

Who passes the solvency test? The Papua New Guinea Companies Act 1996

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THE NEW Papua New Guinea Companies Act, based closely on the New Zealand Companies Act of 1993, contains significant changes to the requirements of the 1966 Act that it supersedes. Many of these changes dispose of anachronistic requirements and are to be welcomed with acclaim. Nevertheless, certain proposed changes are highly controversial.

One such change, relating to the requirements governing corporate financial distributions, will replace the existing capital maintenance rule with a solvency test. The 1966 requirement certainly merits review. In certain circumstances it can lead to, and even encourage, financial irresponsibility.

Unfortunately the solvency test as stated in New Zealand's legislation, on which PNG's new act is based, may well lead to distribution decisions being challenged in the court of law owing to its dependence on the elusive concept of value. Also, weaknesses inherent in the capital maintenance rule are not necessarily eliminated in their entirety under the solvency test.

The limitations of the capital maintenance rule

THE capital maintenance rule can be said to have two fundamental limitations. First, it is evident that it does not achieve its purpose of protecting loan financiers' and creditors' financial interests.

It is unnecessary to develop the theoretical arguments to establish that the capital maintenance rule does not provide the desired protection.

Empirical observation that business liquidations often lead to only partial, or nil, repayment of business debts provides ample demonstration that the rule provides inadequate security to creditors.

Indeed, the rule can in certain circumstances be exploited, in effect to return the initial investment to shareholders, and deny repayments to loan financiers on liquidation. The following illustration demonstrates such a possibility.

Company A has traded profitably for some years, and has produced the following balance sheet to state its current financial position, applying generally accepted accounting practices:

	\$
Share capital	100
Retained earnings	100
Liability finance	<u>100</u>
	<u>300</u>
Fixed assets	
(net of depreciation)	200
Cash	<u>100</u>
	<u>300</u>

Owing to technical developments company A's products are now obsolete. The company's fixed assets designed specifically to produce these products therefore have no productive use, nor any second-hand value. Sale value as scrap may be regarded as negligible, essentially zero.

The directors therefore resolve to liquidate the company. Before doing so, they decide, in the best interest of the shareholders, to distribute accumulated retained earnings as dividends and leave the winding up to the creditors. In so doing the directors leave assets of no value in the business, thus leaving the liabilities undischarged on liquidation. The shareholders, on the other hand, obtain a payment equal to their initial investment, though in principle such payment should have been subordinated to the creditors' claims.

The second limitation relates to the fact that the rule can lead to what is, from a macroeconomic perspective, an inefficient use of capital. Organisations with more share capital finance available than is required to sustain the current scale of operations are prevented from releasing it to shareholders for possible reinvestment in other companies seeking finance needed to implement business expansion, even though the security of the creditors' position would not be affected.

Only the richest of countries, at best, can afford to operate with procedures that inhibit the efficient movement of capital. In a country, such as PNG, with a low level of capital formation, and economic opportunities that require significant capital for effective development, restriction on mobility of capital is intolerable.

The new Companies Legislation will abolish the capital maintenance rule for the determination of legally permissible dividend distributions, replacing it with the 'solvency test'. The solvency test is stated as follows:

- (1) For the purposes of this Act, a company satisfies the solvency test if:
 - (a) The company is able to pay its debts as they become due in the normal course of business; and
 - (b) The value of the company's assets is greater than the value of its liabilities, including contingent liabilities.

Sources of Controversy in the Solvency Test

PROPOSERS of the introduction of the solvency test have argued that the application of the test will prove non-controversial on two counts: first, because the test is based on a provision of the Canada Business Corporations Act of 1985 that has yet to be tested in law; and second, because the need to review 'fair value' (net realisable value) of assets was removed from the proposed New Zealand legislation in the light of the inherent difficulties that were seen to exist in the determination of 'fair value'. Opinion in New Zealand at the time of enactment was that the test in its modified form is readily interpretable.

Unfortunately Canadian experience provides no guide for New Zealand or Papua New Guinea. In Canada, dividend payments are still subject to the old capital maintenance rules as well as the solvency test,

and directors in Canada are not required to certify compliance with the test each time a distribution is made (a requirement of Section 52 subsection 2 of New Zealand's act and PNG's legislation). Furthermore, Canadian legislation does not include contingent liabilities as a factor to consider in the test. In summary, the test is simpler to apply in Canada, and less crucial to the dividend decision.

