



Accounting and Auditing Guide

TRADING WHILST FACTUALLY INSOLVENT

ERRATA: June 2009

Since this Guide was issued in July 1999 and revised in August 2007, the Public Accountants' and Auditors' Act has been superseded by the Auditing Profession Act which contains significant changes relating to reportable irregularities and has rendered certain sections of the Guide outdated. Furthermore, the Companies Act, which might come into effect in July 2010 (*i.e. the Act comes into operation on a date still to be fixed by the President by proclamation in the Gazette, which may not be earlier than one year following the date on which the President assented to this Act.*) would materially affect the issues addressed in this Guide; the Guide, therefore, requires revision to ensure compliance with the provisions of the Companies Act no. 71 of 2008, the Auditing Profession Act no. 26 of 2005 and current auditing standards.

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Notice to Readers

Although Accounting and Auditing Guides do not have the authority of statements of South African Auditing Standards, in the event of significant deviation from the guidance given, and should the auditor's actions be questioned, the auditor may be required to demonstrate that such deviation was justified.

Every effort is made to ensure that the advice given in this guide is correct. Nevertheless that advice is given purely as guidance to members of SAICA to assist them with particular problems relating to the subject matter of the guide and SAICA will have no responsibility to any person for any claim of any nature whatsoever which may arise out of or relate to the contents of this guide.

Introduction

- .01 Section 45 of the Auditing Profession Act No. 26 of 2005, imposes a statutory duty on a registered auditor of an entity, who is satisfied or has reason to believe that a reportable irregularity has taken place or is taking place in respect of that entity, to send a written report to the Independent Regulatory Board for Auditors (IRBA).

The particulars of the report and the manner in which it is submitted to the relevant parties must comply with the prescribed section of the Auditing Profession Act.

Scope of the guide

- .02 The change in the wording Material Irregularity (used in the previous act) to Reportable Irregularity has increased the scope of circumstances that places a duty on auditors to report under Section 45.

It is beyond the scope of this guide to attempt a discussion of all such circumstances.

- .03 The two forms of insolvency that have been recognised by our law for many years are **factual insolvency**, where the undertaking's liabilities exceed its assets, and **commercial insolvency**, that is a state of illiquidity where an undertaking is unable to pay its debts even though its assets may exceed its liabilities. Factual insolvency does not necessarily mean that a going concern problem exists but commercial insolvency is likely to indicate that a going concern problem does exist. This guide only deals with factual insolvency. In the event that there is commercial insolvency, the guidance in the statement on going concern should be followed.

- .04 This guide is concerned with the situation where an auditor's client continues to trade in factual insolvency when its liabilities exceed its assets fairly valued. Hence, it deals particularly with irregularities that are likely to take place in that situation; with the auditor's compliance with his/her duty to report thereon; and with the steps that the client might take to satisfy the auditor that no irregularity is taking place. It also deals in some detail with the question of whether or not the concept of trading in such a situation is affected by agreements with certain creditors to "subordinate" or "backrank" their claims.

Irregularities likely to occur if an undertaking is trading whilst factually insolvent

- .05 The mere fact that a client undertaking is trading whilst factually insolvent is not regarded as an "irregularity" contemplated in Section 45. It does not constitute an offence nor does it infringe any statutory or common law rule or necessarily amount to breach of trust or negligence on the part of management. Further, the fact that an undertaking is factually insolvent does not necessarily mean that the incurring of further debts would constitute fraudulent or reckless conduct (*Ex parte de Villiers & Another NNO: In re Carbon Developments (Proprietary) Limited (in liquidation)* 1993(1) SA 493(AD)). However, in the light of the recent judgment in *Philotex (Proprietary) Limited and Others vs Snyman and Others* 1998(2) SA 138 (SCA) these statements should be regarded with some caution and should not be construed as giving carte blanche to trading while commercially or factually insolvent.
- .06 Despite what is said in paragraph .05, trading while an undertaking is factually insolvent creates a situation in which certain irregularities may readily take place and, in turn, may give rise to the duty to report. As will appear in more detail in paragraphs .08 to .19, the irregularities likely to occur are fraud or recklessness in the carrying on of the business in those circumstances.
- .07 Common law fraud can be committed by any client undertaking and its officers or employees, whether or not it is a company. On the other hand, Section 424 of the Companies Act, 1973 and its provisions in regard to "intent to defraud" and "trading recklessly" are obviously only relevant where the client is a legal persona to which the Companies Act, 1973 is applicable.

