CORPORATE FUNDING AND CONTROL -

THE IMPORTANCE OF THE EQUITY BASE

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Introduction

This morning we are to examine the importance of the equity base in corporate funding and control, with the assistance of an accountant, an economist and a lawyer. I have given those tersely inadequate labels to the gentlemen who are with me on the programme, to bring out an important point immediately. It is that the subject under discussion calls for contributions from at least three disciplines. Indeed, some of the arguments you will hear may suggest that we also need the skills of a sociologist, and, if legislation is to be sought, we cannot proceed without politicians. By the end of the morning, the services of a psychotherapist might also be helpful. It would be a major step forward, and perhaps more than one can reasonably expect, to secure a consensus on some issues about equity capital amongst accountants, economists and lawyers. As for my own part in this - I do not wish to express any concluded views (with some exceptions, as you will see), because I may have to hear and participate in the decision of arguments on the questions we will discuss. Moreover, I am a lawyer by vocation, with only simplistic knowledge of economics and accountancy. At this stage, I regard my main task as being to raise issues for discussion rather than to suggest how the issues should be decided.

The equity base

I understand that the Conference Committee, in settling the topics for discussion, deliberately used the term "equity base" in order to make it clear that the discussion is not to be confined by any particular view of the term "capital". The "equity base" of an entity is the amount of the shareholders' funds (or net assets) and any subscribed but unpaid share capital. As the claims of shareholders rank last in the hierarchy of claims in a winding up, the term "equity base" indicates the quantum of resources available to the entity unconditionally to support all the other items in its balance sheet. The equity base includes all forms of capital except authorised capital that has not been taken up or issued, and so-called "loan capital", being "capital" in the sense of resources obtained from borrowings. So the equity base has been described as "the fundamental risk cushion".[1]

Par Value

Section 14 Companies Act 1955, as enacted by the Companies Amendment (No. 2) Act 1983, maintains the requirement that where the liability of members is limited by shares, the amount of the share capital and "the division thereof into shares of a fixed amount" must be stated in the Memorandum of Association. The amount so stated per share is known as the "par" value. Although the Act does not specifically say so, the amount stated as the share capital is regarded for legal purposes as the capital of the company, in the sense that, as a general rule, that amount is to be preserved intact within the company. I will have more to say about capital maintenance at a later stage.

Some jurisdictions have introduced "no par value" shares. This is a revival of the very early English practice in which the share referred, not to an amount of money, but to the proportion of interest and liability that the holder took in the undertaking as a whole.[2] The precedent most helpful to us in considering this matter comes from Canada, where no par value shares have been introduced under national and some provincial statutes.[3] The Committee that recommended the enactment of the national statute gave the following reasons for its view that par value is undesirable:-

(a) Par value shares could be misleading to the purchaser, who might be led to believe that the par value is an indication of the value of his investment. The investor should realize that a share merely represents a proportionate interest in the net worth of the business and should not be confused by any arbitrary money denomination attributed to that investment.

(b) The removal of the par value concept allows greater flexibility to the corporation in arranging or rearranging its capital structure.

(c) The removal of the par value concept would do away with the accounting and disclosure problems relating to transactions in par value shares.[4]

Every corporation under that legislation is required to maintain a separate stated capital account for each class of shares it issues, showing the full amount of the consideration it receives for the shares. These provisions make it unnecessary to establish a share premium account, with all the complications entailed in that process. Under New Zealand law, although a member's liability is described as limited by shares, in fact he is liable to the company for the consideration stipulated in the contract for subscription and allotment of the shares, which may include a premium. So we have complicated provisions relating to share premiums.(5) Where, for consideration, a company issues options to take up its shares, the nature of the option money is not clear.

Some companies express their dividends as a percentage of the paid-up capital, giving an impression of a high rate of dividend. I have not seen a company express its dividend as a percentage of opening or average shareholders' funds, which would give a more useful indication. The Stock Exchange requires that dividends of listed companies be expressed in cents per share.(6) I would like to see that practice adopted generally.

No par value shares were recommended by the Gedge and Jenkins Committees(7) but have not been introduced in the U.K. The Macarthur Committee did not refer to the subject.(8) I would like to see consideration given to this subject in New Zealand, because I believe it could result in clarification and simplification of some difficult accounting problems, including the treatment of share premiums and the treatment of the capital maintenance reserve under Current Cost Accounting.

The equity base distinguished from market capitalisation

The "market capitalisation" of a company is simply the product of multiplying the current price on the stock exchange per unit of the equity securities the company has issued by the number of the securities. One must use the figure with reservations, because the market price on a given day usually relates to small parcels, and is usually less than the price on a takeover. It is not a measure of the resources available to a company because it relates, not to those resources, but to the shares in the company held by investors. Amongst other factors, the incidence of taxation on dividends results in substantial differences between the value of the net assets of a company and the value of securities issued by the company. Nevertheless, market capitalisations do give rough, and usually conservative, estimates of the current values of companies as going concerns. They are figures to which economists and policy makers should give attention.

From the macro-economic point of view, an indication of the condition of an economy or an industry is obtained by comparing market capitalisations with underlying net asset values.(9) In 1977, the market capitalisation of the 60 companies whose securities were included in the Reserve Bank's

Share Price Index amounted to about 57% of the aggregate of their net assets as reported in their accounts. Since then, there has been a remarkable change. Market capitalisation across the market as a whole is now about 1½ times the amount of net assets stated in the accounts.(10) I am not satisfied that the reasons for the state of, and the changes in, the relationship, have been found yet. I would like to think that the market makes its assessments of companies with regard to current values, disregarding historical costs, but no doubt there are other reasons.(11)

From the micro-economic point of view, the market value of the securities issued by an entity is of great significance to the entity itself, because it affects the options available to the entity in the continuing process of funding its operations. When a company's equity securities stand at a premium in the market, a company may raise additional funds by issuing new securities at a premium. The company receives the share capital and the premium, but the cost of these resources to the company is the dividend on the shares at the same rate as that payable on all shares of the same class. For this reason, directors and finance managers of listed public companies take a close interest in the market price of the securities issued by their companies.

Those overseas jurisdictions where it is lawful for a company to purchase its own shares have some very interesting other things to show us.(12) Sometimes the purchase by a company of its own shares is the best investment the company can make, where the saving in the cost to the company of servicing the shares thus redeemed exceeds the income after taxation from any other use to which the company could apply the funds. From the point of view of the other shareholders in the company, such a purchase may be beneficial because it has the effect of increasing their stake in the company without additional outlay by them. But it is not all worth emulating. The ability of a company to purchase its own shares has given rise to the practice in the U.S.A. known as "green mail". This term is used to describe the activities of astute gentlemen who, thinking a company is ripe for a takeover, purchase a substantial interest and offer it to the company for redemption under the threat of selling the shares to a third party. The company must pay an enhanced price, giving a profit to the "greenmailer" or see the shares pass into other hands. We are well advised to move slowly in this matter of companies purchasing, or assisting in the purchase of, their own shares.

Equity distinguished from Debt

The distinction between debt and equity is very evident in practice, but it is not easy to describe. Both debt and equity securities constitute contracts between investors and issuers. Professor Gower has put the distinction this way. A shareholder has rights *in* the company as well as *against* it, but a debenture holder has only rights *against* the company but never *in* the company itself.(13) The main point of distinction is the fact that the amounts paid up on equity securities may not be reclaimed or repaid except in accordance with special procedures, and except in the winding up of the issuer, whereas the amounts paid up on debt securities are repayable according to the terms of the contract. In the case of debt, provision needs to be made by the entity for the repayment of the debt on maturity, whereas in the case of equity, no such provision need be made, and the entity is bound by the law relating to capital maintenance. A distinction which, in terms of semantics, may seem to be a fine one, is nevertheless of major importance in arranging the capital structure of a company.

