



FINANCIAL STATEMENT REVIEW TOOLKIT

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PREFACE

This toolkit has been prepared by The South African Institute of Chartered Accountants (SAICA), primarily to provide guidance to SAICA members and associates on how to review Annual Financial Statements effectively.

Every effort has been made to ensure that where reference is made to quotes, extracts and paragraphs from IFRS and IFRS for SMEs, the references are correct. The information contained in the toolkit is for information purposes only.

The toolkit does not address independent review or audit issues. The Independent Regulatory Board for Auditors (IRBA) issues separate guides for audit.

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

INTRODUCTION

Most entities outsource the compilation of their annual financial statements (AFS). The in-house finance function therefore is increasingly moving from compiling AFS to reviewing the AFS based on the information it has provided to the outsourcing company. The lists of considerations contained in the toolkit are not meant to be exhaustive; however, the toolkit highlights some of the important considerations for reviewing the AFS of Small and Medium Enterprises (SMEs).

This toolkit contains lists of considerations that can be used in the overall analysis and review of AFS compiled by an independent compiler for approval by the company's board. Reference to "review" does not refer to an independent review as defined in the Companies Act 71 of 2008 (Companies Act) and the *International Standard for Review Engagements, as issued from time to time, by the International Auditing and Assurance Standards Board, or its successor body (ISRE 2400)*.

Not all SAICA members and associates work in environments that have highly qualified finance function resources. The aim of this toolkit, therefore, is to assist a member or an associate with setting up and equipping the members of the finance functions to perform the review of the AFS, to free themselves to focus on significant accounting / tax issues contained in the AFS.

The toolkit seeks to assist directors (of SMEs) who sign off the AFS by providing them with considerations and questions to ask prior to signing the AFS. This toolkit is specifically designed for those entities that might not have an audit committee as part of their governance structures.

The toolkit refers to companies as defined in the Companies Act, but other entities can also use the toolkit, and members and associates should relate the references to companies and directors to their specific entity requirements.

ABBREVIATIONS AND DEFINITIONS USED IN THE TOOLKIT

Accounting period – company's/entity's fiscal year of financial performance

Auditor – any registered auditor as defined in the Auditing Profession Act (APA), 2005

AFS – Annual Financial Statements

Company (Entity) – a juristic person incorporated in terms of the Companies Act of South Africa.

KAMs – Key Audit Matters

PIS – Public Interest Score

SMEs – Small and Medium Enterprises

SOCE – Statement of Changes in Equity

Those charged with governance (TCWG) – those with primary accountability for the governance and performance of the organisation

Statutory records – any records maintained by the entity as required by the Companies Act of South Africa

TB – trial balance

BASIC CONSIDERATIONS – Overall Financial Statements level

Work Performed	Yes	No
Opening balances check		
Confirm that prior-year retained earnings (opening retained earnings) as per the draft AFS and per the final TB agree to the closing retained earnings in the prior year according to the signed (and not the final draft) AFS .		
Confirm that the individual balances agree to the signed prior-year AFS.		
<i>Testing the opening retained earnings confirms that, on an aggregated level, the opening balances are correct. However, this test does not ensure the correctness of opening balances at an account balance level. There might have been late re-classifications in the balance sheet; for example, between debtors and creditors or between short-term and long-term items. These reclassifications will not be identified by testing the retained earnings.</i>		
Solvency and liquidity check		
Confirm that the closing retained earnings are in credit . <i>If the balance is in debit, it means that the balance is negative. This could be a going concern indicator.</i>		
Confirm that total assets exceed total liabilities (solvency).		
Confirm that total current assets exceed total current liabilities (liquidity).		
<i>If solvency and liquidity tests fail, confirm whether the going concern disclosure (both in the directors' reports and in the notes) is sufficient and appropriate. Also confirm whether the directors have obtained sufficient evidence to support the going concern assumption, e.g. financial support evidence such as subordination agreements, letters of support and external guarantees.</i>		
Work Performed	Yes	No
Other overall checks to perform		
Confirm whether the company's name and registration number agree to statutory records.		
Confirm whether the financial year-end date has been correctly updated and is consistently reflected on all pages of the AFS and anywhere that the financial year-end date is inserted in the AFS.		
Confirm that all transfers are accurate, i.e. page numbers, numbers quoted or extracted from other statements contained in the AFS, note numbers, note balances and totals.		

