Chapter five

The role of the external auditors, Ernest & Young ("EY")

A Statutory Framework

Companies Act, 61 of 1973

38 In terms of s286(3) the annual financial statements of a company shall, in conformity with generally accepted accounting practice, fairly present the state of affairs of a company and its business at the end of the financial year concerned and the profit or loss of the company for that financial year and include at least the matters prescribed by Schedule 4 of the Act and comply with any other requirements of the Act. The Accounting Practices Board issues statements of generally accepted accounting practice, known as "big GAAP". Practices which are not codified and contained in a statement may also constitute generally accepted accounting practice, known as "little gaap". But as indicated in circular 8/99 dated December 1999 issued by the South African Institute of Chartered Accountants companies are required to report in terms of GAAP. A company should disclose the precise basis of its accounting policy (ie GAAP or gaap) in its financial statements: Henochsberg on the Companies Act, p 551. S300 provides that it is the duty of the auditor of a company –

(a) to examine the annual financial statements and group annual financial statements to be laid before its annual general meeting;

(b) to satisfy himself that proper accounting records as required by the Act have been kept by the company. Section 301(1) provides that when the auditor of a company has complied with the requirements of, and has satisfied himself as to the matters stated in s300, and has carried out his audit free from any restrictions whatsoever, he shall make a report to the members of the company to the effect that he has examined the annual financial statements and group annual financial statements, and that in his opinion they fairly present the financial position of a company and its subsidiaries and the results of its operations and that of its subsidiaries in the manner required by the Act.

Banks Act, 94 of 1990

39

39.1 In terms of s63(1) the auditor of a bank –

(a) shall, whenever he furnishes, in terms of s20(5)(b) of the Public Accountants' and Auditors' Act 80 of 1991, the Public Accountants' and Auditors' Board ("the Board") with copies of the report relating to an irregularity or suspected irregularity in the conduct of the affairs of the bank for which he has been

appointed, also furnish the Registrar of Banks with such copies and particulars, and;

(b) shall in writing inform the Registrar of any matter relating to the affairs of a bank of which such auditor became aware in the performance of his functions as auditor and which, in the opinion of the auditor, may endanger the bank's ability to continue with a going concern or may impair the protection of the funds of the bank's depositors or may be contrary to the principles of sound management (including risk management) or amounts to inadequate maintenance of internal controls.

39.2 The regulations issued on 26 April 1996 in terms of the Act provide that the annual financial statements of the bank and of a controlling company shall be compiled in accordance with generally accepted accounting practice as required by s286(3) of the Companies Act, 1973 (reg. 4(1)). The consolidated annual financial statements of a bank or a group of banks shall be prepared in accordance with generally accepted accounting practice (reg. 5(3)). The auditor of a bank shall annually, in addition to any other report that a bank is statutorily required to obtain from him, report on the bank's financial position and the results of its operations (reg. 6(1)). The auditor shall annually report on any significant weaknesses in the system of internal

controls relating to financial regulatory reporting and compliance with the Act and the regulations, which came to his attention while performing the necessary auditing procedures to enable him to furnish the reports required under sub-regulation (2). (Reg. 6(3)).

Public Accountants' and Auditors' Act no 80 of 1991

40 Section 20(5)(a) provides that if any person acting in the capacity of auditor to any undertaking is satisfied or has reason to believe that in the conduct of the affairs of such undertaking a material irregularity has taken place or is taking place which has caused or is likely to cause financial loss to the undertaking or to any of its members or creditors, he shall forthwith despatch a report in writing to the person in charge of that undertaking giving particulars of the irregularity, at the same time drawing the attention of such person in charge to the provisions of paragraphs (b) and (c) and requesting him to acknowledge receipt of such report in writing.

In terms of s20(5)(b) unless within 30 days after an auditor has despatched such a report, he has been satisfied that no such irregularity has taken place or is taking place or that adequate steps have been taken

for the recovery of any such loss so caused or for the prevention of any such loss likely to be so caused, he shall forthwith furnish the Public Accountants and Auditors Board ("PAAB") with copies of the report and of any acknowledgement of receipt thereof and reply thereto and such other particulars as he may deem fit.

Chapter 13 of the King Report

41 The King report points out that the audit provides an independent and objective check on the way in which the financial statements have been prepared and presented by the directors exercising their stewardship to the stakeholders. An annual audit is an essential part of the checks and balances required and is one of the cornerstones of corporate governance. Generally accepted accounting practices should only be departed from in the interest of fair presentation. Whilst auditors have to work with management they have to do so objectively and consciously aware of their accountability to the shareholders. The highest standards of business and professional ethics are to be observed by the external auditors.

42 The Registrar testified that as a fact the Reserve Bank relies "very heavily on the external auditors …. They are providing us with independent opinion of the affairs of a bank, specifically as far as the solvency of a bank is concerned and adherence to prudential requirements" (3203, 3221).

B The 2000 Audit

The interim results for 1 March 1999 – 31 August 1999

43 The interim results were published on 22 September 1999 (010009), without the approval of the audit committee which met only on 29 September 1999 ((K2)205.2). Levenstein's justification was that the bank was keen to get its results into the market as soon as possible as "the year-end results, the share price had been badly hit" (1553).

Materiality

44 The materiality level was originally set at R5m (010015), revised to R5.5m (010036) and just before finalisation of the audit was R6.9m (020041). The materiality level increased despite the reduction in the before tax profits of Regal Holdings which were originally estimated at R80m and finally determined at R55.5m.

The branding dispute between EY and Regal Bank for the 2000 financial year

45

45.1 In early April 2000 EY identified an issue relating to the recognition of income derived from branding. On 6 April 2000 Wixley, the chairman of EY, Coppen, a technical partner, Strydom and Van Heerden, the engagement partner, met to discuss the issue (Van Heerden 1021).

45.2 Following on that meeting, and in preparation for an audit committee meeting to be held on 12 April 2000, a document containing "Audit Issues" was drafted by EY. In regard to branding it was said:

> "It is extremely unusual for the measurement of income to be based on an internal valuation. This is because internal valuations will always be subject to some or other bias. Thus income is normally based on transactions with third parties, or by reference to an active market. If none of the above bases is available to establish a value of the income, a conservative approach should be used, and no income recognised until the profits are realised in a transaction with a third party.
>
> … It is not accepted practice to recognise income from investments upfront. Rather the income should be recognised when an investment is sold to an independent party." (010126).

45.3 On 10 April 2000 a board report was prepared by EY (010103) and on 11 April 2000 Van Heerden and Wixley met to discuss the audit committee meeting which was to take place the following day (Van Heerden 1026).

45.4 The audit committee met on 12 April 2000 (010133). There is no minute of the meeting. Van Heerden's recollection is that the "Audit Issues" document was discussed. No agreement could be reached between EY and Regal Bank on the correct treatment of a number of issues, including income from branding (Van Heerden 1027). Buch was a director of Regal Holdings and Regal Bank from inception. He was chairman of the audit committee in 2000. He recalled the audit committee meeting of 12 April 2000. According to Buch, Van Heerden said that EY "had a problem with the branding income". Buch was shocked that EY had raised the issue at such a late stage. The dispute could not be resolved at the meeting. After a lengthy discussion, it was agreed that independent valuations would be obtained (2713-4).

45.5 On the following day, 13 April 2000, Wixley and Van Heerden met with Levenstein. At the end of the discussion, the EY representatives remained unconvinced by Levenstein's views on the valuation of the branded entities and what income was to be taken into account (Van Heeden 1028).

45.6 On 14 April 2000 Van Heerden sent a fax to Levenstein in which he referred to the significant outstanding issues, one of which was “the finalisation of the branding accounting treatment and evaluation thereof”. Levenstein was informed that Thayser, an EY partner in the corporate finance division, would place a value on the branded investments (010133). Levenstein objected to Thayser. Cooke of the corporate finance department of EY then replaced him.

45.7 On 14 April 2000 Levenstein replied to Van Heerden’s fax of the same day. Levenstein asserted: “I confidentially (sic) and emphatically assert however that the conceptual ideology and philosophy regulating and supporting my financial model neutralises the material issues which your correspondent crystallises into focus from an EY perspective. The model creates certain new financial and economic fundamentals that transcend traditional norms.” (010135). Levenstein did not complain that EY had raised the dispute too late.

45.8 The preliminary results for 2000 were due to be released on or about 18 April 2000 (KPMG 168). The results are signed by Lurie and Levenstein. They were not released. The original results had been described as “audited” but were changed to

"preliminary" when the branding income dispute with EY arose (Levenstein 1366).

45.9

45.9.1 There are no minutes of a board meeting in April 2000.

45.9.2 Levenstein alleged in evidence that the results of 18 April 2000 were approved by the board at a formal meeting (1364-8).

45.9.3 Lurie said that if there was no minute of a meeting, then no meeting had taken place (2460-1).

45.9.4 Buch came with a new version, which was that there was a board meeting on 12 April 2000, after the audit committee meeting of that day (2715), but he could not explain why the meeting of the board on 26 March 2000 (K(2) 219) was the 51st meeting and that the meeting on 24 May 2000 (K(2) 225) was the 52nd meeting (2721). Buch testified that the board was informed about the branding income dispute. The board nevertheless approved the financial results in the hope that the issue with EY would be resolved in the bank's favour, i.e. if EY retracted their opposition to the branding income, the results would be approved. The board had in its possession a document similar to the "preliminary results" dated 18 April 2000.

The board approved earnings per share of 79.96 cents (2717-2723, 2765).

45.9.5 Diesel could find no minute of a board meeting in April 2000 or May 2000. His recollection was that there was an audit committee meeting and a board meeting on the same day at about that time "and it was made known to the directors at that point in time that there was a dispute over the branding income" (2659).

45.9.6 The evidence of Davis was heard in camera after a successful application in camera. In essence, the submission on behalf of Davis, was that he is a "mental wreck" as result of abuse that he was subjected to at the bank, particularly at the hands of Levenstein. A letter by a clinical psychologist was handed in, in which the view was expressed that "due to his intensive anxiety, severe stress and being emotionally labile, … if he's exposed to a public enquiry and the media, it would be detrimental to my patient and his present treatment protocol." Davis became very emotional during the application and at one time the commission stood down to enable him to recover.

At the time of the 2000 audit, Davis, who is a chartered accountant, was the chief financial officer and group

company secretary (2832). One of his functions was to keep minutes of board meetings.

45.9.7 He testified that during the course of December 1999 an employee of EY spoke to him about the branding income item on the trial balance sheet, at that time in an amount of about R20m. Levenstein instructed him to provide details of the income to EY "only if they signed a non-disclosure agreement because he referred to it as our recipe for Coke". Davis never saw EY again during the course of the interim audit. EY left the branding income issue "until the death of the audit" (2835).

Davis attended the audit committee meeting of 12 April 2000. He described the disagreement between Levenstein and Van Heerden in detail. Davis added that the meeting ended on the basis that independent valuations would be obtained and the announcement of the results would be postponed for three weeks.

He had no recollection of a board meeting that day. Had a board meeting been held, he would have attended and kept minutes (2840).

45.9.8 He was the creator of the financial part of the preliminary results of 18 April 2000 (KPMG 168) and Levenstein the author of the commentary (2843).

45.10 At the time the results of 18 April 2000 were to be published, Levenstein, and at least the other members of the audit committee, knew that EY had not approved the results. EY raised their contentions about branding income at the audit committee meeting on 12 April 2000; EY met with Levenstein on 13 April 2000 and on 14 April 2000 correspondence about the dispute was exchanged. Yet the bank was so determined to publish its version of the results, that it instructed printers to produce a glossy one page set of results without the approval of its auditors. The disputed branding income made a massive difference to the results: in 1999 other income was R17.6m whereas in 2000 as at 18 April 2000 it was R76.5m (Levenstein 1423).