There are complications. First, there are so-called "perpetual" debentures which do not mature until the winding up of the issuer. In their case, the distinction between debt and equity has its practical effect in governing the priority of distribution of assets in the winding up.

Secondly, there are "convertible" securities, which fall into two groups - shares issued subject to redemption (i.e. equities convertible into debts) and, symmetrically, convertible notes (i.e. debts convertible into equities). I believe that, left to their own devices, commercial men would not have made much use of these refinements in New Zealand, and I doubt that they would have reached the public markets. Securities of these kinds, however, have been given a special status under the Income Tax Act 1976. In assessing tax payable by issuers, interest paid on certain convertible notes is a deductible expense,[14] and dividends paid on specified preference shares are also deductible.[15] After the introduction of these tax changes, a great number of these hybrid securities were issued.[16] I believe that insufficient attention was given to the complications, especially on the Stock Exchange, that were thus created, and I believe that it was unnecessary, for any taxation purpose, to introduce those complications. The decision to allow companies a deduction for tax purposes for dividends paid on new raisings of equity capital could have been implemented by defining the deductible dividends as those declared in respect of capital raised after a given date. The benefit of the deduction would accrue to the company, and redound, as it does now, for the advantage of all equity holders. In the interests of simplicity on the capital markets, I hope that any further changes in taxation laws will not call for the creation of peculiar kinds of securities.

Confusion about capital

After reflecting for over 10 years (with intervals of relief from the subject) on the effects of changing prices on business entities, I have come to this conclusion. The failure, so far, to reach a consensus on what should be done to sustain, supersede or supplement historical cost accounting is largely due to the lack of a common understanding of the concept of "capital".[17] Practitioners of the various disciplines who talk of capital have profoundly different ideas of the meaning of the term. On the assumption that we can agree that the most important of these groups are the accountants, economists and lawyers, I want to give a simple sketch of what I see as the essence of their differing ideas of capital.

A lawyer's approach

A lawyer looks on capital as property. To him, capital is a complex of rights and obligations. This proprietary notion has dominated the development of the law about capital, especially company law, until very recent times. Generally speaking, it has been left to lawyers to refine, amplify and extend the definitions of the rights and obligations attaching to equity capital. It is a continuing process, as is demonstrated by the current exertions in all countries with developed equity markets to reform their takeover laws.

Now a lawyer works most comfortably when he is making logical deductions from ideas of ownership, right and obligation. By this process, I believe, many questions have been settled in the past that perhaps ought to have been considered on a broader basis.

Economists' views of capital

Economists, I understand, regard capital as a resource. This calls for definition, especially where the resource is a capability rather than a tangible. The capability of producing goods and services has transcended in importance the lands, animals and barns filled with produce that represented the wealth of earlier generations. If this capability is to be regarded as capital, we need to define it.

My next thought about economists is that I believe they give attention to values rather than costs. The System of National Accounts, being a system developed, I understand, by economists and statisticians, adopts a current value approach. Within that system, capital represents the current value of the accumulated resources of the nation less external liabilities.(18) This is a view of capital that has a strong appeal to me.

Next, I believe that economists give close attention to the cyclical nature of business operations. From an investor's point of view the relevant cycle may be money-to-assets-to-money. He puts money in, and expects to receive more money in return. From the entity's, and society's, point of view, when one is looking at a continuity of productive operations, it may be more relevant to consider a cycle of assets-to-money-to-assets. If we think of capital in relation to the second cycle, it may be said that when the operating capability of an entity has been reduced (so that the volume of things that can be produced in one cycle is less than the volume that could have been produced in the preceding cycle) there has been a reduction of the capital of the entity.(19) The difficulties of translating this concept of capital into rules of practice are proving to be very formidable.(20)

I will leave my views of economics with an observation sustained in my own experience. "Economic analysis of central legal issues seems to foment storms where otherwise mild breezes blow."[21] Nevertheless, when the law intrudes on matters of economics (as it will if we devise a legal definition of capital), it cannot be denied that economists ought to be heard.

Accountants' views of capital

The accountant acts as an observer, recorder, interpreter and adviser. His concept of capital is essentially a historical one, in which he gives prominence to money subscribed in the past. Essentially, an accountant's concept of equity capital is the amount that has been paid up on the equity shares. But accountants recognise that there is more to it than that. Shares may be issued for a consideration above or (within severe limitations) below par, and rules are needed to settle how the premium or discount should be treated in the corporate accounts. Recognition of the fact that assets are consumed by use or effluxion of time has required the introduction of rules to allow for depreciation. The consequence is that the accounts, showing costs of assets less depreciation, disclose an estimation of assets which must correspondingly be reflected in the other side of the balance sheet. Revaluations of assets are allowed, and most public companies include revaluations in their balance sheets. Moreover, in relation to inventories of goods, generally accepted accounting principles require the substitution of value for cost in certain circumstances. Special problems arise for the accountant, too, in assessing the cost of goods sold from a continuum of acquisitions. Conventions have been developed (FIFO, LIFO and NIFO) to assist the accountant to achieve some consistency in assessing the cost of goods sold and determining the amounts that are attributed to opening and closing inventories.

The accountant's concept of capital is also influenced by the complex corporate structures that have become fashionable involving subsidiaries, joint ventures and associated companies. Thus, we have rules for the treatment as "capital" of pre-acquisition profits of an entity taken over. There are rules for the consolidation of the accounts of a company and its subsidiaries, and, in the case of associated companies, rules for equity accounting, which enable investments to be stated at the amount of the underlying net assets instead of the cost of the investment. There is also the problem of cross-shareholdings and circular shareholdings, which might be approached by saying that such holdings result in a reduction of the capital of each company involved.(22)

In despondency about the whole business, I have often thought that there is something to be said for the view that if historical cost is to remain the main basis of financial reporting, then an attempt should be made to keep it pure by abandoning conventions and excluding revaluations. On that basis it would be desirable to record the dates of the material expenditures so that the dollars spent could be adjusted to a common basis. I have not heard anyone seriously advance or support this suggestion.

A very important point emerging from this rapid scan of accountants' methodologies is the extent of reliance on conventions, both for the statement of capital and the statement of profit or loss. The nature of the conventions may greatly influence the development of an economy. This is especially important under a system of free enterprise, where the hope of profit is the main stimulus to the upbuilding of the community.(23)

Review of the law and practice

Finally by way of introduction, I would like to draw attention to the fact that the Securities Commission has announced its intention to undertake a review of the law and practice relating to financial reporting by entities that have raised funds from the public.(24)

This review is required for a variety of reasons. First, the Securities Regulations 1983, which prescribe the matters that are required to be stated in a prospectus, contain a prescription of the items of financial information that need to be included. They are very different from the provisions they replaced (Companies Act 1955, Fourth Schedule) and from the requirements applying to the annual accounts of companies

(Companies Act 1955, Eighth Schedule). In the light of experience with the Securities Regulations, the Commission will, in its review, raise proposals for the content of annual reports, to the intent that the data required in the prospectus and the data required in the annual report will be consistent as to items. The Securities Regulations have not attempted to prescribe rules for the measurement of the items, except that equity accounting has been proscribed in relation to prospectuses for debt securities. It has been suggested to the Commission that further rules should be devised on these matters, and this suggestion will be explored in the review.

