit committee for the 2010 year. The pro forma complainant points out that the wording in the report is similar to that of the 2009 report – *in duplum* being a significant matter, and the treatment of the *in duplum* loans not being in accordance with IAS 39. As was the case in 2009, the report to the audit committee does not contain values for the *in duplum* error, nor are these misstatements included in Appendix 1 to the report, which records the uncorrected misstatements for the year.

940.9.3 The minutes of the audit committee meeting held on 11 November 2010, reflect amounts in respect of uncorrected misstatements related to impairments on the NPL and ML books. The minutes also contain a statement to the effect that the auditors differ with management's view on the discount rates used on *in duplum* loans and that it is contrary

to IFRS. The minutes, however, do not reflect any amounts in relation to potential misstatements related to the *in duplum* error.

940.10 Mr Cameron-Ellis during his evidence in chief reiterated that reporting the matter to the audit committee did not change the fact that the financial statements did not fairly present in terms of IFRS.

940.11 Attention was drawn to the materiality level of R114 million for 2010, and contrasted with the potential understatement of impairment provisions in respect of the *in duplum* error of R690.7 million. The eventual adjustment for 2010, processed as part of the restatement in 2013, was R266 million which represented the movement in the in duplum error during the 2010 financial year.

941 The first respondent answered these contentions as follows:

941.1 The understatements in respect of the *in duplum* error could not be accurately determined as they were the result of a sensitivity analysis.

941.2 The main point made by the first respondent was that any misstatement arising from discounting in duplum loans at zero percent was offset by a R1036 million overprovision for impairments on the ML book.

941.3 The first respondent also points to the impact of the *in duplum* error in 2010 being 1.8% of the gross advances figure, and that this is within his 2% judgemental tolerable range. He conceded, however, that this was nowhere documented.

942 With reference to the 2011 financial year, the pro forma complainant contends that the error related to *in duplum* remained a serious problem. In support of this he referred to the following:

942.1 It was raised as a key risk in the interim strategy document for the 2011 audit.

942.2 In 2011 the first respondent did not calculate the impact of the *in duplum* error on all the loan books; only on the NPL book. In this regard reference was made to the calculations performed by the Deloitte credit modelling team at July 2011 as documented in the audit working paper "July 2011 Review file note". These calculations reflect a amount of R520 million being underprovided against the NPL loan book in respect of *in duplum.* The first respondent confirmed, during cross examination, that no calculation was done on the potential *in duplum* error in the ML book.

942.3 Reference was made to the 2011 impairments overview memo prepared by the Deloitte credit modelling team, dated 20 September 2011. This memo contains the same figures for *in duplum* as in 2010, namely R350 million and R340.7 million in respect of the NPL and ML books respectively.

942.4 The first respondent confirmed in evidence that no amounts in respect of the *in duplum* error were taken to the schedule of "overs and unders" for 2011. This was also conceded by Mr Chidgey during cross examination.

942.5 Mr Cameron-Ellis testified that the R520 million referred to in paragraph 942.2 was the only reference to the impact of the *in duplum* loan error in the audit working papers in 2011. He further testified that this amount was not communicated to the audit committee.

942.6 The first respondent failed to adequately communicate the issue of *in duplum* error, as well as the extent of the misstatements, to those charged with governance. The pro forma complainant refers to the following in support of his contention:

942.6.1 The minutes of the Group Risk and Capital management meeting of 15 November 2011, attended by the first respondent, record the first respondent having reported that the treatment of the provision for *in duplum* loans was not in accordance with accounting standards, but that the impairments were not understated.

942.6.2 The minutes of the Audit Committee of the same day, attended by the first respondent, reflect the first respondent having said that the discount rate of 0% applied to *in duplum* loans is contrary to IAS 39, but without quantifying the error.

942.6.3 The minutes of the Board meeting of 17 November 2011, which was not attended by the first respondent, contain feedback by the audit committee chairman to the effect that the auditors were not comfortable with the discount rate of 0% applied to *in duplum* loans, but that the numbers were not significant.

942.7 The pro forma complainant again, as was done in 2009 and 2010, contrasts the *in duplum* error with materiality for the year. Materiality for 2011 was R166 million. The pro forma complainant contrasted the *in duplum* error as calculated on the NPL book alone, which was R520 million. The pro forma complainant then points to the 2011 portion of the prior year adjustment as calculated in 2013, which was R753 million. On either version, contends the pro forma complainant, the adjustment for the *in duplum* error was material.

943 The first respondent answered these contentions as follows:

943.1 In 2011, the audit team revisited the issue and had discussions with management around their commitment to build an improved impairment model.

943.2 The first respondent discussed the matter with the then chairperson of the audit committee, Mr Sithole, in the context of discussing a "key audit findings" document, which records opposite the item *"In duplum accounting impact"* –

> *"Discount rates used in the impairment models has been significantly reduced for in duplum accounts (sic).*
>
> *In duplum treatment of discount rates is not IAS 39 compliant"*
>
> *Credit card in duplum is a contravention of the NCA".*

943.3 The first respondent noted to the audit committee that the discount rates would be assessed to respond to the risks identified around the non-performing loan impairment models.

943.4 The first respondent noted that management's modelling techniques had started to become "optimistic", but was nonetheless found to forecast cash flows appropriately;

943.5 The credit modelling team estimated that the *in duplum* effect on the NPL book was R520 million. No 'rough' calculation was carried out on the ML book.

943.6 In the credit memorandum, the audit team concluded in its assessment of the loans and advances balance as a whole that the discount rate was still not compliant with IAS 39. Deloitte presented a sensitivity table demonstrating the impact that *in duplum* had on the discount rate, decreasing it significantly in the retail portfolios, the most significant portfolios to the Bank.

943.7 The impairments overview memo further states that the discount rates in respect of *in duplum* continue to be a point of disagreement with management, and that the respective amounts for *in duplum* would be reported to the audit committee.

943.8 The discount rate disagreement in relation to *in duplum* was raised in the report to the audit committee, in the meeting directly afterwards and at a board meeting on 17 November 2011 (although not quantified).

944 <u>With reference to the 2012 financial year</u>, the pro forma complainant advanced the following contentions.

944.1 No calculation was done on the potential *in duplum* misstatement in 2012, although it remained an error which needed to be addressed.

944.2 Mr Cameron-Ellis testified to the fact that the in duplum error was not quantified in the working papers in 2012.

944.3 The first respondent conceded during cross examination that the impact of the *in duplum* error was not quantified in 2012, nor was it reflected on the "overs and unders" schedule.

944.4 The first respondent's audit work was confined to comparing the discount rates in 2012 to those used in 2011 by performing sensitivities in regard to the *in duplum* effect on the weighted average discount rate (similar to what was done in 2011) and recomputing the accuracy of the discount rates applied by reperforming the weighting calculation;

944.5 The significant audit findings section of the 2012 report to the audit committee makes no reference to the *in duplum* error.

945 The first respondent answered these contentions as follows:

945.1 Based *inter alia* on his work on the discount rates in 2010, 2011 and 2012, he made a judgement call that the *in duplum* effect would not be as significant as in 2011;

945.2 There was a significant growth in the NPL books in 2012, and the new NPLs would not be *in duplum*.

945.3 Management had written off nearly R5 billion from the ML book during the year, of which many would have been *in duplum* loans.

945.4 The proportion of *in duplum* loans as a percentage of gross advances decreased from 37% in 2011 to 29% in 2012.

945.5 The 2012 portion of the prior year adjustment processed in 2013, in fact is a decrease in the loan provision in respect of *in duplum*, of R355 million.

945.6 He had communicated the *in duplum* problem to those charged with governance, to management and to the SARB.

945.7 Back testing indicated that the models were predicting cash flows accurately and the models did not account for post-write-off recoveries.

946 With regard to the 2013 financial year, the complaints regarding the 2013 AFS are dealt with separately below. However, a summary of the evidence and arguments related to the *in duplum* error for 2009 to 2012 would not be complete without considering the restatements that were effected in the 2013 AFS.

947 As stated in paragraph 932 above, the loan impairment provision for 2012 was adjusted in the 2013 AFS by R1 330 million. This is the cumulative effect of the *in duplum* error for the years 2009 to 2012. The adjustments in respect of each specific year are set out in paragraph 931 above.

948 The credit impairment memo for 2013 contains the details of the adjustments required in respect of each year. This memo also sets out the reasoning behind the adjustments and the conclusions reached.

949 The pro forma complainant does not agree with the wording in the memo which states that: *"The difference was noted in previous years but never quantified"*. The pro forma complainant argues that extensive evidence was led to show that the amounts had in fact been quantified in some of the prior years.

950 The pro forma complainant points to the fact of the prior year adjustment as proof that the impairment loan provisions should have already been adjusted in the respective years. The quantum of the prior year adjustment further underscores the case for the amounts having had to be adjusted in the prior years. The pro forma complainant therefore argues that the AFS were misstated in the years 2009 to 2012.

951 The counter argument by the first respondent is this. The fact that the prior year adjustment contains material misstatements in respect of the years 2009 to 2012 does not mean that the adjustments would have been the same if they had been calculated in the specific years, because:

951.1 The 2013 model used different assumptions and different cash flows from the models of the prior years

951.2 The 2013 calculation could not take into account other compensating factors which may have been present in those prior years

952 He maintains that he considered the misstatements within the context of a broader range, which range was above materiality.

***Findings on the treatment of in duplum loans from 2009 to 2012***

953 A proper characterisation of the charge is one that considers the conduct of the first respondent as a whole in relation to the *in duplum* error. The charge was brought as a single charge, rather than separate charges in respect of each of the financial years in question. The charge must thus be considered holistically. This does not however preclude analysis relevant to particular years.

Experts' joint minute

954 An appropriate starting point is to come back to what was agreed between the experts. We repeat the following relevant paragraphs verbatim from the minute:

> ""3. *In duplum is an issue that had been identified in 2009 and had re-appeared on the audit files as a risk in each subsequent year up to and including 2013.*
>
> 4. *The treatment of in duplum loans between 2009 and 2012 did not comply with IAS39 and was therefore an error. IAS 39 requires the original effective interest rate to be used for discounting rather than discounting at a rate of nil. This was notwithstanding that contractual interest could no longer be charged by the bank once the loan had reached in duplum.*
>
> 5. *During 2009 to 2012, the auditor did not insist that the Bank adjust their impairment provision.*
>
> ...
>
> 8. *A correction for in duplum in 2009 to 2012, in terms of which loans would no longer be discounted at a rate blended with zero, would have involved an imperfect approximation (estimate). This is because the future cash flows of the in duplum loans were not separately estimated at the time due to the absence of a separately calibrated model. The inclusion of some high-level correction in the years before 2013 could however have produced a more accurate result.*
>
> ...
>
> 10. *When an error is identified, if it is material, and known to be so, the auditor cannot do nothing. Where there is imprecision, as long as an appropriate estimate is possible, it is still necessary to adjust for the error imprecisely rather than to do nothing.*

> 11. *The auditor had performed an estimation of the potential quantum of the error in 2009, 2010, and partially in 2011. No estimation was recorded on the audit file in 2012. These estimations in isolation exceeded the calculated audit materiality.*
> 12. *There was insufficient documentation included in the audit files of 2009 to 2012 as to how the auditor considered and concluded on the impact of his estimations of the in duplum error on the risk of the overall material misstatement of impairments in the financial statements in each such year."*

955 Based on this consensus -

955.1 The risk associated with discounting in duplum loans at the incorrect rate was identified during every audit;

955.2 The treatment of in duplum loans using an incorrect discount rate instead of the original effective interest rate between 2009 and 2012 was in breach of IAS 39 and was an error;

955.3 In the years when the auditor did an estimation of the potential quantum, they exceeded audit materiality;

955.4 An error having been identified, the first respondent was required to call for an adjustment, but he did not do so;

955.5 There was insufficient documentation included in the audit files from 2009 to 2012 as to how the first respondent dealt with this error.