45.11 On 4 May 2000 EY received Cooke's valuations. He valued the business of RMI at R20.5m, of which Regal Bank's 25% share was worth R5.1m (010172) and he placed a nominal value of R1m on Kgoro, of which the bank's 25% share was worth R250 000 (010161 – 010181).

45.12 The amount Levenstein included in branded income was R55m. Justification for R50.8m, was given in a document in his handwriting as follows:

RMI	R23m
Kgoro	R15m
Medsurge	R8m
Protea Health	R4.8m
	R50.8M

(KPMG 37)

45.13 On 4 May 2000 Wixley, Van Heerden and Heeger of EY met with Levenstein. Extensive discussions did not resolve the dispute. EY informed Levenstein that if the Regal figures were not amended, EY would qualify their report. Levenstein said they should do so. EY offered to resign (Van Heerden 1031).

45.14 On 4 May 2000 Levenstein wrote a letter to Wiese in which the dispute with EY was foreshadowed (N26). Annexures were enclosed. (The annexures may be those at N39 – N69.) He stated: "E&Y are struggling to blend Old Economy accounting standards with my model's sophistication" .

45.15 On 5 May 2000 the BSD and EY met (E41) EY explained the Regal branding model and referred in particular to the bank's 25% share in RMI and 25% share in Kgoro. EY said that there was disagreement between them on the valuation of the investments and how these were to be accounted for in terms of

GAAP. Wiese telephoned Levenstein and said that if EY qualified the 2000 financial statements, he would appoint a curator. The discussion ended on the basis that KPMG would be appointed in terms of s7 of the Banks Act to give a view.

45.16 On the same day Levenstein wrote a letter to Van Heerden of EY (N105) in which Levenstein motivated his position. The letter ended as follows: "Every effort was made to 'work around' your inability to accept the complexities of my various structures and products. My attempts, for example, to accommodate your unjustified and iniquitous draft audit opinion. This was only done to protect and safeguard shareholder and depositor interests. We remain committed to our financials. We strictly reserve all our rights".

45.17 On the same day Levenstein wrote a letter to Wiese in which he contended that EY had not applied themselves professionally; that he was confident that KPMG would share his sentiments; and that there was absolute agreement that he had created a significant banking product that could revolutionise the banking industry (N11).

45.18 On 9 May 2000 Levenstein was interviewed by Alec Hogg on radio in which he was asked about the "franchising business that caused so much trouble at your last financial year". Levenstein explained the branding model and said: "…. the important thing is that track record has been achieved, we've confirmed value in

most cases by converting equity. We received equities in lieu of cash, we've converted them into cash, so that issue has been resolved completely" (S1).

45.19 On 14 May 2000 Levenstein wrote a letter to Wiese in which he repeated his views with comments from other commentators that "the qualification envisaged by Ernst & Young is totally unjustified and indeed irresponsible". He added: "Regal and myself remain totally committed to the year-end financials approved unanimously by the Board and the Audit Committee." (E78). (At the meeting on 5 May 2000 EY had told the BSD that they had been unable to convince the audit committee, at two meetings, that the branding income should not be allowed.)

45.20 On 15 May 2000 KPMG produced its s7 report (E56; DT309).

KPMG was given an undated document signed by Levenstein (KPMG163) in which Levenstein gave the make-up of the amount of R55m which he claimed should be included in "other income" in the audited financial statements (E60). The amount of R50.8 m was included in the amount of R76 595 841 given as "other income" in Regal Holdings preliminary results dated 18 April 2000 (but not released) (KPMG 168).

The report described the branding model (E61).

The model was measured against AC000. In regard to "income" it was found that the model met all relevant criteria, save one, namely:

Standard:	KPMG's comments:
"It can be measured in monetary terms with sufficient reliability.	There is however uncertainty surrounding the value which in turn cast doubt over the reliability of the value. The reason for this uncertainty arises from a lack of being able to verify with certainty the basis on which the branding fee was calculated. In addition, independent valuations performed in support of two of the transactions, are based on projected cash flows, which are in turn dependent on a number of assumptions largely due to the lack of a financial track record in support of these branded entities …" (E71)

In regard to "fair value" the criteria of AC111 §09 was: "The amount for which an asset could be exchanged or a liability settled between knowledgeable willing parties in an arms length transaction".

KPMG came to the conclusion that the amounts reflected in the financial results did not meet the current requirements of South African GAAP (E76).

The conclusion was: "Given that the two new start up ventures, RMI and Kgoro, do not have proven track records as at 29 February 2000, it is difficult to assign an absolute fair value to the licence fee underlying these transactions. This in turn indicates that we are unable to measure fair value with certainty" (E74).

45.21 On 15 May 2000 the BSD held four meetings (I think in this order): with KMPG; with Levenstein and KPMG; with EY; and with EY, Lurie and Buch (E42 – E52). For present purposes it is sufficient to emphasise:

- Levenstein refused to back down and was willing to take the consequences of EY qualifying the 2000 financial statements (E53) (Levenstein 1407);
- Lurie and Buch initially supported Levenstein, but when faced with the threat of deregistration of the bank (E46) agreed that the financial statements could reflect EY's valuations (E48). The amount EY allowed for branding income was R5.5m (010227).

45.22 On 16 May 2000 Regal Holdings published on SENS its "audited" results for the year ended 29 February 2000 (E55.1) In

regard to the "banking model", a great deal was said, including the following: "The leverage of our statutory framework to bridge the gap between a bank and business concern, creates a new financial instrument: and by overlaying the profile of the bank onto a business platform, the risks inherent in the created instrument are dramatically reduced. … Prevailing accounting standards do not have the flexibility to account for the model… The model has and will create enormous wealth for shareholders … Regal are in disagreement with the Auditors regarding the disclosure and treatment of certain investment securities created by the model … The diversions between old and new accounting standards manifests in a so called valuation difference of R30,5 m, after taxation, reducing earnings per share by 30 cent. The board approved the year-end results reflecting earnings per share of 79,96 cents. At the request of the Registrar of Banks we have agreed to defer the valuation difference."

45.23 Van Heerden was out of town on the night of 15 May 2000 and the day of 16 May 2000. During the day on 16 May 2000 he responded to a message to call Martin of BSD. Martin told Van Heerden that Regal intended publishing the results that evening and that he had a final draft of what was to be published. Wixley, Strydom and Van Heerden met at about 20:00 that night. They had a poor copy of a fax which Martin had sent them. Before they could obtain a more legible copy, the Regal Holdings results were released onto SENS (010244.03) (Van Heerden 1041 – 1043).

45.24 After receiving the Business Day of 17 May 2000 in which the audited results were published by Regal Holdings (010292) Wixley wrote a letter to Regal Holdings (010296). A number of comments were made. The first was that the draft announcement was not sent to EY by Regal Holdings prior to its submission for publication, as EY had requested, nor was it considered at the formal meeting of the audit committee. After setting out a number of other concerns the letter asked for a correcting statement that should clearly state that:

"- the figures set out in the announcement are in accordance with generally accepted accounting practice and have the full approval of the directors;

- the changes to the financial statements were made following discussions with the auditors and were not made at the request of the Registrar of Banks; and

- the references to earnings per share of 79.96 cents in the announcement should be ignored."

45.25 EY's objections to the financial statements of Regal Holdings published on 16 May 2000 were these:-

-The results should not have been described as "audited" as EY had not approved the results (Van Heerden 1049).

- In the Income Statement the earnings per share were shown as 50.01 cents (010292) whereas in the commentary on the

"Banking Model" it was said that the "Board approved the year-end results reflecting earnings per share of 79.96 cents".

- The final paragraph of the section on "Banking Model" contained these allegations: "All expenditure incurred to generate this income has been written off in the current year. We estimate that approximately R18m of the expenditure relating to the new model has been accounted for on this basis. Generally accepted accounting practice allows for the setting off of this expenditure against the income deferral." The truth is that not all the expenditure had been written off: R6m had been deferred (Van Heerden 1052, 010227).

45.26 On 18 May 2000 a report appeared in Business Report: "Regal's share reels on news of accounting disagreement" (E55.2) Levenstein is quoted as saying that he had been prepared to accept an exceptional qualification to the results, but Wiese had threatened to close down the bank if Levenstein accepted the qualification as a bank could not release qualified accounts.

45.27 On 19 May 2000 Regal Holdings published this retraction on SENS (010300): "Regal directors together with our auditors Ernst & Young wish to place on record that the 50 cents per share referred to in the results was arrived at in accordance with generally accepted accounting practice and that further reference

to the amounts of 79.96 cents per share were based on alternative valuation and accounting methodologies".

45.28 On 23 May 2000 Levenstein wrote two letters to Wiese (N15 and N20) in which he explained the branding model and attacked EY for being negligent "(possibly even grossly negligent) and unprofessional" in various respects. The one letter ends off as follows: "While I obviously cannot prescribe to you regarding your role as the Registrar of Banks, I trust that your observations of Ernst & Young's conduct during this sorry saga will prompt you to ensure that Ernst & Young are prohibited from being appointed as statutory auditors of any South African bank in the future." (N16).

45.29 At a meeting between the SARB and Regal Bank on 23 August 2000 Lurie said that "Regal would no longer rely completely on [the branding] strategy. … The non-executive directors were confident with the current status of the branding strategy." (E161).

45.30 There were four material differences between the preliminary results of 18 April 2000 (KPMG168), which were not released, and those that were released on 16 May 2000 (E55.1):

a) in the former the "other income" was R76 595 841while in the latter it was R27 045 839, a difference of R49 550 002;

b) in the latter the section on "Banking Model" was added (which incensed EY), a day after the meetings between Regal and the BSD;

c) operating expenses were R35.3m in the preliminary results of 18 April 2000 and R29.3m in the results of 16 May 2000, the difference being R6m, the precise amount of expenditure which was deferred (010227).

d) The word "audited" was removed from the results of 18 April 2000 and replaced with "preliminary" when the branding dispute arose with EY (Levenstein 1395) and yet the results of 16 May 2000 were described as "audited" even though EY had not seen them before publication and the operating expenses had been changed. Levenstein testified that he anticipated the approval of EY (1452). The word "audited" was deliberately chosen (1453). Levenstein said that on the night of 15 May 2000 Davis made contact with Van Heerden of EY and Van Heerden agreed to all the entries (1455-6). Davis said Van Heerden had not agreed to anything (2848).

45.31

45.31.1 Branding expenditure of R18m could not be substantiated. Levenstein said that EY subsequently audited the amount (1410). The only expenditure

referred to in the bank's documents was the R9m in Davis' handwriting (010237) of which R6m was recognised by EY (010227). Levenstein alleged that Davis prepared an "analytical document" (1414, 1418, 1434, 1439). When faced with the handwritten Davis note, Levenstein said that the expenditure must have been R24m (1422). Lurie also testified that Davis had prepared "an analytical document proving the R18m figure" (2467). The coincidence that both Levenstein and Lurie should describe a document as "analytical" cannot be accepted. The probabilities are that they discussed the matter after Levenstein had given evidence and came up with that description.

45.31.2 Levenstein alleged that he did not know that the R6m of expenditure had been deferred (1421, 1437). He wanted to defer the whole R18m but did not do so because EY did not make contact on 16 May (1426, 1434). He did not know that if the R6m had not been deferred, the bank would have made less profit in 2000 than in 1999 (1436-8). Later in his evidence, Levenstein said that Davis would

have discussed the R6m with him and he would have given Davis guidelines (1454).

45.31.3 Lurie said he did know about the deferral of R6m and the reduction in expenditure from ±R35m to ±R29m: he was told by Levenstein or Davis (2466).

45.31.4 Buch testified that "with hindsight", as he had not seen the 16 May 2000 results until they were published, he now knows that R6m branding expenditure was deferred; that there was further expenditure because of the R18m referred to in the "banking model" section in the 16 May 2000 results; and that R24m expenditure must have been incurred (2756-7). He first applied his mind to the results late on 16 May 2000 or on 17 May 2000. He never received any documentary proof of the R6m, R18m or R24m expenditure (2757-8). He had never seen the Davis note (010237) before (2772). Buch was shown the note and asked if that was a proper way to arrive at expenditure. His answer was "No, I do not think that is a very sophisticated way of

calculating the expenditure that was incurred" (2773).