The second reason for the review is that since the Companies Act 1955 was enacted, there have been major developments in accounting theory and practice which may need to be reflected in the law. One of the major developments has been the enactment in the United Kingdom of the Companies Acts of 1980 and 1981, which brought into English law the principles of the Second and Fourth of the EEC Directives on Company Law. For present purposes, it may be noticed that the new Acts contain important new provisions relating to the capital of a company, capital maintenance, restrictions on the distribution of profits and assets, the format and content of accounts, and accounting principles.(25)

Thirdly, it has become apparent that there has not been general compliance with some most carefully considered statements of standard accounting practice issued by the New

Zealand Society of Accountants, notably the first Standard for Current Cost Accounting, known as CCA1. The Securities Commission is very much concerned to see that entities which have raised funds from the public report on their affairs according to the best accounting practice.

The Commission has already decided that the review should begin by directing attention to the definition of the concept of capital. Emeritus Professor T.R. Johnston has accepted a commission to prepare a background paper on this subject. With the humility characteristic of this learned gentleman,[26] he has pointed out that to reach a definition of capital is a task that leading scholars and practitioners throughout the world have been trying to do for many years. He said that "while it is not uncommon for New Zealanders to rise to challenges of a similar degree of difficulty in other fields", he thought the possibility of reaching a definition acceptable to all concerned is as likely as that of the alchemists producing their much sought after elixir.[27] Cautioned by that warning, may we nevertheless proceed this morning with the task of describing, if not defining, the capital of a business entity as part of our enquiry into the importance of the equity base. If it is not possible to settle a single definition for all purposes, at least we ought to be able to settle definitions for particular purposes.

The law of capital maintenance

Neither the Companies Act 1955 nor the U.K. legislation from which it was derived contains an explicit definition of the term "capital". Indeed, the authors of that legislation appear to have been sensitive to the ambiguity of the term, and have generally avoided it except in the phrase "share capital".

Section 75, the very provision which has been held by the Courts to establish the requirement of capital maintenance, is certainly not free from difficulty. It provides in substance that a company may only reduce its "share capital" in certain circumstances, including the circumstance that "paid up share capital is lost or unrepresented by available assets".(28) As Professor Gower has pointed out, "capital" as a clearly defined item exists only as a statement of liability, and as he observes, neither dividends nor anything else can be paid out of a liability.(29) Taken literally, it may be argued that s.75 merely prohibits the reduction of the amounts shown as share capital on the liability side of the balance sheet, except in certain circumstances. If that were the limit of the prohibition, nobody would be much concerned about it.

However, the impact of the section is much more substantial. Consistently, the Courts have ruled that it prevents, except in accordance with its terms, the payment of dividends or distributions out of capital. It is the foundation of the rule that dividends must only be paid out of profits.(30)

For the purpose of these rulings, the Courts have adopted a meaning of the term "capital" very close to the meaning used by economists. In substance, the rule adopted by the Courts is that distributions may not be made to shareholders if the payments would have the effect of reducing the amount of the net assets below the amount of the paid up share capital. But there is an exception, inasmuch as it has been held that past capital losses need not be made good before treating a revenue profit as available for dividend.(31)

The leading authority in New Zealand on this subject is the case of Jenkins v. Harbour View Courts [1966] N.Z.L.R. 1, in which the New Zealand Court of Appeal held that an early "own-your-own flat" scheme was unlawful because it entailed a breach of section 75. A company formed by the intending residents built a block of flats with money provided partly by members as share capital and partly by borrowing on mortgage. The Articles of the company entitled members to leases from the company, each of a designated flat for a term of 99 years, at annual rentals sufficient only to cover outgoings expected to be incurred by the company. The Solicitor-General argued that these arrangements did not constitute a reduction of capital of the company, but the Court of Appeal held to the contrary. It will be noted that the company did not attempt to alter the statement of issued or paid up share capital in its balance sheet. Moreover, the conventional balance sheet could state as an asset the block of flats at historical cost without reduction on account of the encumbering leases (though a prudent auditor would no doubt insist on a note drawing attention to the existence of the leases). Nevertheless, the Court held that there had been a reduction of capital contravening section 75, because the current value of the net assets, taking account of encumbrances, was less than the paid up share capital. The legislature intervened to validate some schemes of this kind.(32)

The quantum of net assets also provided the decisive factor in an important revenue case from Eire.(33) There was a company incorporated in Scotland which had large stocks of whisky. The price of whisky rose dramatically during the war, and it became clear that the company would make enormous profits. Under the Scottish law of the time, such profits would not have been liable for excess profits tax. However, by legislation, excess profits tax was imposed retrospectively. The proprietor of the company took the view that, "if the Revenue were bent on taking from him sums to which, as he felt somewhat strongly, they had no moral claim, he on his part determined to do all that in him lay to defeat their devices now and in the future". He left Scotland and went to Eire. He arranged for the company to sell the whisky and send the proceeds to him in Eire, except for a sum sufficient to pay the creditors of the company other than the Revenue. That sum he left in the company's account in Scotland. The Scottish revenue authorities decided to pursue him. They obtained from the Scottish Courts an order winding up the company. A liquidator, described as a "financial Sherlock Holmes", was appointed. He brought proceedings in the Courts of Eire against the proprietor to recover the money as the property of the company. The proprietor contended that he had received the money in his capacity as a shareholder of the company under an intra vires transaction, inasmuch as the money was paid to him out of profits. But the Court held that the excess profits tax had to be deducted in arriving at the amount of the profits available for distribution.(34) Accordingly, the Court held that there had been a distribution of property which was ultra vires the company and inoperative for that reason.(35) In the end, however, the case was decided in favour of the proprietor, on the ground that the Courts would not, in Eire, enforce the revenue laws of Scotland, and that the claim by the liquidator was an attempt to enforce such laws.

Leaving aside the human interest of the case, the feature important to us is the determination, which appears to have been favourably viewed in the House of Lords in another case, that where, by reason of a distribution to shareholders, the amount of the net assets (taking into account the tax payable by the company in respect of its profits) is reduced below the amount of the paid up capital, there is an unlawful reduction of capital.

This view that capital is equivalent to the amount of the net assets has been reinforced in the United Kingdom by section 34, Companies Act 1980, which requires a public company to call a meeting of its members "where the net assets of the company are half or less of the amount of the company's called-up share capital." There is no definition of "net assets", and commentators have already drawn attention to the problems of valuation inherent in the term.(36)

Earlier, I referred to the rule that held that past capital losses need not be made good before treating a revenue profit as available for distribution.(31) While this is still the law in New Zealand, it has been over-turned in England by the Companies Amendment Act 1980. Companies subject to that Act are required to ensure that all past losses, whether on revenue or capital account, are made good before making any distribution. A company's profits available for distribution are defined as its accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made.(37) It is further enacted that references to profits and losses of any description are references respectively to profits and losses of that description made at any time, whether before, on or after the commencement of the Act and, except in relation to an investment company, are references respectively to revenue and capital profits and revenue and capital losses.(38) On the basis of these definitions, it would seem quite clear that henceforth no distribution may be made by a company to which that Act applies until realised past losses of any description have been made good. It would seem that it is not permissible for the purposes of these rules to "make good" past losses by revaluation of assets, as the Act refers to "realised profits" and "realised losses".(39) However, the term "realised" is not defined in the Act, and some difficulties in applying it are emerging in practice. For example, does a land-owning company realise an increase in value of its property by increasing its borrowings on mortgage of the property?