956 The main thrust of the first respondent's defence is that management's systems were unable to distinguish adequately between loans that were in and out of *in duplum* and were therefore unable to quantify the error requiring adjustment. However, the experts answer that in their minute where they say that if a material

error is identified, *"the auditor cannot do nothing. Where there is imprecision, as long as an appropriate estimate is possible, it is still necessary to adjust for the error imprecisely"*. Paragraph 11 of the minute confirms that the auditor was able to perform and did perform estimates in 2009 and 2010, along with a partial estimate in 2011.

957 Subject only to the issue of the auditor's range, which is discussed below, on the basis of the expert minute alone, the conclusion that the pro forma complainant has proven the material averments underlying the ninth charge is inescapable. It does not deal with the complaint in relation to the 2013 AFS, but even if the first respondent is innocent in that regard, his conduct in relation to the 2009 to 2012 AFS is sufficient to constitute improper conduct.

958 We will nonetheless conduct a further examination of the evidence in relation to each year, before dealing with the auditor's range.

The 2009 financial year

959 The first respondent's main defences in respect of the 2009 year pertain to the difficulty of obtaining an accurate figure for the effect of the *in duplum* error, the recency of the court judgment giving rise to the problem, an argument that other overprovisions compensated for the *in duplum* under-provision, and reliance on the auditor's tolerable range. Reliance was also placed on the fact that the matter was reported to the audit committee, albeit without quantification.

960 The novelty of the problem and difficulty of computation arguments are answered by the fact that an estimate of a R532 million under-provision was done by Deloitte and by the expert's shared view that such an estimate should form the

basis of an adjustment where no more accurate figure is available. The compensation argument does not provide a justification because the estimated amount of the under-provision of R532 million is not compensated for by the net overprovision of R44.1 million. The absence of the amount from the schedule of "overs and unders" also undermines any argument for this under-provision being compensated for by other overprovisions.

961 As Ms de Beer pointed out in her testimony, it is not sufficient to report material non-compliance with IFRS to management or the audit committee. The auditor has to resolve the issue, as he signs the audit opinion which states that the AFS fairly present in terms of IFRS.

962 If management refuses to co-operate in the determination of an adjustment or insists that the underlying data or its system of storage prevent its calculation or refuses to accept the auditor's estimate, yet there are good grounds for believing that the amount is above materiality, an auditor is not without a remedy. Section 7(b) of ISA 705 *Modifications to the Opinion in the Auditor's Report* provides as follows:

> *"The auditor shall modify the opinion in the auditor's report when:*
>
> *(a) ...*
>
> *(b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive."*

963 That option was available to the first respondent in 2009 and in all of the subsequent years where management asserted that it was unable to provide a quantification of the *in duplum* error.

964 Insofar as the issue may have been novel, it was already anticipated in the risk assessment process at the commencement of the 2009 audit. That left sufficient room for the first respondent to confront management in the course of the audit and address the problem. The ISAs do not operate on the basis that a first-time error is excusable and need only be addressed in the following financial year. The IFRS do not permit this either.

965 The first respondent placed reliance on the following testimony by Ms de Beer:

> *"… there is probably some argument that at the beginning if it is not all that material or if it is below materiality and management need time to sort out their systems. But by the second year and the third year and the fourth year to continuously know that there is a problem, which is not just an estimation problem, it is an IFRS problem, it is a noncompliance with IFRS which elevates it to this is really serious and the core part of the business."*

966 This does not avail the first respondent because audit materiality for 2009 was R111 million and the estimated error of R532m was more than four times materiality.

967 Accordingly, the Committee is satisfied that the pro forma complainant has proven the assertions in the charge in relation to the 2009 financial year.

<u>The 2010 financial year</u>

968 The first respondent's estimated the effect of the *in duplum* error in relation to the 2010 financial year at R350 million and R340.7 million on the NPL and ML books respectively, totalling R690.7 million.

969 The primary basis upon which the first respondent justified not dealing with the error in 2010, was an alleged overprovision for impairments on the ML book in the amount of R1036 million. It was suggested that this "compensated for" the under-provision in respect of the NPL book –

969.1 in the amount of R350 million on account of *in duplum*; and

969.2 in the amount of R734.65 in other respects,

which total R1084.65 million, leaving an underprovision of R48.65 million, which is not material.

970 However, there are problems with this calculation:

970.1 As is conceded in the first respondent's heads, if Mr Burra in his calculation of the R1036 million overprovision did not include the *in duplum* sensitivity in the discount rate used for the ML evaluation (the R340.7 million in paragraph 968 above), there remains an under-provision for impairments on the NPL book of R389.35 million (R340.7 million plus R48.65 million), well above materiality. The first respondent could not recall whether or not Mr Burra did or did not include the R340.7 million in arriving at the amount of R1036 million.

970.2 The ABL impairments overview memo dated 27 October 2010 containing the numerical values calculated by Mr Burra, gives a <u>range</u> of potential values for the overprovision of impairments on the ML book, depending on which discount rate is used. It is not confined to the R1036 million figure relied on by the first respondent; the R1036 is calculated as the highest potential overprovision, based on an

assumed application of the ML discount rate. However, applying the NPL discount rate provides an ML book overprovision value of only R597 million and applying a blended discount rate provides a figure of R725 million. On this basis, even if the *in duplum* sensitivity was included in ML book overprovision, it could thus be as low as R597 million. If this figure is used as compensation for the NPL book under-provision (of R1084.65 million), it would leave an under-provision on the NPL book of R487.65 million;

971 Accordingly it is not at all clear that the under-provision for impairments arising from the *in duplum* error was compensated for by the overprovision on the ML book. The uncertainty of the first respondent as to whether or not Mr Burra included the *in duplum* sensitivity, cannot be laid at the door of the pro forma complainant. Given that –

971.1 the estimated total under-provision on the NPL and ML books was calculated to be R690.7 million;

971.2 the 2013 *"ABL impairments overview memo"* in calculating the restatements pertaining to the in duplum error, indicated that the adjustment required in respect of the *in duplum* issue for 2010 was R266m;

971.3 it must follow that there is a *prima facie* case for an under-provision of at least R266m million,

it was incumbent upon the first respondent to put up evidence sufficient to rebut the case for an *in duplum* error in 2010 that was greater than materiality. He failed to do so.

972 Accordingly, the Committee is satisfied that the pro forma complainant has proven the assertions in the charge in relation to the 2010 financial year.

The 2011 financial year

973 The essence of the first respondent's defence in relation to the 2011 year is that he did what was required to alert management to the problem.

974 However, he only performed a partial estimation of the problem. The credit modelling team did a calculation that the effect of the in duplum error on the NPL book was R520m. No calculation was done for the ML book.

975 At the very least it was incumbent upon the first respondent to communicate this estimate to management, yet he failed to do so.

976 In any event, compliance with the relevant accounting and auditing standards is not achieved by reporting a material error to management.

977 Accordingly, the Committee is satisfied that the pro forma complainant has proven the assertions in the charge in relation to the 2011 financial year.

The 2012 financial year

978 In his witness statement, Mr Chidgey tracks the treatment over time of the *in duplum* error and concludes as follows:

*"3.151 From the above it appears that after 2011 and 2012, given the size of the rough calculations, this was an issue where there was need to put more pressure on management and those charged with governance to calculate the true effect of the in duplum policy. This was a difficult area and a combination of management unwillingness or inability to run a correction through the model and the modelling difficulties meant that any number Deloitte put forward was open to attack.*

*3.152 Although this matter was escalated in 2013 and management were successfully challenged it could have been escalated earlier when the Bank provisioning became more aggressive and there was not the cover in the other parts of provisioning models to offset the in duplum effect. At this stage this issue should have been prioritised and more pressure should have been put on management to run the calculation. In 2011 and 2012 the rationale for not providing should also have been documented in the files."*

979 We agree with Mr Chidgey. On a benevolent interpretation of this evidence as not criticising the first respondent's conduct in the 2011 year (save in respect of documentation), it confirms the absence of any justification for his conduct in relation to the 2012 financial year in relation to his treatment of the in duplum problem.

980 Accordingly, the Committee is satisfied that the pro forma complainant has proven the assertions in the charge in relation to the 2012 financial year.

<u>Auditor's range</u>

981 A defence that is offered at a general level in relation to this charge and not necessarily specific to any year, is that the *in duplum* shortfalls, even if they were above audit materiality and in breach of IAS 39, were within the auditor's tolerable range.

982 As the first respondent correctly pointed out, the concept of a range or point estimate is something that is recognised as being a legitimate auditing method in ISA 540 *Auditing Accounting Estimates, including Fair Value Accounting Estimates, and Related Disclosures.* Paragraph 7 contains the following definitions:

> *"(b) Auditor's point estimate or auditor's range – The amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management's point estimate"*
>
> *(d) Management's point estimate – The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate."*

983 Paragraph 13 of ISA 540 provides in relevant part as follows:

> *"In responding to the assessed risks of material misstatement, as required by ISA 330, the auditor shall undertake one or more of the following, taking account of the nature of the accounting estimate:*
>
> *(a) .....*
>
> *(b) Test how management made the accounting estimate and the data on which it is based. ...*
>
> *(c) Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.*
>
> *(d) Develop a point estimate or a range to evaluate management's point estimate. For this purpose:*
>
> > *(i) If the auditor uses assumptions or methods that differ from management's, the auditor shall obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate.*

(ii) *If the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable."*

984 Extensive guidance is then provided on the development of an auditor's point estimate or range in paragraphs A87 to A95. Among these are paragraph A94, which provides as follows:

> *"Ordinarily, a range that has been narrowed to be equal to or less than performance materiality is adequate for the purposes of evaluating the reasonableness of management's point estimate. However, particularly in certain industries, it may not be possible to narrow the range to below such an amount. This does not necessarily preclude recognition of the accounting estimate. It may indicate, however, that the estimation uncertainty associated with the accounting estimate is such that it gives rise to a significant risk. Additional responses to significant risks are described in paragraphs A102-A115".*

985 ISA 540 was amended in 2018 to make it clear that in the case of a bank, an auditor's range might well be many multiples of materiality.