45.31.5 On 15 May 2000, according to Davis, he was requested to contact Van Heerden of EY. He left a message on Van Heerden's cell phone. Van Heerden returned the call. Davis mentioned the issue of expenditure. Van Heerden said he was away at a two day conference and he did not know if he could arrange for someone from EY to go to the bank the next day (2846). Van Heerden did not agree to anything in that conversation (2848). There was no discussion about the R6m expenditure deferral (2875).

45.31.6 On the instructions of Levenstein, Davis prepared a document dated 15 May 2000 which he sent to Van Heerden by fax or e-mail on 15 May 2000 (030427). The document is important. The material part is quoted in full: "Please note the following in respect of the Branding income:-

a) The branding strategy represented a formal departure from conventional old economy strategies;

b) As a result of this change in strategy, corporate finance was closed down. Had Corporate Finance continued it would

have generated approximately an additional R6m in net income, through additional deal flow;

c) By pursuing the Branding strategy, the Bank changed its view on gilts, opting to invest in R100 m, instead of R200 m. At a 5% spread, the Bank relinquished the opportunity to generate an additional R3 m in interest turn;

d) Approximately R2m in costs were incurred in opening the growth gates, in order to support the brand model, through bringing in Neck Steen, the Syfrets 6 and the utilisation of Jeff's time and effort, etc;

e) Free-funding allocated to new buildings to house the model's growth resulted in lost interest income of approximately R2 m;

f) The growth in costs, in anticipation of the Branding model have been approximately R9m.

In summary, total costs of approximately R22m were incurred in developing and growing the banking model. On the basis that your valuation of R5.25m in respect of Kgoro and RMI is recognised in income, costs of approximately R20m should be removed as they pertain to the unrecognized portion of the branding income. The net effect is that R2m of expenses remained to be deducted against the R5.25m of branding income. On this basis, net income after taxation would drop by R16.8 m and eps by 16.5 cents."

45.31.7 Van Heerden had no recollection of seeing the Davis letter of 15 May 2000 on his return to office. While Davis did say that he sent the letter by e-mail or fax, no proof was provided of delivery in either form.

45.31.8 The information in the document was given to Davis by Levenstein, so testified Davis. Levenstein was looking for a R20m adjustment. Davis conceded that all the expenditure reflected in the document was not genuine expenditure, could not be recognised as expenditure, and he did not expect EY to agree to the figure (2856-2863).

45.31.9 On being recalled to give evidence, Levenstein denied that the letter was the "analytical" one he had referred to earlier (3473). He said that he could "remember seeing financial arithmetic arriving at the R18m figure" (3475). Levenstein agreed that at least one of the amounts which made up the R22m did not qualify as expenditure (3478).

45.31.10 According to Davis, the amount of R6m for deferred expenditure was given to him by Levenstein (2849). Davis did not know how

Levenstein had arrived at that amount (2849-50). He thought the figure was probably "designed to avoid releasing a profit warning" (2851).

45.31.11 The Davis note (010237), quoted in full in paragraph 47.3 hereof, was created on 18 May 2000 when EY sent Heeger to the bank to check the adjustments made in the results published on 16 and 17 May 2000 (2854-5). The calculation was done in that rough and ready way at the suggestion of Heeger (2856). Davis agreed that the amount of R9m, R6m of which was deferred, would not meet the requirements of GAAP (2865).

The section in the 16 May 2000 results "banking model" was Levenstein's insertion, according to Davis (2867). Davis denied that the figure of R18m branding expenditure came from him (2868).

45.31.12 Davis' evidence was that some time after the audit Levenstein, when he "was trying to build up some sort of case against Ernst & Young" requested Davis to lie. Levenstein later repeated the request. Davis could not recall the content of the lie: "he asked me to say that Andre

[Van Heerden] had accepted the deferral or that he had said he was going to send somebody over" (2870-2873).

45.32 Levenstein emphasised that branding income was recognised by EY, applying GAAP, even though it was for a much lower amount (R5.5m) than he would have wanted (R50.8m)(1472-3).

45.33 The audited results published on 16 May 2000 were significant for what was not disclosed. The new section on the "banking model" by implication was critical of EY, promised "enormous wealth for shareholders" and stated that the divergence between the old and new accounting standards had led to a valuation difference of R30.5 m, after taxation. But what was not said was that:

- the bank intended to reflect "other income" of R76.5 m instead of the R27 m actually shown;
- EY had threatened to qualify the financial statements if Holdings insisted on reflecting the higher amount;
- the dispute related to projected income from branding, a vital element of the banking model;
- KPMG was appointed by the Reserve Bank to review the valuations;
- KPMG supported EY and went further and opined that no value should be attached to the branded entities;

- Lurie, Levenstein and Buch had agreed the previous day, to the EY valuations.

45.34 Levenstein admitted in evidence that Regal Holdings was obliged to comply with GAAP. He contended that Regal Holdings did comply with GAAP (1322, 1328, 010047). Levenstein does not appear to be contending that EY and KPMG (and now DT) were not applying South African GAAP correctly. And that is a major problem for him. They were not negligent if, according to GAAP, the income could not be recognised and the assets increased in respect of the branding entities.

45.35 Louw of KPMG explained that Regal Bank's stated accounting policy for unlisted investments was to account for them at cost, less provisions for any losses due to a diminution in value. In line with that policy, Levenstein attempted to persuade EY that the investment in the branded entities, such as Kgoro, was at cost. To arrive at the cost of the fee, in the form of a shareholding in the branded entity, he was obliged to value the entity, such as Kgoro, which he did by obtaining the SPV valuations (576-8; 597).

45.36 According to Louw, the purpose or main driver of the branding model was to increase the income of the bank, which might translate into a re-rating of the share price (591, 595, 605).

45.37 Louw was of the opinion that because income could not be measured "in monetary terms with sufficient reliability", it was inappropriate to recognise *any* income. EY nevertheless recognised R5.5m branding income in the 2000 financial statements (010227).

45.38 The original branding strategy appears not to have been pursued after 16 May 2000 (but branded income continued to be included). Levenstein said: "… tactically because of the madness of year-end 2000 we decided to minimise the emphasis on branding …" (1545). EY's valuations at year-end 2001 of branding entities were Medsurge R2.5m, Regal Protea Health R1m, Regal Virtual Solutions nil, Kgoro nil (110204, 110205). At year-end two of the branded entities may have been insolvent, Kgoro with an accumulated loss of R3.7m (150265) and Regal Virtual Solutions, which had a negative equity of R1.2m (110286). Levenstein devoted his energies to the Mettle deals: in 2000: RMI July/August; Stone Manor 30 August; Regal Securities 30 August; Kgoro 11 October; Metshelf 1 27 October; 93 Grayston 17 November; and in 2001 the Metshelf 2 and 3 structures were put in place.

The R2m payment to Levenstein

46

46.1 On 29 December 1999 Levenstein wrote a letter to the directors of Regal Holdings and the bank and submitted "that my efforts for Regal from inception to date justifies a cash bonus of R2m and a structural redesign of my restraint share allocation". In addition to the cash bonus he requested 5m shares. Lurie recorded in handwriting on the letter that the request was approved by the non-executive directors (DT(1)174). There is no record of a discussion at a meeting of the board of directors and consequently no approval by the board of directors: see minutes of meetings on 26 January 2000 and 26 March 2000 (K(2)214-219). (The 5m shares, for various reasons, were never issued to Levenstein).

46.2 On 27 January 2000 Levenstein recorded the approval of the non-executive directors in a letter of that date (DT(1)176).

46.3 On 14 February 2000 Regal Holdings, Regal Bank and Levenstein signed an agreement in terms of which Regal Holdings and Regal Bank agreed to pay Levenstein R2m and to issue 5m shares on or before 31 March 2000 as a restraint of trade payment (DT(1)177). (The original restraint agreement was signed on 7 September 1995 (G56.1).) Levenstein said the "underlined basis, the rationale … refers to goodwill essentially"

(1498). The R2m, although a restraint payment, was allocated to goodwill in the books of the bank and was called goodwill on the balance sheet (Levenstein 1505).

46.4 On 2 March 2000 a further agreement was concluded in terms of which, inter alia, Levenstein became entitled to receive dividends before the issue of shares (DT(1)183). The bank paid Levenstein R2m on 15 February 2000 (E38.1).

46.5 EY were not aware of the letters of 29 December 1999 and 27 January 2000 at the time of the 2000 audit (Van Heerden 1058). It follows that Van Heerden did not know that the R2m was described as a "cash bonus" nor did he know about the 5m shares.

46.6 In the EY document prepared in April 2000 which dealt with "Audit Issues" it was stated under the heading, Disclosure of Intellectual Capital: "The fixed assets include an amount of R2 139 067, being a restraint of trade payment (R139 067) and intellectual capital (R2m) paid to the CEO, Jeff Levenstein. … Lump sum payments to directors fall within the disclosure requirements of the Companies Act. The Act requires disclosure of the full amount in the year the payment is made. The appropriate accounting treatment will depend on the substance of the payment. In this case, as the payment has been made for past

services rendered, the payment should be expensed in full when the agreement has been concluded." (010127).

46.7 Subsequently EY recorded that "Regal has subsequently agreed to disclose this [the R2m payment to Levenstein] as directors' emoluments and expense the asset over 20 years" (010148). Levenstein denied that there was an agreement to treat the payment as director's emoluments (1518).

46.8 While the R2m payment was reflected in EY's working papers as intellectual property, there was no reference at all to the amount in the financial statements (Van Heerden 1067; 010279.2). It must have been included in fixed assets of R39m (010270, Levenstein 1560). However, goodwill and intellectual property were not shown separately in the captions for fixed assets (130077.2). Accordingly the payment of R2m was hidden in the financial statements. No reader of the financial statements would have known that Levenstein had received R2m.

46.9 The payment of R2m to Levenstein was not shown as directors' remuneration in the financial statements. The total directors' remuneration shown was R2.1m (010281).

46.10 In the directors' remuneration notification which Levenstein signed all he disclosed was a basic salary of R413 000 (020273).

46.11 At an audit committee meeting of 9 November 2000 (K(2) 249.2) it was falsely recorded that the R2m bonus had been passed by a resolution on a round-robin basis.

46.12 Lopes was told by Diesel that R2m had been paid to Levenstein. Lopes saw documents on the desk of Brian Levenstein which recorded the bonus and the allocation of 5m shares. Lopes was stunned. Levenstein told his colleagues that they were not to receive any bonuses as he was the only one entitled to do so because he brought in 90% of the income. The board of directors did not approve the payment of R2m or the allocation of shares (Lopes 2023 – 6). Levenstein told Diesel, according to Lopes, "to secure all the deposits that were held in treasury of Jack Lurie and Ronnie Buch and that they were not allowed to trade those accounts until they had signed his agreement" (relating to the R2m bonus and 5m shares) (2024).

46.13 Nhleko's version of the R2m bonus and 5m shares is found in paragraphs 8.2 and 8.3 hereof.

46.14 Lurie testified that he called a breakfast meeting of the non-executive directors on 25 January 2000. He had earlier sent a memorandum (U1.1) containing excerpts of Levenstein's letter of 29 December 1999. No one "dissented to addressing the so-called imbalance" (2494-5). On the next day he received Nhleko's letter

of 26 January 2000 (U58). He regarded the payment of R2m and the allocation of 5m shares as a "restraint", "to address the goodwill imbalance that prevailed from inception" (2492). Lurie said that the executive directors later agreed to the bonus and shares (2498, 2503). He could not explain how the approval of a "cash bonus" by the non-executive directors came to be converted into a "restraint" payment (2499 – 2500).

46.15 None of the directors examined by the commission could explain why the R2m bonus and agreement to allocate 5m shares were not recorded in the 2000 statutory financial statements.

