Insolvency and financial distress

SAICA Audit and Assurance Division

Contents

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Introduction

1. This Guide aims to provide summary guidance to assist a company, its directors, Registered auditors ("auditor"), independent reviewers, compilation practitioners and Chartered

Accountants in other capacities, when considering the application of certain relevant sections relating to solvency and liquidity in the Companies Act, 2008 (“the Act**”)** other relevant laws.

2. Part 1 reflects on the situations where companies find themselves in a state of factual insolvency, commercial insolvency or financial distress and the potential responses that may be considered under these circumstances.
3. Although the Act does not define either a “solvent company” or its converse, - an “insolvent company”, reference to the term “insolvent” in Sections 9, 22, 79, 80 and 163 of the Act. Refer to the Table in Annexure A for the relevant references. The converse of “insolvency” i.e., “solvency” will be used where the context in this Guide requires.
4. The law regulating the insolvency of a company is primarily the provisions of the 2008[1] and 2008 Companies Acts and the law relating to insolvency, underpinned by relevant legislation, common law and case law, which primarily goes beyond the scope of this Guide.
5. In Part 2 of this Guide, we further explore the implications of trading whilst being insolvent or financially distressed and the potential reporting obligations where reckless trading is evident.

Definitions

6. For the purposes of this Guide the following terms have the meanings attributed below:
    - APA - Auditing Profession Act, 26 of 2005
    - Board - the board of directors of a company
    - 1973 Companies Act - Companies Act, 61 of 1973
    - The Act - Companies Act, 71 of 2008
    - CIPC - Companies and Intellectual Properties Commission
    - ISA – International Standard on Auditing
    - ISRS 4410 (revised) - *Compilations*
    - ISRE 2400 (revised) - *International Standard on Review Engagements 2400 (Revised), Engagements to review Historical Financial Statements (Effective for reviews of financial statements for periods ending on or after December 31, 2013)*
    - IRBA – Independent Regulatory Board for Auditors
    - Companies Regulations – Companies Regulations, 2011 to the Companies Act, 2008

[1] Application of Companies Act, 2008 is further discussed in para 40

Part 1

Insolvency

7. In South Africa insolvency is understood to include:

    a. **Factual insolvency:** The term used where the company's liabilities exceed its assets irrespective of whether it is still able to pay its debts ;

    b. **Commercial insolvency:** The term used where a company is unable to pay its debts irrespective of whether its assets may exceed its liabilities.

8. The Act refers to the terms "solvency and liquidity" , which is more fully explained in the context of the section 4 solvency and liquidity test. Liquidity is generally understood to mean commercial solvency.

9. The Act appears to differentiate between insolvency, as contemplated in section 4 and financial distress defined in section 128(1). Insolvency seems to focus on the current ability of a company to meet its liabilities and maintain liquidity, while financial distress looks at the company's projected financial health over the next six months and its potential need for restructuring to avoid insolvency.

10. The most notable differences are the periods of 12 months (for commercial insolvency) and 6 months (for financial distress) indicated in relation to the forward-looking ability of the company for payment of the companies' debts and the mandatory responses to financial distress as prescribed by the Act.

11. The solvency and liquidity test ("the test") as explained in section 4 places a positive duty on the Board to perform the test at the following instances when:

    - providing financial assistance for the subscription of its own securities (S44);
    - providing financial assistance for the subscription of its own securities (S44);
    - providing loans or other financial assistance to directors and to a related or inter-related company (S45);[2]
    - making distributions (S46);
    - issuing capitalisation shares (S47);
    - acquiring own securities or a subsidiary acquiring holding company securities (S48); and
    - amalgamating or merging (S113).

12. Solvency test (factual insolvent): The solvency test is designed to determine whether the assets, fairly valued, exceed the liabilities, fairly valued on the date that the test is considered.[3]

13. Liquidity test (commercial solvency): The liquidity test is designed to indicate whether the company will be able to settle its debts when they become due in the ordinary course of business within a period of12 months after the relevant corporate action is performed or, in the case of a distribution,

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[2] Refer to Companies Amendment Act, 16 of 2024 where loans to subsidiaries will be scoped out, effective date still to be confirmed

[3] Consider requirements of the Act, section 4, in determining the date on which the test is considered

12 months after the distribution is made. This test is generally understood to determine commercial solvency.

14. The factual solvency measure is simply a comparison of assets against liabilities at a point in time,[4] paragraph 17 expands on this, 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 paid.

15. Factual insolvency often occurs with start-up operations, where initial losses are not unusual. However, factual insolvency can also arise at any time because of losses incurred which exceed the capital and accumulated reserves of an entity.

