Frank Clarke and Graeme Dean*

Submission in response to Exposure Draft of the Corporations Amendment (Corporate Reporting Reform) Bill 2010, the associated regulations, commentary to explain the proposed amendments and the draft Regulation Impact Statement, regarding Improving Australia’s Corporate Reporting Framework

Summary

This submission addresses the matters relating to the proposed amendment of a company’s dividend payment decisions, and to the amendment proposing relief in respect of the preparation and provision of a parent company’s financial statements.

Our general propositions in response to the proposed amendments are, re:

254T The suggested amendment will be at best ineffective, misleading, and most likely to result in unreasonable dividends being paid, as a consequence of:

(i) Except in very limited circumstances, it is impossible to determine whether ‘assets exceed liabilities’ under current accounting practice compulsorily complying with the AIFRS; accordingly

(ii) the notions of fair and reasonable if drawing upon conventionally prepared financial statements, are inoperative, ungovernable, hence ineffective tests; and

(iii) a company’s ability to pay creditors drawing upon the circumstances of financial and assessments of what is fair and (or) reasonable outlined in (i) and (ii) above, is likely to be problematic.

295(2) The suggested amendment has the effect of denying shareholders, creditors and other interested stakeholders, the financial statements of a listed company in which they have such an interest. In particular, it limits their access to the aggregative data (though presentable in a disaggregated format) specified, and provides solely consolidated financial statements not relating to any specific legal entity in and against which (in ordinary circumstances) their shareholders or creditors have any enforceable claims. Consolidated statements are prepared in accord with highly questionable accounting practices that generally mask, rather than elaborate, their financial relationships. Shareholders in listed companies will not have access to the financials of the parent companies in which they have invested.

295(3)
Re: Amendments to 254T

We find the proposed amendments curious, in that rather than define the term profit it is proposed to drop it, and allow the primary test for the appropriateness of a dividend payment to be whether those paying can argue successfully that: their company has an excess of assets over liabilities (a kind of rough and limited balance sheet solvency test, is fair and reasonable (a sort of business judgement test), and that such a payment does not materially prejudice the company’s ability to pay creditors. Here, materially, potentially watering-down the solvency criterion. In our opinion the proposed amendment will be inoperable insofar as it is incapable of being properly regulated and administered, for the following reasons.

(a) An excess of assets over liabilities

The problem here lies not in the sentiment most likely underpinning the requirement. No doubt the intention is to inject the regime with a ‘balance sheet solvency test’. Intuitively, that makes sense. Especially when contemplating a monetary outflow decision like when one is deciding on whether to pay a dividend. But conventional accounting statements, whether fully or partially complying with the AIFRS, rarely yield financial data that are fair and reasonable, meaningfully indicative of either a company’s wealth or financial progress. Conventional balance sheets prepared under the AIFRS may include actual amounts of cash held, amounts expected to be collected from debtors, physical assets stated at what it originally cost to acquire them in the past (money long gone), physical assets stated at their fair values – ranging from historical cost, through what it might cost to replace them (money wanted, not held), to current selling prices (potentially money close at hand), or their impaired value – the product of, inter alia, discounting estimates of future revenue streams of cash generating units of which the assets are part (the theoretical current worth of cash that might (but might not) be received in the future); and amounts stated for assets and liabilities that are merely artifacts of the system – for example, tax effect accounting balances and goodwill on consolidation (difficulties with these latter ‘balances’ was well highlighted in the Royal Commissioners’ observations in respect of HIH). The accounting mechanisms by which those valuations enter the balance sheet clearly flow into every statement of financial performance, making income statements extremely unreliable bases for determining the extent to which a company is better or worse off financially at the end of a period than it was at its beginning. We have explained these defects in accounting, and particularly recently the claims made for AIFRS in numerous places. We draw your attention in particular to Chapters 17 of Corporate Collapse: Accounting, regulatory and ethical failure(CUP, 2003) and Chapters, 4, 5, 6 and 9 of Indecent Disclosure: Gilding the corporate lily (CUP, 2007). These chapters are reproduced in the Appendix, parts (a) and (b).

We draw your particular attention to Chapter 4 of our Indecent Disclosure. . . “A Very Peculiar Practice: Accounting Under Scrutiny”. There, the impacts of some of the above practices are illustrated. Table 4.2 (p.82) analyses the financial insignificance of the data in a top 500 Australian company’s balance sheet for determining the salient characteristics of its wealth and financial performance, namely solvency, liquidity, profitability and the like.

The first limb of the proposed test would be in most instances inoperable and certainly impossible to regulate.
(b) *Fair and reasonable* to pay a dividend

Here again reliance is placed on a form of business judgement rule. We have no argument with the sentiment. Fairness and good judgement are admirable qualities. But it seems unnecessary to specify such in directors’ activities, including dividend decisions, as these are covered by existing obligations that directors act in good faith and in the interests of the company. But, what are the criteria of fairness and reasonableness to be applied in a dividend decision? At least one would think financial criteria would loom large. As noted above and supported by the detailed argument and evidence in the material to which we have drawn your attention, it is unlikely that it can be drawn from data derived from conventional financial statements prepared in compliance with the accounting standards. Below (in respect of the proposed amendment) we argue that reliable data are almost certainly not coming from conventional consolidated financial statements.