Fraud

Common law fraud

- .08 The crime of fraud includes unlawfully making, with intent to defraud, a misrepresentation that causes actual prejudice or is potentially prejudicial to another.
- .09 Directors that, for instance, order goods for the company make an implied representation to the seller that they believe the company will be able to pay its debts when they fall due. Although they do not imply that the company is factually solvent, if they know that there is no likelihood of payment and no means of payment, they commit fraud. The same is true if they do not really believe that the company will be able to pay, or if they are recklessly careless whether there is any chance of the debt being able to be paid or not (*Orkin Brothers Ltd v. Bell* 1921 TPD 92; *Ruto Flour Mills (Pty) Ltd v. Adelson* 1959(4) SA 120 (T); *R v. Myers* 1948(1) SA 375 (A), *Ex parte de Villiers & Another NNO: In re Carbon Developments (Proprietary) Limited (in liquidation)* 1993(1) SA 493(AD)). In the Carbon Developments case it was found on the facts (which included a finding that there was no lack of good faith) that there was no material irregularity. However, the fact that persons act in good faith does not necessarily imply that there can be no irregularity - they can act recklessly while acting in good faith, and that, in certain circumstances, could amount to an irregularity. The judgment in the *Philotex* matter emphasises that a director's honest belief as to the prospects of payment when due, while critical in a case of alleged fraudulent trading, is not in itself the determinant of whether he was reckless. It will be irrelevant if a reasonable person of business in the same circumstances would not have held that belief.
- .10 There is a clear danger of criminal fraud where a company is trading whilst factually insolvent. There can be no doubt at all that fraud is an "irregularity". If the auditor is satisfied or has reason to believe that an irregularity has taken or is taking place, which has resulted in material financial loss OR amounts to fraud or theft OR represents a material breach of any fiduciary duty, as contemplated in Section 45, the auditor's duty to report is established.
- .11 It should be mentioned in passing that fraud is a delict as well as a crime. For this reason the directors responsible for the misrepresentation may incur personal liability to the defrauded third party. (*Orkin Brothers Ltd v. Bell* 1921 TPD 92; *Ruto Flour Mills (Pty) Ltd v. Adelson* 1959(4) SA 120 (T); *Alex Murray (Pty) Ltd v. Perry* 1961(2) SA 154(N); *Milne NO v. Harilal* 1961(1) SA 799 (D)).

"Intent to defraud" under Section 424 of the Companies Act

- .12 Directors and others who knowingly carry on a company's business "with the intent to defraud" creditors of the company or creditors of any other person or "for any fraudulent purpose", are guilty of an offence in terms of Subsection 424(3) of the Companies Act, 1973.
- .13 If a company continues to carry on business and to incur debts when there is, to the knowledge of the directors, no reasonable prospect of the creditors ever receiving payment of those debts, it is, in general, a proper inference that the company is carrying on business with "intent to defraud". (*S v. Harper* 1981(2) SA 638 (D) at 681; *R v. Wax* 1957(4) SA 399 (C); *Dorklerk Investments (Pty) Ltd v. Bhyat* 1980(1) SA 443 (W); *Re William C Leitch Brothers Ltd* [1932] 2 Ch 71). Intent to defraud includes the situation where on only one occasion the company incurs a debt that it knows it will be unable to pay (*Gordon and Rennie v Standard Merchant Bank Ltd* 1984 (2) 519 (C)).
- .14 Again, there can be no doubt that this statutory offence based on fraud constitutes an "irregularity" that requires a written report if the other considerations mentioned in Section 45 are present.