46.16 Diesel testified that the R2m bonus and 5m allocation of shares were not discussed at a board meeting. His approval was never sought and never given. He became aware of the allocation of shares in about December 1999 and the R2m bonus when it was paid 15 February 2000 (2661).

46.17 Buch testified that at the breakfast meeting on 25 January all the non-executive directors agreed that the terms and conditions on which the bonus and allocation of shares would take place should first be established (2780). Levenstein was "very upset … that there had not been an automatic acceptance of the situation". So it was decided to discuss the matter the next day to let Levenstein "settle down". On the following day, all the non-executive

directors agreed that the shares would be restraint shares and that the R2m bonus was "going to be based on performance going forward in the future" (2781).

46.18 Buch agreed "with hindsight", that the allocation of 5m shares to Levenstein should have been disclosed in the 2000 statutory financial statements as there was an obligation on Regal Holdings to issue the shares (2789). It is estimated that at the date the obligation arose the shares were worth R36.5m.

46.19 J Pollack could not remember the R2m bonus and 5m share allocation (3018).

46.20 Kaminer's evidence was that he did not approve the R2m bonus "not at all" (3032). At a breakfast meeting the 5m shares were discussed. The directors wanted a meeting with Levenstein to discuss the allocation, but Levenstein did not arrive "and that was that" (3032).

46.21 Radus testified that he was told by Levenstein that the non-executive directors had agreed to the payment of R2m and the allocation of 5m shares. He and Krowitz signed the restraint agreement after having checked with Lurie that the non-executive directors had approved of the agreement. He thought that payment and the allocation was done on the basis of a restraint (3154-6).

R6 m deferred expenditure

47

47.1 EY allowed R6m of expenditure to be deferred on the basis that it related to "accomplishing the branding concept" (010227).

47.2 The first time EY knew of the deferral was on the morning of 17 May 2000 when the EY team of Wixley, Strydom and Van Heerden saw the legible copy of the 2000 financial statements in the Business Day. The deferral had never been discussed with EY before. EY was faced with a fait accompli. EY decided that the deferral was not material, hence this statement in the EY letter of 17 May: "Although we are not in full agreement with the changes, the differences, in our view, do not materially affect the fair presentation of the company's results or of its financial position, and subject to appropriate disclosures in the annual financial statements we are prepared to issue an unqualified opinion on these figures." (010296).

47.3 The amount of R6m was post de facto justified in this way: "At half year expenses were R13.2m. Without increasing infrastructure to incorporate model expenses for year would be ± R26.5m. The expenses were 35.4m therefore effective branding model ±9m, R6m adjustment to expenses debited to pre-payments." (010237).

47.4 The deferral was material because without the deferral, the profits for 2000 would have been less than the profits for 1999. The income before taxation for 2000 as published on 16 May was R55.5m. The figure for 1999 was R50.2m (010292).

47.5 AC000 § 89 provides: "An asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the enterprise and the asset has a cost of value that can be measured reliably." Neither of the requirements are met. Firstly, the future economic benefits had already been recognised in the income of R5.5m. Secondly, the expenditure on branding could not be reliably measured.

"Deposits from other banks"

48

48.1 In the notes to the 2000 financial statements, note 5 (130075) showed deposits from other banks in the sum of R164m.

48.2 The deposits were in fact those made by a Mettle SPV in terms of the Tradequick and RVM structures.

48.3 As neither Mettle nor SPV is a bank (Prinsloo 2980) note 5 is an inappropriate disclosure.

48.4 Statements were handed in by Diesel (KD64-5, 3094) which reflected the depositor as "BOE Bank". Diesel explained that "at

that point in time … there was a relationship between Mettle and BOE … I think that Mettle was a subsidiary of BOE" (3094-5).

48.5 Mettle was not a subsidiary of BOE as at 30 June 1998, according to the annual financial statements of Mettle: BOE owned only 30% of Mettle.

49 The failure of the board to approve the "audited" financial results of 16 May

49.1 There is no minute of an audit committee meeting or a board meeting of either Regal Holdings or Regal Bank approving the "preliminary results" of 18 April 2000 or the "audited results" of 16 May 2000.

49.2 Levenstein contended in evidence that the board of Regal Holdings and the audit committee approved the 2000 financial statements before EY raised their difficulties with branding income (1330, 1334, 1364). EY raised the dispute only shortly before the intended release of the results, necessitating a cancellation of the IES presentation and a postponement of the publication of the results (1331-3). (The correspondence reveals that Levenstein did not raise this complaint at the time.)

49.3 The results that were published were those that went out on SENS on 16 May 2000 and on 17 May 2000. Levenstein contended that the board approved those results (1336) although the board did not meet. There must have been a round-robin resolution (1337), which might not have been in writing (1338). (Art 80.1 of the articles of association of Regal Holdings requires a round-robin resolution to be in writing, signed by a quorum of the directors, and inserted in the minute book (D78).) Levenstein did not know whether the "round-robin process ran its course entirely" (1340). The results could not be delayed again. It would have been catastrophic. There would have been a run on the bank (1340-1). Levenstein was nevertheless adamant that the financial results were approved by the board (1342) but he could not say which directors approved the financial results (1345). The audit committee too did not meet to approve the results (1352). Levenstein could not explain why a minute or written resolution was not subsequently produced after the crisis of 16 May was over (1354).

49.4 The evidence of Lopes was that on 15 May 2000, after the Regal Bank delegation returned from Reserve Bank meetings, J Pollack, Kaminer, Lurie, Buch and Lopes agreed that branding income of R55m should not be included in the 2000 financial statements.

Buch was opposed to the inclusion of the section "Banking Model" in the document which was being worked on (KPMG170). Levenstein nevertheless insisted that it should be included.

Davis told Lopes, according to Lopes, that EY had approved the results that were to be published later that night of 16 May (2033). Lopes was led to believe that Davis was "drafting up what that expenditure was and submitting it to Ernst & Young" (referring to the R6m deferred expenditure (2034)). There was no board meeting and no audit committee meeting to approve the results (2030 – 2031).

49.5 At the meeting Lurie and Buch attended with BSD on 15 May 2000, Lurie undertook to discuss branding income with "the board of Regal" (E47). Yet Lurie did not call a meeting of the board of either Holdings or the bank on his return to the bank on that day or the next day (16 May 2000). He could not explain why he did not do so (2443). Nor could Lurie explain why he did not realise that Levenstein's judgment was suspect. After all, Levenstein was willing to have the bank closed down, so to speak, rather than to agree with SARB, EY and KPMG. All Lurie could say was "I think he lived this bank 24 hours a day, he was very, very committed" (2451).

49.6 Lurie alleged in evidence that he spoke to all the directors on 16 May and that they informally agreed to publication of the results (2453-4), even though he could not recollect whether the directors had even seen the results (2455, 2462). With hindsight, he thought he should have called a meeting or obtained a written round-robin resolution (2463). He contacted all the directors who were not at the bank, including Nhleko. Buch was at the bank. All the directors agreed to the results (2487).

49.7 Diesel was not involved in any way on 15 and 16 May 2000 in approving the results. He was trying to do damage control; he concentrated on his areas of responsibility. He was not aware of the R6m deferral in expenses (2657-8).

49.8

49.8.1 Buch's account of what happened at the meeting of 15 May 2000 with the Reserve Bank does not differ materially from the minute of the meeting. His evidence, further, was that when he and Lurie left the meeting to return to Regal Bank the only adjustment which would be made was to reduce the branding income from R55m to R5.5m (2726-30).

49.8.2 On his return to the bank, it took him "a couple of hours" to convince Levenstein to accept the R5.5m branding income "which we did do eventually" (2731-2). Those at the meeting (at which Levenstein was present) discussed deferring the expenditure which had been incurred in deriving the branding income (2733). Davis was contacted and told to discuss the matter with EY (2733-4). Davis was mandated to agree the amount with EY (2741). Buch's testimony was that an informal meeting of the audit committee took place the night of the 15th of May 2000 and that he and Levenstein were present. The other member of the committee, Slender, was away and could not be contacted. There was no time for a formal meeting (2751).

49.8.3 On 16 May 2000, Buch was not at the bank, so he testified. He was at work. He told management that if he was needed they should contact him (2735). He had no contact with anyone at the bank that day (2739).At about 13:22, after the results had gone through SENS, he received a fax (KPMG 170.1) of the results signed by Lopes and Davis (2736-8). He did not attend an audit committee meeting or a board meeting or sign a round-robin resolution or approve the results in any way that day (2739).

49.9 J Pollack was a non-executive director of the bank and Regal Holdings from inception until 31 December 2000. He is 81 years old. He suffers from memory loss. He could not remember the events of April/May 2000 (3016-7).

49.10 Kaminer was an alternate director to Schneider. After Schneider's resignation, he became a non-executive director of Regal Bank and Regal Holdings. He resigned on 31 December 2000. He is 78 years old. He could not remember whether there was a board meeting which approved the 2000 results; he could not remember that period, but he thought "they did approve it" (3026-7).

49.11 Radus could not remember whether he approved the 2000 results. He was not involved with the events of the night of 15 May 2000.

He was not even sure if he was at the bank on 16 May 2000. He could not remember the events of that day (3113-8).

The 2001 Audit

50

50.1 EY audited Regal Holdings, Regal Bank, the Incentive Trust and the Shareholders Trust for 2001. The audits of the trusts was conducted for the first time.

50.2 On 4 September 2000 the audit committee met ((K2)243.2). The committee, consisting of Buch, M Pollack and Levenstein, approved the interim results for the six months ending 31 August 2000. EY were not invited to the meeting, contrary to banking industry practice.

50.3 On 5 September 2000 the interim results were published (010408) while the s7 review was taking place. An increase in "other income" from R27m (for the year ended 29 February 2000) to R33.4m (for the six months ended 31 August 2000) was shown. In regard to earnings it was said: "Among Regal's many financial innovations is the franchising of the Regal name to organisations that stand to reap enhanced benefits from the application of that brand to their operations. In the year to 28 February 2000, the income earned from Regal's franchising structures was deferred, pending the establishment of a reasonable track

record. Certain of these structures have since achieved the requisite track records and, accordingly, the relevant realised fee income has been included in the interim figures."

50.4 On 21 September 2000 EY wrote a letter to the directors of Regal Holdings (010413) raising a number of concerns: "To our knowledge, no audit committee meeting was held to approve the interim report, nor has the accounting treatment of the franchising structures for the half-year been discussed with us. … It is a matter of considerable concern to us that:

- The interim results were issued without the apparent approval of an audit committee meeting.
- Statements were made to the press by your directors alleging that differences with our firm had been resolved without prior discussion with us.
- The accounting policy set out in the previous financial statements do not appear to have been complied with in the interim report."

50.5 On 28 September 2000 EY, represented by Wixley and Strydom, met with Regal Holdings, represented by Levenstein and Buch. It was agreed that Regal Holdings would not publish financial statements or make an announcement in regard to financial statements without EY being involved and that EY would be invited to all audit committee meetings (Strydom 696).

50.6 In its working papers of 29 November 2000 EY identified as "internal control considerations" the 2000 branding dispute

between the bank and EY which "brought into question the integrity of management" (140123). The dominance of Levenstein introduced the risk that "management override may occur … negating the effect of the internal controls" (140124). The risk of fraud was said to be "quite high" (140154).

50.7 On 30 November 2000 EY finalised its planning board report for submission to the audit committee. Overall materiality for the year ending 28 February 2001 was assessed to be R6m (110020). A factor which was taken into account in arriving at that amount was "the higher risk associated with the loss of senior members of staff during the year" (140083). One of the risk areas referred to in the planning board report was "the recognition of income from Regal's branding entities" (110013).