We can only conclude that the fair and reasonable test is inoperable, that no viable criteria exist and it is therefore incapable of a just and predictable regulation.

(c) Does not materially prejudice . . . ability to pay creditors

This appears to be a watered-down legally-based solvency criterion. Our concern lies, in particular, first with *materially*. Again, whether something is material is a matter of opinion and judgement. There is no definitive measure of materiality and it is not surprising that accountants have struggled with the notion since it was introduced as an accounting test arguably by Lord Plender in his evidence in the 1920s UK Royal Mail case (see *Indecent Disclosure*. . ., pp. 93-4). A solvency test *per se* would provide a more rigid, less manipulable, less ambiguous test. Second, whatever solvency criterion is injected will require cash flow data and particularly information of the current cash or near-to-cash position of the company, and those data need to be supported by what the financial statements disclose. Those data are supplemented by projected cash flow data. Above (and below, in respect there of consolidated financial statements) we argue and illustrate that current conventional accounting complying with the AIFRS does not provide information about the entity’s current financial position.

As with the tests in (a) and (b), we can only conclude that the amendments specify criteria that are inoperable, manipulable, incapable of effective regulation.

Greater protection for shareholders and creditors is claimed in the Draft Regulatory Impact Statement (p. 17). We take that to mean regarding the exposure of shareholders and creditors to corporate insolvencies. But it is unfathomable how this will be the case where the assessments of what *is fair and reasonable* and whether *assets exceed liabilities* are to me made on the basis of data in the accounting statements drawn up in compliance with he AIFRS. And especially so, were the amendments proposed to be accepted, thus limiting the articulated financials to consolidated statements in which most intra-group debts are eliminated (this position is elaborated below).
Re: Amendments to sections 202(2) and 303(2)

Eliminating the necessity that parent companies, especially listed parent companies, prepare and disclose audited financial statements means that interested parties will be denied properly articulated balance sheets and statements of their financial performances. This is a curious move, bearing in mind that the shareholders of the parent, especially a listed parent, usually hold shares in it and likely as not in none of the other related companies. The aggregative data proposed for various classes of assets and equities is the basis for only a limited form of financial analysis. Similar proposals have been made in the past. We provided arguments against such a proposal when it was considered in the 2003 Discussion Paper, ‘Relevance of Parent Entity Reports’ commissioned by AASB, as did many others in their submissions (see www.aasb.com.au – in particular, especially our submission to that Discussion paper which we attach here (item (c) in the Appendix).

Of course the suggested financial reporting regime applies in some other countries (see that previous 2003 AASB Discussion paper for details). We are yet to see cogent arguments in support of it or defensible evidence of the overall virtues claimed for it. The proposal appears to draw upon a belief that consolidated data refer to an identifiable legal entity, and that consolidated financial statements can provide information superior to what is to be gleaned from a parent company’s accounts and those of its separate subsidiaries.

In that context, the proposed amendment appears to rest heavily upon the notion that the companies whose data are combined to create consolidated financial statements comprise a legal entity capable of owning assets and incurring liabilities; that, talk of consolidated assets, consolidated liabilities, group equity and the like, have a valid financial resonance. But the supposed group of related companies is not an entity of the kind to which the Corporations Act otherwise refers, or to which the notion of assets, liabilities, and group equity have other than metaphorical meanings. The so-called group is an accounting fiction, a description of convenience referring to a set of subsidiaries and their parent company. As such, by virtue of the separate legal entity principle enunciated in Salomon v. Salomon (1896), a group, generally (and without covenants to that effect) is incapable of owning assets and incurring liabilities. Hence the notions of consolidated group assets, consolidated group liabilities and group equity are misnomers - such assets and obligations are the legal property and obligations of the separate companies.

Corporate groups of this kind are thus incapable (as themselves) of earning profits or incurring financial losses – the notions of groups profits and losses are absolute fiction; expressions of an aggregative group solvency or insolvency are meaningless in the absence of a Deed of Cross Guarantee between the related companies (see, Indecent Disclosure . . ., Chapter 8 for an explanation of the effect of deeds of Cross Guarantee. Also provided there are survey data about analysts’ and financial officers’ perceptions about the lack of serviceability of ‘closed-group’ consolidated data currently provided in listed companies’ financial statements – in the Notes to the Accounts.). The assets of the separate companies are not automatically available to meet the liabilities of the others; and the financial ratios commonly calculated in financial statement analysis using group data – debt to equity, rate of return, debt cover, classes of one asset to another asset class, the relation of one liability class to another, aggregates of assets and equities, aggregates such as asset backing, etc., -
are likely to be grossly misleading insofar as they imply financial relationships within a group, capacities to combine and offset, that ordinarily (cet. par.) legally do not exist.

