

Proposed Guide

July 2016

Comments requested by 5 October 2016



Proposed Guide for Registered Auditors

Considerations for an Auditor or a Reviewer of a Company which is Factually Insolvent

REQUEST FOR COMMENTS

The Committee for Auditing Standards (CFAS) of the Independent Regulatory Board for Auditors (IRBA) approved this exposure draft, *Proposed Guide for Registered Auditors: Considerations for an Auditor or a Reviewer of a Company which is Factually Insolvent* (this proposed Guide). This proposed Guide may be modified in light of comments received before being issued in final form.

The proposed Guide may be downloaded from the IRBA website:

<http://www.irba.co.za/guidance-to-ras/technical-guidance-for-auditors/exposure-drafts-and-comment-letters>.

Respondents are requested to submit their comments electronically to standards@irba.co.za. All comments will be considered a matter of public record and will be posted on the IRBA website.

Comments should be submitted by **5 October 2016**.

The mission of the IRBA is to endeavour to protect the financial interests of the South African public and international investors in South Africa through the effective and appropriate regulation of audits conducted by registered auditors, in accordance with internationally recognised standards and processes.

In line with the IRBA's legislative mandate, the IRBA's objectives are to create the framework and principles to contribute to the protection of the public who rely on the services of registered auditors and to support registered auditors who carry out their duties competently, fearlessly and in good faith. The goal is to help create an ethical, value-driven financial sector that encourages investment, confidence and promotes sound practices by developing and maintaining auditing standards which are internationally comparable. The statutory responsibility of the Committee for Auditing Standards (CFAS) is to assist the IRBA to:

- develop, maintain, adopt, issue or prescribe auditing pronouncements;
- consider relevant international changes by monitoring developments by other auditing standard-setting bodies and sharing information where requested; and
- promote and ensure the relevance of auditing pronouncements.

Copyright © June 2016 by the Independent Regulatory Board for Auditors (IRBA), all rights reserved. Permission is granted to make copies of this work provided that such copies, in whichever format, are for the purpose of registered auditors discharging their professional duties, for use in academic classrooms or for personal use and provided such copies are not sold for income and provided further that each copy bears the following credit line:

“Copyright © by the Independent Regulatory Board for Auditors. All rights reserved. Used with permission of the IRBA.” Otherwise, written permission from the IRBA is required to reproduce, store or transmit this document except as permitted by law.

EXPLANATORY MEMORANDUM

Contents	Page
----------	------

Explanatory Memorandum

Introduction	iii
Background	iii
Significant matters	iii
Project timetable	iv
Effective date	iv
Guide for respondents	iv
Request for specific comments	v

Exposure Draft

<i>Proposed Guide for Registered Auditors: Considerations for an Auditor or a Reviewer of a Company which is Factually Insolvent</i>	1
--	---

EXPLANATORY MEMORANDUM

Introduction

This memorandum provides background to and an explanation of this *Proposed Guide for Registered Auditors: Considerations for an Auditor or a Reviewer of a Company which is Factually Insolvent* (this proposed Guide).

This proposed Guide has been developed by the Committee for Auditing Standards (CFAS) Solvency Guide Task Group.

The CFAS approved this proposed Guide in June 2016 for an exposure period of 90 days.

Background

This proposed Guide has been developed to provide guidance to registered auditors:

- (a) who are auditors of a company which is trading whilst factually insolvent, in that its total liabilities exceed its total assets; and
- (b) who are independent reviewers in terms of the Companies Act, 2008 (the Companies Act) of the annual financial statements of a company which is trading under insolvent circumstances.

This proposed Guide intends to provide guidance regarding relevant provisions of the Auditing Profession Act, 2005 (the APA), the Companies Act, common law, and case law.

Significant matters

Scope of the Guide

The Solvency Guide Task Group agreed on the following matters regarding the scope of this Guide:

- This Guide is intended for registered auditors performing audits or independent reviews of companies which are factually insolvent.
- Although this Guide necessarily includes a discourse on legal matters, it is not intended to constitute a legal opinion or to provide legal advice.
- This Guide is intended to cover the matters to be considered by an auditor or a reviewer of a company which is factually insolvent, having regard to the APA, the Companies Act, common law and case law – including in particular:
 - Section 22 of the Companies Act dealing with carrying on business recklessly or fraudulently;
 - Section 129 of the Companies Act dealing with “financially distressed” companies;
 - Companies Regulation 29 dealing with reportable irregularities in the context of a review in terms of the Companies Act; and
 - Section 45 of the APA dealing with reportable irregularities in the context of an audit of an entity.
- This Guide is not directed towards, or intended to specifically address, section 4 of the Companies Act (solvency and liquidity test).
- This Guide is not intended as a guide specific to ISA 570, nor does this Guide intend to address all the requirements of that standard.

EXPLANATORY MEMORANDUM

- This Guide is not intended as a guide specific to ISRE 2400 (Revised), nor does this Guide intend to address all the requirements of that standard.
- Although this Guide is presented in the context of companies, this Guide may have application to audits or reviews of other entities, with appropriate adaptation and consideration of other legislation. The APA has application to the audit of any entity.
- This Guide applies to the audit of all companies, including state-owned companies. This Guide also applies to the review of annual financial statements of any company in terms of the Companies Act.
- It is not expected that this proposed Guide will be updated annually. Revisions could be undertaken in response to significant changes in the law, or the accounting or auditing standards, affecting the subject matter of this Guide. Therefore, users of the Guide should consider significant changes in the law, or the accounting or auditing standards since the Guide was issued.

Interpretation of Section 128(1)(f) of the Companies Act

The Task Group dealt extensively with the application of section 128(1)(f) of the Companies Act. The proposed Guide addresses this in paragraphs 48 to 50, 52 to 58 and 65 to 76. The proposed Guide does not provide for alternative interpretations of “insolvent” in section 128(1)(f)(ii) and Regulation 29(1)(b)(iii) which are contrary to its plain meaning. However, it was brought to the Task Group’s attention that some practitioners may be interpreting the law differently to how it is presented in this proposed Guide. This proposed Guide (in particular paragraph 69) addresses this possibility, such that reporting of a reportable irregularity in terms of the Auditing Profession Act is not automatically the default action of the registered auditor in all instances.

Project timetable

Subject to comments received on the exposure of this proposed Guide, the CFAS intends to finalise this proposed Guide in the fourth quarter of 2016.

Effective date

It is anticipated that the final Guide may be approved and issued by CFAS in November 2016. The Guide will be effective from the date of its publication, and represents the law as it stands on that date.

Guide for respondents

The CFAS welcomes comments on all matters addressed in the exposure draft. Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and where appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with the proposals in this exposure draft (especially those calling for change in current practice), it will be helpful for the CFAS to be made aware of this view.

EXPLANATORY MEMORANDUM

Request for specific comments

While the CFAS welcomes comments on all matters addressed in this proposed Guide, the CFAS is specifically seeking comments on the following matters:

- (i) With respect to paragraphs 48 to 50 of this proposed Guide, respondents are asked to consider the implications of the interpretation of "financially distressed" as defined in Section 128(1)(f) of the Companies Act, 2008. Respondents are asked to share the basis of their views.
- (ii) With respect to paragraph 56 of this proposed Guide, respondents are asked whether they agree with the interpretation of Regulation 29(1)(b). Respondents are asked to share the basis of their view.
- (iii) Do respondents agree with the identifications, descriptions of and distinctions between the various types of common responses to factual insolvency dealt with in this proposed Guide, being the letters of support, letters of comfort, guarantees and subordinations?
- (iv) This proposed Guide contains an illustrative subordination agreement in Appendix 3. Respondents are asked to comment on whether or not an illustrative subordination agreement should be included in this proposed Guide.
- (v) Do respondents believe that this proposed Guide should include an illustrative letter of guarantee or letter of support, particularly taking into account the many variations thereof in practice?

Independent Regulatory Board for Auditors
PO Box 8237, Greenstone, 1616
Johannesburg

Issue of Guide

This Guide for Registered Auditors: *Considerations for an Auditor or a Reviewer of a Company which is Factually Insolvent* (this Guide) is issued by the Independent Regulatory Board for Auditors (IRBA). This Guide was approved for issue by the Committee for Auditing Standards.

Purpose

The purpose of this Guide is to provide guidance to registered auditors:

- (a) who are auditors of a company which is trading whilst factually insolvent, in that its total liabilities exceed its total assets; and
- (b) who are independent reviewers in terms of the Companies Act, 2008 of the annual financial statements of a company which is trading under insolvent circumstances.

This Guide may be downloaded from the IRBA website:

<http://www.irba.co.za/guidance-to-ras/technical-guidance-for-auditors/exposure-drafts-and-comment-letters>.

Disclaimer

The IRBA does not accept responsibility for any loss caused to any person who acts, or refrains from acting, in reliance on this Guide.