The new U.K. provision that only realised profits are available for distribution reverses, for the United Kingdom, the previous law that unrealised profits, including unrealised capital profits, may be distributed. The law on the point was regarded as settled by a decision in the Chancery Division of the High Court in which it was said:-

> "If a company has fluid assets available for payment of a dividend, I can see nothing wrong in its using those assets for payment of a dividend, and at the same time, as a matter of account, treating that dividend as paid out of a capital surplus resulting from an appreciation in value of unrealised fixed assets."(40)

This decision has been applied by the High Court in New Zealand,(41) and the statement I have just quoted is still the company law in New Zealand, though not in the United Kingdom. However, distributions from unrealised capital profits are rarely made in New Zealand, because they are subject to income tax in the hands of recipient shareholders.(42) Moreover, in the taxation context, the learned Chief Justice has said that "a capital profit or a capital gain is not made by a mere writing up of a capital asset. Such writing up creates only a paper profit, and is evidence simply of a potential gain or profit".(43)

The questions at issue here are whether or not corporate law should recognise holding gains and losses, and if so, how they should be treated. The listed property companies have been adopting different practices, and it is time the matter was settled on a uniform basis. With respect, I agree with the learned Chief Justice[43] that a profit or loss is not created by writing in the books - but holding gains and losses are created in the market for the assets in question, and are often reflected in the share price of the equities issued by the company that holds such assets. I hope that it will be possible to settle a rule which will be adopted for both corporate and tax purposes.

This leads into another major question on which there has been debate to the point of exhaustion without complete resolution. I must refer to the effects of inflation (or as I prefer to call it - the debasement of the currency) on the equity base. First, I would like to compliment the New Zealand Society of Accountants for its initiatives in this controversial subject. We might not all agree with the first standard for current cost accounting,[44] but there can be no doubt that the promulgation of this statement, and the consideration of accounts prepared in accordance with it (whether published or not) have removed some of the mental blinkers which prevented many people from seeing what has been happening. Thanks to your Society, a beginning has been made towards a perception and understanding of the complex effects of inflation on business entities. According to the historian, Macaulay, it was bad enough in 17th century England when they clipped the edges from the gold and silver coins - "It may well be doubted whether all the misery which had been inflicted on the English nation in a quarter of a century by bad Kings, bad Ministers, bad Parliaments and bad Judges, was equal to the misery caused in a single year by bad crowns and bad shillings".[45] Today the process is more subtle and less visible, but the effects are the same. Accountants share the misery, and should apply their skills towards removing it - which you have done, and, I am sure, will continue to do.

You have set time aside at this Conference for sessions on "Revenue Recognition and Capital Maintenance" and the taxation of businesses, so I will refer only to the confused state of the law by mentioning three cases. In England, current value accounting has been held to be a not unacceptable method of accounting for pricing purposes.[46] On appeal from New Zealand, the Judicial Committee of the Privy Council has held that current value accounting is not acceptable for New Zealand income tax purposes.[47] The New Zealand Court of Appeal has held that "full compensation" for the taking of land for public works must include an allowance for the effects of monetary inflation (measured by the Consumer Price Index) since the land was taken in addition to interest at a rate chosen as excluding any inflationary influence (to avoid double counting).[48] Some members of the Commission tell me that these decisions can be reconciled. They all turned on the language of particular statutes. It seems to me to be impossible to say that the language, and the decisions, in the three cases each recognised the merits. On this matter we need new rules, built on the merits, that may be used consistently for all purposes.

The 1981 Act (U.K.) introduced another major change into English accounting law by including legal rules about accounting principles, especially on the valuation, or measurement, of items.(49) The options of historical cost, current cost or replacement cost accounting have been recognised and preserved, and the choice amongst these options has been left with the companies.(50)

I believe that the foregoing matters establish the need for a review of the New Zealand law of corporate capital maintenance. I have said very little about the problem of accounting for inflation, but once embarked upon the review, I think it will be impossible to escape from the need to reach some conclusions about that. I expect your Society to tell the Commission what the conclusions should be.

Gearing, or the debt/equity ratio

Although the evolution of the modern company can be said to have begun in England as early as 1553 with the formation of the joint stock undertaking known as the Russian Company,(51) the practice of companies borrowing on any scale was a much later development. Early joint stock companies were organised on the basis that the members or proprietors would put up all the money required. Indeed, in the early Elizabethan companies there was no fixed amount of capital. What was fixed was the number of shares. The amount called up on each share increased from time to time as the company had need of funds.(52)

One of the consequences of incorporation is that persons dealing with an incorporated company deal with a legal entity distinct from its members, so that their legal relationships are created with the entity, not the members. Consequently, a member of such a company is not personally liable on contracts between the company and other parties.(53) The result is that persons doing business with or lending money to an incorporated company, if they are prudent, will look carefully at the capital structure of the company, and particularly at the ratio of debt to equity.

The importance of this ratio has been described as follows:-

> "A highly geared capital structure - one in which the liabilities absorb a large part of the total funds - is risky because a relatively small change in the rate of turnover, in profits earned, or in the condition of the money market, may precipitate attempts by creditors to enforce payment of their claims, and oblige debtors to liquidate their assets under disadvantageous circumstances."(54)

For many years a ratio of one-to-one was regarded as appropriate - see Article 69 from Table A to the 1933 Act quoted in footnote (52). Over the last decade, companies have become increasingly dependent on debt finance. The trend has been relatively slow and gradual, but in the 5 years concluding with 1983, the proportion of assets financed by equity on average for the companies included in the Reserve Bank statistics declined from 44.4% to 36.6%. If companies classified as financial are excluded, the decline was from 46.8% in 1978 to 44.5% in 1983.(55) These comparisons do not take full account of the effects of inflation, as most companies reported on the historical cost basis except for revaluations of land and buildings only. One may assume that on a current value or current cost basis, the assets would be shown at increased amounts, while the liabilities would remain unchanged. The apparent changes of gearing may therefore be unreal; indeed, it is probable that in real terms the equity base has increased and the gearing ratio reduced.(56) Nobody knows. For an example of an apparently substantial equity base that could not be found, reference may be made to the statement of the Securities Commission on its investigation of the affairs of Mosgiel Limited after the company had collapsed.(57)

Perhaps of more significance than the debt-equity ratio is the proportion of operating profit (i.e. earnings before interest and tax) that is required to pay interest on debt. For companies (other than financial), this increased from about 16% of operating profit in 1978 to about 34% of operating profit in 1983. The proportion nearly doubled in 1983, reflecting both increased borrowings and higher interest rates in that year.(58)

Equity Accounting

There is a particular problem affecting the equity base in which, so it seems to me, the current practice of accountants and the principles of company law are in conflict. It is known as equity accounting.[59] Under the practice, a company (called an "investing company") which holds shares in another company (called an "associated company") amounting to a "substantial" interest (of the order of 20%) and is "in a position to exercise significant influence" over the associated company, may include in the consolidated accounts of the investing company and its subsidiaries a part of the amount of the net assets and a part of the amount of the profits of that associated company proportionate to its shareholding.

I understand that, as it was originally conceived, the practice of equity accounting was intended to be confined to associations in the nature of partnerships or joint ventures in which the right of each participant to call for a distribution would have been established by contract, or at least common understanding. The practice has extended, however, to virtually all cases in which an investing company holds a 20% interest. There can be no doubt that the willingness of New Zealand listed public companies to invest in the shares of each other has been stimulated by this practice. I have grave reservations about it, because I believe that the rationale for the practice is contrary to the present law. The practice assumes that one company can assert a significant influence on the affairs of another company, especially through the appointment of a representative or nominee director. If there is one principle of company law that is unquestionable, it is that the directors of a company must act in its interests, and must prefer its interests whenever they are in conflict with anything else.[60] The idea that a director can act as representative or nominee of another company (unless he is so authorised by the articles) is, I believe, in conflict with that principle. Nevertheless, the practice is well established, and we constantly see reports in the financial press to the effect that an investing company has representatives on the board of another company. Perhaps it is the law which needs to be changed in this matter, though I prefer to think that the law is sound, and that the practice is questionable.