Recklessness under Section 424 of the Companies Act

- .15 A director or other person that is knowingly a party to the carrying on of a company's business "recklessly", is guilty of an offence in terms of Subsection 424(3) of the Companies Act, 1973. It is clear that proof of gross negligence is sufficient to obtain a conviction (*Shawinigan vs Vokins & Co Limited* [1961]3 ALL ER 396(QB) at 403; *S v. Goertz* 1980(1) SA 269 (C) at 272; *Fisheries Development Corporation of SA Ltd v. Jorgensen* 1980(4) SA 156 (W) at 170).
- .16 The criteria for gross negligence in the conduct of directors and other relevant persons concerning the company's business are:
- the scope of operations of the company concerned,
 - the role, functions and powers of the directors,
 - the amount of the debt,
 - the extent of the company's financial difficulties,
 - the prospects, if any, of recovery,
 - other factors particular to the claim involved, and
 - the extent to which a director has departed from the standards of a reasonable man in regard thereto and thereby evidenced a lack of genuine concern for the prosperity of the company (*Fisheries Development Corporation of SA Ltd v. Jorgensen* 1980(4) SA 156 (W) 170 B-C; *S v Harper* 1981(2) SA 638 (D) 681 A-B) or has assumed an attitude or state of mind characterised by "an entire failure to give consideration to the consequences of one's actions, in other words, an attitude of reckless disregard of such consequences". (See the *Philotex* case) . Certain cases illustrate that convictions for this offence are by no means impossible to obtain (*S v. Goertz* 1980(1) SA 269 (C); *S v. Parsons* 1980(1) SA 397 (D)). A director's conduct could be held to be reckless if he/she fails to exercise proper control over the company's management at a time when he/she should have been aware of mismanagement (*Cronje NO v Stone* 1985 (3) SA 597 (T)) or if the company continues to carry on business and to incur debts when, in the opinion of reasonable businessmen, standing in the shoes of the directors, there would be no reasonable prospect of the creditors receiving payment when due (see the *Philotex* matter at page 145).
- .17 There can be no doubt that:
- where a company is factually insolvent, there is a danger of it being found that its business is being carried on recklessly (which includes gross negligence),
 - recklessly carrying on a company's business as contemplated in Subsection 424(3) constitutes an "irregularity" in terms of Section 45. If all other criteria of the definition of reportable irregularity has been satisfied, the auditor has the duty to report, and
 - this form of irregularity, which for practical purposes consists of gross negligence, is, from the auditor's point of view, the most important one to consider where the client company is trading while it is factually insolvent.
- .18 The auditor's duty to report in terms of Section 45 arises from that Section in the Auditing Profession Act and not from Section 424 of the Companies Act or any other legal rule. Other than complying with Section 45, it is not the auditor's function to ensure that criminal prosecutions against the client or its directors are instituted. It is worth repeating that any irregularity referred to above is, in itself, insufficient to establish the duty to report. The duty only arises if all the requirements of the definition of Reportable Irregularity under Section 1 of the Auditing Profession Act are present.
- .19 Other factors which might be considered relevant in the context of an entity's trading while factually insolvent and which are highlighted in the *Philotex* judgment are:
- where a group of companies is involved, the extent to which a company is dependent on support by its holding company (page 159),

- where a group of companies is involved, the extent to which the board of a company is independent of the board of its financial supporter, or merely an extension of the controlling group (page 179),
- in determining whether a company can continue to trade and pay its debts with group support, clarity should be obtained on the following basic questions before credit is incurred:
 - What financial support will the group provide?
 - For how long will that support be available? (page 175),
- where letters of comfort are obtained their terms must be scrutinised to establish whether they guarantee payment of the debtor company's debts or fall short of a guarantee (page 156),
- the litmus test of factual solvency of a company is the shareholders' interest in the company (page 173),
- revaluation of assets, especially when they are revalued by the directors, should be accepted with caution in determining the solvency or otherwise of an entity (page 174), and
- an important consideration in evaluating the viability of a business is its profit or loss after the charging of interest (pages 176 and 183).

Procedure where the auditor has to report

- .20 Where the client is trading while it is factually insolvent, the auditor should apply his/her mind to the considerations discussed in paragraphs .02 to .19. If in the auditor's reasonable professional judgment he/she has the duty to act, he/she must, **without delay**, send a written report to the IRBA. The report must give particulars of the reportable irregularities and must include such information that the auditor considers appropriate. The auditor must, within 3 days of sending the above report, notify the members of the management board of the entity in writing of the sending of the above report.

An example of the notification is provided in Annexure "A".

The need for further investigation

- .21 The use of the words "**without delay**" in regard to the report required by Section 45 is clearly designed to protect the undertaking and its members and creditors. Any delay on the part of the auditor could result in an increase in the quantum of financial loss and in these circumstances the auditor could be in breach of his/her statutory duty.
- .22 For the purpose of determining whether or not any irregularity contemplated by the section has taken place, an auditor may carry out such investigation as he/she may deem fit.
- .23 Where the auditor undertakes such an investigation, it is preferable to issue such a report as soon as the main facts are known or believed to exist rather than to delay the issue of the report..