In terms of section 56 of the Auditing Profession Act, 2005, neither the IRBA nor any member or employee or committee thereof incurs any liability in respect of any act or omission performed in good faith, unless the performance was grossly negligent.

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

CONTENTS

	Page
Introduction.....	4
Scope	4
Objectives	5
Effective date.....	5
Background	6
Law	7
Case law – summary of certain relevant principles	7
Companies Act.....	10
Companies Regulations, 2011 (Regulations)	11
Auditing Profession Act.....	12
Responses to factual insolvency by companies and auditor consideration thereof	15
Subordination agreements	15
Letters of comfort.....	18
Guarantees	19
Letters of support.....	19
Other responses to factual insolvency	20
Compliance with auditing and review standards	20
Auditor	20
Independent reviewer	22
Appendix 1	24
Illustrative communications in terms of Companies Regulation 29	24
Appendix 2	29
Illustrative communications in terms of section 45 of the Auditing Profession Act.....	29
Appendix 3	35
Illustrative subordination agreement	35

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

CONTENTS

This Guide for registered auditors (“auditors”), Guide for Registered Auditors: *Considerations for an Auditor or a Reviewer of a Company which is Factually Insolvent* (this Guide), provides guidance to auditors in implementing the audit and independent review requirements in the relevant International Standards to meet the additional regulatory reporting requirements in the Companies Act, 2008, the Company Regulations, 2011 and the Auditing Profession Act, 2005.

Guides are developed and issued by the IRBA to provide guidance to auditors in meeting specific legislative requirements imposed by a Regulator. Guides do not impose requirements on auditors beyond those included in the International or South African Standard/s or South African regulatory requirements and do not change an auditor’s responsibility to comply, in all material respects, with the requirements of the International or South African Standards or with South African regulatory requirements relevant to the audit, review, other assurance services or related services engagement.

An auditor is required to have an understanding of the entire text of every Guide to enable the auditor to assess whether or not any particular Guide is relevant to an engagement, and if so, to enable the auditor to apply the requirements of the particular International or South African Standard/s to which the Guide relates, properly.

In terms of section 1 of the Auditing Profession Act, No 26 of 2005 (the Act), a Guide is included in the definition of “auditing pronouncements” and in terms of the Act, the auditor must, in the performance of an audit, comply with those standards, practice statements, guidelines and circulars developed, adopted, issued or prescribed by the Regulatory Board.

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

Introduction

Scope

1. This Guide is intended to cover the matters to be considered by an auditor or a reviewer of a company which is factually insolvent, having regard to the Auditing Profession Act, 2005 (the APA), the Companies Act, 2008 (the Companies Act), common law and case law – including in particular:
 - 1.1 Section 22 of the Companies Act dealing with carrying on business recklessly or fraudulently;
 - 1.2 Section 129 of the Companies Act dealing with “financially distressed” companies;
 - 1.3 Companies Regulation 29 dealing with reportable irregularities in the context of a review in terms of the Companies Act;
 - 1.4 Section 45 of the APA dealing with reportable irregularities in the context of an audit of an entity
2. This Guide has application to a registered auditor (an auditor):
 - 2.1 who is an auditor of a company which is trading whilst factually insolvent; and
 - 2.2 who is an independent reviewer in terms of the Companies Act of the annual financial statements of a company which is trading under insolvent circumstances.
3. This Guide intends to provide guidance to an auditor regarding relevant provisions of the APA, the Companies Act, common law, and case law.
4. This Guide is relevant to an auditor’s responsibilities in the audit of financial statements relating to management’s use of the going concern assumption dealt with in International Standard on Auditing (ISA) 570, *Going Concern*, but this Guide is not intended as a guide specific to ISA 570, and is not intended to address all the requirements of that standard.
5. This Guide is relevant to an auditor’s responsibilities in the independent review of financial statements dealt with in ISRE 2400 (Revised), *Engagements to Review Historical Financial Statements*, but this Guide is not intended as a guide specific to ISRE 2400 (Revised), and does not address all the requirements of that standard
6. This Guide does not override the requirements of the APA, the Companies Act, or auditing standards or other auditing pronouncements issued by the Independent Regulatory Board for Auditors (IRBA) – including ISA 570 and ISRE 2400 (Revised). This Guide also does not override the requirements of any other legislation which may be specific to an entity in relation to the question of factual insolvency.
7. This Guide deals generally with the matters covered, but does not purport to cover every circumstance that may arise, and does not purport to deal with all special considerations that may be relevant in the circumstances.
8. Although this Guide necessarily includes a discourse on legal matters, it is not intended to constitute a legal opinion or to provide legal advice. The discourse in relation to legal matters is intended to deal with certain relevant matters of principle at a high level – it is

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

not a substitute for a proper analysis of the relevant facts pertaining to each specific circumstance, or the nuances relevant to each principle, and is not intended to expound definitively on the relevant issues. This Guide deals with the law as it stands at the date of publication of the Guide.

9. This Guide may be useful for the consideration of the solvency and liquidity test in section 4 of the Companies Act as it deals with matters affecting the consideration and measurement of both solvency and liquidity. However, this Guide is not directed towards, or intended to specifically address, that section.
10. This Guide applies to the audit of all companies, including state-owned companies. This Guide also applies to the review of annual financial statements of any company in terms of the Companies Act.
11. Although this Guide is presented in the context of companies, this Guide has application to audits or reviews of other entities, with appropriate adaptation and consideration of other legislation. The APA has application to the audit of any entity.
12. The potential statutory and common law personal liability of directors and others for all or any of the debts of a company that is trading recklessly or fraudulently is not covered by this Guide.

Objectives

13. This Guide is intended to assist an auditor whose audit client is trading whilst factually insolvent, and in particular to assist an auditor to:
 - 13.1 appreciate the potential legal consequences arising;
 - 13.2 understand the responsibility of an auditor in such circumstances;
 - 13.3 distinguish the responsibility of those charged with governance from the auditor's responsibility;
 - 13.4 consider potential responses by a company to the factual insolvency;
 - 13.5 understand the effect of subordination agreements;
 - 13.6 provide broad guidance regarding an appropriate format of subordination agreements.
14. This Guide is also intended to assist an auditor conducting an independent review of annual financial statements in terms of the Companies Act of a company that is trading under insolvent circumstances – in regard to the fulfilment of the statutory obligations of the independent reviewer.

Effective date

15. This Guide is effective from the date of its publication.

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

Background

16. Although it is not the norm, it is not uncommon in business for a company's liabilities to exceed its assets.
17. When liabilities exceed assets, factual insolvency exists. This is also commonly referred to as technical insolvency.
18. Factual or technical solvency is distinguishable from commercial solvency. Commercial solvency is the ability of an entity to meet its debts as and when these fall due.
19. The ability of a company to meet its debts as and when these fall due is dependent upon the funds available (and reasonably anticipated to be available) to the company.
20. Factual insolvency often occurs with start-up operations, where initial losses are not unusual. However, factual insolvency can also arise at any time as a result of losses incurred which exceed the capital and accumulated reserves of an entity.
21. It is common in South Africa for unlisted entities to have nominal share capital, and for their funding to be provided by shareholders (or shareholder-related entities) by way of loans. In those circumstances, even a minor loss can result in the reflection of factual insolvency.
22. Circumstances can exist where a company is factually insolvent, but commercially solvent. Circumstances can also exist where a company is factually solvent but commercially insolvent¹. This is so as the factual solvency measure is simply a comparison of assets against liabilities at a point in time, whereas the commercial solvency measure involves an assessment of funds available and anticipated to be available at the dates when debts are due to be paid².
23. The funds available to a company include *inter alia* its bank balances, liquid assets, borrowing facilities and committed funding from related parties (such as a holding company or fellow-subsiary). Sometimes, the relationship between current assets and current liabilities is considered as a potential indicator of commercial insolvency³.
24. For the consideration of factual solvency, assets are normally measured at their fair value⁴ (and not only at their carrying value in the financial statements and accounting records) in the ordinary course of business of the company – not in a liquidation or close-down scenario. This assessment thus assumes that the company will continue as a

¹ See *inter alia* *De Jager v Karoo Koeldranke & Roomys (Edms) Bpk 1956(3) SA 594(C)*.

² The assessment is not whether the creditor may *ultimately* be paid - it concerns payment on due date.

³ ISA 570 identifies net current liabilities as a condition which may cast doubt about the going concern assumption.

⁴ When the fair value of an asset is different from the carrying value in the financial statements and accounting records, then when taking into account the fair value of that asset in the factual solvency assessment, it is also necessary to take into account the tax consequences that follow from the notional revaluation of the asset (or a revaluation processed in the books of account and financial statements).

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

going concern in the foreseeable future – which is typically considered as covering the twelve months from the date of the assessment⁵.