986 The first respondent placed reliance on Mr Chidgey's defence of his (first respondent's) employment of the method. His testimony was as follows:

> *""MR SMIT: Could you explain to us your understanding of how Mr Jordan derived his range and thought about his auditor's range?*
>
> *MR CHIDGEY: Yup. Based upon his statement, as I understand it, Mr Jordan was looking at the <u>estimate of impairments as a whole</u> and he looked at the model as being part of that and he looked at also the estimates which were made outside the model and then he applied a range to that based upon the <u>total of advances</u>.*
>
> *MR SMIT: In terms of your understanding of what he says, was that defensible or not defensible in terms of audit theory?*
>
> *MR CHIDGEY: I think it is defensible to do that. I think different auditors may have different views about how you would do that, how you would make that judgement.*

*...*

*[Reference is made to a passage in the first respondent's witness statement and the evidence proceeds]*

*MR SMIT: Mr Jordan indicated that:*

> *'In 2012 the bank's models indicated that management's estimate resulted in a protection (sic) under provision of about 111 million, this was the bank's assessment of the difference between their model and their general ledger.*
>
> *The Deloitte assessment was that the bank was under provided by approximately 150 million to 250 million, taking various discretionary factors into account, in my view however this under provision did not have to be reflected in overs and unders, because it was not an error. It was not an error, because it was within the jurisdictional[78] tolerable range or the range of tolerable modelling variation.'*

*And then he explains how he arrived at the number of 219 million for the 2012 financial year and he states in 361 that:*

> *'In short, the level of imprecision in the model was such that one cannot state with precision that an amount within 150 million to 250 million of the model's answer was an error.'*

*And then he explains how he considered the model, including its various sub models. Now some questions on this, is this an appropriate use of the concept of the auditor's range?*

*MR CHIDGEY: Yes, because what he is doing there is I think looking at impairments as a whole or looking at loan advances as a whole and he is effectively saying what I have got to do is come to an opinion on the figure of loan advances, which is, I stand to correction in terms of 2012 because I am not, I do not have the encyclopaedia or the numbers, but was something like R50 billion plus another 15 to 20 for the memorandum that year. (sic)"*

987 In the committee's view, the use of an auditor's range is manifestly appropriate when comparing the outcomes of, for example, management's impairment model and the auditor's challenger model. Given the vast sums involved, the vast amounts of data that input into the models and the underlying judgements affecting it, it is inevitable that comparison of the outcomes must be at a scale that, in an institution such as a large bank, could not be based on performance

[78] This is probably an error in transcription. The word "judgmental" is likely to have been used.

materiality. It is significant in this regard that Mr Chidgey in the quoted portion of his evidence above justifies the first respondent's use of the method consistently as pertaining to the impairments as a whole and the loan advances as a whole and because it pertained to modelling variation. He did not seek to justify the use of an auditor's range to test whether a material misstatement arising from an incorrect application of an accounting standard could be overlooked.

988 Mr Burra also discussed the concept of a range in the context of a comparison of different models. None of this serves to justify the employment of the concept to overlook a material misstatement arising from the incorrect application of IAS 39. Also of significance in this context is the following part of paragraph A90 of ISA 540:

> *"Further, the decision to develop a point estimate or range may be influenced by the applicable financial reporting framework, which may prescribe the point estimate which is to be used after consideration of the alternative outcomes and assumptions, or prescribe a specific measurement method (for example, the use of a discounted probability-weighted expected value)."*

989 This tends to support an approach that would not allow the use of an auditor's range to justify a departure from the specific measurement method prescribed in IAS 39 for determining the discount rate for the *in duplum* loans.

990 Moreover, the first respondent's rebuttal heads make it clear that -

> *"[t]he tolerable range is not a device to justify errors. It is an auditing technique which ... is described in the audit standards, pertaining specifically to the auditing of account balances subject to estimation (i.e. advances or impairments), to assess whether a difference is an error (or misstatement) in the first place",*

and it is common cause here that there were indeed material errors in relation to the use of the incorrect discount rate for impairing in duplum loans and the audit work related to that.

Conclusion on *in duplum* error between 2009 and 2012

991 Coming back to the point that the ninth charge must be viewed holistically, a consequence of the formulation of the charge in that way is that less reliance can be placed by the first respondent on seeking to undermine the reliability of estimations within each particular year and on questioning the applicability of the restatement calculations in 2013 to the 2009 to 2012 years. The failure over the four years in question to address the problem resulted in an under-provision of in excess of R2 billion that had to be addressed in the 2013 year. That too is evidence that can be considered in assessing the first respondent's conduct in relation to the charge.

992 Nevertheless, based on the foregoing analysis, the committee is satisfied that the pro forma complainant has proven that the errors arising from the failure to discount *in duplum* loans at the correct discount rate meant that the AFS of ABIL and African Bank for the years 30 September 2009 to 30 September 2012 were materially misstated. Enough evidence was put up in respect of each year by the pro forma complainant to show that the misstatements were *prima facie* material. Insufficient evidence was put up in rebuttal. Management having declined to adjust the successive AFS for the errors, the first respondent was required to qualify the audit opinions. Unqualified audit opinions were accordingly incorrectly issued in contravention of ISA 700 "*Forming an Opinion*

*and Reporting on Financial Statements"* and ISA 705 *"Modifications to the Opinion in the Auditor's Report"*.

***The 2013 financial year***

993 The second part of the charge relates to the disclosure of the prior year adjustment in the AFS at 30 September 2013. It is averred that the disclosure of the prior period error is not in accordance with IAS 8: *Accounting Policies, Changes in Accounting Estimates and Errors*, and that therefore the audit opinion should have been modified in terms of ISA 710: *Comparative Information – Corresponding Figures and Comparative Financial Statements.*

994 It is appropriate therefore to examine, firstly, the requirements of IAS 8 as they relate to prior period errors:

> *"42. Subject to paragraph 43, an entity shall correct material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by:*
>
> *(a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or*
>
> *(b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented."*

995 On the issue of disclosure of the prior period error, IAS 8 at paragraph 49 states as follows:

> *"49. In applying paragraph 42, an entity shall disclose the following:*
>
> *(a) the nature of the prior period error;*
>
> *(b) for each prior period presented, to the extent practicable, the amount of the correction:*
>
> *(i) for each financial statement line item affected; and*
>
> *(ii) if IAS 33 applies to the entity, for basic and diluted earnings per share;*

*(c) the amount of the correction at the beginning of the earliest prior period presented; and*

*(d) if retrospective restatement is impracticable for a particular prior period, the circumstances that led to the existence of that condition and a description of how and from when the error has been corrected.*

*Financial statements of subsequent periods need not repeat these disclosures."*

996 The disclosure note related to the prior year adjustment, as reflected in note 43.6 of the AFS of African Bank for 2013, is set out in paragraph 8 above, and need not be repeated fully here. The important part of the note for purposes of this component of the charge is the following:

> *"ABL historically applied a lower weighted average effective Interest rate to calculate the present value of impaired loans, taking into consideration the fact that no interest or fees were permitted to be charged on the threshold loans. As a result of the growth in the threshold loans over time, the difference between the two provisioning methodologies has cumulatively become material for the financial year 2013. The company has therefore changed its provisioning methodology to discount all forecast cash flows at the original effective interest rates."*

997 Note 43.6 goes on to tabulate numerically the effect of the change in the loan impairment provisioning methodology on the line items in the income statement and statement of financial position (balance sheet). Note 43.7 reflects the restated and reclassified statement of financial position as at 30 September 2011.

998 The pro forma complainant contends that the disclosure note is misleading as it gives the impression that the *in duplum* matter became material for the first time in 2013. In fact it had been material in each of the financial years concerned.

999 The first respondent, however, argues that the note should be read together with the numerical disclosure, which clearly shows that the numbers were material in respect of each of the prior years. This, argues the first respondent, cannot be said to be misleading to an informed user.

1000 With respect to the views of the experts, there was agreement between the two groups of experts that the use of the word "error" is not required in the disclosure of a prior year adjustment. However, the IRBA experts assert that the wording suggesting that the error had only become material in the 2013 financial year was misleading and was not "faithful representation" as required by IAS 1 and the reporting framework.

1001 Mr Chidgey testified during cross examination that the disclosure note was not *"an accurate statement"*, and that he would have argued strongly against it if he were the engagement partner. However, he also stated that he does not believe that he would have qualified his audit report, as it is a *"fairly small matter to be qualifying an audit report on"*. Mr Chidgey was further of the view that the disclosure was not a material misrepresentation when considered with the rest of the financial statements, adding that it is *"blindingly obvious that it was a material adjustment"*.

1002 Evaluating the restatements in the 2013 AFS against the requirements of paragraph 42 of IAS 8, consistently with that paragraph -

1002.1 The prior period error has been corrected retrospectively by restating the comparative amounts for the prior period presented (2012);

1002.2 The opening balances of assets, liabilities and equity for the prior period presented (2012) have been restated – a restated and reclassified statement of financial position as at 30 September 2011 has also been presented in note 43.7 of the 2013 AFS.

1003 Paragraph 42 of IAS 8 also states that the prior period error should be corrected in the first set of financial statements after the discovery of the error. The pro forma complainant argued that 2013 is not the first set of financial statements after the discovery of the error. Therefore a prior year adjustment was required in each of the years from 2010 to 2012, with a consequential need to correct and reissue the AFS for each of those years. However, the Committee agrees with the first respondent that –

1003.1 the formulation of the ninth charge does not raise the issue of the absence of a prior year adjustment in the financial statements in any of the years from 2010 to 2012;

1003.2 (subject to the wording of the relevant note), adjustment in the 2013 AFS was consistent with paragraph 42(b) of IAS8.

1004 The foregoing observations show compliance also with subparagraphs (b) to (d) of paragraph 49 of IAS8. However, subparagraph (a) of paragraph 49 requires disclosure of *"the nature of the prior period error"*. It was common cause that the narrative part of the disclosure in note 43.7 was incorrect. This subparagraph of paragraph 49 of IAS8 was thus not complied with.