Steps to satisfy the auditor

- .24 Where the auditor seeks to place reliance on the outcome of an internal investigation by the client, the auditor must guard against the risk of being unduly delayed in drawing his or her own conclusion. Although not provided for in the section, there is no reason why a further report supplemental to the original should not be submitted if further relevant information becomes known or believed.
- .25 Thus, the auditor has a duty to send the second report to the IRBA whether or not the irregularity has been resolved.
- .26 Again, the auditor must exercise reasonable professional judgment in deciding whether or not, in all the circumstances of the case, he/she is satisfied that the steps taken are adequate for the prevention or recovery of the financial loss.

.27 These steps could include any one or more of the following:

- The provision of proof that the company can be reasonably expected to make such profits that the situation of factual insolvency will be reversed within a reasonable period.
- The conversion of loan moneys to share capital or the injection of fresh capital.
- The provision of an acceptable guarantee for payment of all liabilities.
- The provision of a "subordination" or "backranking" agreement, is more fully described in paragraphs .28 - .53.
- An application for a judicial management order.
- An application for a winding-up order.

Subordination agreements

.28 It often happens that there is placed before the auditor, in support of a contention that there is no irregularity or likelihood of financial loss to the undertaking or to its members or creditors, a document that is referred to as a "subordination" or "backranking" agreement.

.29 This is an agreement by a substantial creditor or substantial creditors (usually, but not necessarily, shareholders in the client company) whereby they bind themselves either indefinitely, or for a limited period, and either unconditionally or subject to specific conditions, not to claim or accept payment of the amounts owing to them until the happening of a particular event, for example, the restoration of the finances of the undertaking to a position of solvency, or the payment of all other creditors. Often private companies embark on trading with a nominal paid up share capital and finance business operations through loans from members. Frequently these loans are treated as if they were part of the capital of the company (*Ex parte de Villiers & Another NNO: In re Carbon Developments (Proprietary) Limited (in liquidation)* 1993(1) SA 493(AD)).

.30 Subordination agreements may take many forms. They may be bilateral, that is, between the undertaking and creditor. They may be multilateral and include other creditors as parties. They may be in the form of a *stipulatio alteri*, that is, for the benefit of other and future creditors and open to acceptance by them. The subordination agreement may be a term of the loan or it may be a collateral agreement entered into some time after the making of the loan.

.31 The legal character and effect of such an agreement were described as follows by Goldstone J.A. in the Carbon Developments case. "Save possibly in exceptional cases, the terms of a subordination agreement will have the following legal effect: the debt comes into existence or continues to exist (as the case may be), but its enforceability is made subject to the fulfillment of a condition. Usually the condition is that the creditor may enforce the debt only if and when the debtor is factually solvent, excluding the subordinated debt. The valuation of the assets would normally be on a going concern basis, on the assumption that the undertaking will continue to trade." It cannot, save in terms of conditions that it contains, be withdrawn or cancelled without the consent of the undertaking.

.32 As in the case of other contracts for the benefit of third parties, the rights of the third party do not arise until it has accepted the benefit. If, therefore, the agreement was cancelled between the undertaking and the creditor before the third parties (namely, the other creditors), had accepted the benefit, they could not enforce the agreement. It might be argued that a creditor who gives credit on the strength of financial statements, which make reference to the subordination, has accepted the benefit thereof and cannot be defeated by the cancellation of the subordination agreement that may be regarded as a reckless act.

.33 As the effect of the subordination agreement is likely to be legally decided only when the undertaking is in liquidation, regard must be had to the judgment in the Carbon Developments appeal case to the effect that where there is a subordinated debt, there is no question of a rearrangement of the statutory ranking of

claims of the creditors, who are to be paid out of the unencumbered assets of the company. The position would be no different in principle from the case of a creditor that, for whatever reason, decided not to prove a claim with the liquidator. Indeed, where there is a probability of a contribution being levied upon creditors, it is a common occurrence for creditors to refrain from proving a claim.