25. If a company is considered not to be a going concern, then the assets should be considered at their realisable amounts⁶, and the measurement of liabilities should include all liabilities that arise in a liquidation or close-down scenario.
26. To continue operating as a going concern, a company must be commercially solvent. There is thus a link between the factual solvency assessment and commercial solvency, as the asset and liability values may be different if a company is not a going concern.

Law

27. The directors of a company have the responsibility to ensure that a company operates in a responsible manner generally and when its liabilities exceed its assets. An auditor considers the actions taken by the directors in the circumstances.
28. An auditor is not responsible for the actions of the directors, and is normally not party to the carrying on of the company's business⁷.

Case law – summary of certain relevant principles

29. There is no prohibition against a company continuing to trade whilst its liabilities exceed its assets⁸ i.e. whilst it is factually insolvent.
30. However, trading whilst factually insolvent⁹ does raise the potential for possible recklessness, or even fraud.
31. Continuing to trade whilst factually insolvent does not itself amount to reckless or fraudulent trading, but trading under such circumstances raises a “flag” in relation to potential reckless or fraudulent trading. Continuing to incur debt whilst factually insolvent raises the inevitable questions as to whether the debt incurred will be paid as and when due, and whether it is reasonable and responsible for the company to continue trading and incurring new debt in those circumstances.
32. If a factually insolvent company incurs new debt, that does not, of itself, constitute reckless trading¹⁰. However, when a company is factually insolvent, that should cause the directors to have an elevated level of regard to the interests of creditors
33. If a company continues to incur debt where there is no reasonable prospect of the creditors being paid when due, then in general, the proper inference is that the business

⁵ IAS 1, *Presentation of Financial Statements*, states in paragraph 26 that in assessing whether the going concern principle is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period.

⁶ See footnote 4, but applied to realisable value in forced sale or close-down scenario.

⁷ *Powertech Industries v Mayberry and Another 1996(2) SA 742*.

⁸ *Ex parte de Villiers & another NNO : In re Carbon Developments (Pty) Limited (in liquidation) 1993(1) SA 493(A)*.

⁹ ISA 570 identifies a net liability position (i.e. liabilities exceed assets) as a condition which may cast doubt on the going concern assumption.

¹⁰ *Carbon Developments (supra)*.

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

is being carried on recklessly¹¹. This is objectively measured in the context of the notional reasonable person in business, but subjectively to postulate this person with similar knowledge and background to the actual directors¹².

34. An honest belief by the directors as to prospects of payment to creditors when due is critical in assessing fraudulent trading, but not in itself a determinant of reckless trading¹³.
35. A genuine belief as to prospects of payment of creditors when due is not relevant if objective considerations establish recklessness¹⁴.
36. If a company continues to incur credit when to the knowledge of the directors the debts will not be paid as and when due, that will typically amount to an intent to defraud and fraudulent trading – which would be a breach of the common law (in addition to applicable legislation), and hence unlawful conduct.
37. The legal test for recklessness involves a consideration *inter alia* of¹⁵:
 - 37.1 the scope of operations of the company;
 - 37.2 the role, functions and powers of the directors;
 - 37.3 the amount of the debts;
 - 37.4 the extent of the financial difficulties; and
 - 37.5 the prospects (if any) of recovery.
38. The ordinary meaning of “reckless” includes gross negligence, with or without consciousness of risk-taking¹⁶. Gross negligence includes an entire failure to give consideration to the consequences of one’s actions – an attitude of reckless disregard of such consequences¹⁷.
39. Recklessness is present when the conduct is grossly unreasonable. Although business involves entrepreneurial risks, if credit is incurred when there is an objectively strong chance (falling short of a virtual certainty) that creditors will not be paid when due, that indicates reckless trading¹⁸.
40. Recklessness is distinguishable from mere negligence – which is indicated when the incurrance of debt in particular circumstances creates a material, but not high risk of non-payment of creditors, and which risk reasonable businessmen would refrain from running in the particular circumstances¹⁹.

¹¹ See *inter alia* *Ozinsky NO v Lloyd and Others* 1992(3) SA 396.

¹² *Philotex (Pty) Limited v Snyman* 1998 (2) SA 138 SCA and *S v Van As* 1976(2) SA 921(A).

¹³ *Philotex* (supra).

¹⁴ *Philotex* (supra)

¹⁵ *Fisheries Development Corporation of SA Limited v Jorgensen & Another: Fisheries Development Corporation of SA Limited v AWJ Investments (Pty) Limited and others* 1980(4) SA 156(W).

¹⁶ *S v Van Zyl* 1969(1) SA 553(A).

¹⁷ *S v Dhlamini* 1988(2) SA 302(A).

¹⁸ *Philotex* (supra).

¹⁹ *Philotex* (supra).

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

41. In a group scenario²⁰ (which may also have application in other contexts), the following is relevant in assessing recklessness:
- 41.1 the ability of a company to pay its creditors without group support;
 - 41.2 the extent of the company's dependence on support from its holding company (or group companies);
 - 41.3 if a company is unable to pay its debts without group support, clarity on basic questions is required before incurring debt for the continued operation of the business, namely:
 - 41.3.1 what financial support will the group provide?
 - 41.3.2 for how long will that support be available?
- Without clarity and commitment on the questions above, it is neither reasonable nor responsible to take the risk, knowingly or not, that trade creditors might not be paid.
42. Clarity and commitment are required not only where a company relies solely on a shareholder to provide funding, but also where shareholder funding is essential for the company to survive even though other funding is available²¹.
43. Other relevant matters to be considered in an assessment of potential reckless trading include the following²²:
- 43.1 the litmus test of factual solvency of a company is the shareholders' interest in the company i.e. assets versus liabilities;
 - 43.2 revaluations of assets, especially when conducted by the directors, should be considered with caution in assessing the factual solvency of a company;
 - 43.3 the profit (or loss) after interest is illustrative of profitability and the ability to pay debts;
 - 43.4 although as a matter of law an overdraft is repayable on demand, it is not reckless for a director to assume that the bank will not unexpectedly call it up before the term – in circumstances when the bank, after due consideration, had granted and increased the overdraft for a fixed term²³.
44. The issues above are not the only matters to be considered by an auditor, who includes all relevant facts in the consideration.

²⁰ *Philotex* (supra).

²¹ *Fourie NO v Newton* (562/09) [2010] ZA SCA 150.

²² *Philotex* (supra).

²³ *Fourie NO v Newton* (562/09) [2010] ZA SCA 150.

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

Companies Act

Reckless or fraudulent trading

45. Section 22 of the Companies Act prohibits companies from carrying on their business “... *recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose ...*”²⁴.
46. In terms of schedule 5 to the Companies Act, Chapter 14 of the Companies Act, 1973 (the 1973 Companies Act) continues to apply with respect to the winding-up and liquidation of insolvent companies²⁵. Chapter 14 of the 1973 Companies Act includes section 424, which provides that where any business of a company is carried on recklessly or with intent to defraud, every person knowingly a party²⁶ to such conduct is guilty of an offence²⁷.
47. It is thus unlawful for a company to trade recklessly or with intent to defraud.

Financially distressed companies

48. Section 128(1)(f) of the Companies Act defines “*financially distressed*” in relation to a company as meaning that:
 - “(i) *it appears to be reasonably unlikely that the company will be able to pay all of its debts as they become due and payable within the immediately ensuing six months; or*
 - “(ii) *it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months ...*”
49. Section 129(7) of the Companies Act provides that if a company is financially distressed as defined and the board has not resolved that the company voluntarily begin business rescue proceedings, the board must deliver a written notice to shareholders, creditors and representatives of the employees of the company, explaining that the company is financially distressed as contemplated in section 128(1)(f), and provide the reasons for not adopting the resolution to begin business rescue proceedings.
50. If a company is factually insolvent, then it falls within the definition of “*financially distressed*” in section 128(1)(f)²⁸, and the company is required to act in the manner set out in section 129(7).

²⁴ Section 214(1)(c) of the Companies Act provides that it is an offence for a person to be knowingly a party to an act or omission by a company calculated to defraud a creditor or any fraudulent purpose.

²⁵ In terms of Schedule 5 to the Companies Act, certain sections of the 1973 Companies Act do not apply to the winding-up of a solvent company.

²⁶ *Powertech* (supra).

²⁷ Section 424(3) read with section 424(1) of the 1973 Companies Act.

²⁸ Based on the actual words used to ascertain the meaning of the language of the provision itself, and the interpretation being objective in form, without determining the subjective state of mind or intention. See *Natal Joint Municipal Pension Fund v Endumeni* 2012 (4) SA 593 (SCA) and *Bothma-Batho Transport v S Bothma & Seun Transport* 2014 (2) SA 494 (SCA).