<p>Confirm calculation of Public Interest Score (PIS) to determine if a company requires an audit or independent review.</p>		
<p>Confirm that the statutory record information agrees to statutory records, where applicable. This information includes:</p> <ul style="list-style-type: none"> ○ Directors' information (names, surnames, dates appointed and resigned, including any other changes to the directors' information as per register of directors); ○ Dividends declared and paid information (current and prior year as per minutes and board resolutions); ○ Company secretary information (and any changes thereto); ○ Holdings of interests in other entities and movements in these holdings; ○ Supporting evidence for any disclosed post-balance sheet events; ○ Changes to share capital, share premium (as per securities register); ○ Supporting evidence for the going concern disclosure; ○ Details of the bankers and auditors; ○ Any other resolutions; and ○ Disclosure of directors and prescribed officers' remuneration (if applicable) (section 30(4) of the Companies Act). 		
<p>Confirm that the name and professional designation (if applicable) of the individual who prepared or supervised the preparation of the AFS are included (section 29(1)(e)(ii) of the Companies Act).</p>		
<p>Confirm that the date on which the AFS were approved for issue by the directors is correctly reflected. Ensure that this date is also supported by the minutes of the meeting or round robin date when the AFS were approved for issue.</p>		
<p>Confirm that the date on which the AFS were approved for issue by the auditors in the auditor's report is correctly reflected.</p> <p><i>This date cannot be before the AFS were approved for issue by the directors.</i></p>		
<p>For those entities required to disclose key audit matters (KAMs), confirm disclosure to approved governance structures, in minutes of meetings or via any other communication, from those charged with governance (TCWG) of the company.</p>		

BASIC CONSIDERATIONS – Balance Sheet / Statement of Financial Position level

Work performed	Yes	No
Balances (amounts) disclosed on the face of the balance sheet should be agreed to the notes as referenced on the balance sheet for both the current and prior year.		
<p>The property, plant and equipment (PPE) balance reflected on the face of the balance sheet should agree to the carrying value at the end of the year as per the note (for both current and prior years).</p> <p>Confirm that the depreciation (disclosable item) amount reflected in the note agrees to:</p> <ul style="list-style-type: none"> ○ The amount disclosed on the face of the income statement (if applicable); and ○ The amount disclosed in the note to the reconciliation of net profit before tax to cash flows in the note (if there are any disposals during the year on items that were depreciated, the amount reflected in this note will be net of the depreciation of the disposed assets). Depreciation is a non-cash item. 		
<p>Movement in intangible asset balances will mainly be the result of either amortisation of an intangible asset or an impairment of an intangible asset:</p> <ul style="list-style-type: none"> ○ Agree this movement to the relevant note and also to the income statement or statement of comprehensive income. ○ For cash flow statement purposes, impairment or amortisation will be a non-cash item; therefore, confirm that the adjustment has been added back in the reconciliation of net profit before tax to cash flows in the notes to the AFS. 		
<p>Movement in investment balances will be as a result of:</p> <ul style="list-style-type: none"> ○ Additions or disposal of investment; ○ Revaluation of investment; or ○ Impairment of investments. <p>Agree this movement to the relevant note and also to the income statement or statement of comprehensive income.</p> <p>In the cash flow statement, this movement in cash component will be reflected as cash flows from investing activities.</p>		
<p>Deferred tax assets and liabilities (compute the difference and check against the movement in the income statement).</p> <p><i>For example:</i></p> <ul style="list-style-type: none"> ○ <i>Deferred tax asset debit balance is Y2 220 Y1 200; therefore, your deferred tax asset movement is R20. (Debit the balance sheet account and credit the income statement account.)</i> 		