These matters are explained more fully in chapters 16 and 17 (forming part (a) of the Appendix to this submission) of our Corporate Collapse . . . (1997, 2003). There we argue and illustrate the misleading use of the corporate group notion and the misleading nature of consolidated financial statements. Those matters are explored further in Chapter 9 (see part (b) of the Appendix below) of our Indecent Disclosure . . . (2007).

There, it is noted that a generalised support for conventional consolidated financial statements is couched in terms implying interest in aggregated financial information about the wealth and financial progress of the related companies comprising the so-called group. This may well be. Accordingly, we illustrated an alternative method for deriving the appropriate ‘group’ data in Chapter 17 and the Appendix to Chapter 17 of Corporate Collapse . . . , and in Chapter 9 (“An Alternative Group Therapy to Consolidation Accounting” of Indecent Disclosure . . . (see Appendix to this submission) a method by which aggregated data might be presented in a form that does not offend the separate legal entity doctrine and avoids using the questionable techniques used to prepare conventional consolidated financial statements. The mechanism we illustrate better achieves the objectives usually supporting a need to prepare and report consolidated statements of a group of related companies.

Importantly, we accept that frequently information is sought regarding the overall level of indebtedness of the related companies. This concern underpins the misleading notion of group solvency. By eliminating (some) intra-group indebtedness in the consolidation process, conventional consolidated financial statements (at best) disclose indebtedness (of companies within the group) only to non-group companies. The aggregating mechanism we describe in the appendix to Chapter 17 of Corporate Collapse . . . and Chapter 9 of Indecent Disclosure . . . (see Appendix, Parts (a) and (b) to this submission) has the potential to disclose the detail necessary for determining the balance–sheet derived solvency of each of the related companies, detailing the source and destination of their borrowings and lending – this, in a matrix of all borrowing and lending by the companies reveals which are net-borrowers and which are net-lenders, regarding both related and non-related companies. Debt exposure both within and outside the ‘group’ is revealed. The Appendix to Chapter 17 illustrates using data from the liquidation of a high profile 1980s Australian company. Since the publication of this reform proposal advances in computer technology and the increasing use of XBRL reporting makes this idea even more compelling on a cost-benefit basis, than when it was proposed originally.

The Draft Regulatory Impact Statement declares that the parent entity’s full audited financials ‘clutters the annual report with unnecessary detail and is potentially confusing’ (p.11). There, ‘clutters’ and ‘unnecessary’ are arguably disingenuous comments, bearing in mind that no evidence is provided in support of either claim. Indeed, whether the entity’s financials are necessary is the issue in question. Likewise the estimated cost of preparing parents’ accounts appears a trivial matter. The parent’s full audited financials are necessary for the preparation of the consolidated financial statements; alternatively the preferred Option as in the proposed amendment not only is sanctioning the inclusion of non-audited parent company data in the consolidated financial statements, but also possibly the no-audit of the proposed parent aggregative data. How are regulatory agencies ‘that rely upon financial statements to conduct their supervisory duties’ (p.12) to do so with unaudited
parent data in the consolidated financials? And how, under the proposed regime, are the current annual regulatory attempts at tracking listed companies’ ‘solvency’ positions likely to be enhanced by not having access to the relevant parents’ financial statements?

The benefits claimed (p.13) for the preferred amendment (Option (b), p.12) are unsubstantiated there and otherwise difficult to fathom. Complexity is unproven. Those who understand consolidation procedures might argue that the parent company’s accounts enhance an understanding of the consolidated data. Or the reverse, as was originally the stated intention of consolidated statements that they enhance the understanding of the data in the parent companies’ accounts (see R.G. Walker, *Consolidated Statements*, Arno, Press,1976; and Walker’s 1984 NCSC submission, “Accounting requirements for groups of companies” (reproduced here as Appendix (d)) ; Chapter 16 of Corporate Collapse … and Chapter 7 of Indecent Disclosure …) Reduced compliance costs can be deemed a benefit only if the reduction exceeds the financial benefits of providing access to the information withheld and is not offset by the costs of providing the disaggregated parent data as proposed.

Appendix

(a) Clarke, F., Dean, G.W. and K.G. Oliver, *Corporate Collapse: Accounting, regulatory and ethical failure*, CUP, 2003, Chapters 16 and 17.

(b) Clarke, F. and G.W. Dean, *Indecent Disclosure: Gilding the corporate lily*, CUP, 2007 Chapters 4, 5, 6, 8, and 9.

(c) Clarke, F. and G.W. Dean, submission to the AASB 2003 discussion paper ‘Relevance of Parent Entity Reports’.

(d) R. Walker, “Accounting requirements for groups of companies” submission to NCSC Discussion paper on corporate groups and cross guarantees, 1984. Permission to reproduce given by Professor Walker.

*Frank Clarke is Professor Emeritus at the University of Newcastle and Honorary Professor of Accounting at The University of Sydney. Graeme Dean is Professor of Accounting at The University of Sydney.*