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

Companies Regulations, 2011 (Regulations)

51. The Regulations made by the Minister of Trade and Industry in terms of section 223 of the Companies Act provide for the independent review (as distinct from, and instead of, an audit) of annual financial statements of certain categories of companies²⁹.
52. Regulation 29(6)(a) provides that an independent reviewer that is satisfied or has reason to believe that a “*reportable irregularity*” has taken place (or is taking place) must, without delay, send a written report to the Companies and Intellectual Property Commission (the Commission) giving particularities of the reportable irregularity.
53. Regulation 29(1)(b) defines a reportable irregularity as meaning “*any act or omission committed by any person responsible for the management of a company, which –*
 - (i) *unlawfully has caused or is likely to cause material financial loss to the company or to any member, shareholder, creditor or investor of the company in respect of his, her or its dealings with that entity; or*
 - (ii) *is fraudulent or amounts to theft; or*
 - (iii) *causes or has caused the company to trade under insolvent circumstances.*”
54. The definition of “*reportable irregularity*” in the Regulations is *not* the same as the definition of “*reportable irregularity*” in the APA.
55. The independent reviewer is alert to the possibility of the existence of a reportable irregularity in terms of the Regulations, and the independent reviewer’s obligation to report in such circumstances.
56. Regulation 29(1)(b)(iii) is considered to deal with factual insolvency.^{30, 31, 32}
57. Thus, in terms of Regulation 29(1)(b)(iii), if a company whose annual financial statements are subject to a review (and not an audit), has traded, or is trading whilst factually insolvent, that conduct itself constitutes a reportable irregularity. Consequently, the reporting obligations of the independent reviewer of that company in terms of the Regulations would apply³³.
58. If a company whose annual financial statements are subject to review (and not an audit) is factually solvent, but is, or appears to be, trading recklessly or fraudulently, then the independent reviewer should consider whether there is a reportable irregularity in terms of Regulation 29(1)(b) (i) or (ii) i.e. whether trading under such circumstances has

²⁹ In terms of section 30(2) and 30(7) of the Companies Act, read with Regulation 28, certain private companies do not require an audit of their annual financial statements, which are only required to be independently reviewed.

³⁰ Trading whilst commercially insolvent would fall into Regulation 29(1)(b)(ii).

³¹ Based on the Companies and Intellectual Property Commission Guidance Note dated 23 June 2015, it appears that, at the date of publication of this Guide, it may interpret Regulation 29(1)(b)(iii) as meaning commercial insolvency, and *not* factual insolvency. However at the date of publication of this Guide, a note on the CIPC website in relation to business rescue suggests that factual solvency *would* fall within the meaning of “insolvent” as dealt with in section 128, the wording of which is virtually the same as Regulation 29.

³² See footnote 28.

³³ Companies Regulation 29(6)-(8).

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

caused, or is likely to cause material financial loss to any or all of the parties identified in the Regulation, or is fraudulent or amounts to theft.

59. If an independent reviewer is satisfied or has reason to believe that the circumstances in Regulation 29(1)(b)(i) or (ii) exist, then the report in terms of the Regulations should be made to the Commission³⁴.
60. An illustrative example of the required reports to the Commission in terms of Regulation 29 appears in Appendix 1.

Auditing Profession Act

61. Where an entity appoints a registered auditor that is a firm to perform an audit, the firm must decide as to the individual registered auditor/s within the firm that is/are to be responsible and accountable for that audit³⁵.
62. Section 45(1) of the APA imposes a statutory duty on the individual registered auditor of an entity that is satisfied or has reason to believe that a “*reportable irregularity*” has taken place or is taking place in respect of the entity, to report to the IRBA³⁶.
63. The definition of reportable irregularity in the APA is different to that in the Regulations.
64. The phrase “*reportable irregularity*” is defined in section 1 of the APA thus:
- “reportable irregularity” means any unlawful act or omission committed by any person responsible for the management of an entity which –*
- (a) *has caused or is likely to cause material financial loss to the entity or to any partner, member, shareholder, creditor or investor of the entity in respect of his, her or its dealings with that entity; or*
- (b) *is fraudulent or amounts to theft; or*
- (c) *represents a material breach of any fiduciary duty owed by such person to the entity or any partner, member, shareholder, creditor or investor of the entity under any law applying to the entity or the conduct or management thereof.”*
65. The two most important differences between the definition of “*reportable irregularity*” in the APA and that in the Regulations are:
- 65.1 in the Regulations, the mere act of trading under insolvent circumstances is a reportable irregularity, but not in terms of the APA;
- 65.2 in the APA, a material breach of a fiduciary duty is a reportable irregularity, but not in terms of the Regulations.

³⁴ Companies Regulation 29(6)-(8).

³⁵ Section 44(1)(a) of the APA.

³⁶ IRBA Revised Guide for Registered Auditors, Reportable Irregularities in Terms of the Auditing Profession Act.

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

66. Both the APA and the Regulations classify fraudulent acts and any unlawful act or omission that has caused (or is likely to cause) material loss to the identified parties, as a reportable irregularity.
67. If a company is trading recklessly or with intent to defraud, or fraudulently, this would be an unlawful act – being a breach of section 22 of the Companies Act and section 424 of the 1973 Companies Act, and contrary to the common law (in relation to the fraudulent conduct).
68. Reckless or fraudulent trading would ordinarily be expected to constitute a reportable irregularity, as this is an unlawful act committed by the persons responsible for management (typically the directors), and:
 - 68.1 the act would have caused or would be likely to cause material financial loss to creditors (and in particular new or increased creditors, who would be unlikely to be paid when due), and/or to the entity, any partner, member, shareholder or investor of the entity; and/or
 - 68.2 in the case of fraudulent trading, is fraudulent or amounts to theft; and/or represents a material breach of management’s fiduciary duty owed to the entity – by allowing the entity to trade recklessly or fraudulently; and/or
 - 68.3 in breach of legislation.
69. If the entity that is trading recklessly, fraudulently or with intent to defraud, is subject to an audit, and the auditor is satisfied or has reason to believe that this constitutes a reportable irregularity in terms of the APA, then the individual registered auditor/s responsible and accountable for that audit must comply with the reporting and other requirements of the APA in relation to reportable irregularities, and report to the IRBA^{37,38}.
70. If a company continues to trade whilst it is factually insolvent, and it has not complied with section 129(7) of the Companies Act, then that non-compliance is unlawful i.e. the failure by the board to deliver written notice to each affected person explaining that the company is factually insolvent and thus “financially distressed” in terms of the Companies Act, and setting out their reasons for not voluntarily beginning business rescue proceedings.
71. In those circumstances, an auditor considers whether that unlawful act constitutes a reportable irregularity in accordance with the APA. This requires an assessment as to whether the unlawful act falls into any one of the three sub-sections within the reportable irregularity definition in the APA.
72. If a company has been, and is likely to be able to meet its debts when due in the future, then the breach of section 129(7) is unlikely in itself to amount to a reportable irregularity.
73. If an auditor is satisfied or has reason to believe that a reportable irregularity has or is taking place as a result of a breach of section 129 of the Companies Act, the auditor

³⁷ Sections 45(1)-(3) of the APA.

³⁸ IRBA *Revised Guide for Registered Auditors, Reportable Irregularities in Terms of the Auditing Profession Act*.

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

must comply with the reporting and other requirements in the APA in relation to reportable irregularities, and report to the IRBA³⁹.

74. Notably, whilst the sole fact of a company trading whilst factually insolvent is not of itself a reportable irregularity in terms of the APA (reportable to the IRBA), this sole fact is a reportable irregularity in terms of Regulation 29(1)(b)(iii) (reportable to the Commission).
75. Despite the fact that a factually insolvent company may not be trading recklessly or fraudulently or with intent to defraud, if that company is subject to a review of its annual financial statements (and not an audit) in terms of the Regulations and the Companies Act, there would be a reportable irregularity in terms of the Regulations. However, if that same company was subject to an audit (and not a review) in terms of the Regulations and the Companies Act⁴⁰, there would be no reportable irregularity in terms of the APA (and Regulation 29 does not apply).
76. If an entity, which is not a company, is trading recklessly, but *not* fraudulently or with intent to defraud, that may not be unlawful. In those circumstances, the auditor carefully considers whether any law applying to the entity prohibits reckless trading. If there is no unlawful act or omission committed by any person responsible for management of an entity, then in the absence of other adverse indicators, there will not be a reportable irregularity as contemplated in the APA. However, other obligations could arise for the auditor, from other legislation and from the International Standards on Auditing⁴¹ (ISAs).
77. As part of an auditor's obligation to comply with the auditing pronouncements issued by the IRBA⁴², the auditor *inter alia*:
- 77.1 considers management's use of the going concern assumption in the preparation of the financial statements⁴³;
- 77.2 obtains and properly documents⁴⁴ sufficient appropriate audit evidence⁴⁵ relating to the factual insolvency and the responses thereto, the related audit procedures conducted, and the effect on the audit opinion;
- 77.3 considers whether the company has complied with laws which may have a material effect on the financial statements⁴⁶, for example, the notice required by section 129(7) of the Companies Act⁴⁷;
- 77.4 considers the effect of factual insolvency and the responses thereto in the auditor's communication with those charged with governance of the company regarding

³⁹ Sections 45(1)-(3) of the APA.