<p>Confirm disclosure of deferred tax and its supporting calculation or note.</p> <p>If an entity has deferred asset balances on its balance sheet, consider the recoverability of the deferred tax asset balance:</p> <ul style="list-style-type: none"> ○ A deferred tax asset is an asset on a company's balance sheet that may be used to reduce taxable income in future. It is the opposite of a deferred tax liability, which describes a balance that will increase income tax paid in future. 										
<p>Taxation that is refundable should be confirmed with the South African Revenue Services (SARS) statement for each company. If the SARS statement shows a lesser refundable amount than the AFS, consider whether the full amount that the company is reflecting as refundable is fully recoverable and propose an adjustment where required.</p> <p>Taxation payable should also be confirmed with the SARS statement, and the amount reflected in the AFS should be reconciled with the SARS statement.</p>										
<p>Bank, cash and cash equivalents (debit balances) minus the bank overdraft, cash and cash equivalents (credit balances) should agree to the cash and equivalents at the end of the period reflected in the cash flow statement. Check set offs of favourable bank balances and Overdrawn balances are permissible</p>										
<p>Share capital and any movement in equity should normally agree to the share certificates as statutory records of issued share capital and also to the statement of changes in equity (SOCE).</p>										
<p>Closing retained earnings should normally equal:</p> <table border="1" data-bbox="248 1370 1142 1527"> <tr> <td></td> <td>Opening retained earnings (prior year)</td> </tr> <tr> <td>Plus</td> <td>Net profit after tax per current year income statement</td> </tr> <tr> <td>Less</td> <td>Dividends declared in the current financial year</td> </tr> <tr> <td></td> <td>Closing retained earnings (current year)</td> </tr> </table>		Opening retained earnings (prior year)	Plus	Net profit after tax per current year income statement	Less	Dividends declared in the current financial year		Closing retained earnings (current year)		
	Opening retained earnings (prior year)									
Plus	Net profit after tax per current year income statement									
Less	Dividends declared in the current financial year									
	Closing retained earnings (current year)									
<p>Confirm cash flow statement adjustment of any non-cash items, e.g. provisions, impairment or depreciation.</p>										
<p>Confirm that the movement in the provisions between current year and prior year should agree to the net amount of:</p> <ul style="list-style-type: none"> ○ Provisions raised during the year; and ○ Provisions utilised during the year according to the provisions note. <p>The movement on the face of the balance sheet between the current and prior years should agree to the amount added back or subtracted in the reconciliation of net profit before tax to cash flows in the notes to the AFS.</p>										

BASIC CONSIDERATIONS – Income Statement level

Work performed	Yes	No
Confirm that the cost of sales accounting method is consistently applied and as per approved company policy, i.e. first in first out (FIFO), last in first out (LIFO) or the average costing method.		
Review the cost elements to ensure that no costs that qualify for capitalisation were expensed Also ensure that administrative expenses and selling expenses are not included above the gross profit line. Cost of sales should include only production costs and cost of bringing those goods into production.		
Confirm the accurate transfer of the inventory balance (finished goods at the end of the period) to the balance sheet. The transfer should be closing stock at the end of the period, calculated at the cost price and not at the selling price of the items.		
Review cost of sales to ensure correct treatment of obsolete inventory.		
Compute the Gross Profit percentage (GP%) (current and prior year) and compare to the expected GP% as per management accounts. <i>Investigate any significant differences between the actual GP% as per the AFS and the management accounts GP% and between current GP% and the prior-year GP%, and document explanations.</i>		
Test and confirm reasonability of any expenditure, e.g. rental expenses and salaries, with approved budgets and prior reporting periods		
Confirm items such as depreciation, provision, expense or impairment, and agree to the relevant balance sheet disclosure and other AFS disclosure. These are normally standalone disclosures in the notes to the AFS.		
Confirm the tax amount as reflected on the face of the income statement to the tax note: <ul style="list-style-type: none"> ○ Deferred tax assets and liabilities (compute the difference and check against the movement in the income statement). <i>For example: Deferred tax asset debit balance is Y2 220 Y1 200; therefore, your deferred tax asset movement is R20. (Debit the balance sheet account and credit the income statement account.)</i> 		

The net profit after tax amount reflected on the face of the income statement should agree to the net profit after tax amount reflected in the SOCE.		
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BASIC CONSIDERATIONS – Statement of Changes in Equity (SOCE)