16. 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 subsidiary). Sometimes, the relationship between current assets and current liabilities is considered as a potential indicator of commercial insolvency.[5]

17. For the determination of factual solvency, assets are normally measured at their fair value[6] (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 going concern in the foreseeable future – which is typically considered as at least covering the twelve months from the date of the assessment.[7] Factual insolvency does not necessarily mean that a going concern problem exists, but commercial insolvency is likely to indicate that a going concern problem exists.

18. In *Murray NO and Others v African Global Holdings (Pty) Ltd and Others 2020 (2) SA 93 (SCA)* the SCA considered in its judgment how it should be determined whether a company is solvent or insolvent. Since there is no definition of a solvent company in the Act, the SCA relied on the judgment in *Boschpoort Ondernemings (Pty) Ltd v ABSA Bank Limited 2014 (2) SA 518 (SCA)*, in which case the SCA previously held that for purposes of the 2008 Act, a company will be solvent, if it is commercially solvent.

A. Responses to insolvency

19. The directors of a company have the responsibility to assess the risk of insolvency, albeit commercial or factual insolvency of the company, the appropriate responses thereto, and whether the company should continue to trade in those circumstances. The independent reviewer, auditor and compilation practitioner considers the responses, actions and disclosures taken by the directors and the company in the context of their potential reporting duties.

20. Where a company continues to trade, Boards must respond appropriately to ensure that the company remains able to pay its debts and does not fall short of the reckless trading or financial distress provisions in the Act. Possible responses include:

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[4] See *inter alia De Jager v Karoo Cooldrink & Roomys (Edms) Bpk 1956(3) SA 594 (C).*

[5] ISA 570 (Revised), *Going Concern*, paragraph A3 identifies a net current liability position as an example of an event or condition that, individually or collectively with other events or conditions, may cast significant doubt on the entity's ability to continue as a going concern.

[6] 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).

[7] 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

a. Recapitalising the entity by:

    i. injecting fresh capital into the organisation

    ii. converting intercompany loans into capital

b. Obtaining a subordination agreement (Refer to Annexure B)

c. Obtaining a letter of support (Refer to Annexure B)

d. Financing or refinancing the company

Note: Any of the above actions may have additional consequences, e.g., tax and other contractual legal obligations, and the board is advised to obtain professional advice in this regard.

Financial distress

21. The Act introduced the concept of business rescue and business rescue proceedings which is primarily aimed at rescuing a failing company that is financially distressed.

22. "Financially distressed" is defined in section 128(1)(f) of the Act as follows:

    a. *"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 6 months (interpreted as known debts) or*

    b. *It appears to be reasonably likely that the company will become insolvent within the immediately ensuing 6 months (interpreted as prospective liabilities)".*

23. It is generally accepted that a company with liquidity concerns (i.e., a company unable to pay its debts) needs to take action to restore liquidity. .

B. Responses to financial distress

Board resolves to commence business rescue proceedings

24. In terms of section 129(1) the Board may resolve that the company voluntarily begin business rescue proceedings and place the company under supervision if the Board has reasonable grounds to believe that:

    a. the company is financially distressed; and

    b. there appears to be a reasonable prospect of rescuing the company.

25. In section 129(7) of the Act, if the Board has reasonable grounds to believe that the company is "financially distressed", and the Board has decided not to place the company under business rescue, the board must notify all affected persons giving reasons why the company has not been placed under business rescue.[8]

26. Affected persons include all shareholders, employees, trade unions and creditors. Failure by the directors to give such a notice would amount to a breach of the Companies Act and could

[8] Section 129(7) of the Act

render the directors personally liable to a claim by any person who has suffered any damage arising from the directors' failure to give such notice.[9]

27. Where the directors are aware of the fact that the company is not able to pay its debts as they become due and payable, or it appears reasonably likely that the company will become insolvent within the next 6 months, the Board has a duty to consider business rescue if the company seems to be financial distressed and there seems to be a reasonable prospect to rescue the company (*Southern Palace Investments 265(Pty) Ltd v Midnight Storm Investments 386 Limited and others 2012 (2) SA 423 (WCC*).

28. However, a company may not be placed in business rescue if liquidation proceedings have been initiated or there is no reasonable prospect of rescuing the company.[10]

29. In terms of section 129(3) a formal process must be followed once the Board has taken the decision to voluntarily commence business rescue.

30. Within 5 business days after the Board has adopted and filed a resolution to commence business rescue the company must publish a notice of resolution and its effective date to every affected person and appoint a business rescue practitioner who satisfies the requirements of section 138 and who has consented to act as the business rescue practitioner. The current practice includes the fact that the business rescue practitioner needs to have a license issued by the CIPC.[11]

31. After appointing a practitioner, a company must file a notice of the appointment of the practitioner within 2 business days after making the appointment and must publish a copy of the appointment to each of the affected within 5 business days after the notice was filed.