50.8 On 8 December 2000 the audit committee approved the EY planning board report (K2) 259).

50.9 On 25 January 2001 EY submitted its engagement letter to Regal Holdings (110025). The letter was signed on behalf of Regal Holdings by Cohen on 14 February 2000. In the letter it was stated: "As auditors of the group our objective (and our duty under the Companies Act) is to examine the annual financial statements presented to us by the directors, and then to report to the shareholders. As directors, you are responsible for the maintenance of proper accounting records and the

preparation of annual financial statements which fairly present the financial position, results of operations and cash flows of the group in conformity with generally accepted accounting practice and in a manner required by the Companies Act. … To enable us to fulfil our audit responsibilities, you will provide us with full access not only to all accounting records, but also to other documents such as minute books, share registers, statements, correspondence etc." Included in EY's "terms of business" was the following statement: "Our work will be conducted in accordance with Statements of South Africa Auditing Standards and will be planned and performed to enable us to obtain reasonable assurance that the financial statements are free of material misstatement".

50.10 On 31 January 2001 the audit committee met. EY was present. The letter of engagement was handed to Cohen. The audit was to commence on 17 February 2001 (110150).

50.11 On the same day the board of Regal Bank met (110043). Cohen and Oosthuizen were appointed to the board and it was noted that Van der Walt was to be appointed to the board. It was stated that the Africa Consulting Group had been appointed to keep and distribute minutes of all meetings. Price Waterhouse Coopers were appointed internal auditors.

50.12 On 28 March 2001 the audit committee met (110198). EY was present. It was noted that Scheepers had been appointed a non-executive director of Regal Bank and Regal Holdings with effect

from 1 April 2001 and that Zarca had been appointed group financial director and a director of Regal Bank and Regal Holdings with effect from 1 July 2001. EY tabled Appendix A, a document setting out issues identified by EY, the response of management, and the resolution of the issues. Appendix A was updated from time to time and presented to various audit committees thereafter.

50.13 On 12 April 2001 the draft financial statements were discussed at an audit committee meeting (110224). Income before taxation was shown as R115.8m. EY required substantial adjustments to the figures presented. An updated appendix A was tabled (110253, 110235). Levenstein testified that the adjustments required by EY (110366) and agreed to at the audit committee meeting of 12 April were not due to error but in order to scale down profitability: the adjustments were "orchestrated" between Cohen and Strydom. The audit committee meeting was "purely theatre" (1645). Yet Levenstein conceded that one major adjustment was necessary, namely, an adjustment for R26.7m for "overprovision of dividends to be received on preference share agreements and under approval of interest to be paid on associated deposits (1647). Cohen said that the figures were not "orchestrated". When Strydom expressed the view that the profit

was too high, Cohen said that it was "out of the bounds of reality" and that instead of a 80% - 90% growth in earnings, the maximum should be 30%. When Strydom subsequently produced the list of adjustments referred to earlier, Cohen accepted them (1962 – 1965).

50.14 On 25 April 2001 the profit announcement as tabled by management was approved by the audit committee. Income before taxation was R71.5m (110353, 110342), a reduction of R44.3m from the R115.8m, after EY's adjustments had been taken into account.

50.15 On 26 April 2001 Regal Holdings provided EY with a letter of representation (110391). The letter is signed by Cohen as audit committee chairman and Levenstein as CEO. The letter contained a number of factual allegations which were subsequently found to be false by EY. One of the errors which Levenstein conceded was that the bank was shown as having a 25% shareholding in Kgoro, whereas the shares had been sold on 11 October 2000 (1666). The shareholding was also incorrectly shown in the presentation to analysts (110400).

50.16 The audited results for 2001 were published on 30 April 2001 (110399). At about the same time a presentation was made to analysts (110401).

50.17 At an audit committee meeting on 21 May EY reported that it would provide an unqualified audit report subject to the finalisation of a few outstanding issues (110413).

50.18 On 25 May 2001 the FM article "Betting on a brand" appeared (110463), followed by another article in the FM on 1 June 2001 "Surprising surge in price" (110460).

50.19 Regal Holdings issued a second letter of representation on 13 June 2001, signed by Cohen only. Unlike in the first letter, the representations in this letter were qualified by the phrases: "to the best of our knowledge and belief" and "based on undertakings given by management" (110483).

50.20 On Friday, 22 June 2001, Strydom was requested to join Cohen at the meeting with Investec.

50.21 On the following morning, representatives of Regal Bank, EY and Investec met at the bank. The due diligence commenced at 12:00. During the course of the day Strydom and Van der Walt had a discussion about the possible acquisition. It is common cause between Strydom and Van der Walt (2590) that Van der Walt mentioned four matters to Strydom: -

- the sale of 8m Regal Holdings shares to Mettle was not a true sale in that the "risk and reward" of the shares remained with Regal Bank;

- the purchase of Regal Holdings shares by the Incentive Trust and the Shareholders Trust was not good practice;
- Regal Holdings had bought the 15% shareholding of Worldwide through Pekane in terms of s38(2) of the Banks Act;
- After year-end, two bundles of R10m worth of preference shares had been bought, the effect of which was that the risk and reward remained with Regal Bank.

Strydom was so concerned at these disclosures that he requested the chairman of EY, Wixley, to join him. On the Sunday, Hourquebie, the CEO of EY, joined Wixley and Strydom at the bank. EY attended the board meeting that night.

50.22 On Monday, 25 June 2001, Strydom met with the BSD. EY withdrew its consent for the publication of the audited financial results. The reasons were contained in the letter EY sent to Regal Holdings on 9 July 2001 (110488):

"It appears that certain information was withheld from us during the course of our audit and that certain representations made to us were untrue. …

Without limiting the extent of our re-assessment, we specifically refer to:

- A number of structured transactions in which the ultimate effect of the transactions might be different from that presented to us.
- Regal Bank financing the purchase of some 45% of the shares of Regal Holdings. We believe that it might be difficult to demonstrate

that each of these advances were given "in the ordinary course of business" in terms of Section 38 of the Companies Act … Regal Bank might also be in contravention of Sections 37, 38 or 78 of the Banks Act regarding the funded shares …

- The possibility that one or more material irregularities and/or undesirable practices may have been committed which required to be reported by us under the Public Accountant and Auditors Act and the Banks Act, respectively."

D The misrepresentations to EY

51 Pekane

51.1 Pekane Investments (Pty) Ltd ("Pekane") was the registered holder of 15,5m shares in Regal Holdings (180235). Pekane was a subsidiary of Worldwide African Investment Holdings (Pty) Ltd ("Worldwide").

51.2 EY was aware of the facts set out in § 51.1 above.

51.3 Van der Walt informed DT on 17 August 2001 that:

"2. Regal Bank apparently repurchased the above shares from Pekane on 29 December 2000 for the consideration of R60m. The funding for this shows as an interest bearing overnight loan in Treasury.

6. A number of Bank staff members were entitled to shares in a holding company in terms of various service agreements. Due to the unavailability of

shares, these were never issued. A letter signed by the Chairman and CEO was sent to the abovementioned staff members ceding the right to any dividend receipts on the Pekane shares to them in lieu of their entitlement in terms of their service agreements." An example of a letter was attached to the Van der Walt memorandum. In the letter an undertaking was given to an employee that the bank would procure the transfer to the employee of 5 000 Regal Holdings shares, the registered holder was described as Pekane and the beneficial holder was said to be the Shareholders Trust. (180233-4).

51.4 Prior to 23 June 2001, EY was not aware of the purchase of the Regal Holdings shares by Regal Bank on 29 December 2000 for R60m.

51.5 The facts as disclosed to EY at the time of the audit were the following:

- EY requested Regal Bank to furnish information on, and the recoverability of, "Phekani Inv. (overnight loans) R60.2m" (150027). On 12 March 2001 Cohen gave EY this response, prepared by Davis: "Phekani – this is secured by shares with a market value of approximately R70m."(150034 read with 150030.2). EY thereafter recorded the transaction in a schedule of overnight loans with Treasury in these terms:

"Phekani Inv: on loan: R67 400 805: This secured by shares with a marked value of approximately R70m" (180128).

- Strydom's evidence was that he did not make the connection between Phekani Investments and Pekane, the investment arm of Worldwide.
- At a board meeting of Regal Holdings on 31 January 2001 Levenstein reported that "the return of the Worldwide shares would create an opportunity to distribute smaller parcels in blocks of perhaps 50 000 to loyal Regal supporters at a small discount to the market price …" ((K3)3). Strydom understood from that minute that "Regal was placing the shares … being a conduit" and was not a buyer of the shares (Strydom 827).

51.6 Strydom discussed the purchase of the Regal Holdings shares by Regal Bank on 29 December 2000 with Cohen some time after the conversation with Van der Walt. Cohen repeated what Van der Walt had said on 23 June 2001, namely, that the acquisition was one in terms of s38(2) of the Banks Act. On 11 July 2001 Cohen furnished EY with a copy of an opinion written by Prof. Vorster on 20 December 2000.

51.7 In the draft 2001 financial statements in the "Analysis of Share Register" Pekane was reflected as a major shareholder of 15.5m shares, representing 15% of Regal Holdings shares (130149). The financial statements were approved by the board of directors.

51.8 Strydom testified that if he had been told the truth during the audit process he would have reported the matter to the BSD because, in effect, Regal Bank would have owned 30% of Regal Holdings shares and that was not good business practice. It was "a fairly incestuous investment" (Strydom 839). He would have ensured that any interest that Regal Bank earned on the loan to Pekane was not recognised as income in the financial statements of Regal Bank as it would have been "income earned in effect from yourself" (Strydom 840).

51.9 Levenstein's recollection of the agreement with Worldwide was that the bank agreed to pay below the market price, R3.90 per share instead of R4.80 or so, and Worldwide ceded to the bank their dividends, while Worldwide remained the beneficial shareholders; the agreement was not a "buy-back". It must have been a written agreement (1710).

51.10 Levenstein said that the statement in the letter addressed to the employees (18234) that the beneficial shareholder was Shareholders Trust was a brilliant strategy devised by Prof.

Vorster (1712). However, when the point was made that his earlier evidence had been that the bank was acting as a nominee for a designated buyer, he said the terminology was wrong (1713).

51.11 Levenstein said that it would have been Diesel that described the payment of R60m as a loan; he would not have been aware of the technical nuances of s38(2) of the Banks Act (1720). The incorrect recording of the transaction was "of no consequence" (1724). Davis did not understand the complexity of the transaction (1729).

51.12 During December 2000 Diesel was contacted by Levenstein at home while he was on leave. He was informed by Levenstein that Pekane had offered the Regal shares for repurchase in terms of the original sale agreement. The price was below the current market price. Diesel, as treasurer, was asked by Levenstein to ensure that there was R60m cash available to pay the price. On returning from leave, in early January 2001, Diesel noticed that a loan had been created in the name of Pekane. Levenstein told Diesel to leave the loan in place as a sale of the shares to a third party was imminent (Diesel 2627-9).

51.13 Levenstein handed in a document dated 22 December 2000 which had been sent to the directors of Regal Holdings and Regal Bank

(E365). It purported to explain the agreement with Worldwide. The document was prepared by Levenstein (1752). It contained the statement that the Worldwide shares had been "acquired" at R3.90 per share; the "borrower" of the R60m was "Jeff Levenstein and Ian Radus"; and the security was a pledge of approximately 16m Regal Shares. The period of the funding was up to 6 months.

51.14 Levenstein testified that he and Radus would not have been the true borrower. The true borrower was the "designated third party" (1749-51). The true purchaser was the designated third party (1751), despite the statement that the shares had already been acquired.

51.15 At the time, however, in late December 2000, there was no designated third party. The negotiations with Hanover RE and Mettle in 2001 came to nought. No one ever stepped into the shoes of Regal Bank. To all intents and purposes, it had paid R60m for the Worldwide shares, which it acquired, albeit with the intention to transfer them into strong hands.

51.16 Nhleko handed in correspondence between Worldwide and Lurie in terms of which Worldwide offered its Regal Holdings shares to Regal Bank on 1 December 2000 (U1.4) for R5.50 per share. On 12 December Lurie, acting on behalf of Regal Bank made a

counter offer at R3.90 a share for a total price of R60.2m (U1.6), which Worldwide accepted (U1.7) (Nhleko 2314).

