LETTERS OF SUPPORT

Introduction

This circular provides guidance that is to be read in conjunction with the Accounting and Auditing Guide on Trading Whilst Factually Insolvent. The circular does not replace the Guide but serves to provide additional guidance in situations where evidence of continuing support of a third party is required, and is sought by means of a letter of support. The auditor is advised to note, however, that a letter of support should not be regarded as a substitute for a subordination agreement. .01

When obtaining a letter of support the auditor should have regard to the intention and ability of the provider of the support to comply with the terms contained therein. .02

Where evidence of continuing support of a third party is required, and is sought by means of a letter of support

A letter of support is an undertaking, usually but not necessarily by a parent company giving comfort about financial support to be provided to its subsidiary. For purposes of this Circular reference is made to a parent company and its subsidiary, although letters of support may be used in other kinds of business relationships as well. .03

Letters of support vary in their wording, but most are likely to contain one or more of the following statements: .04

- The parent company indicates that it is aware of its subsidiary's obligations.
- The parent company states that it will not reduce its shareholding or participation in the subsidiary during the currency of the obligations.

- The parent company states that it will provide its subsidiary with the financial means to meet its obligations.
- The parent company states that it will do everything in its power to ensure that the subsidiary is properly managed in accordance with prudent fiscal policies so as to ensure repayment of any obligations.
- The parent company states that it will exercise its influence on the subsidiary to meet its obligations.
- The parent company states that its policy is to ensure that the subsidiary is in a position to meet its obligations.
- The parent company states that its policy is to support its subsidiary.
- The parent company states that it has complete confidence in the management of its subsidiary.
- The parent company states that it has always regarded its subsidiary's obligations as its own.
- The parent company states that it will arrange for the subsidiary's commitments to its third parties to be performed in a satisfactory way.
- The parent company states that it will exert its full influence over the subsidiary to repay its third parties on maturity.
- The parent company states clearly the nature of the support that it intends to provide to its subsidiary.
- The parent company states clearly the extent of the support that it intends to give to its subsidiary.
- The parent company states clearly the period for which the letter of support is intended to be operative.

.05 The auditor should be aware of the fact that the wording of the letter of support might not necessarily create a binding legal obligation, and should therefore seek to satisfy himself as to the intention and legal enforceability of the letter of support. Where the letter of support merely indicates a general intention to provide support it might not be enforceable.

.06 The use of letters of support as opposed to other more definite forms of obligations such as a guarantee may give rise to an initial inference that the parties do not wish to create legal obligations. This inference will be reinforced or dispelled by the actual language of letters of support.

The wording of the letter of support should therefore be examined meticulously to determine the true intention of the entity providing the letter of support.

.07 In determining the adequacy of the letter of support as audit evidence, the auditor should apply his judgement as to whether or not legal advice should be obtained in relation to the enforceability or otherwise of such letter of support.

Johannesburg   **I Sehoole**
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