- .34 Subordinating a claim, therefore, cannot be categorised as interfering with the *pari passu* payment of creditors by the liquidator when following the provisions of the Insolvency Act. In the opinion of the full bench of the Appellate Division, the liquidator of an undertaking would be obliged to have regard to a subordination agreement that was valid and in force as at the date of winding up.
- .35 Subject to what is said in paragraph .05 the fact that the liabilities of an undertaking exceed its assets does not necessarily mean that the incurring of further debts would constitute fraudulent or reckless conduct. In that context, the existence and terms of a subordination agreement would be material and relevant in deciding whether or not the persons conducting such undertaking incurred debts with the reasonable expectation of their being paid in the ordinary course of business. The fact that a major creditor has subordinated its claim, and to that extent created a *moratorium* for the benefit of other creditors, is obviously relevant in determining the subjective state of mind of the undertaking or those conducting its business.
- .36 On the above analysis of its legal effect, the auditor should recognise that a subordination agreement represents a valuable concession to the undertaking to which it is given, and one that the auditor is entitled, if not obliged, to take into account in the discharge of his/her functions under Section 45. However, before the auditor regards such an agreement as being relevant to the decision that any reportable irregularity arising from the continuance of trade whilst factually insolvent is not one that is "likely" to cause financial loss, the auditor must have regard to the following aspects:
- The fact that a subordination agreement has been entered into is only one element to be taken into account by the auditor and may not be the complete answer in addressing the problem of trading in insolvent circumstances. In particular, it must be remembered that a subordination agreement does not have any effect on the liquidity or otherwise of the entity.
 - The intention and ability of the creditor to comply with the terms of the subordination agreement.
 - Whether or not the creditor is legally entitled to subordinate the amount owing, for example, the creditor may have pledged or ceded the amount owing as security for other liabilities, for example, bank overdraft facilities.
 - That the subordination agreement is a written one signed on behalf of the creditor concerned with due authority, and duly accepted by the undertaking concerned, and that all legal formalities for its validity have been complied with.
 - Whether or not the subordination agreement relates to a claim of sufficient size that its valid subordination in favour of other creditors will create a situation in which exception cannot be taken to the continuation of trading.
 - The factual solvency of the creditor at the date of signature of the subordination agreement. Section 26 of the Insolvency Act, 1936, provides in essence that on insolvency (and, by extension in terms of the Companies Act, on liquidation) every disposition of property not made for value may be set aside if immediately after the disposition was made the liabilities of the insolvent exceeded his/her assets. If the insolvency supervenes within two years the onus is on the person to whom the disposition was made to justify it and retain it, whereas after two years the onus passes to the trustee to reclaim the disposition. In order to avoid the difficulties arising from this section the subordination agreement should contain a clause relating to the factual solvency of the creditor at the date of signature as reported upon by the creditor's auditors.

- .37 An agreement by a creditor of the client undertaking to subordinate a claim could well be held to be a "disposition" within the meaning of Section 26. The enquiry would then be whether or not it was one "without value".
- .38 "Value" in this context means value in the ordinary sense; it is not confined to a monetary or tangible material consideration, nor must it necessarily proceed from the person to whom the disposition is made. Whether or not value has been received for a disposition must be determined with reference to all the circumstances under which the transaction was made.
- .39 A shareholder that subordinates his/her claim would probably be held to have received "value", namely, the fact that the company continues to operate for the shareholder's eventual benefit. The same might apply to a creditor who trades extensively with the undertaking and in whose interests it is that it should continue in business. A substantial creditor who subordinates his/her claim in order to "nurse" a debtor in the hope of an eventual recovery may also, in certain circumstances, be held to have received "value".
- .40 Particular care is required where another company in the same group effects the subordination. A holding company that subordinates its claim against its subsidiary would probably be held to have received "value" in that the subsidiary continued to operate for its eventual benefit. In the absence of special circumstances, however, the subordination of a claim against a holding company by its subsidiary, or against a subsidiary by a fellow subsidiary, must be treated with great caution. It has been said that "the continued financial stability of the whole group of companies" could constitute "value" in such circumstances (*Goode, Durrant and Murray Ltd v. Hewitt and Cornell* 1961(4) SA 286 (N) at 219 H). But where the disposition (the subordination) is forced upon the subsidiary or fellow subsidiary concerned by the directors of the holding company without regard to the interests of the subsidiary or fellow subsidiary, so that the subsidiary or fellow subsidiary is impoverished and forced into liquidation, there was clearly no benefit or "value" and the disposition (the subordination) would be set aside (see *Langeberg Koöperasie Bpk v. Inverdoorn Farming and Trading Co Ltd* 1965 (2) SA 597 (A)).
- .41 An enquiry into "value" would of course, in practice, be unnecessary if the creditor subordinating a claim was a person or company of sufficient substance. No question of the creditor's solvency would then arise.
- .42 While recognising the difficulties of evaluating the force of a subordination agreement, and the overriding possibility that after its existence has been proved to the satisfaction of the auditor the agreement may be cancelled between the undertaking and the creditor, it is unlikely that the auditor would refuse to give full weight to such an agreement if he/she is satisfied that it is valid, adequate, and in force at the time when he/she has to make a decision. The auditor should confirm the validity and existence of the agreement prior to the issue of the auditor's report. It would be advisable for the auditor to keep copies of the agreement as part of the working papers.
- .43 In many circumstances, an undertaking will take remedial action, either following a report from the auditor in terms of Section 45, or on its own initiative. The auditor cannot be expected, if the steps taken are adequate at the time to eliminate an irregularity or financial loss, to be concerned with the possibility that the undertaking may (in circumstances that may amount to a fraud or at least to a deception of creditors) reverse the steps taken.
- .44 The auditor is entitled to assume that either he/she or a subsequent auditor will detect any such reversal, and that a fresh irregularity may have arisen at that stage and will be reported on. It may be argued that the discovery will take place too late, but this could also be the case in other circumstances.