51.17 According to Levenstein, the shares were delivered to Regal Bank (1759) after payment of the R60m to Worldwide.

51.18 There was a loan of R60m, not to Pekane (as reflected in the bank's records), but to the designated third party (Levenstein 1762).

51.19 Cohen was the person who sought advice from Prof. Vorster on 20 December 2000. He asked Vorster if the Worldwide shares could be bought "pending on–sale to a third party or into the market" (Cohen 1930). Vorster furnished a written opinion (E369). The material facts contained in the opinion are: "Worldwide held 16% of the issued shares in RTBH in respect of which other shareholders held a pre-emptive right. This right was exercised, the share certificates were delivered together with transfer forms signed in blank as to the transferee and the purchase price was paid with funds made available by Regal Treasury Private Bank Ltd ("the Bank"). The shares are now in the possession of Regal nominees, a wholly-owned subsidiary in the RTBH group. The funds advanced by the bank had been booked as a loan, presumably to the shareholders who exercised the pre-emptive rights. It is the intention to place the shares in the

market within 6 months from the date of purchase." (110479). In evidence Cohen admitted that, save for the first and last sentences, all the facts were incorrect. He could not explain how that had come about (1934).

51.20 The opinion ended on this note: "Section 38(2)(c) provides, however, that the shares may be registered for a period not exceeding six months in the name of a company controlled by the bank (i.e. Regal Securities or Nominees) or in the name of an employee of the bank if it is necessary to facilitate delivery to the purchaser.

I would suggest that, unless the Registrar consent to the holding of the shares in the present form pending the sale (which he is entitled to do), the shares be registered in the name of two or more employees of the bank in compliance with s38(2)(c)" (E372).

51.21 Cohen believed that the letter sent to the directors (referred to in §51.13) was drafted in accordance with the opinion (1936) but the advice given was not correctly executed (1941). The letter to the employees in which the Shareholders' Trust was described as the beneficial owner of the Pekane shares was also incorrect (1944).

51.22 Lurie's understanding was that Pekane sold the shares to the bank for R60m to be "housed in entities for a period of six months to give effect to a transfer … into some strong hands" (2544-5). The board approved the purchase at a meeting or by round-robin resolution (2545).

51.23 Rod, who worked in the treasury, was instructed to generate a cheque in favour of Standard Bank Stockholders and "to generate it in the form of a loan account". It was probably Kay who gave him the instruction. He carried out the instruction (3166).

51.24 Radus' understanding of the Pekane transaction was that "Regal would buy back the Pekane shares … and they would be housed in some sort of company or something or other pending the purchase by a proposed purchaser of those shares. … I think Regal must have paid for the shares." (3136).

51.25 Diesel testified that the interest on the Pekane "loan" was R5.36m, increasing the opening balance of R60.27m to R65.64m (3088).

51.26 Davis, however, testified that the debit in Regal's books of R6m in respect of the RMI dividend was transferred to the account on Levenstein's instruction. Davis conceded that this was not a valid entry (2878-80).

The 8 m shares sold to Mettle

52

52.1 The knowledge that EY had prior to 23 June 2001 about the 8m Regal Holdings shares sold to Mettle was the following:

- In the DT s7 review of 31 October 2000 it was said that the loans of R36m to the Shareholders Trust were secured by Regal Holdings shares worth R17.6m. No provision or adjustment was made by the bank for any potential write-off. The review continued: "The CEO and management are confident that there is no permanent diminution in the value of the shares and that no provision is necessary. He also informed us that a substantial number of shares will be placed with a new shareholder at a price of between R5 and R6 per share." (DT(1)30).
- EY was informed by the bank that 8m Regal Holdings shares had been sold to Mettle during late 2000 for R5.50 per share, a premium of about R1 per share. EY assumed that that is the transaction that is referred to in the DT s7 review. EY was assured that it was an out-and-out sale (Strydom 841).

- In Appendix A, which was tabled at various audit committee meetings, this was noted:

  "5. Sale of 8m Regal Shares at R5.50 by the Shareholders Trust to Mettle:

  Bank Supervision informed us that Mettle indicated in an article in the Financial Mail of 1 December 2000 that they did not have a stake in Regal and pointed out that the sale was merely a security provided by Regal for the back leg of a structured finance transaction." (110218).

- In the first letter of representation dated 26 April 2001 Regal Holdings made the following representation:

  "That the sale of 8 million Regal shares at R5.50 by the Shareholders Trust to Mettle was unconditional and that the shares are registered in Mettle's or its nominee's name. (110395).

- In the second letter of representation the same representation was made but preceded by the words: "based on representations by management" (110487).

- The draft 2001 financial statements reflected Mettle Securities Ltd as the owner of 8 million shares (0130149).

- On 11 May 2001 EY sent an e-mail to Davis in which Davis was asked, in regard to the 8 million shares sold to Mettle: "Was this transaction part of the normal operations

of the trust i.e. placing shares in strong hands, or was it part of one of the structured deals with Mettle? If it was part of the structured deals, which one was it part of?" The answer given by Davis was: "The transaction was simply a means of achieving the objectives of the trust, i.e. moving shares from weak to strong hands. I think SARB's concern, arises from an FM article, where Hein Prinsloo of Mettle was misquoted." (180097). Davis said that he obtained that information from Levenstein (3426).

- At an audit committee meeting held on 28 March 2001 it was minuted that the 8m Regal shares sold by the Shareholders Trust to Mettle were unconditionally registered in Mettle's name (110200).
- In dealing with the BSD queries arising from the DT s7 review, EY on 14 May 2001 accepted Regal Bank's representations: "The Mettle transaction forms part of the normal operations of the Rand Shareholders Trust i.e. 'to allocate shares from weak hands into strong hands'" (110445).

52.2 On 23 June 2001 Van der Walt told Strydom that the 8 million shares were placed in a structure behind preference shares and that the 8 million shares were in a portfolio and that the portfolio was part of a preference share structure. Strydom understood Van

der Walt to mean that the risk and reward in regard to the 8 million shares remained with the bank (Strydom 844). On analysing the Metshelf One transaction Strydom came to the same view as Van der Walt.

52.3 Levenstein in evidence said that Scheepers had given Strydom "an insightful, complete, categoric, immutable insight" into the Mettle portfolio. He alleged that it was an arms-length transaction and that the risk and reward did not lie solely with the bank (1740-1741). Scheepers testified that all he gave Strydom was a "very superficial" insight.

Metshelf 2 and 3 Structures

53

53.1 Van der Walt told Strydom on 23 June 2001 about two lots of R10m that Regal Bank put in a structure to finance the purchase of Regal Holdings shares after the year-end. Strydom subsequently identified the structures at Metshelf 2 and 3. Van der Walt told Strydom that the structures were normal in the market place and there was nothing illegal about them. (Strydom 852).

53.2 Strydom, however, was concerned that the transactions were not good banking. Taking into account the other transactions that Van der Walt described to him, Strydom came to the view that Regal Bank in effect owned 45% of Regal Holdings shares.

54 EY's concern was that if the 45% shareholding was cancelled, the share capital and reserves of approximately R441m would be reduced below the required R250m share capital. If the Mettle structures were not cancelled, on the calculations EY did, Regal Bank would move to a capital adequacy below the required 8% (Strydom 8454).

The recognition of branding income

55

55.1 EY concurred with the recognition by Holdings of branding income in the sum of R24m, made up as follows:

Regal Protea Health	R1 m
Medsurg	R2.5m
RMI	R20.5m
	R24m

55.2 The amount of R20.5m was the difference between the sale price of R26m and the amount of R5.5m recognised in the 2000 financial year (Strydom 919).

55.3 EY set off the amount of R20.5m against an amount of ±R20m in respect of a royalty agreement which it regarded as an onerous contract (Strydom 926).

55.4 At the time of the audit EY was not shown three of the agreements which made up the RMI structured finance deal: the preference share agreement, the security deposit agreement and the pledge and cession of securities. Had EY been shown those agreements, it would not have regarded the sale as an actual or real sale and it would have reversed the income of R20.5m and reduced the profit by R26m (Strydom 927).

56

56.1 EY concurred with recognition of R5.9m as income earned on preferent shares of R150m in New Heights in respect of the Kgoro deal. (140276, Strydom 933).

56.2 Fundamental to the recognition of the interest was proof that a deposit had been made. Regal Bank contended that Mettle had made the deposit. In a board report submitted to the audit committee, EY called for confirmation from Mettle "as to the existence of a R150m deposit held by them with Regal" (110361). As at the end of April EY had not received confirmation but assumed that the deposit had been made as it was "the opposite side of the R153m preference share investment. … At no time when we discussed confirming the deposit (with Mettle) with the audit committee or Jonathan Davis have they denied that it is a deposit." (140268). On about 27 May 2001 EY contacted Mettle and requested confirmation. Confirmation has never been received (Aitken 947).

56.3 What EY did not know was that the preference share agreement was part of a structured finance deal. EY did not have knowledge of the sale agreement and the call option agreement.

56.4 Had EY known the true facts, they would have realised that a deposit of R150m had not been made and they would not have

concurred with the recognition of income of R5.9m as there was no true sale.

57

57.1 EY concurred with the recognition of income of R5.2m on a value of R125.5m for Metshelf 106 preference shares (140276).

57.2 Unknown to EY, the underlying portfolio consisted of Regal Holdings shares. Had EY known the true facts, they would not have concurred with the recognition of the income (Strydom 943).

58

58.1 Regal Bank wanted EY to recognise income of R185m in respect of the forward sale contract of 93 Grayston Drive. The amount was "based on a R600 million maturity value and yield of 12.47%, the amortised value of the forward sale contract of 93 Grayston Drive is approximately R185,261,126.00". (160327)

58.2 EY informed the audit committee on 28 March 2001 that they required a valuation of the immovable property from an independent valuator (110199).

58.3 EY was aware of the sale of property and addendum but was unaware of the existence of the preference share agreement, the

put option agreement and the call option agreement (Strydom 962).

58.4 Regal Bank obtained a valuation from a valuer, De Vos, who placed a value of R144m on the property. One of the assumptions he made was that the property would be fully let. EY accepted the valuation.

58.5 In the board report EY reflected "other income" of R88m. That amount included R36.5m as "revaluation on 93 Grayston Drive". (110365).

58.6 In the summary of audit differences it was said that the following items had not been adjusted for and included:

	Balance Sheet	**Income Statement**
Onerous contract – no provision made	(20,463,573)	20,463,573
Over accrual for valuation of Regal Protea Health	(600,000)	600,000
Under accrual for revaluation of property	17,500,000	(17,500,000)
Net Effect:	**(3,563,573)**	**3,563,573**

(110366)

58.7 The total of R54m of the amounts of R36.5m and R17.5m was arrived at by deducting the cost of development of 93 Grayston (R90m) from the De Vos valuation (R144m). R36.5m of the R54m was appropriated to "other income" and R17.5m was set off against the onerous contract and the over accrual for revaluation of Regal Protea Health. Strydom conceded that, but for the onerous RMI contract, EY would have recognised another R17.5m in "other income" (Strydom 969). The set-off was a compromise between Regal Holdings and EY.

58.8 It follows that 93 Grayston contributed 41.4% of "other income" if R36.5m is recognised (and 62.5% if R54m had been recognised).

58.9 Taking into account the true nature of the 93 Grayston structured finance deal, EY would still have concurred with the recognition of the R54m but under another caption. In the income statement the R54m would not have been shown as "profit on financial instruments" but rather as "revaluation of investment property" (Strydom 972). In the profit announcement (110399) "financial instruments" were shown to constitute 41.46% of "non-interest income" of R88m.

58.10 Analysts would regard profit on financial instruments as more significant for a bank than a revaluation of immovable property (Strydom 972).