⁴⁰ Or subject to an audit in terms of some other legislation.

⁴¹ As an example, these circumstances would be likely to cast doubt on the going concern assumption dealt with in ISA 570.

⁴² Sections 41(6)(b) and 44 (3)(a) of the APA.

⁴³ ISA 570 identifies a net liability position (i.e. liabilities exceed assets) as a condition which may cast doubt on the going concern assumption.

⁴⁴ ISA 230, *Audit Documentation*.

⁴⁵ ISA 500, *Audit Evidence*.

⁴⁶ ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*.

⁴⁷ The notice to creditors could result in the company no longer being a going concern if creditors no longer grant credit and/or call up amounts due.

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

- significant findings from the audit⁴⁸, including identifying the potential for personal liability of directors and others in the circumstances;
- 77.5 considers the effect of the factual insolvency and the response thereto on the audit report on the financial statements⁴⁹.
78. Although an independent review appears to fall within the definition of an “audit” in terms of section 1 of the APA, section 30(8) of the Companies Act provides that an independent review required by the Companies Act does not constitute an audit within the meaning of the APA.⁵⁰
79. An auditor (acting as auditor or as independent reviewer) considers the effect of the factual insolvency, and related issues, and the responses thereto on client acceptance and continuance⁵¹.
80. A registered auditor who fails to report a reportable irregularity is guilty of an offence in terms of the APA⁵².
81. An illustrative example of the required reports in terms of section 45 of the APA appear in Appendix 2.

Responses to factual insolvency by companies and auditor consideration thereof

82. The directors of a company have the responsibility to assess the effect of factual insolvency of the company, the appropriate responses thereto, and whether the company should continue to trade in those circumstances. An auditor considers the responses and actions taken by the directors and the company. Possible responses to factual insolvency are described in the sections below:

Subordination agreements

83. A common response to factual insolvency is for the company to enter into an agreement with a major creditor (typically its shareholder or a related party) in terms of which the creditor agrees not to demand or accept any payment of the amounts owing to the creditor until such time as the company’s assets exceed its liabilities.

⁴⁸ ISA 260, *Communication with those charged with Governance*.

⁴⁹ ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*; ISA 701, *Communicating Key Audit Matters in the Independent Auditor’s Report*; ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor’s Report*; ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report*; ISA 720 (Revised), *The Auditor’s Responsibilities Relating to Other Information*.

⁵⁰ IRBA *Revised Guide for Registered Auditors, Reportable Irregularities in Terms of the Auditing Profession Act*.

⁵¹ ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and other Assurance and Related Services Engagements* and, as applicable to either an audit or an independent review, ISA 220, *Quality Control for an Audit of Financial Statements* or ISRE 2400 (Revised), *Engagements to Review Historical Financial Statements*.

⁵² Section 52(1)(a).

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

84. Such an agreement is normally referred to as a “subordination” agreement or a “back-ranking” agreement – where the creditor subordinates or back-ranks its claim in favour of the other creditors of the company.
85. A subordination agreement is a contract between the company and the subordinating creditor, which is *inter alia* for the benefit of other creditors.
86. The subordination by a creditor does not change the legal nature of the amount owing to the subordinating creditor – which remains a liability⁵³. The debt is thus still included in total liabilities in assessing factual insolvency.
87. In addition, the subordination by a creditor does not change the accounting nature of the amount – which remains a liability (and does not become equity) in terms of International Financial Reporting Standards (IFRS)⁵⁴, assuming the entity is a going concern.
88. Thus, a subordination agreement does not change the factual insolvency position, and the subordinated liabilities remain liabilities – albeit liabilities whose payment has been deferred until the occurrence of a future event.
89. The typical subordination agreement also provides that, in the event of the liquidation of the debtor company, the subordinating creditor will not pursue a claim in the estate of the company.
90. If the company is *not* a going concern (and then liquidation is probable), then the subordinated liabilities (or at least part thereof) would be excluded as liabilities⁵⁵ on the basis that no amount would be paid as the claims of those subordinated creditors (or part thereof) would normally be extinguished if the company is placed in liquidation.
91. However, in a going concern scenario, the implicit assumption is that the subordinated creditor will ultimately be paid, and thus the amounts due to the subordinated creditor are properly classified as liabilities – both in law and for financial reporting purposes.
92. Whilst a subordination by a creditor does not change the factually insolvent position of a company, it can significantly benefit the other creditors of the company, and the company itself.
93. The other creditors benefit as the subordinating creditor would not form part of any pool of creditors on a liquidation of the company, thus increasing the amount receivable by the other creditors from the realisation⁵⁵ of the assets of the debtor company.
94. In addition, the ability of the company to pay the other creditors in the ordinary course should be enhanced by the elimination of the requirement for any cash to be paid to the subordinated creditor by the company – which is also a benefit for the company itself.

⁵³ *Carbon Developments* (supra).

⁵⁴ International Accounting Standard (IAS) 32, *Financial Instruments: Presentation*, paragraph 25 – assuming the entity is a going concern. Also see the International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs), Section 11.

⁵⁵ Such loans would then be treated as reserves and part of equity in terms of IAS 32, *Financial Instruments: Presentation* / IFRS 7, *Financial Instruments: Disclosures*.

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

95. A subordination agreement ordinarily indicates responsible action taken in the face of factual insolvency, in order to protect the interests of the creditors and increases the likelihood of the non-subordinated creditors being paid.
96. Subordination agreements vary. Sometimes the subordinating creditor subordinates its entire claim until the debtor company's assets exceed its liabilities. However, sometimes the subordinating creditor will only subordinate so much of its claim as is equivalent to the deficit of the company i.e. it will subordinate its claim only to the extent of the debtor company's excess of liabilities over assets i.e. the deficit of the debtor company.
97. An auditor examines and considers each subordination agreement on its own merits and in the particular circumstances – considering in particular the likely practical effect of the subordination on the company and the other creditors, and the enforceability thereof.
98. In assessing a subordination agreement, an auditor considers *inter alia* the following:
- 98.1 whether the subordinating creditor is properly authorised to subordinate its claim and enter into the subordination agreement;
- 98.2 what the financial position of the subordinating creditor is at the date of the subordination – in particular, whether the subordinating creditor is itself factually solvent⁵⁶, and the effect of the subordination on its own solvency position. The subordinating creditor may have to impair the loan receivable which it has subordinated and, if so, that would affect the subordinating creditor's own solvency position;
- 98.3 the duration of the subordination agreement, and what circumstances bring it to an end;
- 98.4 whether the subordination agreement can be cancelled, and if so under what circumstances;
- 98.5 the amount which is subordinated, relative to the deficit of the company;
- 98.6 the terms of the subordination, and in particular what will trigger the payment to the subordinating creditor. Typically the subordinating creditor agrees that it will be paid only when the assets of the company, fairly valued, exceed liabilities;
- 98.7 whether the amount owing to the subordinating creditor will bear interest, and if so at what rates;
- 98.8 if the amount subordinated is denominated in foreign currency, the effect of changes in exchange rate;
- 98.9 if the subordinating creditor is in a foreign jurisdiction, the legal effect thereof on the validity and enforceability of the subordination.
99. A subordination agreement is only one factor to be considered by an auditor. Such an agreement, whilst beneficial to the other creditors and the company, does not provide new cash that may be required by the company in the future to fund its obligations

⁵⁶ If the subordinating creditor is itself factually insolvent, then the subordination of its claim against the company may, under certain circumstances, be set aside as a voidable disposition.

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

(although it does preserve cash). A subordination is seldom conclusive in relation to an auditor's assessment of commercial solvency or going concern, which requires various other exercises and considerations⁵⁷.

100. In assessing the value of a subordination, an auditor exercises judgement and considers whether legal advice⁵⁸ should be obtained in relation to the effect of the subordination. There is however no obligation on an auditor to seek legal opinion. Ultimately, an auditor exercises professional scepticism and his or her own prudent judgement to determine the effect and value of the subordination, and what action should be taken by the auditor.
101. An auditor considers whether the terms of the creditor's subordination have been disclosed in the debtor company's financial statements in accordance with IFRS. Similarly, the terms of the subordination agreement may have to be disclosed in the subordinating creditor's financial statements, in accordance with IFRS. The subordination may affect the measurement of the amount receivable in the creditor's financial statements, measured in accordance with IFRS⁵⁹.
102. The directors of the company and the subordinating creditor should consider the potential tax consequences, if any, arising from the specific wording of the subordination agreement. An auditor considers whether appropriate provision for tax, if any, arising from the subordination has been made in the financial statements of the relevant companies.
103. An illustrative example of a subordination agreement appears in Appendix 3.