1005 We turn now to ISA 710 *Comparative Information – Corresponding Figures and Comparative Financial Statements*. Paragraph 12 of ISA 710 reads as follows –

> *"12. If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, and the corresponding figures have not been properly restated or appropriate disclosures have not been made, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements, modified with respect to the corresponding figures included therein."*

1006 Paragraph A6 of ISA 710 provides as follows:

> *"A6. When the prior period financial statements that are misstated have not been amended and an auditor's report has not been reissued, but the corresponding figures have been properly restated or appropriate disclosures have been made in the current period financial statements, the auditor's report may include an Emphasis of Matter paragraph describing the circumstances and referring to where relevant disclosures that fully describe the matter can be found in the financial statements (see ISA 706)."*

1007 The pro forma complainant contends in the charge sheet that, in terms of ISA 710, the first respondent should have expressed a qualified or adverse opinion on the financial statements at 30 September 2013 on the basis that the corresponding figures had not been properly restated or that appropriate disclosures had not been made.

1008 The pro forma complainant has not led evidence, nor contended that the restated amounts are inaccurate or that the corresponding figures had not been properly restated. The nub of the complaint of the pro forma complainant in this part of the charge relates to a particular sentence in note 42.6 in the 2013 AFS of African Bank which reads: *"As a result of the growth in the threshold loans over time, the difference between the two provisioning methodologies has cumulatively become material for the financial year 2013."*

1009 The differing arguments on this matter have been canvassed under the discussion of IAS 8 above. What remains to be established, is the appropriateness or otherwise of the disclosure, and whether this should have resulted in a modified audit opinion.

1010 As previously mentioned, Mr Chidgey agreed that this particular statement in the disclosure was not accurate. However, he also believed that it was not of sufficient materiality to warrant a qualified audit opinion being issued. Mr Chidgey also pointed out that a reading of the financial statements in its entirety shows that the adjustment in each of the prior years was material.

1011 On balance, taking the differing views into account, the Committee is satisfied that the disclosure of the prior year adjustment is not materially inaccurate so as to result in a qualified or adverse audit opinion. Nor is it such that an emphasis of matter paragraph was required. This is so, even if the disclosure was not in accordance with the requirements of paragraph 49(a) of IAS 8. A modified audit opinion was not required under the circumstances.

1012 Having said that, the non-compliance with IAS 8, whilst not amounting to improper conduct, is not insignificant. The misdescription of the error was consistent with the first respondent's audit failures in not insisting on the appropriate adjustments in the 2009 to 2012 AFS, which did constitute improper conduct.

***Audit work***

1013 To the extent not already covered, we turn to the ISAs that the first respondent is charged with breaching.

1014 ISA 200: *Overall Objectives of the independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* describes the overall objectives of the auditor as follows:

> *"11. When conducting an audit of financial statements, the overall objectives of the auditor are:*
>
> *(a) to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and*
>
> *(b) to report on the financial statements and communicate as required by the ISAs, in accordance with the auditor's findings.*

1015 Paragraph 15 of ISA 200 requires that –

> *"[t]he auditor shall plan and perform an audit with professional scepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated."*

1016 Paragraph 17 of ISA 200 requires that -

> *"[t]o obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion."*

1017 For the reasons given above, the first respondent failed to maintain an attitude of professional scepticism and further failed to plan and perform the audit to reduce risk to an acceptable level in that he failed appropriately to take into account the error relating to the incorrect discount rate in relation to i*n duplum* loans, in formulating a conclusion in the successive audit opinions from 2009 to

2012, despite having knowledge of the fact that the rate was not compliant with IAS 39. He accordingly breached ISA 200.

1018 Paragraph 17 of ISA 220 *Quality Control for an Audit of Financial Statements* requires that –

> *"[o]n or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the management team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued."*

1019 For the reasons given above, the first respondent failed to ensure that there was sufficient appropriate evidence to support the conclusions reached on the discount rate used for *in duplum* loans. He accordingly breached ISA 220.

1020 Paragraph 5 of ISA 230 *Audit Documentation* provides –

> *"The objective of the auditor is to prepare documentation that provides:*
>
> *(a) a sufficient and appropriate record of the basis for the auditor's report; and*
>
> *(b) evidence that the audit was planned and performed in accordance with ISAs and applicable legal and regulatory requirements."*

1021 Other provisions in ISA 230[79] give more detailed effect to that objective.

1022 For the reasons given above, the first respondent failed to document how the information referenced in paragraph 30.5 of the schedule of charges (see

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[79] See the additional paragraphs of ISA 230 referred to in paragraphs 781 to 784 above.

paragraph 43.5 above) was addressed in forming final conclusions in the AFS of ABIL and African Bank for the 2009 to 2012 financial years.

1023 The expert witnesses agreed that the audit files for 2009 to 2012 did not contain sufficient documentation on how the auditor considered and concluded on the *in duplum* error and the risk of the overall misstatements of the impairments in the AFS for those years. Both the first respondent and Mr Chidgey conceded during cross examination to the deficiency in the documentation and audit evidence.

1024 The first respondent accordingly breached ISA 230.

1025 Paragraph 5 of ISA 450 *Evaluation of Misstatements Identified During the Audit* reads as follows:

> *"The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial."*

1026 Paragraphs 11 and 12 of ISA 450 then provide as follows:

> ***"Evaluating the Effect of Uncorrected Misstatements***
>
> *11. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. When making this determination, the auditor shall consider:*
>
> *(a) the size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and*
>
> *(b) the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, accounts balance or disclosures, and the financial statements as a whole.*
>
> *12. The auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they individually or in aggregate have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements*

> *individually. The auditor shall request that uncorrected misstatements be corrected."*

1027 The first requirement of ISA 450 is that the auditor should accumulate the misstatements identified during the audit. The term "accumulate" envisages the misstatements being brought together in one place, or on one schedule. Evidence was led, and the working papers have shown, that for the years 2009 to 2011 the misstatements related to *in duplum* were quantified for either the entire loan book or parts thereof. However, these amounts were not recorded on the "overs and unders" schedule for any of those years. This was confirmed by Mr Chidgey during cross examination. The misstatement for 2012 was not quantified and not recorded on the "overs and unders" schedule.

1028 It was agreed between the expert witnesses that the first respondent did not insist that management should adjust their loan impairment provision for the years 2009 to 2012.

1029 For the reasons given above, the first respondent failed to accumulate and assess the misstatements related to *in duplum* despite identifying material non-compliance with IAS 39 during the course of the audits of 2009 to 2012. He accordingly breached ISA 450.

1030 Paragraphs 16 to 18 of ISA 700 *Forming an Opinion and Reporting on Financial Statements* provide as follows:

> *"16. The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.*
>
> *17. If the auditor:*

*(a) concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or*

*(b) is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement,*

*the auditor shall modify the opinion in the auditor's report in accordance with ISA 705.*

*18. If financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, the auditor shall discuss the matter with management and, depending on the requirements of the applicable financial reporting framework and how the matter is resolved, shall determine whether it is necessary to modify the opinion in the auditor's report in accordance with ISA 705."*

1031 For the reasons given above, the misstatements were known by the first respondent, were material for each year from 2009 to 2012 and were not adjusted for. In those circumstances, the first respondent could not conclude that the financial statements were free from material misstatement and it was incorrect for an unmodified opinion to have been issued for each of the financial years ending 2009 to 2012. He accordingly breached ISA 700.

1032 Paragraph 6 of ISA 705 *Modifications to the Opinion in the Independent Auditor's Report* provides as follows:

*"The auditor shall modify the opinion in the auditor's report when:*

*(a) the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or*

*(b) the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement."*

1033 For the reasons given above, the first respondent failed to modify the audit reports for ABIL and African Bank, in circumstances where he ought to have done so, in relation to the material misstatements arising from the use of the

incorrect discount rate for *in duplum* loans for each of the financial years ending 2009 to 2012. He accordingly breached ISA 705.

1034 The first respondent's compliance with ISA 710 in relation to the AFS of ABIL and African Bank for the 2013 financial year have been dealt with above and no breach was found that was sufficient to constitute improper conduct.

1035 In relation to each of the ISAs (save for ISA 710), the schedule of charges also refers, in respect of the audit of the AFS of ABIL and African Bank for the financial year ending 30 September 2009, to the version of the ISA that was in force up to 14 December 2009. This includes ISA 320 *Audit Materiality* in relation to the complaint in paragraph 30.7.4 of the charge. We have considered these earlier versions and are satisfied that they too were breached for the reasons given above.

***Conclusion***

1036 In the circumstances, the committee is satisfied that the pro forma complainant has proven sufficient of the material averments in the ninth charge for a conviction. This is so notwithstanding that improper conduct was not proven in respect of the 2013 financial year. The committee accordingly finds the first respondent guilty of contravening disciplinary rules 2.1.1, 2.1.5, 2.1.20 (in respect of section 4.4 of the Old Code) and 2.1.21 of the Old Disciplinary Rules and rules 2.1, 2.5, 2.6 (in respect of section 130.1(b) of the Code), 2.7 and 2.17 on the basis set out above in respect of the ninth charge.

## THE TENTH CHARGE

1037 The tenth charge is in two parts. The first pertains to alleged dishonest conduct on the part of the first and second respondents. The second part pertains to alleged failures of independence, objectivity and professional scepticism on the part of the first and second respondents.

### *Dishonesty*

1038 The essence of the dishonesty charge is that the first and second respondents deliberately turned a blind eye to information in an email that Mr Raubenheimer had sent to Mr Kirkinis on 10 October 2013. In the email, Mr Raubenheimer sought Mr Kirkinis' consent to convey to Deloitte his concerns about impairment of the loan book of African Bank allegedly being understated by R3,750 million.

1039 At the same meeting, it is alleged that the first and second respondents requested Mr Raubenheimer not to send the envisaged email to Deloitte because, were he to do so, this would *"limit Deloitte's 'wiggle room' in relation to the audit"*. They allegedly further warned him that he should not destroy his relationship with Mr Kirkinis by sending the email and that, were he to do so, *"the first and second respondents would have been compelled to act thereon as if it were a fraud report."*

1040 The essence of the respondents' plea on this charge is that they deny that any such meeting took place. They also deny ever having conveyed to Mr Raubenheimer that he should not send the email in question. According to them, the first they knew of the email was upon receiving the charges.