The accounting standard is being reviewed by the Society. I have taken steps to ensure that the review will give consideration to the suggestion that the balance sheet of the investing company, and the consolidated balance sheet of the investing company and its subsidiaries, should disclose investments in other companies at valuation (with a note to the accounts disclosing the historical cost and the basis of valuation), and that the profit and loss accounts should disclose only dividends declared by the associated company. Possibly, and I put it merely tentatively, there might be an exception where by contract the investing company is entitled to call for payment of a specific proportion of the profits of the associated company.

A particular accounting difficulty arises where there are cross-shareholdings and circular shareholdings. We have examples of this problem amongst listed public companies.[61] The solution suggested at one time that each might include in its profits the proportionate share of the profits of the other (which, carried to its conclusion, involves a mathematical progression to infinity) is to my mind too absurd to be given any credence. An alternative solution, that the capital of each should be regarded as reduced to the extent of the common amount in each shareholding, seems to me to be the proper one.

Similar problems arise in relation to circular shareholdings where more than 2 companies are involved. I have not seen a satisfactory solution to them.

The importance of the equity base in the funding of companies

From its formation, the Securities Commission considered that insufficient attention had been given to the role of equity investment, that there was a lack of published material on the economics of it, and that there were remarkable gaps in the statistical information available about it. The Task Force on Tax Reform had a similar experience, finding that, in relation to company incomes and tax, "sufficient data for full consideration of taxation policy issues are not currently available".[62] So, the Securities Commission engaged the New Zealand Institute of Economic Research to examine the subject and prepare a background report upon the economic role and performance of equity investment in New Zealand.[63]

One may look at this subject from at least three points of view, viz:-

- having regard to considerations affecting firms;

- having regard to considerations affecting investors;

- having regard to considerations affecting an economy as a whole.

The Institute referred to each of these. As to the first and last, I prefer at this time merely to quote from the report as follows:-

> " The assumption underlying this report is that the level of equity investment is important to our long-term economic welfare. The reasons for this are worth spelling out. In essence, equity investment is believed, in a private enterprise economy, to fill a crucial function in the mobilisation of financial resources for investment in the stock of corporate capital, largely physical assets.
>
> In more detail the argument runs as follows:
>
> - Continuing investment in capital goods (buildings, structures, plant and machinery, land improvement, etc) is necessary to replace worn-out and/or obsolescent capital stock.
>
> - Additional physical investment over and above this replacement investment adds to the nation's total capital stock, increasing total productive capacity and so allowing increased economic growth and welfare.
>
> - For economic growth and change a certain kind of investment is important, namely investment in new and risky technologies. If investment of this type is lacking, then New Zealand producers are liable to fall behind competitors elsewhere. Also, average returns on investment are likely to be lower, and economic growth slower, if high-risk (but on average high-return) projects are avoided.
>
> - Companies are responsible for most private sector fixed investment. Some of this is financed

internally, from retained earnings. The most important source of finance in terms of magnitude is, however, external, namely borrowing from financial institutions or from the public.

- No lending institution, however, would normally consider financing a large-scale venture solely on borrowed funds. The person or company undertaking the venture would be expected to contribute a significant share of funds on their own account, providing greater security against default for the lenders. In return for bearing more of the risk, the company expects, of course, to obtain a better return on average than the lender.

- Suppose however that there is a tendency for a larger proportion of investment to be financed by borrowing. The result would be that a larger proportion of the income from the investment must be paid in interest. Sometimes this can have inconvenient results, for instance if the investment has an unexpectedly lengthy gestation period before producing income, or if income fluctuates markedly and is insufficient in some periods to cover interest due.

- The tendency therefore would be for investment financed predominantly by debt to be directed towards reasonably safe ventures, avoiding riskier projects. The long-term effect, for the company and the economy, is likely to be adverse.

- Instead of relying on internal funding or external debt finance, however, a company will typically endeavour to finance much of its activity by share capital and part of any major expansion by a <u>new issue</u> of shares, that is selling additional shares in the company. Purchasers of the shares participate in the returns from the company's activities in the form of dividends paid on the shares. But dividend payments rank behind the payment of debt interest as a charge on the company's income. (Preference shares take an intermediate position between fixed-interest debt and ordinary shares.) Should income be insufficient then the dividend payout can be cut, providing companies with a cushion against bad years. Importantly, companies will feel less constrained in undertaking potentially high-return but risky ventures. ...

- Thus equity investment has a pivotal role in promoting innovative and risk-taking investment.

- This justifies the concern sometimes expressed that an insufficient amount of new equity is being incomplete. Nevertheless, the Institute was able to draw some conclusions, which I quote:-

> "Shares have not, on average, been an attractive investment in [the decade ending with 1981]. Although share prices did not keep pace with inflation, they did gain in value over the period. Adding this capital gain to the dividend yield, shares appear on average to have gained a slight positive real pre-tax return for the period from 1971 to 1981, but less than 1 percent per annum. Capital gains on shares were much less than for investment in housing or in farm land [but income from property has not been compared with that from shares.] (64)

As to the cause of these phenomena, the Institute said this:-

> "It appears that no single specific cause can be identified for the fall in real equity values. Increased uncertainty; the effects of inflation on the tax system; a declining underlying rate of return economy-wide; all have probably played a part. The uncertainty about cause makes it difficult to prescribe a cure. The surest key to a strong share market is, of course, a strong economy. But even if the economy continues its recent lacklustre performance, there are still specific policy measures which could be implemented and which would improve the climate for business, investment, the share market, and for equity. Perhaps the best interim conclusion which can be reached is that a reform of both the taxation system and of accounting procedures generally, so that the incidence of tax becomes more certain and less subject to variations in the rate of inflation, would have beneficial effects on share markets, and therefore on the ease of marketing new issues, and would generally encourage venture capital and technological change." (65)

<u>Assembling Equity Capital</u>

The Securities Act 1978, and regulations made under that Act, have substantially reformed the law about offering securities to the public. Some major changes have been the strengthening of the law about prospectuses, which are now required to be much more informative and detailed than hitherto, and the relaxation of the law about advertising that refers to a registered prospectus. These provisions are becoming well known, and I will not take up your time in describing them. I want to mention only 2 points:-

(a) The securities industry is a dynamic one. It is not possible to forsee all developments and to devise laws that will be appropriate in every situation without exception. The process of keeping the law under review is an important and continuing one. Because of the existence of its wide powers of exemption, the Commission has been able to assist in some experiments, and as we have experience in the operation of these, we hope to translate the exemptions into more general rules.

(b) I will be very interested to hear from your discussion groups of any difficulties with the new legislation you have encountered in practice, and of any suggestions you may have for changes to the law.

There is a more general theme I would like to mention. The Institute of Economic Research reported that the proportion of equity investments held by individuals has been declining and the proportion held by institutions and other companies has been increasing. There is a tendency towards "inter-mediation".(66) Increasingly, shares are moving from individuals to investment companies, life insurance offices, and more recently, venture capital partnerships. In the late

1950's there was a movement to establish unit trusts and investment syndicates, by which the public was offered the opportunity to take up units in trusts holding a wide range of equity investments giving investors the protection of a wide spread of risk. This was abruptly stopped by a change of taxation law whereby unit trusts became liable to taxation in the same way as companies.[67]

One could say that these developments suggest a policy issue of some importance. The issue is whether it is preferable for the business of equity investment to be concentrated in the hands of a group of more or less expert managers (so that the general public is involved only to the extent of entrusting funds to the experts) or, on the other hand, whether it is preferable to foster direct personal investment by individuals in the companies themselves.