Letters of comfort

104. A common response to factual insolvency is for a holding company or fellow-sub subsidiary to provide a so-called "letter of comfort".
105. A letter of comfort has no effect on factual insolvency.
106. The value and benefit of such a letter to an auditor (and indeed to the company itself and to its creditors) depends on the specific wording thereof, and in particular whether the letter amounts to a financial guarantee and enforceable legal undertaking, or merely records a "best efforts" or a general corporate governance commitment. The auditor is circumspect regarding the degree of importance attributed to a letter of comfort.
107. A letter of comfort is not regarded as a substitute for a subordination agreement.
108. Letters of comfort vary, but commonly include statements from a holding company or related party that:
 - 108.1 it is aware of the subsidiary's financial position;
 - 108.2 the group policy is that group companies should meet their obligations;
 - 108.3 it will ensure that the company is properly managed; and

⁵⁷ ISA 570.

⁵⁸ If legal advice is sought, an auditor complies with ISA 620, *Using the Work of an Auditor's Expert*.

⁵⁹ IAS 39, *Financial Instruments: Recognition and Measurement* / IFRS 9, *Financial Instruments*. Also see IFRS for SMEs, Section 11.

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

- 108.4 it supports its subsidiaries to meet their obligations.
109. A letter of comfort indicating a general intention to provide support may not create a legally enforceable obligation.
110. A letter of comfort is only one factor to be considered by an auditor. A letter of comfort would typically not provide new cash that may be required by the company. A letter of comfort is seldom conclusive in relation to the consideration of commercial solvency or going concern, which requires various other exercises and considerations⁶⁰.
111. An auditor examines and considers each letter of comfort on its own merits and in the particular circumstances – considering in particular the practical effect of the letter of comfort on the company and its creditors, and the enforceability thereof.
112. In assessing the value of a letter of comfort, an auditor exercises judgement and considers whether legal advice⁶¹ should be obtained in relation to the effect of the letter of comfort. There is however no obligation on an auditor to seek legal opinion. Ultimately the auditor exercises his or her own prudent judgement to determine the effect and value of the letter of comfort, and what action should be taken by the auditor.

Guarantees

113. Another common response to factual insolvency is for a holding company, shareholder or related person to provide a guarantee to certain creditors. Assuming the guarantor is able to satisfy such financial commitment, this protects those creditors which are the beneficiaries of the guarantee, but generally this would not cover the broad body of creditors.
114. An auditor considers whether the accounting effect and disclosure of the guarantee have been dealt with in the guarantor's financial statements in accordance with IFRS. In addition to required disclosure, the guarantee may affect the measurement of liabilities in the guarantor's financial statements, in accordance with IFRS⁶².

Letters of support

115. Sometimes a holding company, shareholder or related party will indicate that it will provide support by way of providing sufficient funding to the company to meet its obligations. This is distinguishable from a letter of comfort as it involves the provision of finance to the company. (Sometimes the wording of a letter of comfort also provides for financial support to be provided).
116. A commitment to provide financial support has no effect on factual insolvency, but can have a major effect on commercial solvency.
117. Assuming that the party to provide the support is able to provide the necessary amount of funding, and that there is clarity and commitment regarding the amount and duration

⁶⁰ ISA 570.

⁶¹ If legal advice is sought, an auditor complies with ISA 620.

⁶² IAS 39, *Financial Instruments: Recognition and measurement* / IFRS 9, *Financial Instruments*. Also see IFRS for SMEs, Sections 12 and 21.

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

of the financial support to be provided, that could be conclusive evidence of the ability to meet debts as due, despite factual insolvency.

118. An auditor examines and considers any letter of support (and any other response to the factual insolvency) on its own merits and in the particular circumstances – considering the practical effect of the actions taken on the company and its creditors, and the enforceability of the actions taken.
119. In assessing the value of the letter of support (and any other responses to the factual insolvency), an auditor exercises judgement and considers whether legal advice⁶³ should be obtained in relation to the effect of the letter of support. There is however no obligation on an auditor to seek legal opinion. Ultimately the auditor must exercise his or her own prudent judgement to determine the effect and value of the responses, and what action should be taken by the auditor.

Other responses to factual insolvency

120. Other actions and events that can materially affect factual solvency (and commercial insolvency), and an auditor's consideration include:⁶⁴
- 120.1 fresh issue of share capital for cash (or firm commitment for issue of shares); and/or
 - 120.2 capitalisation of part or all of amounts owing to creditors, typically being amounts owing to a holding company or related parties (or firm commitment to capitalise loans); and/or
 - 120.3 re-negotiating the terms and conditions of loans, including amounts payable and extending/deferring payment dates and settlement in order to reduce the likelihood of default; and/or
 - 120.4 material profits or losses, and asset realisations;
- up to the date of issue of the financial statements, and the date of the audit report.

Compliance with auditing and review standards

Auditor

121. An auditor has an obligation to comply with the auditing pronouncements issued by the IRBA, which include the International Standards on Auditing (ISAs).
122. Without detracting from the matters to be considered by an auditor as dealt with above, and without detracting from any of the ISAs, in the conduct of an audit of a company whose liabilities exceed its assets, an auditor:
- 122.1 considers whether to accept or continue the audit engagement considering *inter alia* the additional audit risk that may arise⁶⁵;

⁶³ If legal advice is sought, an auditor complies with ISA 620.

⁶⁴ Also refer to ISA 570, *Going Concern*, that addresses *inter alia* additional procedures when events and conditions are identified that may cast significant doubt on the entity's ability to continue as a going concern.

⁶⁵ ISQC 1 and ISA 220.

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

- 122.2 performs the audit with professional scepticism, including in relation to representations regarding, and responses to, the factual insolvency, and is alert to conditions which may indicate possible misstatement due to error or fraud, and with a critical assessment of evidence⁶⁶;
- 122.3 prepares documentation that provides a sufficient and appropriate record of the basis for auditor's reports and that evidences that the audit was performed in accordance with the auditing standards with regard to the circumstances⁶⁷;
- 122.4 considers whether sufficient appropriate audit evidence has been obtained regarding compliance with laws and regulations relative to the factual insolvency and related issues, which may have an effect on the determination of material amounts and disclosures in the financial statements or which may be fundamental to the operating aspects of the business (including the company's ability to continue in business), and considers the appropriate response to any identified or suspected non-compliance identified during the audit⁶⁸;
- 122.5 considers whether there has been appropriate communication with those charged with governance to understand the effect of factual insolvency on the audit and to obtain information relevant to the audit⁶⁹;
- 122.6 considers any effect on the planning of the audit so that appropriate attention is directed towards the factual solvency issue and anticipated risks of material misstatement flowing therefrom^{70, 71};
- 122.7 obtains sufficient appropriate audit evidence regarding the risk flowing from the factual insolvency and the company's responses thereto⁷²;
- 122.8 obtains sufficient appropriate audit evidence regarding the responses to the factual insolvency to be able to draw reasonable conclusions on which to base the auditor's opinion⁷³;
- 122.9 considers the completeness of litigation and claims involving the company which may be linked to, or arise from, factual insolvency (such as a breach of debt covenants)⁷⁴;
- 122.10 considers events occurring between the date of the financial statements and the date of the auditor's report that may affect the financial statements and the matters considered in relation to factual insolvency⁷⁵;

⁶⁶ ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, ISA 240, *The Auditor's Responsibilities relating to Fraud in an Audit of Financial Statements*.

⁶⁷ ISA 230, *Audit Documentation*.

⁶⁸ ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*.

⁶⁹ ISA 260, *Communication with those charged with Governance*.

⁷⁰ ISA 300, *Planning an Audit of Financial Statements*.

⁷¹ ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*.

⁷² ISA 330, *The Auditor's Responses to Assessed Risks* and ISA 570.

⁷³ ISA 500, *Audit Evidence*.

⁷⁴ ISA 501, *Audit Evidence – Specific Considerations for Selected Items*.

⁷⁵ ISA 560, *Subsequent Events*.

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

- 122.11 considers the appropriateness of management's use of the going concern assumption and the preparation of the financial statements and whether there is material uncertainty about the company's ability to continue as a going concern⁷⁶;
- 122.12 considers that a net liability (or net current liability) position may cast doubt about the going concern assumption – and may trigger adverse consequences for the company if this position breaches debt covenants⁷⁷;
- 122.13 requests written representations from management with appropriate responsibility for the financial statements and knowledge of the matters concerned, *inter alia* specific to factual insolvency and the responses thereto⁷⁸;
- 122.14 if the company is part of a group, considers the effects of the company factual insolvency and the responses thereto on the group financial statements and the consolidation process⁷⁹;
- 122.15 considers whether legal advice should be sought regarding the factual insolvency and the responses thereto, and conducts appropriate procedures to determine whether that advice (if sought) is adequate for the auditor's purpose⁸⁰;
- 122.16 evaluates the effect of uncorrected misstatements of the financial statements that may be related to, or that may be a result of the company's factual insolvency (the effect or possible effect on account balances and disclosures, and the financial statements as a whole)⁸¹;
- 122.17 considers the effect of the factual insolvency and related issues on the audit report⁸²; and
- 122.18 considers whether the circumstances should be dealt with in the Key Audit Matters section in the audit report⁸³.