1041 In his witness statement, Mr Raubenheimer describes the events on the day of the alleged meeting as follows:

> *"57. On the morning of 10 October 2013, Mr Kirkinis called me on my way to work and I advised him that I would be sending him an email regarding the impairment provisioning and my views regarding this. I wanted him to consider the email and provide me with his views in relation thereto.*
>
> *58. Later that morning, at 09h48 I sent the email to Mr Kirkinis and copied Mr Roussos, setting out the contents of an email that I intended to send to Deloitte, in particular to the first respondent and Mr Burra."*

1042 The email sent to Mr Kirkinis reads as follows:

> *"From: Gustav Raubenheimer*
>
> *Sent: Thursday, October 10, 2013 9:48 AM*
>
> *To: Leon Kirkinis*
>
> *Cc: George Roussos*
>
> *Subject: ABIL Impairments*
>
> *Leon,*
>
> *As mentioned this morning, I would like to send the following CYA note to the auditors (Sihlalo and Pravin) while CC'ing yourself, George, Nic Adams and Johnny Symmonds. I would like to do so tomorrow.*
>
> *Sihlalo,*
>
> *This notice serve (sic) to confirm that I had communicated to you that, in my opinion, ABIL's credit impairments is (sic) understated by R3,750m as at 31 August 2013.*
>
> *The R3,750 m is made up of the following mutually exclusive amounts:*

| | |
|---|---|
| *GL understated vs the cashflow model* | *825* |
| *In duplum accounts discounted at 0%* | *2 045* |
| *Change in impairment event (IBNR)* | *1 123* |
| *Materiality allowance* | *- 250* |
| | *3 743* |

> *In addition I have concerns about post-default advances which will add approximately R700m to the impairment requirement.*

*Regards,*

*Gustav Raubenheimer*

*Credit Executive : ABIL."*

1043 Mr Raubenheimer, in his witness statement goes on to say:

> *"58. ......The intention of the email was to ... confirm that I had communicated to the first respondent that in my opinion ABIL's credit impairments were understated by R3750m as at 31 August 2013.*
>
> *[the amounts contended for by him are then repeated and explained]*
>
> *59. Mr Kirkinis did not respond to my email and he did not discuss the content of this email with me. I ultimately did not send the email to Deloitte.*
>
> *60. On the same day, i.e. 10 October 2013, at about 17h00, I was approached by the First and Second Respondents whilst at my desk. I was not scheduled to meet them. They requested that I talk to them in private and not at my desk. We then moved to a boardroom. The First respondent asked me how much I thought the Bank was underprovided by. I advised him that I was about to send them an email with that exact information and the actual number. The Second Respondent advised me not to send the email because if I did so, this would reduce their 'wriggle room' in relation to the audit. The First respondent concurred and said he would need to treat the email in the same manner as he would treat a tip-off that has come through the fraud hotline that Deloitte was manning on behalf of the Bank. We then discussed the contents of the email I wanted to send them and the specific numbers in relation thereto. At the end of the meeting they warned me about my dealings with Mr Kirkinis and how I was handling things with him. They expressed concern that this could destroy my relationship with Mr Kirkinis. After the meeting, I went to fetch my car keys and wallet from my desk and left. This meeting terribly upset me.*
>
> *61. As at 10 October 2013, the First and Second Respondents had still not conveyed to me what their stance on provisions was. I still did not know what they would accept and what they would not. My feeling was that Deloitte would allow Mr Kirkinis to get away with a lot of things. I was anxious that they would not take these things seriously. The meeting on 10 October 2013 troubled me greatly and was one of the strangest incidents that ever happened to me. I can only assume that the First and Second Respondents wanted to have as much space to apply their judgement and did not want to be painted into a corner. My feeling was that they were under a lot of pressure from Mr Kirkinis and in a difficult situation.*

62. *It was strange to me that I was proposing to give the First and Second Respondents material evidence in relation to the audit and that they categorically refused to receive it. This was not congruent with what auditors should do and I expected them to support me in convincing the Bank to provide appropriately. Deterred from sending this specific email, my biggest concern at the time was that I would not be able to show at a later stage that I had raised these concerns with the First and Second Respondents. I therefore continued to provide Deloitte with information, as per my email to Mr Burra on 11 October 2013 and kept the flip chart as evidence of the meeting that occurred on 15 October 2013. At this point, I was satisfied that I had conveyed my concerns and that I would be able to show that I had, however I was not comfortable or happy with the First and Second Respondent's reactions and conduct during this meeting."*

1044 In his oral testimony, when asked why he felt the need to send the envisaged email to Deloitte, he said –

> *"So I felt the need to put something in writing that proves I have raised all of these issues with them … I wanted it on record in black and white that I had raised these issues."*

1045 In further describing the meeting in his evidence-in-chief he said –

> *"So, it almost felt like – you know, a threat that if I do not treat my relationship with Kirkinis carefully and this email can be seen as, as actually crossing him, that there could be repercussions for me and for my career at the bank."*

1046 Jordan's evidence in response to this charge in his witness statement reads as follows:

> *"586 … I have no recollection of meeting with Mr Raubenheimer on 10 October 2013, or of him mentioning to me (on that day or any other) that he had sent or would send an email dated 10 October 2013 to Mr Kirkinis requesting permission to convey his concerns to Deloitte in writing. I most certainly did not ask him not to do so, nor told him that Deloitte would need to treat it as a '*fraud report*' or that it '*would limit Deloitte's wiggle room*' in relation to the audit. It would have made no sense to do so, since Mr Raubenheimer's views were well-known to me, to the other Deloitte partners / directors involved and to the management of the Bank, including Mr Kirkinis. His views*

*were on several occasions conveyed in writing and orally to me, and – as I know from my subsequent perusal of the Bank's internal documents – to Mr Kirkinis."*

1047 The second respondent's evidence regarding the email and the alleged meeting is set out as follows in his witness statement:

*"Mr Raubenheimer never sent this email to Mr Jordan, Mr Burra or to me. I do not recollect such a meeting with Mr Raubenheimer or having a discussion at that stage of the audit about his relationship with Mr Kirkinis or about sending emails. I have no recollection of meeting with Mr Raubenheimer on 10 October 2013 or of him mentioning to me that he had sent an email dated 10 October 2013 to Mr Kirkinis requesting permission to convey his concerns to Deloitte in writing."*

1048 Also relevant to his charge is second respondent's evidence regarding his first meeting with Mr Raubenheimer towards the end of September 2013. The relevant part of his witness statement reads as follows:

*"82 … I asked him to explain his views on the Bank's impairments. Mr Raubenheimer suggested that there should be additional impairments, which totalled about R4 billion. It was made up of different components which I will discuss later. I asked him if he thought that the full R4 billion should be provided. He said that he did not consider that necessary, and understood that his was a conservative view. He said he would prefer if all of it was provided, but recognised that it could unnecessarily negatively impact the Bank. He believed the core of the Bank was a good business, and did not believe the full R4 billion impairment was required. I repeated this question to him in our later meetings. His view remained the same.*

*83. During this first discussion, Mr Raubenheimer asked me if he should email me the supporting documents for the views we discussed at this first meeting. The supporting documents may have been an earlier presentation to a Bank credit committee. I said that Deloitte, as standard practice, preferred not to audit by email. I explained that I was not directly involved in the impairment audit, and that those teams directly involved in the impairment audit – either Mr Burra's credit impairment modelling team or the audit team dealing with impairments led by Mr Mavuka – should ask for, or be provided with, the information on an encrypted flash drive so that it could be pulled directly into our audit files.*

84. *I told Mr Raubenheimer that I could not see Mr Jordan signing off on a set of financial statements if Mr Raubenheimer was not comfortable with the recorded level of impairment. I explained to Mr Raubenheimer why that would be the case – that no auditor can afford to sign off an audit opinion where informed members of management have such divergent views on such a complex and subjective matter. As auditors, we understand that management in companies have differences of opinion and sometimes go through serious debates on issues. In the end, we typically require a view supported by all of management. If someone in an important and knowledgeable position still did not support the majority view, we need to be informed about that and we would consider the impact on our audit. Mr Raubenheimer understood this.*
85. *It was during this same discussion that Mr Raubenheimer asked how he should go about achieving the outcome he preferred. I interpreted this as a mentoring type of request and provided my views – I said that the person Mr Raubenheimer needed to convince appeared to be Mr Kirkinis, and that Mr Raubenheimer should approach him directly but not in a confrontational way.*
86. *I have no recollection of informing Mr Jordan of this discussion, probably as I did not regard it as important or contentious. I also have no recollection of either emails or relations with Mr Kirkinis being discussed with Mr Raubenheimer in any meeting where Mr Jordan was present."*

1049 The oral testimony of the witnesses was consistent with their written statements.

1050 Although it is common cause that Mr Kirkinis never responded to the email addressed to him, Mr Roussos, who was copied on the email, did so as follows the next day:

> ***From:*** *George Roussos <GRoussos@AfricanBank.co.za>*
>
> ***Date:*** *11 October 2013 12:13:20 PM SAST*
>
> ***To:*** *Gustav Raubenheimer <GRaubenheimer@AfricanBank.co.za>*
>
> ***Subject: Re: ABIL Impairments***
>
> *Just thinking about our chat and this mail, and have been mulling over how we deal with this challenge.*
>
> *Underlying this whole scenario is the fact that we recognize the various points whether they be actual model differences and / or accounting treatment / recognition requirements.*
>
> *It also hinges on the fact that there is full disclosure by and to all stakeholders concerned (including SARB)*

*1. Model gap*

*the gap of 825 is dealt with by providing the additional 700 as has been agreed to by all parties. We then have the [ACCIs] and materiality number to deal with the remainder.*

*Any new gaps are booked as and when they occur*

*2. IBNR*

*The auditors motivate and sign off that their IBNR calc is correct. This is differ (sic) to your interpretation but the auditors must be able to substantiate their version.*

*3. In Duplum*

*We acknowledge that there is an In Duplum difference which arises largely because of the fact that we had discounted these loans at 0% and they need to be discounted at contractual and that this will be written off / amortized on the following basis (we need to see and agree the calc)*

*Any new In Duplum w.e.f. 1 October is booked as it comes (I don't know what that means from a numbers perspective)*

*I don't know if this actually deals the issue but I'm typing out aloud."*

1051 This email was also seemingly forwarded to Mr Kirkinis.

1052 That represents the factual background to the charge. The Committee's approach to the adjudication of these competing versions must be that laid down in *Stellenbosch Farmers' Winery Group v Martell et Cie*[80] where the Supreme Court of Appeal held as follows:

> *"[5] On the central issue, as to what the parties actually decided, there are two irreconcilable versions. So too on a number of peripheral areas of dispute which may have a bearing on the probabilities. The technique generally employed by courts in resolving factual disputes of this nature may conveniently be summarised as follows. To come to a conclusion on the disputed issues a court must make findings on (a) the credibility of the various factual witnesses; (b) their reliability; and (c) the probabilities.*
>
> *As to (a), the court's finding on the credibility of a particular witness will depend on its impression about the veracity of the witness. That in turn will depend on a variety of subsidiary factors, not necessarily in order of importance, such as (i) the witness's candour and demeanour in the witness-box, (ii) his bias, latent and blatant, (iii) internal contradictions in his evidence, (iv) external contradictions with*

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80 2003 (1) SA 11 (SCA) at para 5.