- .45 An example of a suitable agreement to subordinate a claim is provided in Annexure “B”.
- .46 A possible wording of a directors' resolution of a debtor company agreeing to and accepting the contract may read:
- "It was resolved that the company agrees to and accepts the subordination by of its claim against the company amounting to R in terms of a document dated duly executed by the said a certified copy of which document is annexed to this resolution."
- .47 The suggested wording contemplates that the whole of the relevant claim has been subordinated. In appropriate circumstances, however, it might be sufficient if only part of a claim is subordinated. Provided that the auditor is satisfied that the amount subordinated is at least equivalent to the extent of the factual insolvency (the amount by which liabilities exceed assets), a part subordination should be acceptable. The resolution would have to be amended accordingly.
- .48 A last question requiring comment is the treatment of subordination agreements in financial statements. A note regarding the subordination agreement setting out all the important terms of the agreement should be included in the financial statements of the debtor concerned. For example, an important issue in the agreement is the disclosure of the circumstances under which the agreement can be terminated or varied, and the following wording may suffice in appropriate cases:
- "A creditor (name if appropriate) has subordinated its rights to claim or accept payment of the debt of R owing to it by the company until an auditor has reported that the company's assets, fairly valued, exceed its liabilities."
- .49 Non-compliance with a subordination agreement, by for example a substantial reduction of the subordinated loan to the prejudice of creditors, could constitute a reportable irregularity in terms of Section 45 of the Auditing Profession Act. The auditor should consider the requirements in the auditing statement on detecting and reporting illegal acts, other irregularities or errors, and if necessary consider getting legal advice.
- .50 Where the subordinated amount is material, and there is inadequate provision for possible loss, there should be a note to the financial statements of the creditor concerned. The following wording may be suitable:
- "The company has subordinated its right to claim payment of a debt of R owing to it by until the assets of that concern/company, fairly valued, exceed its liabilities. At being the most recent date as at which the financial position of that concern/company was determined, there was a shortfall in assets, after being fairly valued, of R"
- .51 The auditor should consider issuing a qualified report on the financial statements of the creditor on the grounds of an inadequate provision. In a likely permanent decline in value of the debt, the debtor's latest balance sheet information may not be sufficient. The future prospects of the debtor should also be taken into account in determining an adequate provision for loss.
- .52 It can be anticipated that information will not always be available to facilitate the inclusion of the second paragraph in the note in so positive a form as that above. In such cases, that note should be worded according to the circumstances.
- .53 The subordinated debt should be suitably described in the balance sheets of the debtor and creditor concerns and probably shown separately and not grouped, for example, with current liabilities or current assets.