Taxation policy has not been consistent in this. Some rules favoured intermediation, such as the special treatment for tax purposes of payments made for life insurance premiums and superannuation fund contributions. Other rules were against intermediation, such as the taxation of unit trusts (but not trustee companies' group investment funds) as companies. Investment partnerships may not be unit trusts, and the many small investment clubs are probably not unit trusts. In some jurisdictions, notably Quebec, a deliberate policy has been adopted of encouraging personal investment in equities by means of tax concessions. Residents of Quebec may claim a special deduction for investments made by them in the equity capital of companies incorporated in Quebec.(68) New Zealand allows a deduction for calls paid on shares in mining companies.(69) The Securities Commission has received evidence from experts in the law and practice in the United States, to the effect that it is regarded as high policy there to encourage widespread personal investment in American corporations.

This is a matter which, I think, ought to be allowed to develop as investors wish. On that basis, the law, including the tax law, should not introduce a bias for or against any particular method of investment. I think the change in tax law affecting unit trusts was unfortunate. It had the effect of arresting what was promising to become a very useful method of assembling equity capital. No tax came from it. In the forthcoming review of business taxation, I hope that careful attention will be given to the effects of the tax regime upon the modes of investment that are made available to the public, and that emphasis will be placed upon the neutrality principle in this respect.

Taxation and the equity base

There is a very great range in the effective rates of income tax paid by companies. Indeed, some companies receive payments (euphemistically described as negative income tax) from the taxpayers. Others pay tax at low effective rates, and others again pay tax at very high effective rates.[70] Some of this gives effect to deliberate government policies for the promotion of particular activities. I do not wish to enter the argument about them in this paper, except to say that I am very much concerned about the maintenance of the equity base of entities that are not favoured by such policies.

Some experts have expressed the opinion that on average, after adjustment for the effects of inflation, real earning rates of return of shareholders' funds have been negative since 1974.[71] I need scarcely say that, looking at averages, where the range is wide, can be very misleading. Some rates of return have been much more negative than others.

A large question which is especially appropriate for your expert attention is to determine whether the tax regime should recognise the effects of inflation, and if so, by what means. The Task Force on Tax Reform expressed an important opinion on this matter, viz:-

> "The Task Force is of the view that the objective of the tax system should be to recognise only the effects of the general level of inflation as it affects the business unit. Under this approach, if the replacement costs of the assets of a business rise at a rate faster than that of the general price level, the general inflation element of increases in asset values would be excluded from profits leaving only the real element of profits subject to tax. In other words, the tax system would recognise that the owners' equity in a business should be maintained in terms of general purchasing power before a profit is recognised, but would not protect owners in the event that prices of the particular assets in which they have elected to invest increase at a rate faster than the general rate of inflation. The converse would apply in the case where the specific values of the assets of the business rise more slowly than the general rate of inflation.

Application of a general index would therefore leave with the owners of a business the gain or loss generated by their own decision to undertake a particular line of business, but would allow for changes in the value of money. It might thus be considered a parallel to the relative position of firms in an economy in which prices change, but there is no overall inflation.

The Task Force accordingly concludes that a general price index rather than a range of specific price indices should be utilised in adjusting income for tax purposes."[71]

The Task Force also was prepared to see different systems of accounting for tax and reporting purposes.[73] I must say that I read those views of the Task Force with concern, as I deplore the idea that there should be one set of books for the shareholders and a different set of books for the Revenue. My opinion is that the tax regime should accept the data provided by the appropriate industrial and commercial accountancy practice.

I hope that in the forthcoming review of business taxation very careful attention will be paid to the effect of taxation upon the equity base of productive entities. In this matter, one tends to think of the capital-intensive industries which need to provide for the replacement of assets. The problem may be more acute in the other industries, especially the industries that rely on personal skills and services, such as the so-called high-technology industries. They are the ones that provide real prospects of employment for the labour force. The costs of providing jobs, servicing the employees and meeting redundancy claims are not usually reflected in the balance sheet. Perhaps they should be. Those costs are not willingly met by lenders, who are reluctant to finance intangibles. The costs fall upon equity investors, a point which is not, in my opinion, sufficiently appreciated. I would like to hear an economist on the question whether there is any correlation between the scale of equity investment and unemployment.

The Equity Base and the Control of Companies

The discussion so far refers to the function of equity securities in the funding of companies. The subject for discussion extends to the control of companies, on which I want to mention only one particular matter.

Voting rights on questions arising within the company are usually confined to equity securities, though debt securities, especially debenture trust deeds, often contain provisions governing the behaviour of the company in various matters. As a generality, however, it may be said that it is a majority of the equity securities that, in theory at all events, carry the ultimate right of decision of company policies.

Lord Jenkins' Committee referred to evidence which that Committee had received suggesting that the provisions which preclude a subsidiary from holding shares in its holding company should be extended to eliminate control through cross-shareholdings or circular shareholdings.(74) The Committee said:-

> "Our attention has been drawn to the case where, for example, 3 companies (with a common board of directors or with boards which agree to act in concert) each have a holding of 26% of the ordinary voting shares of each of the other companies. In these circumstances, the board of directors of each company, with the assistance of the boards of the other companies, command a majority, and therefore cannot be removed by the remaining shareholders ...."

The Committee did not recommend a change in the law to prohibit such cross-shareholdings, but cited the evidence to strengthen its recommendations, subsequently implemented, for amendments to require the public disclosure of such arrangements.

We have experience of similar arrangements in New Zealand. Perhaps the most notable were the arrangements made between Lion Breweries Limited and Androcles Corporation Limited which, for professional reasons, I am not at liberty to discuss.(75) The arrangements amongst Goodman Group Limited, Wattie Industries Limited and N.Z. Forest Products Limited, which are, as I write this, under investigation by the Securities Commission, also appear to fall into this class.

At the least, the existence of cross-shareholdings and circular shareholdings in public companies ought to be disclosed. The Securities Commission has included provisions to require such disclosure in its recommendations to the Government on the subject of disclosure of interests in shares.(76)

Lord Jenkins' Committee referred to the suggestion that the holders of cross-shareholdings should be disqualified from voting, but recommended such a disqualification only where the shares in question were held by a subsidiary (a course the Committee would permit in certain circumstances), or were held in trust for the company that had issued them.[77] These recommendations have been implemented in the United Kingdom by legislation to the effect that where a public company has a "beneficial interest" in shares issued by it that are held by someone else, the voting rights may not be exercised.[78] I am inclined to go further and suggest that where there are cross-shareholdings by one group of companies in another, the voting rights should be in abeyance in respect of each holding. This would be consistent with the reduction of capital theory mentioned earlier in this paper with reference to equity accounting.

Conclusion

In this paper I have followed the legal tradition of asking many questions without providing any answers. In this way, lawyers recognise the limitations of their calling. I am appealing to you to provide the answers within your specialty, and in doing so, I must acknowledge the support and help which the Securities Commission has had from your Society and its members. There is a great deal more to be done, and I conclude by posing the following catechism which your discussion groups might find it convenient to address. The questions are:-

(1) Why is equity capital important?

(2) What should be regarded as capital for accounting purposes?

(3) Should inflation be recognised in accounts? If so, how? If not, should revaluations be permitted?

(4) What should be done about equity accounting?

(5) Should cross-shareholdings be regarded as reductions of capital?
Also circular shareholdings?

(6) Should the law be amended to allow a company to purchase its own shares?

(7) Should the law be amended to authorise, or require, the issue of no-par-value shares and the establishment of a stated capital account?

(8) What transfers to and from the stated capital account should be allowed or required,
e.g. <u>To the account</u> -

(a) The full consideration received by the company for the shares?

(b) Option money received by the company for options to subscribe for shares?

(c) Transfers from profit and loss account to capital maintenance reserve?
If so, how should they be derived?