The problem created by the introduction of contingent liabilities into the New Zealand/PNG version of the test is demonstrated by the following illustrative example:

Company B has net assets with a value determined consistent with the requirements of the solvency test of \$200,000. The company has a policy of paying an annual dividend of \$50,000, (a sum that is less than the annual profit figure). The company is now sued for damages for \$160,000.

How should the company proceed, particularly if legal advice is noncommittal? The directors may risk prosecution by paying the dividend. Suspending the dividend will presumably anger the shareholders, and possibly indicate that they feel the plaintiff has a strong case when this is not so. The accountant's principle of prudence may not lead to decisions in the best interests of the company. Further, if cautious reactions to such a situation were to become a norm, significant quantities of finance may become unnecessarily immobilised in the corporate sector, slowing macroeconomic development.

The example assumes that no ambiguity is associated with the term 'value'. Some explanation of the difficulty created by the term 'value' is required as, depending on its interpretation, financially healthy firms may be classified as insolvent under the test. If 'value' is interpreted to mean 'fair value', heavy investment in specialised assets may be deemed valueless outside a particular form of business. The mining industry offers a dramatic example in Papua New Guinea.

Consider such an operation with significant creditor financing. On establishing operations, the net realisable value for the fixed assets investment will fall from purchase price to zero. The entity will fail to meet the second part of the solvency test. This will be met only when the

entity has built up sufficient inventories of minerals or cash balances through sale of product to make good the deficiency. Thus significant current assets will have to be held in the company.

The restriction on distributions is unhealthy from a financial management point of view, as capital is tied up unproductively. It will also act as a disincentive to investment in this area of economic activity as dividends cannot be expected until the organisation has retained sufficient resources to meet the solvency test.

As this scenario serves to impede the mobility of capital unnecessarily, once again the solvency test can be seen to create the same problem as exists under the capital maintenance rule. Unfortunately the removal of the term 'fair value' from the solvency test does not resolve the valuation problem.

If the test is to be applied in a form that can make sense in the context of such industries as PNG's mining sector, it has to allow for the valuation of assets in terms of the present value of projected future cash flows. This simultaneously generates a more realistic, but also a more subjective assessment of the organisation's solvency. Further, as the draft law is silent on the form of asset valuation to be used, the inference drawn from the mining example that present value is the appropriate determinant of value may not apply to all assets.

Indeed the two elements of the solvency test suggest that two forms of valuation may be required. Condition 1 states: 'The company is able to pay its debts as they become due in the normal course of business.' Discharge of debts in the near future will usually involve the liquidation of assets. As current assets will be liquidated in the normal course of business their fair values will be the pertinent values to apply. Condition 2 states: 'The value of the company's assets is greater than the value of its liabilities, including contingent liabilities.'

It is here that it would seem the present value of future cash flows must be applied. The following questions arise:

(a) In determining values under condition 2, should all assets be calculated at their present value, or fixed assets only, other assets being valued at the fair value? As present values can only usually be assessed for assets collectively, prudence dictates that valuations for condition 2 should be made on the basis of present values only. This also obviates the need to distinguish between fixed and non-fixed assets, a distinction that

is occasionally arbitrary. While this two-fold valuation may enable a theoretically meaningful assessment of solvency, fundamental practical problems remain. The subjectivity of present value calculations has already been referred to.

(b) Is it possible that fair values required to determine the standing of a firm under condition 1 may prove transitory? This may well be the case for commodities for which the world price fluctuates from day to day. Such fluctuations can from time to time be significant. The problem will of course be exacerbated by the current instability of the international value of the kina. A business involved in trading in commodities could quite reasonably pass the solvency test on the date a distribution decision is determined, but fail it on the date the distribution is to be made! Such uncertainties again open up the possibility of making distributions to shareholders when solvency test conditions allow large distributions, thereby denuding the company of real resources immediately prior to a liquidation, in a similar fashion to Company A's distribution manoeuvre. Where there is a potential for abuse there will be a fear of abuse. The valuation system underlying the solvency test offers such a potential. Therefore we may not expect the valuations underlying a financial distribution to go unchallenged.

In an attempt to anticipate which problems might arise in the application of the solvency test, a questionnaire posing ten different scenarios was constructed, eight of which required a judgment as to whether a proposed dividend could be declared having regard to the solvency test. Respondents were required to give a simple yes/no response in each case. These scenarios are based on problems already under consideration in New Zealand, although not yet the subject of any legal challenge. Scenarios 1 and 6 did not require a judgment, the correct decision being, in the researcher's view, self evident. Their inclusion was intended to identify spurious responses, or responses from ill-informed persons. The questionnaires were sent to a random sample of equal numbers of persons in four professional groupings: Company Director, Company Executive, Professional Accountant and Professional Lawyer.