Work performed	Yes	No
<p>The share capital balance must agree to the share capital balance on the face of the balance sheet and the amount disclosed in the notes:</p> <ul style="list-style-type: none"> ○ Any changes or movements in the share capital balance must be evidenced and supported by appropriate statutory records. Changes to share capital could inter alia be the result of the issue of shares, repurchases of shares or share buy backs. ○ The memorandum of incorporation (MOI) sets out the classes of shares and the number of shares of each class that a company is authorised to issue. In addition, in respect of each class of shares, the MOI of a company is required to set out the preferences, rights, limitations and other terms associated with a class of shares. ○ The number of authorised shares of each class and the preferences, rights, limitations and other terms associated with a class of shares may only be changed by an amendment of the MOI by a special resolution of the board of the company, which may increase or decrease the number of authorised shares of any class; reclassify any classified shares (that is, amend the terms attached to such shares) that have been authorised but not issued; classify any shares that have been authorised but not issued; or determine the preferences, rights, limitations or other terms of shares in a class, unless the MOI provides for a different approval process (section 36 of the Companies Act 71 of 2008 (Companies Act)). <ul style="list-style-type: none"> ▪ <i>It should be noted that if there is a change to the MOI, Form CoR 15.2 must be filed with the CIPC.</i> ○ Except to the extent that a company's MOI provides otherwise, directors are authorised to issue the shares of a company, provided that the shares issued have been authorised by or in terms of a company's MOI and such shares are within the classes authorised and adequate consideration is received by the company for such shares (section 38 of the Companies Act). ○ Issuing shares in a company is a simple process in that all that is required is for the directors to pass a resolution authorising the company to issue the shares, subject to specific requirements in the MOI or shareholders' agreement. ○ The Companies Act requires only the approval of shareholders for issuing of shares by special resolution in exceptional circumstances; namely, where a company intends to issue shares to a director, future director, prescribed officer or future prescribed 		

<p>officer of that company or a person related or inter-related to that company or a director or prescribed officer or a nominee of the above. If the voting power of the class of shares that are issued or issuable as a result of the transaction or series of integrated transactions will be equal to or constitute 30 per cent of the voting power of all the shares of that class held by shareholders immediately before the transaction, or more of the voting rights in that specific class, a special resolution will also be required (section 41 of the Companies Act).</p> <p><i>Confirm the details of the change in share capital against any agreements to understand the substance of the change and what is required for the particular change in terms of the Companies Act.</i></p>		
<p>Confirm that the retained earnings opening balance agrees to the signed prior-year AFS.</p> <p>Confirm that the closing balance agrees to the closing retained earnings balance reflected on the face of the AFS.</p>		
<p>Confirm that the net profit reflected in the SOCE agrees to the net profit reflected on the face of the income statement.</p>		
<p>Where dividends have been declared by the directors, confirm that the directors have performed the solvency and liquidity tests as required by the Companies Act of South Africa. <i>(Refer to page 18 of the toolkit for considerations when declaring a dividend in terms of the Companies Act.)</i></p>		
<p>The total balance of equity reflected in the SOCE should agree to the total equity balance reflected on the face of the balance sheet.</p>		
<p>Any movements in any other reserves should agree to the underlying supporting documents.</p>		

BASIC CONSIDERATIONS – Cash flow statements

Work performed	Yes	No
IAS 7 allows for the use of direct or indirect methods to prepare a cash flow statement. Below are the important considerations and general principles of the cash flow statement.		

CASH FLOW STATEMENT – Why does the business prepare a cash flow statement?

The statement of financial position (balance sheet) and the statement of comprehensive income (income statement) are based on the accrual principle, which means that the company recognises a profit the moment a product is sold, or a service is provided, rather than only when cash is received. It is quite seldom therefore that the net profit reflected in the income statement is the same as the cash balance as reflected in the balance sheet.

It is for this purpose that the cash flow statement is prepared. The cash flow statement is constructed by taking the latest two balance sheets (current year and prior year) and the income statement that covers that period. The cash management of a company is affected by three categories of cash flows. These are described below.