The impact on the preliminary 2001 Financial Results if EY adjustments were made

59

59.1 Prior to the publication of the profit announcement on 15 May 2001, management had contended for a profit of R115,8m, which EY had adjusted by R44.3m and reduced to R71.5m.

59.2 On EY's evidence, had full and honest disclosure been made to them the profit would have been reduced by the following adjustments:

	Rm
RMI: sale proceeds	20,5
RMI: 2000 valuation	5,5
RMI: Fee from Elul	2,7
Kgoro:	5,9
Metshelf:	5,2
Protea Health	,6
Interest reversed Pekane “loan”	1,2
	41,6

59.3 The profit of R71.5m, reduced by R41.6m, would have been R29,9m. But for the profit of R36.5m disclosed on 93 Grayston, the bank would have made a loss.

59.4 The profit on 93 Grayston of R54m should have been separately disclosed as a revaluation of immovable property and not disclosed as profit financial instrument.

59.5 This does not take into account:

- potential losses on advances to employees and directors totalling R34.8m (130119) to buy Holdings shares;
- the debit of R20m referred to in §86 hereof.

<u>The impact on the interim results of 31 August 2000 if EY adjustments were made</u>

60

	Rm
Profit before tax in announcement	49,5
Less:	
[A] 50% of errors rectified at year-end:	
• Overestimate of pref dividends	13,4
• Underestimate of depreciation	,3
• Bank expenses in Shareholders Trust	1,3
• Bad debt provision	4,0
[B] Reductions due to non-disclosure:	
• RMI: proceeds of sale	20,5
• RMI: 2000 valuation	5,5
• RMI: Elul fee	2,7
[C] Consolidation of Incentive Trust: elimination of interest to accord with year-end treatment	1,195
Subtotal	**48.8**
Total	**,65**

60.1

60.2 Had Regal Holdings accounted correctly at half year-end it would have had a nominal profit of ± R650 000.00.

60.3 This does not take into account:

- potential losses on advances to employees and directors and/or the Incentive Trust (±R18m) and potential impairment to the Shareholders Trust (±R18m) (DT(1) 30-32);
- the payment of R650 000 to Levenstein as "dividends" (which was included as a debit balance in creditors at 31 August 2000 instead of being written off (DT(1)28);
- advances to directors and senior managers in the amount of R2.6m (referred to in §90.1 hereof and DT(1)38).

Criticisms of EY

2000 Audit

61

61.1 EY itself, in the document of 12 April 2000, came to the conclusion that no branding income should be recognised: "... income is normally based on transactions with third parties, or by reference to an active market. If none of the above bases is available to establish a value of the income, a conservative approach should be used, and no income recognised until the profits are realised in a transaction with a third party. ... It is not accepted practice to recognise income from investments upfront. Rather the income should be recognised when an investment is sold to an independent party". (The emphasis is mine.)

61.2 Cooke of EY thereafter did his valuations. He valued Regal Bank's 25% share of RMI at R5.1m and 25% of Kgoro at R250 000.00.

61.3 KPMG was appointed by SARB in terms of s7 to express a view on branding income. Their conclusion was that no income should be recognised.

61.4 EY nevertheless eventually recognised R5.5m.

61.5 No amount should have been recognised. True, it was a much smaller amount than the amount Levenstein wanted recognised

(R50.8m) but by recognising some income, as Levenstein pointed out, EY acknowledged that Levenstein could recognise income when it could not be reliably measured, whereas, in truth, the original EY view and the KPMG view were in accordance with GAAP, the standard to which Regal Bank ascribed.

62

62.1 Wixley, the chairman of EY, testified that he took the conduct of Regal Holdings about which he complained in his letter of 17 May 2000 "very seriously" (3462). It was for that reason that he forwarded the letter to the Registrar. He believed the necessary corrections to the financial results of 16 May 2000 (KPMG170) were made in the retraction by Regal Holdings on 19 May 2000 (010300)(3463).

62.2 Wixley said that EY was willing to accept the R6m deferral because, during the meeting he had with Van Heerden on 17 May 2000, their feeling was "that there was a basis for some small adjustment [R3m] and that viewed on balance the adjustment of 6m was not material to an appreciation of the financial results of the company or its financial position" (3466).

62.3 Wixley said that he was not aware whether EY "were happy with the statement that approximately R18m of expenditure relating to the new model

> had been accounted for … I can only assume that at the time we believed that that was a reasonable statement" (3469-70).

63 On 17 May 2000, EY, instead of writing the weak letter of that date, should have notified Regal Bank and the Reserve Bank that they would persist in qualifying their results for these reasons:-

63.1 The agreement between the Reserve Bank and Lurie and Buch on 15 May was that EY's recommended R5.5m for branding income should be recognised.

63.2 When EY saw the results on late 16 May 2000 and early 17 May 2000, they realised that Regal Bank had changed the expenditure figures and that R6m of "branding expenditure" had been deferred.

63.3 The R6m deferral of expenditure was significant way beyond its quantum:

- the expenditure of R6m was deferred without EY's consent;
- the recognition of R6m expenditure was contrary to AC000 paragraph 89;
- the deferral had the effect of avoiding disclosure of a reduction in profits;

63.4 The objections which EY had to the financial statements of 16 May 2000 were all valid:

- the results should not have been described as "audited" as EY had not approved the results;
- in the income statement the earnings per share were shown as 50.1 cents whereas elsewhere in the document reference was made to earnings of 79.9 cents per share "approved by the Board";
- the statement that about R18m of branding expenditure had been written off in the current year was false, as R6m had been deferred.

63.5 EY knew that the branding expenditure was *not* R18m. The only document that EY saw was the Davis document in which he deduced, on the most speculative possible basis, that the branding expenditure was about R9m, R6m of which he deferred.

2001 Audit

64

64.1 At the meeting between BSD and EY on 12 February 2001 (F27), Martin emphasised that the main focus of the audit for the 2001 year would be the DT s7 review. A number of issues raised in the s7 review were dealt with in the meeting. Relevant for present purposes is that the relationship between Regal Bank and Mettle

was canvassed in various respects. EY was specifically instructed to review specific areas on behalf of BSD, including:

- "To review the transaction between Mettle Ltd and the trust …
- the rationale of the Mettle transaction;
- to review involvement of Mettle Ltd in the branding strategy;
- to review contractual and legal relationships between the bank and Mettle Ltd with regard to various transactions;
- to review the shares purchased off the market price;
- to determine the need for specific provisions;
- if the accounting treatment of this transaction was incorrect, Ernst & Young should disclose how it should be correctly reported." (F36).

It was minuted that Strydom said he would "visit Mettle to get the whole picture of the transaction and clarification on related issues before he could draw a conclusion on the Mettle transaction …" (F35).

64.2 At the audit committee meeting on 12 April 2001, the draft audited financial statements were tabled. It was minuted that "Ernest & Young requested more time to finalise the accounts and to clear outstanding issues … The proposed dates for the release and publication of the results was 2 May, but not later than 3 May … In view of this deadline, it was agreed that management and the auditors would expedite all unresolved matters that could delay the finalisation of the accounts." It was further agreed, according to the minutes, "that all outstanding issues pertaining to corporate governance, regulatory compliance and

internal controls be dealt with as a matter of urgency by management in consultation with the internal and external auditors" ((K3)106-7).

64.3 Cohen testified that included in the matters which EY and management were required to resolve were the R150m deposit from Mettle and that the 8m shares had been sold to Mettle (1969).

64.4 On 18 April 2001 the Reserve Bank wrote a letter to Cohen, in his capacity as chairman of the audit committee, requiring that various items be included in the year-end audit of Regal Bank. The list is similar to the one canvassed by the BSD with EY on 12 February 2001. Included in the list of items are the Mettle transactions, the financing of shares by the bank when purchased by the trusts and so on (F23).

64.5 At the audit committee meeting on 25 April 2001 (K(3)112) the group and bank audited financial statements as tabled by EY were approved, subject to minor adjustments. According to Cohen, that meant that the outstanding issues had been dealt with by management and EY (1970).

64.6 On 30 April 2001 the audited results for the year-end of 28 February 2001 were published (110399).

64.7 The meeting between EY and Mettle never took place. It was scheduled for 28 June 2001, but curatorship intervened. Had the meeting taken place before 30 April 2001, as should have happened, and had Mettle made full disclosure, Strydom could not have agreed to the publication of the audited results on 30 April 2001.

64.8 Van der Walt's evidence was that what he told Strydom on 23 June 2001, by way of off-the-cuff remarks, he had himself discovered over a period of time. Since February he had become suspicious about certain matters. He made investigations. He thought EY could, and should, have done so themselves (2591, 2601).

64.9 The evidence of Prinsloo of Mettle was that a meeting was arranged with EY somewhere in April or May 2001, which was cancelled by Levenstein. Prinsloo said that if EY had telephoned Mettle, EY could have "got all the contracts in one file" (2953, 2993). "And when anyone looks objectively at the preference share agreements, one should ask whether the Mettle SPV's had "any balance sheet? No. What is my security? It is an NCD from Regal. Simple, so you cannot show the two separate. Just a few questions would have showed that … If you know they have invested in a preference share, that is it. It is just the logical next question … What is my security" (2995-6).

64.10 Strydom's explanation for not seeing Mettle before 30 April 2001 was that it was not normal for an auditor to visit the suppliers of a bank and initially EY thought the documentation given to them by the bank was sufficient (3444, 3447). After the publication of the interim results, it became clear that certain information was not true, that made EY suspicious and hence their insistence on seeing Mettle (3445). The meetings that were arranged were cancelled and EY "had to insist that they be reinstated" (3447). When it was put to Strydom that he had told the BSD on 12 February 2001 that he would visit Mettle, Strydom said that "we thought the easiest way was to see Mettle … Later on [we] decided that we had received the full picture" (3448).

65

65.1 Cohen's evidence was that when he met with Strydom on 14 February 2001 he pointed out to Strydom "this Pekane transaction or the s38(2)(c) transaction" (1974). Strydom's evidence was that it was only after he had spoken to Van der Walt on 23 June 2001 that Cohen told him that the acquisition was one in terms of s38(2) of the Banks Act and on 11 July 2001 Cohen furnished Strydom with a copy of the Vorster opinion of 20 December 2000.

65.2 EY's knowledge at the time of the 2001 audit about Pekane, in essence, was that Pekane, a subsidiary of Worldwide, was the registered holder of 15.5m shares in Regal Holdings and that and that there was an overnight loan of R60.2 m to "Phekani Investments", secured by shares with a market value of approximately R70m.

65.3

65.3.1 On 31 January 2001 at a meeting of the Holdings board Levenstein reported that "the return of the Worldwide shares would create an opportunity to distribute smaller blocks of perhaps 50 000 to loyal Regal supporters …" (K(3)(1)). Strydom testified that his understanding of that minute was that the bank would act as broker, not as purchaser and later as seller of Holdings shares (3451).

65.3.2 Strydom said that he did not make the connection between "Phekani Investments" and "Pekane" until after the profit announcement (3452). He was not aware that the security of shares of R70m was not investigated by EY. It was only on 23 June 2001 that he became aware that the shares were Regal Holdings shares (3452-3). When pertinently asked: "Should Ernest & Young not have investigated what the security was and what its value was?", Strydom replied:

> "Yes … probably I think that Ernest & Young accepted the representation from Regal management too easily on that one" (3453). Strydom conceded that the "overnight loan" of R60m was a "very large exposure" (3453-4).

65.4 EY did not ask to see the alleged loan agreement, the alleged agreement of security, and what shares had been provided for security. They should have done so. They had been placed on their guard in the previous year in regard to the branding dispute and the publication of the financial results on 16 May 2001. This was not a client that deserved trust. Had EY made enquiries of the kind required, they would have realised that Regal Bank had bought Regal Holdings shares for R60m and that Worldwide was no longer a shareholder.