(d) Unrealised capital profits?

(e) Realised capital profits?

(f) Any other item?

<u>From the account</u> -

(g) Distributions to members, provided the net assets after distribution exceed the amount of (a) and (b)?
Approval of members?
Approval of the Court?

(h) Any other item?

(9) What is the importance of the debt/equity ratio?

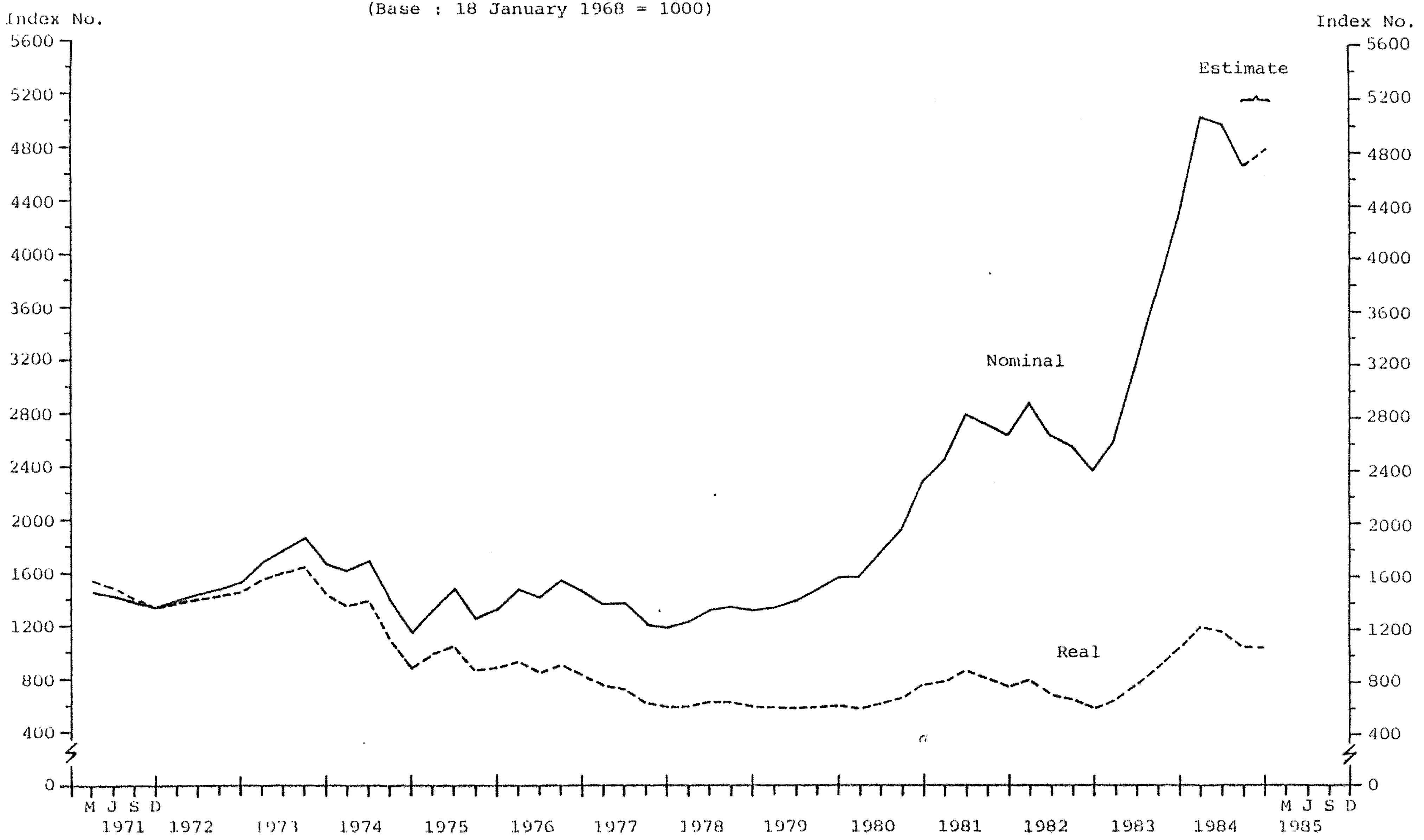
(10) Should rules for determining income be the same for taxation and reporting purposes?

(11) Should accounting standards be translated into law?

If you can answer these questions, we will have made a useful beginning to the review of the law and practice of financial reporting.

Figure 3: The Reserve Bank Share Price Index - Real and Nominal Movements[1]

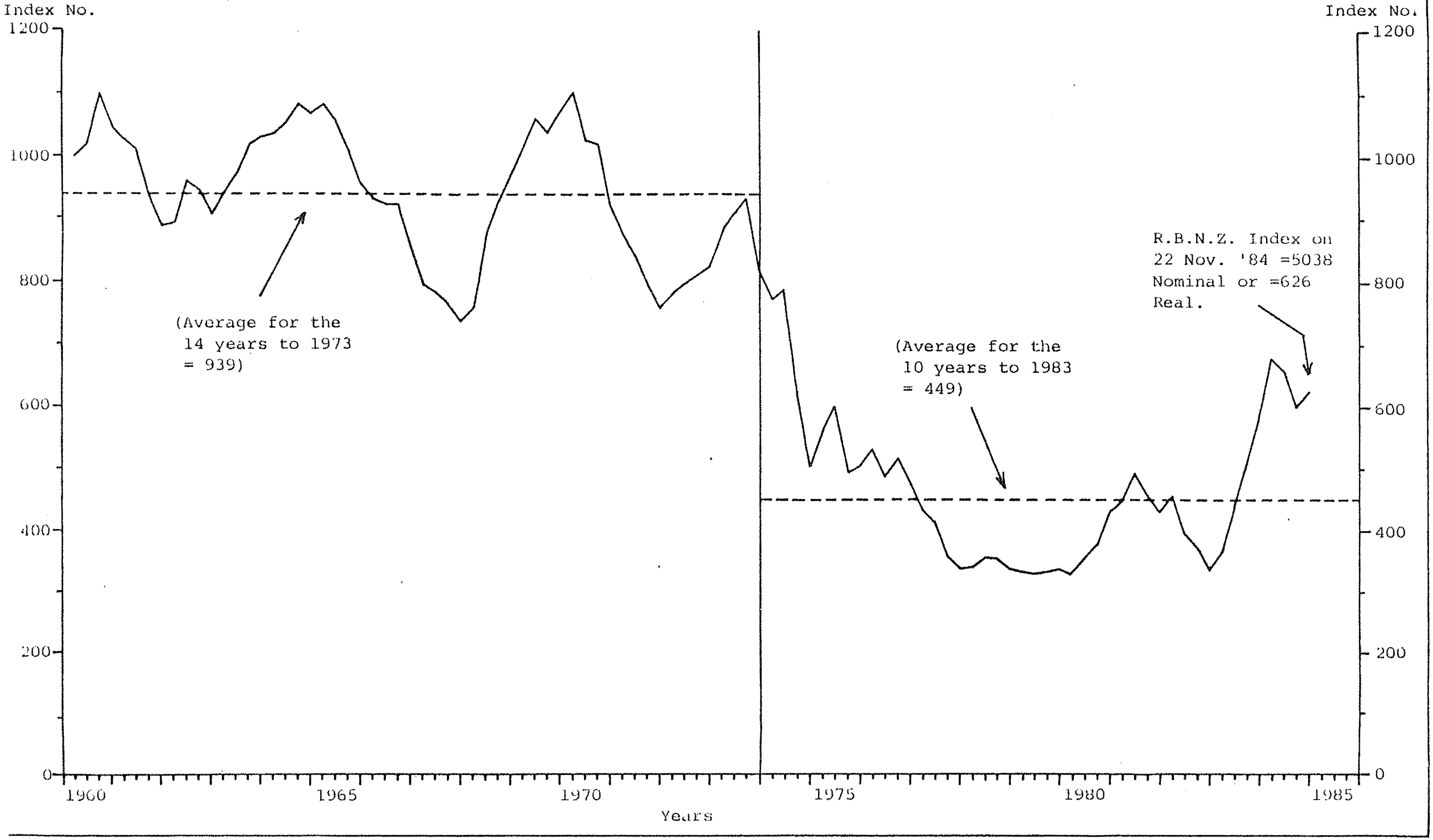
(Base : 18 January 1968 = 1000)



Source: Reserve Bank of New Zealand.