Cash flows from operating activities

- These cash flows are generated internally by the company from its operating activities and concern the cash generated from sales of the product or service of the business. This is essentially the company's working capital. These cash flows are the reason that the business exists, and this is the cash flow that is under the company's control.
- This is the cash flow that is:
 - Generated mainly by the company's revenue streams
 - **Less:** any operating expenses incurred to generate revenue
 - **Add back or subtract** any non-cash items
 - **Add back or subtract** any working capital changes.
- This cash flow is the only cash flow that is sustainable. If the company does not make surplus cash in this section of the business, its sustainability is put in jeopardy. Companies that have a negative cash flow from operating activities for three years in succession are likely to face severe cash flow problems. For this reason, it is critical for a company's financial function to be able to forecast cash flows accurately monthly. It is prudent for the company to have at least six months of cash reserves in its bank account at all times.
- Below is a summary of how cash generated by operations is computed:

	Profit before tax (as shown on the face of the income statement)
Add / Subtract	<i>Non-cash items</i>
	- Depreciation / Impairment of PPE
	- Amortisation / Impairment of intangible assets
	- Profit / Loss on sale of asset
	- Movement in provisions
Add / Subtract	<i>Items to be reflected separately on the face of the cash flow statement</i>

	- Interest received / paid
	- Taxation paid
	- Dividends received / paid
Add / Subtract	<i>Changes in non-cash component of working capital</i>
	- Plus decrease in accounts receivables (this means debtors are paying you what they owe you; it is important to collect money from customers or clients on time as this is the lifeblood of the company)
	- Minus increase in accounts receivables (this means more cash is now in the hands of your customers; this is bad for cash flow, especially if the cash has been in the hands of the debtors for long periods – longer than three months. This means that the company is financing the debtors)
	- Plus decrease in inventory or work in progress (WIP) (this means inventory is being sold and cash tied up in inventory is being released; therefore, this is an inflow)
	- Minus increase in inventory or work in progress (WIP) (this means more cash flow is tied up in inventory and therefore this is a cash outflow)
	- Plus increase in creditors (this means the company is extending the period it takes to pay suppliers – an inflow of cash as the money stays in the company’s bank account for longer)
	- Minus decrease in creditors (this could mean you are paying your suppliers quicker and should negotiate a longer term – this is a cash outflow. Note that paying creditors earlier than collecting accounting receivables is bad for cash flow purposes as it means the company is financing both its debtors and creditors)

Cash flows from investing activities

- These are cash flows generated internally from non-operating activities.
- This category of cash flows would include:
 - Cash spent on investments in plant and equipment;
 - Non-recurring proceeds on disposal of fixed assets or investments; or
 - Other sources and uses of cash outside of the normal operating activities of the company.
- Cash generated from this activity is not and should not be what sustains the company.
- Normally cash from this category is considered an outflow rather than an inflow, as the company spends cash on acquiring or maintaining its assets to maintain its operations or to grow.
- Below is a summary of how cash from investing activities is computed:

Negative	An increase in the PPE balance as reflected in the balance sheet means that the company has spent money to buy additional PPE during the year.
Positive	A decrease in the PPE balance as reflected in the balance sheet means that the company could have disposed of some items of PPE during the year and then obtained cash for the disposal.
Negative	An increase in the investments' balance as reflected in the balance sheet means that the company used its cash flow to invest.
Positive	A decrease in investments as reflected in the balance sheet if it is a disposal will indicate that cash was received by the company from disposing of its investment; this is a positive cash flow for the company.
Positive	A decrease in loans receivable is an indication that payment could have been received. This is an inflow for the company, as the company now has more cash after the loan was paid.

Cash flows from financing activities

- These are cash flows to and from external sources, such as lenders, investors and shareholders.
- A new loan, the repayment of a loan and the issue of shares are some of the activities that would be included in this section of the cash flow statement.
- Below is a summary of how cash from investing activities is computed:

Negative	A decrease in loans payable is an indication that payment could have been made to a finance provider. This is an outflow for the company, as the company now has less cash after paying its loans than before it paid its loans.
Positive	An increase in loans payable is an indication that finance providers gave more financial support to the company by injecting more cash into it. This is an inflow for the company, as the company now has more cash in its bank account.
Negative	A decrease in share capital or other equity balance could indicate that the company has purchased back some of its shares from investors. This is a cash outflow for the company.
Positive	An increase in share capital or other equity balance could be an indicator that the company offered more shares or equity and received cash in return. This is a cash inflow for the company.