Going concern basis of accounting

- .54 Where the justification for the continuance of trading rests on a subordination agreement, the existence of the agreement will normally justify the adoption of a going concern basis of accounting, as distinct from a realisation basis with possible consequential losses and costs. Where a subordination agreement exists, it might change the nature of the instrument and it would thus require a re-assessment of its classification between liability and equity. The subordination agreement might return the company to factual solvency and it may also ensure that the company avoids commercial insolvency. The auditor therefore should ensure that the subordination agreement is current and enforceable each year and that its existence is adequately disclosed in the financial statements.
- .55 It is also important to remember that the existence of a valid, enforceable subordination agreement does not necessarily mean that the undertaking is a going concern. Such agreements are concerned with past indebtedness only and not a commitment to provide further funds to keep the undertaking in business for the foreseeable future. Consideration should be given, therefore, to ensuring that the amount subordinated is sufficient to cover any future losses that might be incurred by the undertaking in the foreseeable future and before its anticipated return to profitability.
- .56 Where the existence of a subordination agreement is insufficient to enable the auditor to express an unqualified opinion, the auditor should follow the guidance given in the International Standards on Auditing relating to reporting.
- .57 Where a qualified audit report is given on the grounds that, despite the existence of a subordination agreement, there is uncertainty as to the continuance of trading, it should be clear that the uncertainty relates to a going concern basis of accounting and not to the subordination agreement.
- .58 In the event that it is necessary for the auditor to report this matter to the IRBA, members are required to follow the guidance provided in Section 45 of the Auditing Profession Act.

ANNEXURE “A”

EXAMPLE OF NOTIFICATION TO MANAGEMENT BOARD

The Chairman and Board of Directors, XYZ Company Ltd

Dear Sirs,

Your company's liabilities exceeded the fair value of its assets at and there does not appear to have been any improvement in the position since that date.

It is necessary to draw your attention to the fact that:

- fraud is committed when a person incurs debt on behalf of the company, which that person knows the company will not be able to pay; or when he/she does not really believe that the company will be able to pay those debts; or when he/she is recklessly careless whether or not there is any chance of those debts being able to be paid or not, and
- where any business of a company is carried on recklessly (and proof of gross negligence is sufficient proof of recklessness), every person who is knowingly a party thereto is guilty of an offence in terms of Subsection 424(3) of the Companies Act, 1973.

It appears that the company is continuing to trade without reasonable expectation of being able to meet its liabilities and this is likely to cause material financial loss to the company or all or some of its members or creditors.

In view of the foregoing, we have reason to believe that a reportable irregularity as contemplated in Section 45 of the Auditing Profession Act (Act 26 of 2005) (the Act) has taken place or is taking place. Accordingly we have sent a written report to the Independent Regulatory Board for Auditors (IRBA), as we are obliged to do in terms of the Act. A copy of the report and the relevant section of the Act are attached.

We will be pleased to discuss the report with the directors and to afford you an opportunity to make representations to us in respect of the report.

The Act requires us to send another report to the IRBA within 30 days from the date of our first report, setting out our opinion relating to the matter.

Kindly acknowledge receipt of this notification in writing.

Registered Auditor CA (SA)

Location

Address

Date

ANNEXURE “B”

EXAMPLE OF AN AGREEMENT TO SUBORDINATE A CLAIM

MEMORANDUM OF AGREEMENT

**between
X LIMITED
("X")
and
Y LIMITED
("Y")**

Whereas:

- A. X is the sole major shareholder (a substantial creditor) of Y.
- B. X has agreed to assist Y by subordinating, subject to certain terms and conditions, its claim(s) against Y and in favour and for the benefit of other creditors of Y.
- C. It is desirable to record the matters agreed upon.

Now, therefore, it is agreed as follows:

- 1. It is recorded that, as at, X constituted a substantial creditor of Y in the amount of R for moneys lent or advanced/goods supplied/services rendered.
- 2. In order to assist Y, X agrees, subject to the limitation imposed in 4 below, that:
 - 2.1 it subordinates for the benefit of the other creditors of Y, both present and future:
 - so much of its claim against Y as would enable the claims of such other creditors to be paid in full, alternatively
 - so much of its claim against Y as would enable the claims of such other creditors to be paid in full but not exceeding the amount recorded in clause 1, alternatively,
 - the amount of R.....
 - 2.2 X hereby warrants that its claims against Y have not been ceded to any third party and that no third party has any interest in those claims,
 - 2.3 the claims of such other creditors of Y, both present and future, will rank preferentially to the subordinated claim of X against Y, and
 - 2.4 in the liquidation of or judicial management of or compromise by Y, it will not prove or tender to prove a claim in respect of its subordinated claim, which proof would reduce or diminish any dividend payable to other creditors, whether present or future, and accordingly, X hereby abandons that claim to the extent that it would reduce or diminish the dividend payable to those other creditors.
- 3. It is the intention of the parties that this agreement shall constitute 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 any or all of such creditors who may then enforce any term of this agreement.