Independent reviewer

123. An independent review is conducted in compliance with ISRE 2400 (Revised). This requires *inter alia* that the review be planned and performed with professional scepticism and competence appropriate to the circumstances. Without detracting from the requirements of ISRE 2400 (Revised), in the context of a company which is factually insolvent, considerations include:

⁷⁶ ISA 570, *Going Concern*.

⁷⁷ ISA 570, *Going Concern*.

⁷⁸ ISA 580, *Written Representations*.

⁷⁹ ISA 600, *Special Considerations – Audits of Group Financial Statements*

⁸⁰ ISA 620, *Using the Work of an Auditor's Expert*.

⁸¹ ISA 450, *Evaluation of Misstatements Identified during the Audit*.

⁸² ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*; ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*; ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*; ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*; ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*.

⁸³ ISA 701.

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

- 123.1 the acceptance or continuance of the review engagement regarding *inter alia* the additional risks that may arise;
- 123.2 indications of fraud or non-compliance with laws or regulations arising from the factual insolvency;
- 123.3 whether there has been appropriate communication with those charged with governance regarding the company's factual insolvency;
- 123.4 events occurring between the date of the financial statements and the date of the independent reviewer's report that may affect the financial statements and the matters considered in relation to factual insolvency;
- 123.5 the company's ability to continue as a going concern (and the doubt that may be raised from factual insolvency);
- 123.6 whether legal advice should be sought regarding the effect of the factual insolvency and the company's responses thereto;
- 123.7 requesting written representations from management with appropriate responsibility for the financial statements and knowledge of the matters concerned, *inter alia* specific to factual insolvency and the responses thereto;
- 123.8 whether sufficient appropriate evidence has been obtained in relation to the effect of, and responses to, factual insolvency – to form a conclusion on the financial statements; and
- 123.9 evaluating the effect of uncorrected misstatements of the financial statements that may be related to, or that may be a result of the company's factual insolvency (the effect or possible effect on account balances and disclosures, and the financial statements as a whole); and
- 123.10 the effect of factual insolvency and any uncertainty, on the independent reviewer's report on the financial statements.

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

Appendix 1

Appendix 1

Illustrative communications in terms of Companies Regulation 29

1.1 Illustrative report to Commission in terms of Regulation 29(6)

[Auditors Name]

[Address]

[Practice Number]

To Companies and Intellectual Property Commission
PO Box 429
Pretoria
0001

The dti Campus
(Block F) 77 Meintjies Street
Sunnyside
Pretoria

Email: independentreview@cipc.co.za *[The CIPC requires that such reports be sent by email]*

Dear Sirs

REPORT IN TERMS OF COMPANIES REGULATION 29(6)(a)

Company: *[Name of the company]* *[Company No.]*

1. *[Name of auditor]* is the independent reviewer of the annual financial statements of _____ for the year ended _____ in terms of Regulation 29.
2. We are satisfied or have reason to believe that a reportable irregularity as contemplated in Regulation 29(1)(b)(iii) has taken place, or is taking place, in respect of the company.
3. The particulars of the reporting irregularity are the following:
As at [insert appropriate date] the company was trading under insolvent circumstances in that its liabilities exceeded its assets, fairly valued.
4. A copy of our letter to the directors of the company regard to the above is enclosed.

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

Appendix 1

[Although Regulation 29(7) provides that the notification to the board must occur within 3 days of the report to the Commission, the Commission's Notice 7 of 2016 requires a copy of the letter to the board to be sent to the Commission with the first report].

Yours faithfully

[Name of the firm/individual]

[Practitioner]

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

Appendix 1

1.2 Illustrative notification to board of directors in terms of Regulation 29(7)

[Auditors Name]

[Address]

[Practice Number]

To the directors of the company

Dear Sirs

REPORT IN TERMS OF COMPANIES REGULATION 29

Company: *[Name of the company] [Company No.]*

1. In accordance with Companies Regulation 29(6), we have reported a reportable irregularity to the Companies and Intellectual Property Commission.
2. A copy of our letter to the Commission is annexed hereto.
3. We also enclose herewith a copy of Companies Regulation 29.
4. Please contact us urgently to discuss the report in order that the board of the company may have an opportunity to make representations in regard thereto.
5. In terms of the Regulations, we are obliged to send another report to the Commission not later than *20 days from the date of the report in terms of Regulation 29(b) referred to above*, which second report must include the matters referred to in Regulation 29(8)(c), the contents of which Regulation is evident from the attached.

Yours faithfully

[Name of the firm/individual]

[Practitioner]

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

Appendix 1

1.3 Illustrative second report Commission, in terms of Regulation 29(8)

[Auditors Name]

[Address]

[Practice Number]

To Companies and Intellectual Property Commission

Email: independentreview@cipc.co.za [*The CIPC requires that such reports be sent by email*]

Dear Sirs

REPORT IN TERMS OF COMPANIES REGULATION 29(8)

1. We refer to our report to the Commission dated _____ sent in terms of Regulation 29(6). This is the second report, as required by Regulation 29(8).
2. We have discussed the report with the board of the company and provided them with an opportunity to make representations in regard thereto.
3. In our opinion as independent reviewer:

No reportable irregularity has taken place or is taking place in the manner as contemplated by the Companies Regulations. In support of this statement the following particulars and information are provided:

alternatively:

The suspected reportable irregularity is no longer taking place and adequate steps have been taken for the prevention or recovery of any loss as a result thereof. In support of this statement the following particulars and information are provided:

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

Appendix 1

alternatively:

The reportable irregularity is continuing. In support of this statement the following particulars and information are provided:

[Delete inapplicable paragraphs]

4. *[If reportable irregularity continues]* The contact details for the company:

Names of directors
Telephone numbers
Email addresses
Postal address

Yours faithfully

[Name of the firm/individual]

[Practitioner]

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

Appendix 2

Appendix 2

Illustrative communications in terms of section 45 of the Auditing Profession Act

2.1 Illustrative first report to the IRBA in terms of s45(1) of the APA

<Firm letterhead>

<Date>

The Director: Legal
Independent Regulatory Board for Auditors
PO Box 8237
Greenstone
1616

Building 2
Greenstone Hill Office Park
Emerald Boulevard
Modderfontein
1609

Email: RIs@irba.co.za

Telephone: 087 940 8800

Dear Madam

FIRST REPORT: REPORTABLE IRREGULARITY

Name of entity audited: <Insert>

Registration number of entity: <Insert>

My firm has been engaged by <insert name of audited entity> to:

[Delete if not applicable]

1. Audit the company's annual financial statements.
2. Audit the entity's financial statements with the objective of expressing an opinion as to their fairness with an identified financial reporting framework.
3. Audit financial and other information, prepared in accordance with suitable criteria, with the objective of expressing an opinion on the financial and other information.

I have reason to believe that a reportable irregularity, as defined in the APA, has taken, or is taking place. I am not able to make a legal determination in respect of the suspected unlawful

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

Appendix 2

act or omission, but have exercised professional judgement, based on the evidence or information which has come to my attention, including undertaking further investigations of information as were considered necessary in the circumstances.

Particulars of the reportable irregularity are:

The entity appears to be trading recklessly / with intent to defraud creditors / fraudulently [*delete inapplicable*] as it is continuing to incur debts when there does not appear to be a reasonable prospect that the creditors will be paid when due / when it is known that the creditors will not be paid [*delete as necessary*].

This conduct is unlawful in terms of section 22 of the Companies Act.

The conduct constitutes a reportable irregularity in terms of one or more of the criteria in the definition of reportable irregularity in the Act.

[and/or]

The company has failed to issue the required notice in terms of Section 129(7) despite the fact that as at _____, the company was factually insolvent and had not voluntarily begun business rescue proceedings. [*Delete as necessary*]

This omission is unlawful in terms of Section 129(7) of the Companies Act. [*Delete as necessary*]

The conduct constitutes a reportable irregularity in terms of one or more of the criteria in the definition of reportable irregularity in the Act.

Please acknowledge receipt of this report.

Yours faithfully

<Signature of registered auditor>

<Name of registered auditor>

Registered Auditor

<Registered Auditor's IRBA registration number>

<Registered Auditor's direct email address>

<Registered Auditor's direct telephone number>

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

Appendix 2

2.2 Illustrative notification to members of the management board in terms of s45(2) of the APA (to be sent within 3 days of sending the s45(1) report to the IRBA)

<Firm letterhead>

<Date>

Members of the management board

<Name of entity>

<Address>

Dear Members

REPORTABLE IRREGULARITY

This letter is issued in accordance with the requirements of the Auditing Profession Act, No. 26 of 2005, (the APA), section 45 – *Duty to report on irregularities*.