Company directors under the proposed legislation will be collectively responsible for making a dividend proposal, and will be required to affirm that the company meets the solvency test after having allowed for the dividend distribution. Company executives, Accountants and Lawyers

might all reasonably be called upon to give professional advice on this matter. Their judgments, too, are obviously pertinent. Respondents were asked to indicate in which capacity they had answered the questionnaire. Any questionnaire returned that indicated that the reply had been made in some other capacity was discarded in the analysis.

The response rate to the questionnaire proved to be disappointing. Given the small numbers of professionally qualified Accountants and Lawyers in Papua New Guinea, a high response rate was sought to give a reliable indicator of collective professional opinion on the questions posed. One respondent answered 'no' to question 1, where the answer 'yes' was taken to be self evident. (This respondent also answered 'no' to the other nine questions). This response has not been analysed further. Of the remaining responses, over half the respondents answered 'yes' to question 6, where the researcher took the answer 'no' to be self evident. This single question was then put to another group, who were also asked to provide a brief explanation for their response. All five accountants approached answered 'no' to the question. This in itself raises concerns regarding the understanding of the solvency test. The responses that included a 'yes' answer to question 6 have been retained in the following analysis. Useable responses constituted 27% of the deliverable sample. The responses obtained are summarised as follows:

Question No.	Number of responses	
	Yes %	No %
2	8	92
3	85	15
4	69	31
5	77	23
6	54	46
7	92	8
8	62	38
9	92	8
10	54	46

Analysis

AS JUDGMENT was required by respondents in answering these questions, it was intended to assess responses by use of the 't' test. This procedure has been applied, but given the low response rate caution must be exercised regarding the significance placed on the conclusions drawn. The null hypothesis formulated was that responses would be 100% 'yes' or 'no'. Formally:

$$H_0 = 1.00.$$

The alternative hypothesis was stated as, responses would be less than 100% 'yes' or 'no'. Formally:

$$H_a < 1.00.$$

The null hypothesis holds at the 10% level of significance for questions 2, 3, 5, 7 and 9. As true unanimity was not anticipated, the largest margin traditionally regarded as acceptable (10%) in testing hypotheses is considered appropriate. Clearly the results cannot support the view that there is general agreement as to how the solvency test should be interpreted in all situations.

Ambiguity within the draft legislation

POINTS to be considered in respect to ambiguity within the legislation relate to: (i) an apparent contradiction between sections 4(i)b and 4.4(a) in the draft legislation with regard to contingencies; (ii) the bases upon which assets should be valued; and (iii) whether, in applying the test, reference is being made to current assets, or assets in totality.

The difficulty relating to the treatment of contingencies in the test has already been noted in the New Zealand literature on this issue. Such difficulties may be reflected in the responses received to question 8. If, in applying the solvency test, cognisance has to be taken of liabilities that are merely possible, why not also allow for future events that are virtually certain?

The difficulty relating to appropriate asset valuation in question 10 might also be laid at the door of the draft legislation. The company must meet the solvency test on the date that the distribution is determined and continue to do so up to the time the distribution is made. Three respondents felt strongly enough to volunteer concerns with the draft legislation. Their concerns are in line with the issues raised here. A critical review of the sections of the draft Act pertaining to the solvency test would seem to be called for. One source of difficulty, the incorporation of contingent liabilities in the test, may be resolved by deleting reference to them. The Canadian model of the solvency test makes no mention of contingent liabilities. If apparent ambiguities cannot be practically eliminated, two possibilities would seem to suggest themselves. One is to revert to the capital maintenance rule as the legal determinant of dividend distributions. Despite this rule's acknowledged limitations, it may still prove a more satisfactory alternative to the solvency test approach. The alternative would be to establish an interpretation of the solvency test that would prove acceptable in common law, by way of professional pronouncement. (This task could perhaps be undertaken by the Accounting Standards Review Board to be established by the legislation. As ASRB's pronouncements are to have the force of law, it would seem to be the most appropriate body.)

Respondents' understanding

RESPONSES to the questionnaire also suggest a less than perfect understanding of the application of the solvency test on the part of respondents. Lack of consensus on the response to question 4 cannot be traced to any apparent ambiguity in the draft legislation.