Critique of the Financial Statements of Regal Holdings for 2000 and 2001

The interim results of 31 August 1999

66

66.1 The audit committee did not approve the interim results. It met only on 29 September 1999, after the results had been published on 21 September 1999. EY attended the meeting.

66.2 The results (130042.1) had these significant entries:-

- Income before taxation was R40m for the six month period, compared to R50m for the whole previous year. The inference is that branding income was included. Davis testified that R21m in branding income was recognised (3429). At year-end the income before taxation was R55.5m.
- Debenture capital of R30m was shown. At year-end EY required the whole amount to be set off and therefore nil debenture capital was shown.
- Deposits showed an increase from R295m to R425m. Included in the latter amount were the amounts of the Tradequick (R100m) and RVM (R50m) transactions.

The results for 29 February 2000

67

67.1 The "audited" results published on 16 May 2000 are analysed in detail above.

67.2 The statutory financial results ("the glossies") (130043) are dated 16 May 2000 (130065). As at that date the board had not approved the results. The glossies were published in about September 2000. At no time after 16 May 2000 and before publication did the board on any occasion approve the glossies.

67.3 The financial statements were misleading in these respects:-

- In the Directors' Report it was said that the Incentive Trust was not operational at year-end whereas it was in fact operational and had been advanced R15m for the purchase of Regal Holdings shares to that value (020133).
- The allocation of 5m shares which Regal Holdings agreed to make to Levenstein was not disclosed contrary to paragraph 10 of the Fourth Schedule to the Companies Act.
- In the balance sheet pre-payments of R7m were shown. The amount of R7m included the R6m deferred branding expenditure. The amount of R6m was sufficiently significant to warrant accurate disclosure as deferred expenditure.

- The R18m expenditure referred to in the "banking model" section of the results published on 16 May 2000 was not dealt with at all.
- A deposit of R164m was shown (130075) "from other banks", whereas in truth at least R150m of the deposits had been made by Mettle SPV's, which were not a bank.
- Branding income of R5.5 should not have been recognised as it could not be measured in monetary terms with sufficient reliability.
- R6m of branding expenditure should not have been deferred as any expenditure on branding could not be reliably measured.
- The statement is made that "there are no significant concentrations of credit risk" (130077) whereas in fact Holdings was exposed to Mettle for at least R150m.
- Negotiable securities in an amount of R227m were shown (130077). Included in that amount were preference shares of R150m, which should have been disclosed in those terms.
- The R2m was in truth remuneration as it was a bonus for past services. It should accordingly have been disclosed as part of directors' remuneration.

- The earnings per share should have reflected fully diluted earnings per share, taking into account the obligation to issue 5m shares to Levenstein.
- Disclosure was made of "related party transactions", but no disclosure was made of moneys lent to related parties such as Levenstein Data, JL Associates, Forfin Finance and Shareholders Trust.
- The glossies purported to have been approved on 16 May 2000 (130065) whereas in truth they were never approved.

The interim results for 31 August 2000

68

68.1 The interim results were published on 5 September 2000 (010408), having been approved by the audit committee on the previous day (K(2)243.2) EY was not invited to attend the meeting.

68.2 The income before taxation was R49.5m. If the EY adjustments now contended for by EY had been made at that time, a nominal profit of R650 000 would have been made. In fact, if the further adjustments and potential adjustments were reflected a loss of

R2.6m (see §60.2 hereof) and a potential loss of R36m would have been shown.

The preliminary results of 28 February 2001

69

69.1 The preliminary results were published on 30 April 2001 (110399).

69.2 The profit was R71.5m. On EY's evidence, had full and honest disclosure been made to them, the profit would have been reduced by an amount of R41.6m, leaving a profit of only R29.9m.

69.3 This does not take into account:

- potential losses on advances to employees and directors totalling R34.8m (130119) to buy Holdings shares;
- the debit of R20m referred to in §86 hereof or the R6m in §51.26 hereof.

The solvency of Regal Bank

70 A solvency review was done by the curator during July 2001 and updated thereafter. The position at the time that Marshall of DT testified

on 24 August 2001 was as follows (Marshall 371 et seq; DT(2)552 et seq):

		R000
(1)	Shareholders funds (excess of book value of assets over book value of liabilities):	452 721
(2)	Less:	
	(a) Loss on Investec sale	-45 032
	(b) Related loans	-190 507
	(c) Provision: other loans	-27 710
	(d) Provision: inter-company loans	-38 865
	(e) Structured finance transactions	-105 156
	(f) Impairment of fixed assets	-25 830
	(g) Impairment of investments	-9 668
	(h) Sundry asset impairment	-12 638
(3)	Net recoverable asset value	-2 690

71

71.1 Ad paragraph (1): Shareholders Funds

Shareholders funds are made up of share capital and retained earnings less amounts distributed, for example, by way of dividends. The liabilities consist mainly of deposits.

71.2 Ad paragraph (2)

(a) Loss on Investec Sale

The amount of R45 m is the difference between the value of the advances book of R350m and the price of R305m paid by Investec.

(b) Related loans

The sum of R190m is dealt with earlier.

(c) Provision: other loans

Management made a provision of R15.5m for loans which were regarded as irrecoverable. DT reviewed about 93% of the advances book and came to the conclusion that the amount should actually be R43.2m. Accordingly, an additional provision of R27.7m was made. A number of

the loans were secured by Regal Holdings shares, which, at a nil value, rendered the security valueless.

(d) Provision: Inter-company loans

The management accounts of Regal Bank reflected loans to related parties, most of which were subsidiaries of either the bank or Regal Holdings:

	Rm
Regal Securities	25,3
Regal Fund Managers	7,1
RMI	1,0
Regal Treasury Trust Services	1,4
Regal Outsourcing	0,7
Regal Asset Management	1.1
Other inter-company loans	2,0
	R38,9m

The related parties were not able to repay the loans. It did not appear that the bank could continue as a going concern and hence the related parties could not continue to operate.

(e) Impairment of fixed assets

The sum of R25,8m was made up as follows:

		Rm
(i)	Technology (Sempres)	14,2
(ii)	Intellectual capital	1,7
(iii)	Sundry impairment	9,9
		R 25,8m

(i) On the assumption that the bank could not continue as a going concern, the technology which the bank had acquired from Sempres Ltd was regarded as impaired to the extent of R14.2 m.

(ii) Management informed DT that the amount of R1.7m was possibly the sum of R2m paid to Levenstein which had been amortised.

(iii) On the assumption that the bank would not continue as a going concern, the remainder of the fixed assets were impaired. For example, furniture, fittings and computer equipment were impaired by 50% and restraints of trade by 100%.

(f) <u>Impairment of investments in branded entities and other institutions</u>

(i) A value of R900 000 was ascribed to the investment in 18m Sempres shares.

(ii) The investments in the branded entities Medsurge (R350 000), Protea Health (R2.4m) and Regal Virtual Solutions (R750 000) were impaired as no buyers could be found for the shares. An investment in furniture and art of R3.2m was regarded as being worth R1.6m, leaving an impairment of R1.6m.

(iii) An overnight loan of R5m to Sempres was secured by shares worth R600 000, leaving an impairment of R4,4m.

(iv) An amount of R7m was invested in the Regal Guilt and Hedge fund. After winding up the fund R6.1m was realised, leaving an impairment of R900 000.

(v) The Mettle portfolio held shares in Absa and Stanbic at a market value of R2.3m.

(vi) An investment in a United States company, Bright Spark Investments, of R2.2m, was found to have been not bright.

(vii) The shortfall between assets (R45m) and liabilities (R45.2m) of a Regal Bank subsidiary, Rand Treasury Credit, was R282 000.

(viii) The amount of R9.7m was accordingly made up as follows:

Total impairment of investments in §'s (ii), (iii), (iv), (vi) & (vii):	R12,9m
Less value of investments in §'s (i) and (v)	R 3,2m
	R9,7m

(g) Sundry asset impairment

The sum of R12.6m was made up as follows:

		Rm
(i)	Accounts receivable	-0,9
(ii)	Prepaid expenses	-1,9
(iii)	Unallocated bank items	-4,9
(iv)	Deferred tax asset	-4,8
		R12,6m

Balance Sheet of Regal Bank

72 The unaudited adjusted balance sheet as at 26 June 2001 was:

Assets	**R000**
Cash	310.674
Overnight treasury loans	22.261
Loans to property companies	129.549
Inter-company loans	4.448
Advances	94.138
Listed shares	4.065
Fixed assets	6.519
Unlisted investments	8.930
Accounts receivable	6.750
TOTAL ASSETS	587.330
Liabilities	
Deposits	579.000
Accounts payable	2.418
Taxation	8.602
TOTAL LIABILITIES	590.020
NET LIABILITY	-2.690

73

73.1 The summarised balance sheet as at 31 August 2001 was provided to the commission by the curator on 18 October 2001 (DT(2)563):

	R million
Cash	190
Overnight treasury loans	16
Loans to property companies	115

Intercompany loans	15
Advances	102
Listed shares	2
Fixed assets	3
Unlisted investments	9
Accounts receivable	8
TOTAL ASSETS	460
Deposits	560
Other creditors	10
TOTAL LIABILITIES	570
ESTIMATED DEFICIT	110

Notes:

(1) Assets represent the curator's best estimate of recoverable amounts. Current discussion with a potential offeror's estimate of the total recovery value of assets ranging between R376 million to R406 million.

(2) Provision has not been made for any possible legal claims against the bank.

(3) The deficit indicates a loss for creditors of 19c in the Rand. A minimum of a further 11 c will be incurred in liquidation costs and other expenses.

73.2 The comparison between the position as at 26 June 2001 and 31 August 2001 is:

	26 June 2001	31 August 2001
Assets	R587.3m	R460m
Liabilities	R590m	R570m
Estimated deficit	R2.7m	R110m

73.3 The threatened legal claims against the bank are for:

- R20m by RMI;
- R70m by a depositor on the basis that his demand for repayment was made prior to curatorship;
- R1bn by Kgoro on the basis that promises were made to Kgoro as part of the branding transaction which have not been carried through. The curator regards the claims as ill-founded.

73.4 The curator is pursuing possible claims by the bank against Sempres, Forfin Finance, Levenstein Data and JL Associates (3409). The prospects of recovery are not encouraging (3410).

73.5 The curator informed the commission that he has received an offer for the Stone Manor complex and that interest has been shown in 93 Grayston, although no offer has been received. The immovable properties have been written down by an amount which is equivalent to 3c per Rand for each depositor. In the curator's discussions with Investec Bank, it places a lower valuation on the properties. If Investec Bank is correct, an additional 2c could be lost for depositors (3412-3).

73.6 The curator was requested to provide an explanation for the increase in the estimated deficit of R2.7m as at 26 June 2001 to R110m as at 31 August 2001. This is the explanation (DT(2)566):

	Balance @ 30 June	Curator Adjustment	Adjusted Balance	Reason
Assets				
Cash	311	121	190	1
Overnight treasury loans	22	6	16	2
Loans to property companies	130	15	115	3
Inter company loans	4	-11	15	4
Advances	94	-8	102	5
Listed shares	4	2	2	6
Fixed assets	7	4	3	7
Unlisted investments	9	-	9	
Accounts receivable	7	-1	8	
TOTAL ASSETS	587	127	460	
Liabilities				
Deposits	579	19	560	8
Accounts payable	2	-8	10	
Taxation	9	9	-	
TOTAL LIABILITIES	590	20	570	
NET LIABILITY	-3	107	-110	

Reason:

1. Payments since date of curatorship included R 78m for cheques inadvertently R/D'd on 26 June, R32m for hardship payments, building completion costs and operating expenses
2. Revaluation in lieu of recoverability of security
3. Revaluation in lieu of valuation of properties
4. Revaluation in lieu of recoverability
5. Deterioration of arrears position due to non-payment
6. Revaluation of shares in terms of market value
7. Revaluation in terms of valuation of assets by sworn appraisers
8. Deposits adjusted for payments made in lieu of hardships and interest accrued