*what was pleaded or put on his behalf, or with established fact or with his own extracurial statements or actions, (v) the probability or improbability of particular aspects of his version, (vi) the calibre and cogency of his performance compared to that of other witnesses testifying about the same incident or events.*

*As to (b), a witness's reliability will depend, apart from the factors mentioned under (a)(ii), (iv) and (v) above, on (i) the opportunities he had to experience or observe the event in question and (ii) the quality, integrity and independence of his recall thereof.*

*As to (c), this necessitates an analysis and evaluation of the probability or improbability of each party's version on each of the disputed issues.*

*In the light of its assessment of (a), (b) and (c) the court will then, as a final step, determine whether the party burdened with the onus of proof has succeeded in discharging it. The hard case, which will doubtless be the rare one, occurs when a court's credibility findings compel it in one direction and its evaluation of the general probabilities in another. The more convincing the former, the less convincing will be the latter. But when all factors are equipoised probabilities prevail."*

1053 The committee has applied its mind to all of the circumstances surrounding the tenth charge with reference to the criteria in *Stellenbosch Farmers' Winery*. It is neither appropriate nor necessary to document every component of that analysis. We highlight only those considerations that follow in the paragraphs below.

1054 As regards the witnesses' candour and demeanour in the witness box, there is little that makes any one of them stand out from the other. Regard must be had to Mr Raubenheimer's concession that, insofar as he conveyed at the risk committee meeting of 29 October 2013 that he was satisfied with the impairments, although would have preferred R500m more, he had been untruthful as to his true wishes. He attempted to withdraw this concession on the following day of the hearing. He sought to do so on the basis that he had received legal advice overnight that one only tells a lie if one has the intention to lie, which he said he did not have.

1055 In the committee's view, there is a limit on how much can be made of Mr Raubenheimer's initial concession of untruthfulness. Whether or not one accepts Mr Raubenheimer's version as to what his state of mind was at the risk committee meeting on 29 October 2013, there are other ways to describe any unspoken reservations, than untruthfulness. Beyond this, there was little to choose between the three witnesses as concerns their candour and demeanour in the witness box.

1056 As far as the witnesses' bias, latent or blatant, is concerned, it was essentially common cause that Mr Raubenheimer harboured antipathy towards Deloitte. However, if one accepts his version regarding the charge in question, that antipathy would be comprehensible. The committee bears in mind in this regard that Mr Raubenheimer testified under subpoena and had no personal interest in the outcome of the proceedings.

1057 As far as first and second respondents are concerned, there would have been bias inherent in their need to defend themselves. However, that latent bias did not appear to have any particular manifestation in their evidence.

1058 As far as internal contradictions within the evidence of each of the witnesses are concerned, there are aspects of Mr Raubenheimer's evidence which require consideration.

1059 Mr Raubenheimer makes the point that when the first and second respondents approached him on 10 October 2013, it was not a scheduled meeting and "*they requested that I talk to them in private not at my desk*". They then moved to the Tsitsakama board room for the discussion.

1060 Under cross examination, Mr Raubenheimer characterised this behaviour on the part of the respondents as being *"a little ... [unusual]"* because previously the respondents had been comfortable with discussing impairments at his desk in an open-plan office. The impression conveyed by Mr Raubenheimer to the committee was that the behaviour on the part of the respondents was suspicious.

1061 Once at the private board room, Mr Raubenheimer describes the meeting as having commenced on the following basis:

> *"The first respondent asked me how much I thought the bank was under-provided by. I advised him that I was about to send them an email with that exact information and the actual number."*

1062 The first sentence is odd. It suggests that Jordan was at that point unaware of this information. Yet on Mr Raubenheimer's own version, it had been conveyed by him to the first respondent or other persons at Deloitte at least on 29 September 2013 and 2 October 2013.

1063 The second sentence however is particularly puzzling. As pointed out above, the essence of the charge is that the respondents' dishonestly sought to prevent Mr Raubenheimer from sending an email to them, the content of which was already in existence and had been communicated to Mr Kirkinis. Yet it is clear from the second sentence that on Mr Raubenheimer's own version, until that point, the respondents had no knowledge whatsoever of the envisaged email. Why then the suspicious prior conduct of convening an unscheduled meeting at the end of the working day at a place where they could meet without being overheard? It suggests prescience on the part of the respondents in respect of an email of which they had no knowledge.

1064 What is also odd about Mr Raubenheimer's account is that it is at this point in the conversation that the second respondent warns against sending an email, because it would reduce *"wiggle room"* or *"wriggle room"*. It is also at this stage that the first respondent allegedly warned that he would have to treat the email as a fraud tip-off. Yet it is only after this that, according to Mr Raubenheimer, *"we then discussed the contents of the email I wanted to send them and the specific numbers in relation thereto"*.

1065 Again, this makes no sense. It suggests that the respondents sought to supress the email before they knew of its contents. These are serious internal contradictions in Mr Raubenheimer's version.

1066 As far as external contradictions with extracurial statements or actions are concerned, there are aspects that call for consideration. The first time that Mr Raubenheimer made mention of the alleged meeting of 10 October 2013 was in his second submission to the Myburgh Commission on 24 October 2014 where he described the events as follows:

> *"On the 10th of October 2013, Danie Crowther and Sihlalo Jordan requested to meet with me at the bank's offices. During this meeting, I reconfirmed to them the material issues that I am uncomfortable with, and that I had actually sent an email to Leon (see Annexure Q to my previous submission) listing these, requesting permission to convey these to Deloitte in writing as I was at that stage really concerned that my concerns were not taken seriously enough. Both of them requested me not to do so and warned me to be careful not to totally destroy my relationship with Leon. As a result of this warning and as it was evident that my concerns were now being taken seriously, I refrained from putting my concerns in writing, especially without Leon's permission."* (emphasis added).

1067 Whilst there are aspects of this account that are consistent with his account before the committee, there is a glaring inconsistency. On this version, his decision not to send the email was based, at least to a significant degree, on the

respondents' taking his concerns seriously and the failure of Mr Kirkinis to give permission for the sending of the email. The version presented to the Myburgh Commission, suggesting that the email was not sent because the respondents were now taking his concerns seriously, is not consistent with the version presented to the Committee (and which forms the nub of the charge), that they suppressed the email and the information in it and threatened him with career-impacting consequences should he send the email to them.

1068 Three more things are significant about the Myburgh Commission evidence. The first is that he does not refer to any suspicious behaviour at the commencement of the meeting by requiring a meeting out of the earshot of others.

1069 The second is that he gives as an additional reason for not sending the email, Mr Kirkinis' failure to give him permission to send it. That reason is consistent with the documentary record. The "CYA" email was addressed to Mr Kirkinis and sought his permission to despatch it to the auditors. That permission was not forthcoming. Yet this was not offered by Mr Raubenheimer to the Committee as a reason for not sending the email.

1070 The third is that he qualifies the word "destroy" with the word "totally". This qualification did not appear in his evidence before the Committee. It points to there already being problems in the relationship between Mr Kirkinis and Mr Raubenheimer and raises the question whether further damage to the relationship would have been a particular concern for Mr Raubenheimer.

1071 An aspect of Mr Raubenheimer's conduct and statements which can be considered consistent with his complaint and upon which emphasis was placed by the pro forma complainant, is his conduct in retrieving the page of the flip chart

upon which he had set out his views on impairment in a presentation to a meeting held on 15 October 2013 with the respondents. On the pro forma complainant's argument, this was a powerful indicator of Mr Raubenheimer having been dishonestly prevented from conveying his views in writing and being forced to use this opportunity to retrieve and retain a written recordal of his views. However, on the respondents' argument, this meeting was another indicator of the absence of any inhibition on Mr Raubenheimer's ability to communicate his views regarding impairment freely to them. His retrieval of the flip chart page, the respondents contend, is simply conduct consistent with Mr Raubenheimer's tendency to document and keep records of events.

1072 An extracurial statement that provides support for the pro forma complainant's case, is that contained in second respondent's personal notebook, a copy of an extract from which was attached to his witness statement. This pertained to an internal Deloitte meeting held on 11 October 2013 in which he wrote, as the penultimate of several points, *"Get Gustav on side"*. The pro forma complainant argued that the words used "*states an agenda to influence Mr Raubenheimer to abandon his existing position and adopt a different position … The note is, given the proximity in time to the alleged discussion and the overall context at the time, extremely significant."*

1073 Second respondent's explanation of this was as follows:

> *"At that stage it was – I mean we all knew that management and Mr Raubenheimer was not aligned and management needed to get Mr Raubenheimer on side. So – and until that is the case there is no way we can finalise the audit.*
>
> *And the deadline is a concern. We were clearly beyond the time that we thought it would take to finalise impairments. So we were quite worried about our ability, and management's ability to finish everything*

*that is required to issue financial statements, both for year-end reporting purposes and for the capital raise."*

1074 On the basis of this testimony, it was argued on behalf of the second respondent that he provided a credible explanation. Management and Mr Raubenheimer were not aligned. It was management, not Deloitte, that needed to get Mr Raubenheimer on side. *"This was because it was management's responsibility to resolve internal differences, not that of the auditor"*. Moreover, counsel pointed out that the second respondent made the notes available and attached them to his witness statement of his own volition and addressed the issue in his evidence in chief. This was not the behaviour of a person seeking to hide difficult or contentious issues.

1075 It is so that the note is ambiguous as to who it is that should *"get Gustav on side"*. The second respondent fared reasonably well under cross examination on this issue, as the following extract reveals:

*MR MALAN: You see which makes it all the more mysterious why you would use that wording and why you would be saying that in a meeting which is an internal meeting, that has got nothing to do with the client, and do you at least if I can put it to you like this, do you at least see the difficulty that one might have with that wording given the fact that there is an allegation that the previous day you seem to be trying to do exactly that according to Mr Raubenheimer's version?*

*MR CROWTHER: So, so I hundred percent understand that that comment is the kind of comment that would be put to me in the dock. I was there at the time, I am happy to field a question like that, there was never any intention from anyone in the Deloitte team side – on the Deloitte team to get to an outcome other than the right number.*

*And in terms of impairments, one of the big challenges that we, that existed at that stage was that management internally between Mr Raubenheimer and executive management was not aligned and until they aligned, we had a significant audit challenge.*

*MR MALAN: Ja, but as I understand you basic answer you [wonder] why one would develop a certain line of thought if you have an allegation from Mr Raubenheimer as we do, and the very next day*

*what you write down on a piece of paper in an internal meeting is get Gustav on side, can understand why that …*

*MR CROWTHER: I understand that I am facing that question and I am happy to look anybody in the eye and answer that question…*

*MR MALAN: Yes.*

*MR CROWTHER: As I did."*

1076 The further extracurial statements that must be considered in this context were those made by Mr Raubenheimer to Messrs Nunes and Winterboer at the time of the 2014 audit. Nunes says the following in his witness statement:

> *"24. This meeting was set up sometime in September/October 2014 when the year end fieldwork had commenced. This was the first time I met Mr Raubenheimer and was taken aback at the level of hostility directed at Deloitte, and at me as the representative of Deloitte. He blamed Deloitte for a lack of support in 2013 when he said he raised concerns with regards to the Bank's level of impairments, saying that if additional provisions had been raised historically, the Bank could have avoided curatorship. Mr Raubenheimer said that he had wanted to send an email at the time, which I understood was to be addressed by him to Mr Kirkinis. I recall that he said that Mr Crowther had advised him against sending the mail as it would not leave Deloitte with much 'wiggle room'. I realised that this was likely to be a tense working relationship as a result of Mr Raubenheimer's hostility towards Deloitte.*
>
> *25 I thereafter spoke to Mr Crowther and told him what Mr Raubenheimer had alleged regarding the email to Mr Kirkinis. Mr Crowther responded that Mr Raubenheimer had taken what he had said out of context. I do not recall that Mr Crowther in my conversation denied that he had used the words 'wiggle room' in a discussion with Mr Raubenheimer, but I am aware that Mr Crowther in his witness statement denies that he ever used this phrase in a discussion with Mr Raubenheimer, stating that he and Mr Raubenheimer spoke Afrikaans to each other, and that he never uses the phrase.*
>
> *26 I recall sharing with Mr Crowther the fact that Mr Raubenheimer was angry but I do not recall debating the reasons for Mr Raubenheimer's anger in any depth with Mr Crowther. Mr Raubenheimer had not shared with me the e-mail which he claimed he had been advised against sending. I thus did not have any email to hand in my discussion with Mr Crowther. In so far as there is a suggestion that Mr Crowther was party to a suppression of evidence I must stress that this would be entirely inconsistent with my professional knowledge and experience of Mr Crowther."*

1077 In his evidence in chief, Nunes was asked, in the context of this evidence, whether Mr Raubenheimer in this discussion mentioned first respondent in any way. Nunes confirmed that he did not. Nunes confirmed under cross examination that Mr Raubenheimer made no mention of first respondent.

1078 Mr Winterboer's evidence in this regard was as follows:

> *"MR SMIT: Yes. You did, however, also ask for a second partner, Mr Crowther, here to be removed from the audit, is that correct?*
>
> *MR WINTERBOER: That is correct.*
>
> *MR SMIT: And more or less do you know when that occurred?*
>
> *MR WINTERBOER: I think it was early on, you know, as I had the discussions with, you know, with the senior executives and I think Mr Raubenheimer alleged that Mr Crowther made certain statements. On the face of it I felt uncomfortable and that was it. You know, I have subsequently met Mr Crowther so that was no indication of any - I just felt that it was, you know, it is difficult. It may not even have been true that he said that but that was my perception at the time.*
>
> *MR SMIT: Yes. No, I completely understand. I suppose what I want to check with you is Mr Raubenheimer did not relay any negative comments to you about Mr Jordan [when he] relayed negative comments to you about Mr Crowther.*
>
> *MR WINTERBOER: I mean, I cannot remember offhand, you know, certainly I think - and Mr Nunes I see talks about it in terms of the overall, he felt he was - whatever it was, not supported by Deloitte and what he tried to achieve with provisions and so on. So whether it was directed [at] Mr Jordan or not I do not think he actually directed any criticism of Mr Jordan himself."*

1079 These extracurial statements by Mr Raubenheimer to Nunes and Winterboer are, to a degree, corroborative of Mr Raubenheimer's version but they suffer from a flaw in that they only refer to second respondent as having been present. As counsel for the respondents pointed out, the pro forma complainant, in order to prove his case, must show that a meeting took place at which both first and second respondents were present. To the extent that he refers only to second respondent as having been present, they tend to corroborate second

respondent's version of an earlier, innocent exchange between him and Mr Raubenheimer alone.

1080 With reference to (a)(v) of the *Stellenbosch Farmers' Winery* analysis, the probabilities are dealt with below.

1081 As far as the calibre and cogency of the various witnesses are concerned, subject to what is said above regarding the meeting of 29 October 2013, none of the three witnesses stands out in particular above the other.

1082 As far as reliability of the witnesses' evidence is concerned, all face the difficulty that they were testifying about events that had taken place six years earlier. Again, none stood out as having a better recall than the other. Mr Raubenheimer faces the difficulty that the version told closer to the time to the Myburgh Commission is inconsistent in the respects set out above with the version testified to before the Committee.

1083 As regards the assessment of the probability or improbability of each party's version, we have already indicated above the internal contradictions in Mr Raubenheimer's evidence. In the respects in which his witness statement was internally contradictory, it was also improbable. It is improbable that a secretive approach would be adopted to a meeting with a view to suppression of an email of which the respondents were unaware. It is also improbable that the respondents would have sought to suppress the sending of an email before they were aware of its contents.

1084 An important component of assessing the probabilities is to look at the available documentary evidence. The "CYA" email was addressed to Mr Kirkinis and

sought his permission to send the email to the auditors. It is common cause that that permission was never given. From the perspective of the documentary record, the failure of Mr Kirkinis to grant the permission sought in the email becomes *prima facie* the most probable reason for it not having been sent. Added to this, the email was responded to by Mr Roussos. In his email, Mr Roussos sought to assuage Mr Raubenheimer's concerns and to show that Mr Raubenheimer's concerns had been taken on board, saying –

> *"Underlying this whole scenario is the fact that we recognise the various points whether they be actual model differences and/or accounting treatment / recognition requirements."*

1085 In saying that *"it also hinges on the fact that there is full disclosure by or to all stakeholders concerned (including SARB)"* he was implying that there was no need to send the email to the auditors. All stakeholders had been alerted.

1086 He went on to address specifically each of the areas of concern that had been raised by Mr Raubenheimer in his email, including the model gap, the IBNR and *in duplum*. His email concluded:

> *"I don't know if this actually deals [with] the issue but I am typing out aloud."*

1087 Again, on the documentary record, Mr Roussos' email would provide a further, probable explanation for Mr Raubenheimer not having addressed the email to the auditors.

1088 Added to this, in cross examination, Mr Raubenheimer testified that Mr Roussos cautioned him against sending the email. Again, this provides a further probable cause for the email not having been sent which tends to undermine the pro forma

complainant's case that dishonest conduct on the part of the respondents led to the suppression of the email.

1089 Also counting in favour of the respondents as far as the probabilities are concerned, is the fact that on numerous occasions both before and after the alleged meeting of 10 October 2013, Mr Raubenheimer was able to communicate to Deloitte his own views regarding the appropriate level of impairments both orally and in writing. These included –

1089.1 A meeting towards the end of September 2013 at which Mr Raubenheimer indicated to second respondent his view that there should be additional impairments totalling approximately R4 billion;

1089.2 A reiteration of this view at a subsequent meeting on 30 September 2013 with Mr Burra and second respondent;

1089.3 The meeting on 2 October 2013 with Mr Burra, first respondent and Ms Sangone from Deloitte, together with Messrs Nalliah, Strauss and Mr Raubenheimer from the bank, where quantifications of the base gap, IBNR, cash flows and the discount rate in respect of *in duplum* loans were discussed (the views expressed at the meeting were documented by Mr Burra in the annexure to his email of 2 October 2013 in which Mr Raubenheimer was copied);

1089.4 Importantly, because it followed the alleged meeting of 10 October 2013, the meeting of 15 October 2013 in which Mr Raubenheimer recorded his views on impairments on the flip chart, the original of which he retained and presented in evidence at the hearing;

1089.5 The one-on-one between Mr Raubenheimer and second respondent on the same day, 15 October 2013, where he had *"no difficulty at all"* in meeting with second respondent.

1090 All of these instances tend to undermine the probability of Mr Raubenheimer having been persuaded or intimidated into holding back the email envisaged in the CYA email.

1091 The pro forma complainant placed particular reliance in assessing the probabilities on the ongoing audit-related discussions that were taking place between representatives of Deloittes, including the respondents and Mr Pinnock, on the one hand, and the executive management of the bank, including Messrs Kirkinis and Nalliah.

1092 In this regard, the pro forma complainant argued as follows:

> *"The sequence of events regarding the meetings in October 2013 were put to the first respondent, all of which he accepted as having taken place … and management's views on the Deloitte stance as expressed in those meetings was also largely uncontroversial. At a meeting on 9 October 2013 (a day before the alleged 10 October 2013 meeting) Deloitte reassessed the situation and advised management that they could not see an amount of R 1,5 billion as being sufficient and the impairment number should be in the region of R 2,5 billion. Management accused Deloitte of changing the "goalposts" as Deloitte had in the previous meeting of 7 October 2013 indicated that they believed that R 1,5 billion would be sufficient. The first respondent conceded that Deloitte had changed their position before 10 October 2013 from R1,5 billion to R 2,5 billion. The second respondent conceded that Deloitte were heavily criticised by Mr Kirkinis on the 9th of October 2013 for moving from a perceived position of R1.5 billion in additional impairments to R2.5 billion. This was clearly the precipitating factor motivating the 10 October 2013 meeting with Mr Raubenheimer – the very next day. Negotiations had reached a critical point."*

1093 In response to this argument, the respondents point out, with reference to documentary and oral evidence, that the discussions with executive management had not reached anything like the degree of finality around the figure of R2.5 billion impairments that would create a motive for suppressing contrary views from Mr Raubenheimer. On the contrary, they contend that they saw in Mr Raubenheimer as a proponent of high levels of impairment, an ally in their attempts to persuade particularly Messrs Kirkinis and Nalliah of the correct level of impairments. In seeking to demonstrate the absence of any finality as at 9 October 2013, the respondents point to the following:

1093.1 On 7 October 2013 something of a deadlock had been reached between executive management and Deloitte when the chairs of the risk and audit committees had chosen to side with management rather than Deloitte in acquiescing only to a maximum of R700m in impairments;

1093.2 On 8 October 2013, Rian Smit, who worked with Mr Raubenheimer, sent first respondent and Burra an email containing a range of IBNR impairment scenarios that were then under discussion, including *"Gustav's Original Model"* reflecting IBNR impairments at R1.123m;

1093.3 Discussion of the ACCIs only really commenced on 9 October 2013, when Mr Roussos joined the meetings with executive management;

1093.4 On 9 October Mr Nalliah sent African Bank's financial manager, an email to explore matters of accounting treatment which could serve to counteract the impact of the large additional impairments Deloitte was seeking;

1093.5 On 11 October 2013, first respondent sent Botes an email indicating a range of possible impairment outcomes including *"ABIL Model"* at R4.10bn *"Deloitte Actual Model"* at R4.961bn, "*adjusted*" R2.87bn and "*post IBNR"* at R2.878bn;

1093.6 On 14 October 2013, there was an exchange of emails, the first from Botes to first respondent and the second in reply from first respondent to Botes as follows (only the relevant part is quoted):

*"**From:** Botes, Brian (ZA - Durban)*
***Sent:** 14 October 2013 11:24 AM*
***To:** Jordan, Mgcinisihlalo (ZA - Johannesburg)*
***Cc:** Shipp, Darren (ZA - Johannesburg)*
***Subject:** RE: ABL*
*Hi Sihlalo*
*Can I just get some clarity on the numbers below*