4. The subordination referred to in 2 shall remain in force and effect for so long only as the liabilities of Y exceed its assets, fairly valued, and shall lapse immediately upon the date that the assets of Y exceed its liabilities and shall not, except by further agreement in writing, be reinstated if thereafter the liabilities of Y again exceed its assets, provided that the liabilities of Y shall be deemed to continue to exceed its assets unless and until the auditor of Y has certified in writing that he/she has been furnished with evidence which reasonably satisfies him/her that the liabilities do not exceed the assets.
5. X hereby agrees that, until such time as the assets of Y, fairly valued, exceed its liabilities, and the auditor's certificate referred to in 4 above has been issued, it shall not be entitled to demand or sue for or accept repayment of the whole or any part of the amount subordinated owing to it by Y and set-off shall not operate in relation to the subordinated claim in respect of any debts owing by it now or in the future; provided that if the auditor of Y shall certify in writing that he/she has been furnished with evidence that reasonably satisfies him/her that the amount of the subordinated claim exceeds the amount by which the liabilities of Y exceed its assets, such excess portion of the subordinated claim as is specified in the said certificate shall be released from the operation of this agreement. It is recorded that X acknowledges that it is responsible for requesting the auditor to issue the said certificate and for the costs in this connection.

Note: One of the following clauses should be included if the loan is subject to interest.

- It is agreed that from the date of signature hereto no interest is due and payable or will be paid by Y on all or part of the balance owing to X.
or alternatively
 - It is recorded that interest is due to X on the balance owing at z% per annum compounded (monthly or on). Interest due to X (will be payable to X on and will not form part of this subordination agreement) or (will not be payable to X but will be treated as an amount still due to X and will be added to the amount subordinated in favour of other creditors in terms of this agreement).
6. Should all or part of the amount due to X be repaid, inadvertently or deliberately, then X agrees that it will immediately refund to Y the amount repaid.
 7. X and Y undertake that in the event of cancellation or variation of this agreement in any respect, each will, as a condition precedent to the coming into force and effect of such cancellation or variation, advise the auditor of Y in writing forthwith of the cancellation or variation.
 8. The costs of and incidental to the preparation and stamping of this agreement shall be borne and paid for by Y.

SIGNED by X atthis day of 199..

AS WITNESSES: for X LIMITED

1

2 DIRECTOR
being duly authorised hereto by a resolution of the directors passed on,
a certified copy of which is attached.

SIGNED by Y atthis day of 199..

AS WITNESSES: for Y LIMITED

1

2 DIRECTOR
being duly authorised hereto by a resolution of
the directors passed on, a certified
copy of which is attached.

NOTES TO ANNEXURE “B”

1. The wording of this "subordination" or "backranking" agreement is intended to apply solely to the case of subordination arising out of financial difficulties of the debtor company. In other cases of subordination, the wording may vary considerably.
2. Where the subordination is of part only of a claim, preamble B and clause 2.1 should be changed accordingly. Clause 5 should also be tailored to clarify whether the excess of the amount due (clause 1) and the amount subordinated (clause 2) can or cannot be repaid.
3. Where the creditor is a natural person, it might be desirable to stipulate that the subordination is binding on his/her heirs and estate, although this actually follows as a matter of law.
4. Where more than one creditor has subordinated amounts owing by the debtor, complex legal issues can arise and the auditor should consider taking legal advice. However, the following matters should, amongst others, be taken into account in drafting such an agreement:
 - change clauses 2.1, 2.2 and 2.3 to exclude amounts owing to other subordinated creditors from "other creditors",
 - provide in the agreement for an "order of preference" to enable the auditor to issue the solvency certificate,
 - provide in the agreement for notification by the debtor to the creditor if any further subordination agreements are entered into by the debtor with other creditors or if any subordination agreements entered into with other creditors lapse, are incapable of performance or are released or cancelled by virtue of an auditors "solvency" certificate,
 - provide for the company to undertake to advise other subordinated creditors accordingly.
5. The drafter of the agreement should consider whether or not the amount envisaged in clause 5 is in terms of clause 1 or 2.1 of the agreement.