BASIC CONSIDERATIONS – Those Charged with Governance

The finance function should consider preparing and presenting the following to those charged with governance (TCWG) to assist them in understanding the context of the AFS even where there is no audit committee:

- Significant accounting policy or disclosure changes or identified issues;

- Consideration of any new accounting standards and their impact on the current accounting policies and disclosures;
- A report of significant transactions, accounting and auditing issues identified; the report could be a high-level document on:
 - How these transactions impacted the components of the AFS;
 - Whether there are any significant disclosures required owing to these identified issues;
 - Whether commentary relating to these issues needs to be included in the directors' or audit committee reports;
 - Whether any of these issues meet the criteria to be reported in the KAMs – where a company is required or has chosen to report on KAMs in its AFS;
- Information as to how and whether management has assessed the useful lives, residual values and depreciation rates as still appropriate and reasonable;
- Where there is goodwill in the balance sheet, how impairment has been tested, what was the calculated headroom and whether this headroom has increased or decreased from the prior year;
- Where there are impairment considerations, how management has assessed that the underlying assumptions are still appropriate and based on the latest available information;
- Whether management has written off any significant debtors or inventory in the current year; whether these were provided for in the prior year and, if not, how the impairment arose; and consideration of any significant events that could have arisen in the current period that might impact the impairment thereof;
- If the company has loans, how management has confirmed that the loan covenants have been complied with; this can be achieved through:
 - Review of minutes of meetings;
 - Review of subordinate contracts or any other contacts;
- Whether the company has any assets that were pledged as security and whether the disclosure in the AFS is adequate;
- Whether management has identified possible contingent liabilities and whether these have been disclosed, through review of but not limited to minutes of meetings, contracts and legal costs for completeness;
- The effective tax rate and whether it is significantly different from the effective tax rate of the prior year and, if yes, the components causing this difference;
- Consideration of any segment reporting requirements;
- In the case of consolidation, the accuracy of inter-company transactions and disclosures thereof and detailed disclosure of any related parties and related party transactions;
- During the cash flow statement review, whether non-cash flow items were accurately adjusted, e.g. depreciation, provisions and impairments;
- Foreign exchange transactions and disclosures;
- Any significant post-balance sheet events that have been disclosed in the AFS; the criteria used to identify which events required disclosure and which events

did not; and the period in which management assessed the events post the balance sheet;

- Whether management has performed solvency and liquidity tests for each company within the group (if in a group environment) and the conclusion reached for each company;
- How management concluded that it is appropriate to use the going concern assumption; in instances where a company has total liabilities that exceed total assets (insolvency) and where current liabilities exceed current assets (not liquid), the supporting evidence that management has obtained to support the going concern assumption, and the disclosures that have been made in the AFS and the directors' reports; and whether the directors' approval was required for any of the remedial actions and how the directors were informed of these issues;
- If the board of the company has reasonable grounds to believe that the company is financially distressed, then the board needs to consider going into business rescue;
- If the board has not adopted a resolution to commence business rescue proceedings, the board must deliver written notice to each affected person setting out the reasons for not initiating business rescue proceedings.

CONSIDERATIONS – Distributions authorised by the Board as required by the Companies Act of South Africa (Act 71 of 2008)

The Companies Act requires the directors to ensure that the distributions are declared in the correct manner and with the correct procedure. Not doing so could result in the possibility of a director being held personally liable for the amount the company paid out in terms of a distribution declared and paid in contravention of the Companies Act. The Companies Act extends this liability to include an alternate director, prescribed officer, a person who is a member of a committee of the board or the audit committee (irrespective of whether or not the person is also a member of the company's board). These people are subject to the same duties of care, skill and diligence as a director on the board.

Section 46 of the Companies Act of South Africa requires that distributions only be made if:

- Authorised by a board by resolution or pursuant to an existing legal obligation of the company or a court order; and
- Immediately after giving effect to the resolution, it reasonably appears that the company will satisfy the solvency and liquidity test; and
- The board resolution acknowledges that the board applied the solvency and liquidity test; and
- The board reasonably concluded that the company will satisfy that test immediately after completing the proposed distribution.

What are the solvency and liquidity tests?