32. Should the company fail to comply with the notices and appointment of the business rescue practitioner, its resolution to begin with business rescue proceedings lapses, and the company may not file a further notice for the company to commence business rescue voluntarily for a period of 3 months after the date on which the lapsed resolution was adopted, unless a court approves the filing of a further resolution.

33. A company that has adopted a resolution to commence business rescue may not adopt a resolution to begin liquidation proceedings unless the resolution has lapsed.

Board does not resolve to commence business rescue proceedings

34. Should the Board have reasonable grounds to believe that the company is financially distressed, but the Board has decided not to apply for business rescue, the Board must deliver a written notice to all affected persons setting out the reasons for not commencing business rescue. Affected persons include all shareholders, employees, trade unions and creditors.

35. Business rescue has a defined process which must be followed to ensure that business rescue can continue and be successful.

36. It is recommended that auditors/independent reviewers and compilation practitioners seek professional advice on technical and legal matters where necessary. All considerations need to be appropriately documented in the working papers.

[9] Section 218(2) of the Act

[10] Section 129(2) of the Act

[11] Section 130(2) of the Act

Liquidation (winding up of insolvent company)

37. A company may be liquidated either voluntarily, by means of the board of directors passing a resolution to that effect; or an application can be made to court either by the company itself (a shareholders' resolution is required) or by a creditor or shareholder of the company.
38. Once a court grants a winding-up order, the commencement of the winding-up is the date on which the application for winding-up was presented to the court (approximately the date upon which papers were first filed at court). Where liquidation commences by way of resolution, winding-up commences when the resolution is registered with the CIPC established under the Companies Act.
39. Despite the repeal of the 1973 Companies Act, the transitional provisions in Item 9 of Schedule 5 of the 2008 Act, determines that certain sections in the 1973 Companies Act continue to apply. The law regulating the winding-up of a company is contained substantially in Part G of Chapter 2 of the 2008 Companies Act and Chapter XIV of the 1973 Companies Act read with the laws relating to insolvency, insofar as they are applicable.
40. In short, the winding-up of solvent companies is governed by the Act, while the winding-up of insolvent companies is governed by the Insolvency Act, 1936 (Insolvency Act) and the 1973 Companies Act.

The Act does not define either a "solvent company" (as referred to in item 9(2) of Schedule 5 thereto) or its converse, an "insolvent company". The resultant uncertainty was resolved by the Supreme Court of Appeal in *Boschpoort Ondernemings* (*Pty*) *Ltd v ABSA Bank Ltd*. The Court concluded that by retaining the deeming provisions as to when a company is unable to pay its debts as contained in section 345 of the 1973 Companies Act in the context of a winding-up of a solvent company in the Act, the clear indication was that the reference to an "insolvent company" in the Act could only mean a company that is "commercially insolvent". Therefore, it followed that the reference to a "solvent company" must be the converse, namely, a company that is commercially solvent. Accordingly, in order for a solvent company to be wound up in terms of either section 80 or 81 of the Act, it must be "commercially solvent", while a company that is "commercially insolvent" (albeit factually solvent) is to be wound up in accordance with Chapter XIV of the 1973 Companies Act (as provided for in item 9(1) of Schedule 5 of the 2008 Act.

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Annexure A

Prevalent Sections in the Companies Act, 2008 referring to the term "insolvent"	
Section 9 (4) (a) read with Schedule 5	Despite the repeal of the 1973 Act, the transitional provisions in Schedule 5 of the 2008 Act, determines that certain sections in the 1973 Act continue to apply. Item 9 of Schedule 5 provides that Chapter 14 of the 1973 Act continues to apply with respect to the winding-up and liquidation of companies. Sections 423 and 424 in Chapter 14 will remain available to be used by creditors against directors where companies have been wound up or liquidated and has caused losses to creditors. Item 11(1) of Schedule 5 determines further that Section 424 is still available to a debtor in respect of claims that arose prior to 1 May 2011 and where companies have not yet been wound up. Section 9 (4)(a) determines that the Minister, by notice in the *Gazette*, may determine a date on which the above interim measures ceases to have effect, but no such notice may be given until the Minister is satisfied that alternative legislation has been brought into force adequately providing for the winding-up and liquidation of insolvent companies.
Section 22 (1) (b)	A company is prohibited from trading under insolvent circumstances
Section 79 (3)	If, at any time after a company has adopted a resolution contemplated in section 80, or after an application has been made to a court as contemplated in section 81, it is determined that the company to be wound up is or may be insolvent, a court, on application by any interested person, may order that the company be wound up as an insolvent company in terms of the laws referred to or contemplated in item 9 of Schedule 5.
Section 128 (f)	**''financially distressed''**, in reference to a particular company at any particular time, means that— (i) it appears to be reasonably unlikely that the company will be able to pay all of its debts as they fall 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;
Section 162(2)(b)	(2) Upon considering an application in terms of subsection (1), the court may make any interim or final order it considers fit, including— *(a)* an order restraining the conduct complained of; *(b)* an order appointing a liquidator, if the company appears to be insolvent;