The APA defines a reportable irregularity as any unlawful act or omission committed by any person responsible for the management of an entity, which -

- (a) has caused or is likely to cause material financial loss to the entity or to any partner, member, shareholder, creditor or investor of the entity in respect of his, her or its dealings with the entity; or
- (b) is fraudulent or amounts to theft; or
- (c) represents a material breach of any fiduciary duty owed by such person to the entity or any partner, member, shareholder, creditor or investor of the entity under any law applying to the entity or the conduct or management thereof.

I have reason to believe that a reportable irregularity has taken or is taking place and, as required by the APA, I have reported particulars of the irregularity to the Independent Regulatory Board for Auditors (IRBA) in a written report dated <insert date> a copy of which is attached. As indicated in that letter, I am not able to make a legal determination in respect of the suspected unlawful act or omission, but have exercised professional judgement, based on the evidence or information which has come to my attention, including undertaking further investigations of information as were considered necessary in the circumstances.

The APA requires me as soon as is reasonably possible, but no later than 30 days from the date of the individual auditor's report which was forwarded to the IRBA, to send another report to the IRBA which must include:

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

Appendix 2

1. A statement that I am of the opinion that:

- (1) no reportable irregularity is taking place; or
- (2) the suspected reportable irregularity is no longer taking place and that adequate steps have been taken for the prevention or recovery of any loss as a result thereof, if relevant; or
- (3) the reportable irregularity is continuing.]

2. Detailed particulars and information supporting the statement above.

Please note that, where the reportable irregularity is continuing, the IRBA has a responsibility to notify any appropriate regulator in writing of the details of the reportable irregularity and to provide it with a copy of my report.

I invite you to discuss my report to the IRBA, at a meeting to be arranged as soon as possible, and at that meeting I will afford you the opportunity to make representations in respect of my report.

Please acknowledge receipt of this report.

Yours faithfully

<Signature of registered auditor>

<Name of registered auditor>

Registered Auditor

<Registered Auditor's IRBA registration number>

<Registered Auditor's direct email address>

<Registered Auditor's direct telephone number>

[Considering its importance, the auditor should consider whether the letter should, in addition to other forms of delivery, be hand-delivered to the entity with written acknowledgement of receipt obtained on delivery]

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

Appendix 2

2.3 Illustrative second report to the IRBA in terms of s45(3) of the APA

<Firm letterhead>

<Date>

The Director: Legal
Independent Regulatory Board for Auditors
PO Box 8237
Greenstone
1616

Building 2
Greenstone Hill Office Park
Emerald Boulevard
Modderfontein
1609

Email: RIs@irba.co.za

Telephone: 087 940 8800

Dear Madam

SECOND REPORT: REPORTABLE IRREGULARITY

Name of entity audited: <Insert>

Registration number of entity: <Insert>

I refer to my report of <insert date of initial report>.

I have included a copy of the written notice which was sent together with the abovementioned report to the members of the management board of the entity within three days of my having sent the first written report to you.

I have discussed that report with the members of the management board and have afforded them an opportunity to make representations in respect of the report. I have also undertaken such further investigations as I considered necessary.

I have included written representations made by members of the management board of the entity in respect of the report. [Delete if not applicable]

[OR]

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

Appendix 2

Although I have taken all reasonable measures to communicate with the management board in respect of the suspected reportable irregularity, the board has failed or declined to engage in discussions with me. <However, I have undertaken such further investigations as I considered necessary. / I have also been unable to undertake such further investigations as I considered necessary>. [Delete whichever sentence is not applicable].

I report that in my opinion <no reportable irregularity has taken place or is taking place / the reportable irregularity is no longer taking place and that adequate steps have been taken for the prevention or recovery of any loss as a result thereof, if relevant / the reportable irregularity is continuing>. [Delete whichever is not applicable]

Details and information in support of my statement above are as follows:

<Provide details and information>

Contact details of the entity:

- <Insert title of person that can be contacted e.g. the CFO>
- <Insert name of contact person>
- <Insert telephone number of contact person>
- <Insert email address of contact person>

Please acknowledge receipt of this report.

Yours faithfully

<Signature of registered auditor>

<Name of registered auditor>

Registered Auditor

<Registered Auditor's IRBA registration number>

<Registered Auditor's direct email address>

<Registered Auditor's direct telephone number>

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

Appendix 3

Appendix 3

Illustrative subordination agreement

[This illustrative subordination agreement is merely a broad guide to the potential format of a subordination agreement. It is not intended to cover every circumstance. A subordination agreement should be specific to the circumstances of the company and the subordinating creditor. The legal and tax consequences of such an agreement need to be considered by the parties to the agreement.]

The wording of this illustrative subordination agreement is intended to apply solely in the case of subordination due to the factual insolvency and/or financial difficulties of the debtor company. For other circumstances, the wording may be materially different.]

AGREEMENT

between

X (PTY) LIMITED (“X”)

and

Y (PTY) Limited (“Y”)

1. X has agreed to assist Y by subordinating its claims against Y in favour, and for the benefit, of other creditors of Y, subject to the terms and conditions below.
2. As at _____ [date] X was owed approximately R_____ (_____ Rand) by Y for monies lent or advanced / goods supplied / services rendered / interest.
3. X agrees that it will not demand or accept payment of any amount due to it until such time as Y’s assets, fairly valued, exceed its liabilities.
4. In the event of a liquidation of Y, X undertakes that it will not prove, or tender to prove, a claim in respect of its subordinated claim, which would reduce or diminish any liquidation dividend payable to other creditors of Y (whether present or future).
5. This agreement shall remain in force and effect for so long as the liabilities of Y exceed its assets, fairly valued.
6. The agreement shall lapse upon the date that the assets of Y, fairly valued, exceed its liabilities, and shall not, except by further agreement in writing, be reinstated if thereafter the liabilities of Y once again exceed its assets.

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

Appendix 3

7. The asset and liability position for purposes of this agreement shall be based on the audited annual financial statements, or written assurance from the auditors to Y regarding the financial position at any other date.
8. X warrants that:
 - 8.1 it is empowered to enter into this subordination agreement;
 - 8.2 its claims against Y have not been ceded to any third party, and no third party has an interest in those claims;
 - 8.3 it is itself factually solvent, in that its assets, fairly valued exceed its liabilities as at the date hereof, and the subordination will not render X factually insolvent.
9. It is the intention of the parties that this agreement constitutes a contract for the benefit of other creditors of Y, both present and future, and that the benefit shall therefore be capable of express or implied acceptance by all or any of such creditors, who may then enforce any terms of this agreement.
10. The amounts owing by Y to X shall be interest free until _____ / shall bear interest at the following rates _____ % (*delete where irrelevant*). Any interest accumulated on the amount owing by Y to X shall be subject to this subordination agreement.
11. Should any amount be paid to X by Y inadvertently or deliberately during the currency of this agreement, then X agrees that it will immediately refund such amount to Y.
12. X and Y undertake that in the event of any intended cancellation or variation of this agreement in any respect, each of them will, as a condition precedent to coming into force and effect of any cancellation or variation, advise the auditor of Y in writing of such intended cancellation or variation.
13. The costs of, and incidental to, the preparation of this agreement shall be borne and paid for by Y.

SIGNED BY X at _____ on this _____ day of _____

Director

(Who warrants his authority to act for X,
and is duly authorised by a resolution of
the directors, a copy of which is attached)

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

Appendix 3

SIGNED BY Y at _____ on this _____ day of _____

Director

(Who warrants his authority to act for Y,
and is duly authorised by a resolution of
the directors, a copy of which is attached)

NOTES

1. Where the subordination is only for part of a claim, this must be made explicit in clause 1 (as in the example below) and all references to the claims of X in the clauses that follow should be amended to refer to the "*the subordinated claim*"

... subordinating *so much of its claims against Y that is equal to the excess of Y's liabilities over its assets, fairly valued ("the subordinated claim")*, in favour of ..."
2. Where the subordinating creditor is a natural person, it may be desirable to stipulate that the subordination is binding on that person's heirs and estate.
3. Where more than one creditor has subordinated any amount owing to it by the debtor, appropriate legal advice should be taken, and *inter alia* the following matters should be taken into account into the drafting of subordination agreements in those circumstances:
 - 3.1 The other subordinating creditors should be excluded from the benefits flowing from the subordination.
 - 3.2 It may be necessary to provide for an order of preference in the event of insolvency of the debtor.
4. The subordination agreements should contain a clause requiring notification by the debtor to the subordinating creditor if any further subordination agreements are entered into by the debtor with any other creditor, or if any cancellation or variations are made in relation to other subordination agreements.