Section 4 of the Companies Act sets out the solvency and liquidity test requirements for purposes of the Companies Act. These two tests are performed to indicate the overall general financial well-being of a company, which in the long run measures the business strength of that company.

- The total assets (as fairly valued) of the company must be equal to or exceed its total liabilities (as fairly valued) (including reasonably foreseeable contingent liabilities). This is a **solvency test**. A solvent company is one that owns more than it owes; in other words, it has a positive net worth and a manageable debt load.
- 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 12 months after the relevant action is performed or, in the case of distributions, 12 months after the distribution is made. The total current assets (as fairly valued) of the company must equal or exceed its total current liabilities (including reasonably foreseeable contingent liabilities). This is the liquidity test.

How to calculate the solvency and liquidity of a company

Solvency test

Calculate the solvency ratios (these are ratios that give an indication of whether the company's cash flows can service long-term debt – plus interest on that debt).

Below are examples of ratios to calculate to determine the solvency of the company:

- **Debt to equity = Total debt / Total equity.** This ratio indicates the degree of financial leverage being used by the business and includes both short-term and long-term debt. A rising debt-to-equity ratio implies higher interest expenses, and, beyond a certain point, it may affect a company's credit rating, making it more expensive to raise more debt.
- **Debt to assets = Total debt / Total assets.** This is another leverage measure that quantifies the percentage of a company's assets that have been financed with debt (short-term and long-term). A higher ratio indicates a greater degree of leverage and, consequently, financial risk.
- **Interest coverage ratio = Operating income (or EBIT) / Interest expense.** This ratio measures the company's ability to meet the interest expense on its debt with its operating income, which is equivalent to its earnings before interest and taxes (EBIT). The higher the ratio, the better the company's ability to cover its interest expense.

Liquidity test

- **Current ratio = Current assets / Current liabilities.** The current ratio measures a company's ability to pay off its current liabilities (payable within one year) with

its current assets such as cash, accounts receivable and inventories. The higher the ratio, the better the company's liquidity position.

- **Quick ratio = (Current assets – Inventories) / Current liabilities.** The quick ratio measures a company's ability to meet its short-term obligations with its most liquid assets and therefore excludes inventories from its current assets. It is also known as the "acid-test ratio".
- **Days sales outstanding (DSO) = (Accounts receivable / Total credit sales) x Number of days in sales.** DSO refers to the average number of days it takes a company to collect payment after it makes a sale. A higher DSO means that a company is taking unduly long to collect payment and is tying up capital in receivables. DSOs are generally calculated quarterly or annually.

Liability for contravention of section 46

A director will be liable for loss, damages or costs sustained by the company as a direct or indirect consequence of being present at a meeting at which a resolution approving a distribution was voted on, or for knowingly consenting to or failing to vote against the resolution approving a distribution, despite knowing that the distribution was contrary to section 46. Liability is joint and several with any other person who may be liable for the same act. Being present at a meeting means that the director is required to vote for or against the dividend. They cannot abstain from voting. If they abstain they may still be liable (section 77 of the Companies Act).

So what is the solvency and liquidity test?

When a company's balance sheet fails either a liquidity or a solvency test, this could be an indication that the going concern assumption used by the directors has not been appropriately considered.

In an instance where the current liabilities exceed the current assets, this could be an indicator that the company might not be able to honour its liabilities as these become due and payable within the 12-month period. In an instance where total liabilities exceed total assets, this could be an indicator that the company is not able to honour both its long-term and short-term obligations.

In these instances, the directors will have to make certain disclosures in the directors' report and also provide supporting evidence (letters of guarantee, subordination agreements, forecasts and cash flows) that the company will continue to be a going concern in future.

Should the board of directors have concerns with regard to whether the company is a going concern, then they need to consider business rescue and the definition of financial distress in section 128(f) of the Companies Act and the subsequent requirements.

CONSIDERATIONS – Other instances where the Companies Act requires solvency and liquidity tests to be performed

The solvency and liquidity tests must be utilised for all of the following:

- Financial assistance for the subscription of securities (section 44)
- Loans or other financial assistance to directors (section 45)
- Capitalisation of shares (section 47)
- Company or subsidiary acquiring company's shares (buy backs or buy ins) (section 48)
- Amalgamations or mergers (section 113)