

Auditors Beware

THE COMPANIES ACT No. 7 OF 2007. by Suren Rajakarier FCA

The new Sri Lankan Companies Act came into effect on 3rd May 2007. In accordance with certain provisions of the said Act, auditors are required to issue a certificate under specific circumstances called the 'Solvency Certificate'. In addition auditors may be required to resolve a question on determination of a fair and reasonable price in share purchase transactions. We as auditors would have to perform these tasks without performing a 'management function' for the client company.

Solvency

The directors of a company must consider whether a company meets the solvency test in certain circumstances, including:

- Distributions to shareholders
- Redemption of any shares.
- Assistance by the Company in a purchase of its own shares.
- An amalgamation proposal.

As part of their consideration the Directors will ask the auditors for a Solvency Certificate. To fulfil this responsibility placed on auditors, we would be required to perform reasonable procedures in accordance with the Sri Lanka Auditing Standards and the Sri Lanka Auditing Practice Statements.

As this procedure was considered very important, it has been included in the Companies Act. Therefore, hope that all auditors will be placing equal importance whilst issuing such a certificate and therefore fulfill their responsibility to the shareholders. From recent events it is also evident that the regulators' expectation from such a certificate is very high, in order to control recklessness of directors.

In many cases, as a result of prudent management, companies will meet the test fairly easily. However, directors of companies that are marginally solvent will need to know with certainty whether the test has been satisfied, as this may be difficult to establish at a later date.

The Test

To satisfy the solvency test:

- A company must be able to pay its debts as they become due in the normal course of business; and
- The value of the Company's total assets must be greater than the total value of its liabilities and its 'Stated Capital'
- In computing the value of assets and liabilities, a fair valuation or assessment may be taken into reckoning.

When to Test?

The solvency test must be met on an amalgamation or if a company proposes to:

- Make a distribution;
- Repurchase or redeem shares; or

- Provide financial assistance for acquiring the company's own shares.

Mandatory Considerations

In considering whether a company meets the test, directors must have regard to:

- The company's most recent financial statements that comply with section 151 of the Act, whilst Section 150 stipulates that such financial statements are to be in compliance with the requirements of the Act.; and
- All other circumstances that they know, or ought to know, may affect the value of the company's assets and liabilities (including contingent liabilities).

The test implies that directors will not be allowed to close their eyes to circumstances.

Distributions

In the case of distributions, prior to making a 'Distribution', the Board of Directors have to be satisfied that the Company immediately after the proposed 'Distribution' will satisfy the 'Solvency Test'. To pass the solvency test, companies must be able to pay their debts as they fall due (cash-flow test) and must have a positive net asset balance less the stated capital (balance-sheet test), after making the dividend.

Directors' Obligations

Directors are required to resolve that the company will be able to pass the solvency test immediately after the relevant transaction is implemented. The directors must also sign a certificate to that effect setting out in full the reasons for their opinion.

Directors should, for their own protection, set out in detail the grounds for their opinion that the company is solvent. References should be made to valuations, reports, and advice taken or received on which the opinion is based. Failure to provide adequate reasons in the director's certificate may raise an inference, in hindsight, that the directors did not have any reasonable grounds for their belief.

Auditors' Duties

In order to fulfil our responsibility we should request from the Board;

- A letter setting out the planned distribution, if it's a distribution or other plans
- Adequate time to perform the required procedures
- Latest financial statements prepared in accordance with SEC 151 of the Act
- The Directors assessment of the fair value of assets & liabilities, in the event of fair value or another method of assessing the value of assets and liabilities is used
- The Directors assessment of the company's ability to pay its debts as they become due in the normal course of business
- A cash-flow statement proving that the company will be able to pay their debts as they fall due after the planned distribution.

As auditors we would have to consider the appropriateness of the latest financial statement provided to us. As required by section 151 the latest financial statements are required to give a 'True & Fair View' and an audited financial statement would qualify this test, however, interim dividends may be paid during a financial period where the interim financial statements may not have been audited.

Plan the work as required by the auditing standards. The cash-flow test has a prospective element to the work and the balance sheet test can be easily carried out based on audited

financial statements, except for adjustment for any event that occurred subsequent to approving the audited financials. Therefore, more the time gap between the date of the solvency certificate and the distribution date, more the level of judgment will be.

Further, under the Act a certificate is required from the auditor. Therefore, it may be appropriate for the auditor to provide 'reasonable assurance' by way of the certificate. As this Act can be termed a public interest legislation the auditor should not agree specific limited procedures with the directors and then report on factual findings, as this would defeat the purpose of such legislations.

In short, in deciding whether a company is solvent, directors must be hard-headed and realistic; and auditors must be independent and technically competent to give an opinion.

Fair and Reasonable Price Determination by Auditor

Where the Board agrees to purchase the Shares by the Company, the Board shall as per Section 95 nominate a fair and reasonable price, and give notice to the Shareholder, and the Shares are then deemed to be purchased by the Company, upon receipt by the Shareholder of such notice.

If the price nominated by the Board is not acceptable to the Shareholder, he shall give notice of objection to the Company, then the Company shall refer the question of determination of a fair and reasonable price to the Auditors.

This would be an instance where the auditor will be brought to perform a task bordering on management functions. This type of engagement is not clearly covered under auditing standards and therefore the auditor would have to get extensive guidance from an expert or their international affiliates to arrive at a conclusion. Standard form certificates should be avoided. Each certificate should be specifically tailored to the relevant company and its particular character and circumstances.

Other Rules for Auditors

- Auditor should ensure that judgment is not impaired by reason of any other relationship with or interest in the Company or any of its subsidiaries. Therefore, certain rules for independence have been introduced.
- Auditor shall deliver to the company a statement of amounts payable by the Company as audit fees and expenses and as a separate item any fees and expenses payable by the Company for other services, along with the audit report.
- Auditors on ceasing to hold office must deliver:
 - statement on circumstances connected therewith which should be brought to the attention of shareholders/ creditors or
 - statement that there are no circumstances that merit the attention of shareholders/ creditors

This article is not supposed to provide a legal view or interpretation of the Companies Act. The writer has endeavoured to highlight certain key provisions that would affect a member of ICASL as an auditor, in complying with the requirements of the Act.

The writer is a fellow member of the ICASL & CIMA and is a partner of KPMG Ford Rhodes Thornton & Co. He is also the alternate chairman of the Statutory Accounting Standards Committee and a member of the Statutory Auditing Standards Committee.