- *They have an impairment provision of R12.3bn,*
- *Before processing R4.1bn (their calc). [SJ See above revised calc]*
- *They have agreed to an additional R700m,*
- *And we are requesting an additional R245m.*
- *But this will still be well shy of their R4.1bn or our R4.9bn.*
- *An additional impairment >R700m will cause them to breach their SARB capital adequacy…*

1093.7 First respondent answered as follows:

*On 14 October 2013*

***From:** Jordan, Mgcinisihlalo (ZA - Johannesburg) <mgjordan@deloitte.co.za>*

***Sent:** 14 October 2013 14:00*

***To:** Botes, Brian (ZA - Durban)*

***Cc:** Shipp, Darren (ZA - Johannesburg); Burra, Pravin (ZA - Johannesburg); Crowther, Danie*

*(ZA - Cape Town)*

***Subject:*** *RE: ABL*

*Brian,*

*See below my comments. Just to add that we have made further analysis and Pravin's range has decreased from the R1.8 below to just below R.8bn with more reduction as he has included ML values (R70m) and haircut some calculations (R200m). This number could then be further reduced by us due to the NPV calculation on cash initiatives (the R300m - 500m)*

*I am meeting with Nithia just now as he has an update on the IBNR accounting interpretation which he says we are wrong on. This is the argument about what IAS 39 requires vs implies. For the micro loan industry is 'impaired' determined at 1 month default or rather some later point. ABIL adopts the latter and discloses this in their policies [definition] in the integrated report. They are consulting EY on this.*

*The last remaining issue for us [and them] would then be In Duplum. Simply we are looking for accounting justification for why a rate lower than original contractual [perhaps not 0%] can be justified for the discounting. If EY finds a way for them then that potentially decreases this amount further.*

*Regards,*

*Sihlalo Jordan"*

1093.8 Also on 14 October 2013, first respondent met with the BSD and conveyed to them that Deloitte continued to differ with management on *in duplum* and that in relation to IBNR, Deloitte was still finalising its position;

1093.9 On 15 October 2013, Mr Nalliah sent an email to Van Deventer of the BSD setting out the differences of opinion between the bank and Deloitte as Mr Nalliah perceived them. The opening paragraph of the email reads:

*"Following on from your discussion with Leon at the Prudential yesterday and our call this morning, set out below is what Leon promised to send you on the status of our impairments audit and discussions with Deloitte."*

Reference is then made to *"four areas that have arisen in the course of Deloitte's audit"*. These are then listed and discussed. The email then concludes in respect of the fourth item, ie loans *in duplum* as follows:

> *"This interpretation of the standard has been researched further by both Deloitte and African Bank and it is hoped to obtain closure on this by close today, Tuesday 15 October 2013.*

1093.10 Further meetings with the BSD, within Deloitte, with Goldman Sachs and with management occurred between 15 and 17 October;

1093.11 Minutes of a meeting of the board of directors of ABIL and African Bank held on Friday 18 October 2013 point to agreement more or less having been reached between Deloitte, ABIL and the Bank save for the testing for impairment in the tax asset in Ellerine Furnishers and the goodwill within ABIL.

1094 In the committee's view, the above evidence referred to by the respondents is sufficient to refute the suggestion that a point of finality had been reached in the discussions on 9 October 2013 which created an incentive to suppress any written document from Mr Raubenheimer to Deloitte calling for impairment at the levels which he did.

1095 Weighing all of the foregoing analysis of the credibility of the witnesses, their reliability and the probabilities, along with a careful consideration of all of the evidence, the committee concludes that the pro forma complainant has failed to satisfy the onus of proving on a balance of probabilities, the dishonesty of which first and second respondents were accused. They must accordingly be acquitted on the first part of the tenth charge.

***Independence, objectivity and professional scepticism***

1096 The second part of the tenth charge can only be described as an awkward appendage to the dishonesty component of the charge.

1097 It commences in paragraph 35 (see paragraph 45.3 above) with a recordal of matters of which both the first and second respondents were alleged to be aware, based on evidence emanating from emails, discussions, submissions to the Myburgh Commission and the audit files of ABIL and African Bank for the year ended 30 September 2013.

1098 In paragraph 35.1 (see paragraph 45.3.1 above) the charge refers to the first and second respondents' alleged awareness that processing a higher impairment charge would impact on the following for ABIL and African Bank, namely, breach of debt covenants, exposing the banking market in general to *"systemic risk"*, *"failure of the rights offer"*, *"negative effect on the credibility of the bank"*, *"limiting access to funding with effecting liquidity" (sic)*, *"drop in credit rating"* and *"drop in share price"*.

1099 While each of these, in the main, is not the subject matter of one of the other charges, the introductory allegations relating to awareness of the implications of processing a higher impairment charge overlap with the complaint at the core of the first, second, third, fifth, sixth and ninth charges.

1100 Paragraphs 35.2 to 35.8 (see paragraphs 45.3.2 to 45.3.8 above) pertain to the first and second respondents' alleged awareness in respect of matters which relate directly to charges 1, 2, 5 and 9.

1101 Paragraph 35.9 (see paragraph 45.3.9 above) refers to their alleged awareness in respect of "*other indicators on the audit files, that the impairment provisions were not in line with IFRS, contained 'much less than prudent' assumptions and practices and were potentially biased towards showing a much more favourable financial position than was indeed the case*" and goes on to allege that these indicators were not properly quantified and analysed and were not taken into account in formulating the auditor's opinion. While vague, it again alludes to facts which form the basis of other charges.

1102 The facts of which the respondents are alleged to have been aware in paragraph 35.10 (see paragraph 45.3.10 above) are –

> *"Mr Kirkinis had indicated in meetings with the First and Second Respondents that it would 'sink' African Bank if Deloitte continued to hold its stated position as indicated in a submission to the Myburgh Commission. The First and Second Respondents were aware, alternatively should have reasonably have been aware that 'sinking' ABIL and African Bank would be the likely outcome if higher impairment charges were processed, the resultant pressure led to an intimidation threat."*

1103 Again, here there is overlap with the charges dealing with the appropriate level of impairments.

1104 Generally, taking into account the first and second respondents' alleged awareness of the matters listed in paragraph 35, would require incorporating into this charge facts and conduct that form the subject matter of other charges. Moreover, insofar as it overlaps with other charges, it draws the second respondent into charges which he does not face, and on which he has not had the opportunity of defending himself.

1105 Paragraphs 36.1 and 36.2 (see paragraphs 45.4.1 and 45.4.2 above) then postulate that on the basis of the first and second respondents' acceptance of previous less than prudent judgements or estimates of management that were indicators of bias and the level of partner continuity of ABIL and African Bank, they faced a self-review threat and a familiarity threat respectively.

1106 Paragraph 36.3 (see paragraph 45.4.3 above) then reads:

> *"Despite safeguards, for example having a special quality control review partner in addition to a quality review partner, being put in place to manage the increased risk of the audit, these did not actively consider or prevent the threats of self-review, familiarity and intimidation."*

1107 Again, to consider whether or not this complaint is proven against the first and second respondents requires consideration of factual material that forms the subject matter of other charges, including allegations with which the second respondent is not charged.

1108 Paragraph 36.4 (see paragraph 45.4.4 above) reads:

> *"The abovementioned threats of intimidation, self-review and familiarity resulted in bias and the undue influence of others to override sound auditing judgement which led to a compromise of the fundamental principles of objectivity and integrity contained in the Code."*

1109 To the extent that this sub-paragraph builds on the preceding sub-paragraphs, it suffers from the same defects. It is also vague.

1110 Paragraph 37 (see paragraph 45.5 above) then goes on to identify breaches of the International Standards on Auditing and the Code of Conduct. However, it commences with the words "*within the context of the above facts*", referring, presumably, to all of the averments in paragraphs 33 and 34 (i.e. the dishonesty

component of the charge), and paragraphs 35 and 36 (i.e. the independence, objectivity and professional scepticism components of the charge).

**1111** Paragraph 37 thus adopts as its starting point all of the problems of overlap with other charges and the first part of the tenth charge.

**1112** Paragraphs 37.1 to 37.6 (see paragraphs 45.5.1 to 45.5.6 above) go on to aver with reference to ISA 200, ISA 220 and ISA 240 as well as sections 120 and 290.7 of the Code of Conduct, that the first and second respondents failed to investigate responses from management that were inconsistent, failed to consider if the misstatements identified by Mr Raubenheimer were an indication of fraud, failed to comply with the relevant ethical requirements, failed to maintain an attitude of professional scepticism and failed to remain alert for evidence of noncompliance with ethical requirements throughout the course of the audit engagement.

**1113** Whilst isolating the relevant sections of the Code and the relevant components of the Independent Standards on Auditing, this final listing of complaints all hark back to factual material that forms the subject matter of other charges and draws the second respondent into charges of which he is not accused.

**1114** To convict the respondents on this second component of the tenth charge would, in the committee's view, be procedurally unfair, substantively unfair and would risk their being convicted on charges or elements of charges in respect of which the first respondent has already been found to be guilty or not guilty, as the case may be, and with which the second respondent was never charged.

1115 It may be that there were lapses in objectivity, independence and professional scepticism that were contributing factors in respect of those charges on which the first respondent has been found guilty. Likewise threats of self-review, familiarity and intimidation may have played a role. But the first respondent has already been found guilty in respect of that conduct and it is inappropriate for him to be charged (or convicted) separately in respect of contributing or motivating features of the lapse in professional judgement. In respect of those where he has been acquitted, one must accept that there was the requisite objectivity, independence and professional scepticism, and that any threats were appropriately dealt with. In respect of the second respondent, if he has not been charged with the manifestations of his alleged lapses in objectivity, independence and professional scepticism, he should not be found guilty of these alleged lapses in professional judgement.

***Conclusion***

1116 We accordingly find that the pro forma complainant has failed to prove the tenth charge against the first and second respondents and they are acquitted on this charge.

**OVERALL CONCLUSION**

**1117** The Committee accordingly finds -

1117.1 the first and second respondents not guilty on the tenth charge;

1117.2 the first respondent not guilty on the fourth, fifth, seventh and eighth charges;

1117.3 the first respondent guilty on the first, second, third, sixth and ninth charges.

Alan Dodson SC

Chairperson

5 October 2020

Committee constituted by Mr Alan Dodson, Mr Akhter Moosa, Ms Rene van Wyk, Mr Lucien Pierce, Mr Suren Sooklal and Mr Horton Griffiths

Legal team for the pro forma complainant:

Attorneys: ENS Africa represented by Mr F Malan, Ms P Rodgers, Ms N Abader and Ms N Coleman

Counsel: Mr S Symon SC

Legal team for respondents:

Attorneys: Webber Wentzel represented by Ms K Gawith and Ms K Wolmarans

Counsel: Mr M van der Nest SC, Mr D Smit and Ms L Zikalala