Further, responses did not appear to conform to the application of a consistent valuation rule. The researcher cannot claim a perfect understanding of the solvency test as formulated by the draft legislation, nor of the problems posed. However, one of the following patterns of responses might have been expected to emerge in each response.

Question	Basis of asset valuation applied			
	Book value	N.R.V.	P.V.	Hybrid*
2	yes	no	no	no
3	yes	no	yes	yes
4	yes	yes	yes	yes
5	yes	no	yes	yes
6	yes	yes	yes	yes
7	yes	yes	yes	yes
8	yes	yes	yes	yes
9	yes	no	yes	yes
10	yes	yes	yes	yes

*The hybrid valuation involves valuing assets held for liquidation (i.e. current assets, and the property referred to in question 3) at net realisable value for the purposes of part (a) of the test, and assets collectively by their present value for part (b) of the test, as set out in section 4 of the draft legislation.

Fifteen per cent of all the responses analysed conformed to the configuration of responses given for the use valuation and hybrid valuations. No respondents matched answers with those given for book values or net realisable values. Together with the 54% 'yes' responses to question 6 this suggests that understanding of the means by which the solvency test is to be applied is not good.

Acknowledgment

I would like to acknowledge the helpful comments of Ms Barbara Hau'ofa on the penultimate draft of the paper. She is of course in no respect responsible for the limitations that readers will doubtless identify.

Appendix The questionnaire used to sample professional opinion on applications of the solvency tests.

QUESTIONNAIRE INFORMATION

The following shows a balance sheet, in summarised form, drawn up recently for a corporate entity.

		K
Current Assets		3,000,000
Less Current Liabilities (before dividend provision)		2,000,000
NET WORKING CAPITAL:	1,000,000	
Fixed Assets	3,600,000	
		K4,600,000
Financed by:		
Paid in Capital		2,500,000
Accumulated Profits Brought		
Forward from previous years	300,000	
For Year just ended	800,000	1,100,000
TOTAL SHAREHOLDERS' EQUITY:		3,600,000
Term Liability		1,000,000
		K4,600,000

The company would like to declare an annual dividend amounting to K700,000, which is the same amount as the dividend paid last year.

These latest financial statements both comply with applicable financial reporting standards and give a true and fair view. There are no other circumstances which affect or may affect the value of the company's assets and liabilities. Further, the valuation of assets and estimates of liabilities are reasonable in the circumstances. Expectations are that the business will be able to maintain annual profits at the current levels for some years into the future.

QUESTIONS

Consider each of the following Ten questions independently.

In your view, can the company make the proposed dividend payments, and meet the solvency test requirements in each of the cases detailed below:-

1. Information pertinent to the dividend decision is precisely as stated above.
2. A contingent liability is noted in the financial statements that a claim has been served in the High Court against the company alleging breach of contract and claiming K5,000,00 but that it is not possible to estimate the financial effects of this claim on the company.
3. Fixed Assets include a property which has been on the market for two years without offer. An offer has been received recently but for a sum K500,000 less than the written down amount at which the property is recorded in the balance sheet.
4. The company is a holding company and has no accumulated profits. The balance sheet summarised above is the consolidated balance sheet. All accumulated profits are held within two wholly owned subsidiary companies.
5. The fixed assets consist entirely of mine sites, and specialised mining equipment. In the event of any liquidation fixed assets will have no resale value.
6. The term liability, although listed as a non current liability, will mature in one month's time.
7. A large part of the company's current assets is comprised of inventories and consequently it has become customary to take extended credit terms from creditors, sometimes up to 90 days. While the company has not sought the approval of creditors for this extended credit, it has received very few complaints from creditors.
8. Recently, the directors made the decision in principle to rationalise the major business unit over a 3 year period. No specific details have yet been finalised but it is expected that an announcement to shareholders and employees will soon be made that the implementation costs to be incurred in the next three months will amount to approximately K1,000,000. These costs will include both redundancy payments and the writing off of plant and machinery. The profit forecasts, once the rationalisation is completed, are very favourable.
9. The company's fixed assets include goodwill paid for the purchase of brand names and other companies in the past of K1,200,000, which are now incorporated in the major business unit.
10. Current assets include inventories of raw commodities which are held for export. Sales prices are set in terms of overseas monetary units. These are valued in the balance sheet at K1,500,000. However, given fluctuations in commodity values, and the international value of the kina these may ultimately realise no more than K1,000,000.

Please use the attached sheet to indicate your responses.