Annexure B

A. Subordination agreements

1. A subordination agreement is an agreement with a 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.
2. 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.
3. A subordination agreement is a contract between the company and the subordinating creditor, which is *inter alia* for the benefit of other creditors.
4. The subordination by a creditor does not change the legal nature of the amount owing to the subordinating creditor – which remains a liability[12]. The debt is thus still included in total liabilities in assessing factual insolvency.
5. 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 IFRS® , assuming the entity is a going concern.
6. 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.
7. 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.
8. 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 liabilities[13] 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.
9. 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.
10. 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's ability to pay its debts.
11. 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 realisation of the assets of the debtor company.

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12 *Carbon Developments* (supra).

13 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*.

12. 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.

13. A subordination agreement ordinarily indicates responsible action taken in the face of insolvency, to protect the interests of the creditors and increases the likelihood of the non-subordinated creditors being paid.

14. 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.

15. Each subordination agreement needs to be examined and considered on its own merits and in the circumstances – considering the likely practical effect of the subordination on the company and the other creditors, and the enforceability thereof.

16. In assessing a subordination agreement, the following needs to be considered:

    a. whether the subordinating creditor is properly authorised to subordinate its claim and enter into the subordination agreement;

    b. what the financial position of the subordinating creditor is at the date of the subordination – in particular, whether the subordinating creditor is itself factually solvent[14], 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;

    c. the duration of the subordination agreement, and what circumstances bring it to an end;

    d. whether the subordination agreement can be cancelled, and if so under what circumstances;

    e. the amount, which is subordinated, relative to the deficit of the company;

    f. the terms of the subordination, and 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;

    g. whether the amount owing to the subordinating creditor will bear interest, and if so at what rates;

    h. if the amount subordinated is denominated in foreign currency, the effect of changes in exchange rate;

    i. if the subordinating creditor is in a foreign jurisdiction, the legal effect thereof on the validity and enforceability of the subordination.

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

[14] 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.

considerations[15]. A letter of support (described below) is often combined with a subordination agreement.

18. In assessing the value of a subordination, judgement should be exercised, and consideration given as to whether legal advice[16] should be obtained in relation to the legal implications of the subordination. Ultimately, professional scepticism should be exercised, and prudent judgement applied to determine the effect and value of the subordination agreement, and what action should be taken.

19. Consideration should be given to whether the terms of the creditor's subordination have been disclosed in the debtor company's financial statements in accordance with IFRS Accounting Standards. Similarly, the terms of the subordination agreement may have to be disclosed in the subordinating creditor's financial statements, in accordance with IFRS Accounting Standards. The subordination may affect the measurement of the amount receivable in the creditor's financial statements, measured in accordance with IFRS Accounting Standards.[17]

20. 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, and whether appropriate provision for tax, if any, arising from the subordination has been made in the financial statements of the relevant companies.

B. Letters of support

21. Letters of guarantee include a legally binding agreement with the intention of a holding company, shareholder or related party to provide sufficient funding to the company to pay its debts and meet other obligations, as prescribed in the agreement.

22. Providing the necessary amount of funding, and clarity and commitment regarding the amount and duration of the financial support, contributes to evidence of the ability to meet debts as they fall due and as prescribed in the agreement.

23. A letter of support should be examined and considered on its own merits and in the circumstances – considering the practical effect of the actions taken on the company and its creditors, and the enforceability of the actions taken. A letter of support is often combined with a subordination.

24. The holding company, shareholder or related party that provides the support should have the legal capacity, ability and authority to provide the support in compliance with section 45 of the Act. There is no longer an obligation on a holding company offering financial assistance to its subsidiaries to comply with the procedure of getting a resolutions and other related approvals.

25. In assessing the legal authority and value of the letter of support, judgement should be exercised, and consideration given as to whether legal advice[31] should be obtained if there is uncertainty.

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15 ISA 570 (Revised)

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

17 IAS 39, *Financial Instruments: Recognition and Measurement* / IFRS 9, *Financial Instruments*. Also see SMEs Accounting Standard, Section 11.