1. All prices at the 15th of the mid-month of the quarter. Deflated using Consumer Price Index, 1971 prices.

Figure 4: Reserve Bank Share Price Index Deflated by CPI.
(Base : March Quarter 1960 (=1000))



Sources: Reserve Bank of New Zealand. Department of Statistics.

31 January, 1985

FOOTNOTES

(1) Spencer Russell, Governor of the Reserve Bank of New Zealand, in his address to the Building Societies Association Conference, Wednesday, 21 November 1984.

(2) See footnotes (51) and (52).

(3) Section 24, Canada Business Corporations Act. Section 22, Business Corporations Act (Ontario).

(4) "Proposals for a new Business Corporation Law for Canada", being a report of a committee set up by the Government of Canada, (R.W.V. Dickerson, Chairman), Volume 1, pages 97-101 (Information Canada, Ottawa, 1971).

(5) Section 26, Canada Business Corporations Act. Section 24, Business Corporations Act (Ontario). Cf. Section 64 Companies Act 1955 as enacted by s.3 Companies Amendment Act 1982.

(6) New Zealand Stock Exchange Listing Requirement 504.

(7) Report of the Committee on Shares of No Par Value (M.L. Gedge, Q.C., Chairman) 1954, HMSO Cmnd. 9112. Report of the Company Law Committee (Lord Jenkins, Chairman) 1962, H.M.S.O. Cmnd. 1749, paras. 32-34.

(8) Reports of the Special Committee to review the Companies Act (Hon. Mr. Justice Macarthur, Chairman) 1971 and 1973, Government Printer, Wellington.

(9) I referred to this in addressing your Summer School in 1981. (Vol.60, "The Accountants' Journal" (1981) pages 99-103.) The New Zealand Institute of Economic Research took the discussion a little further in 1983 in a report prepared for the Securities Commission (Institute of Economic Research "Equity Investment in New Zealand" January 1983). The relationship between market capitalisations and replacement values of assets is known as "Tobin's q", after the American economist James Tobin, who observed the importance of this in encouraging or discouraging new issues of equity securities, new investment in fixed assets, and company takeovers.

(10) Francis Allison Symes & Co., "Sharemarket Statistics", November 1984, page 10.

(11) The New Zealand Institute of Economic Research considered that in New Zealand the relative attraction of the different forms of investment arises principally from differential tax treatments and differing effects of inflation.

(12) Notably the U.S.A. and Canada. In the U.K., the Companies Act 1981 has made it possible for a company to purchase shares in itself - s.46 et seq.
<u>Pennington</u>, op.cit. Chapter 5, especially pp.95-99.
<u>Professor Gower</u>'s views before the enactment of the new legislation were published in June 1980 "The Purchase by a Company of its Own Shares", HMSO Cmnd. 7944.

(13) Gower's "Principles of Modern Company Law", 4th Ed., 399.

(14) Sections 195, 196 Income Tax Act 1976.

(15) Sections 62(2), 194 Income Tax Act 1976.

(16) Smith and van Zijl (1983) 5 N.Z. Journal of Business, 96.

(17) I was counsel for one of the oil companies before the Commission of Inquiry into the Distribution of Motor Spirits and Ancillary Products (R.T. Feist, Chairman) which considered the profitability of wholesalers and retailers in the oil business, with particular reference to the so-called "oil shock" increases in procurement costs in 1973. The Commission's report, presented to Parliament on 30 April 1976, contains a full discussion (chapters 23 to 30) of the system of price control in force at the time, and of the principles on which the price-fixing jurisdiction ought to be exercised. Attention is especially directed to the evidence of Professor T.K. Cowan, which is discussed in chapter 30 of the report, on the question of capital maintenance in these extreme conditions. Two works on accounting concepts that I have found especially helpful are Edwards and Bell "The Theory and Measurement of Business Income", University of California Press (1961), and a small monograph by R.W. Gibson "Concepts for Financial Statements" (2nd Ed.) Law Book Co., Melbourne (1984).

(18) There is a brief description of the system in 1984 New

Zealand Yearbook 689. See also T.P. Hill, "Profits and Rates of Return", OECD Paris, 1979, at p.8. J. Hibbert "Measuring the Effects of Inflation on Income, Savings and Wealth", OECD Paris (1983).

(19) This concept of productive capacity, operating capability or ability to produce, dominated the thinking, I believe, of the official enquiries into inflation accounting - see for example the Report of the Committee of Inquiry into Inflation Accounting (I.L.M. Richardson, Chairman). Government Printer, Wellington, 1976, at para. 4.17-4.24.

(20) One of the notions I find most difficult with CCA is the thought that there has been a loss of "capital" where, for example, a finance company which began the year with enough money to finance 100 motor cars, ends the year with the same (or an increased) amount of money, but because of a rise in the price of motor cars, can finance a number of motor cars less than 100.

(21) J. Krier, "Economics in the Law School", University of Pennsylvania Law Review, 122 p.1664-1705, cited by P. Burrows and C.J. Veljanovski in "The Economic Approach to Law", Butterworths, 1981 at p.1. See also J.M. Oliver "Law and Economics - An Introduction", Allen & Unwin (1979). The division of opinion amongst the Advisory Committee on Tender Offers for the U.S. Securities and Exchange Commission is a good example of the fomenting storms. S.E.C. July 1983.

(22) See the report of the Company Law Committee, chaired by Lord Jenkins, June 1962, H.M.S.O. Cmnd. 1749, at paras. 151 to 156.

(23) This thought owes much to a statement by G.O. May, "Twenty-five Years of Accounting Responsibility 1911-1936", American Institute Publishing Company, New York, 1936, quoted by R.P. Brief "Nineteenth Century Capital Accounting and Business Investment", Arno Press, New York, 1976. Brief expresses the opinion that accounting theory and practice in the nineteenth century rather consistently over-estimated profit, with the consequence that business expectations were raised and economic growth stimulated. Thus, he says, accounting conventions had a direct affect upon economic growth (p.183 et seq.). In my opinion, historical cost accounting continues to exaggerate operating profits, but this certainly does not stimulate economic growth. Instead, it has brought the relevance and utility of historical cost accounts into question.

(24) Securities Commission - Report for the year ended 31 March 1982, p.6, Government Printer, Wellington.

(25) "Tolley's Companies Act 1980", Tolley Publishing Co. Ltd., 1980, by Mary Arden and George Eccles.
Leigh and Edey "Companies Act 1981", Butterworths 1981.
R.R. Pennington "The Companies Acts 1980 and 1981: A Practitioner's Manual", Lloyds of London Press Ltd., 1983.

(26) He is a lawyer as well as an accountant.

(27) Letter to the Chairman of the Securities Commission, unpublished, dated 14 July 1984.

(28) Section 75, Companies Act 1955 (N.Z.), s.66 Companies Act 1948 (U.K.).

(29) Gower, op.cit. 230.

(30) Gower, op.cit. 229.

(31) Gower, op.cit. 231.

(32) Section 80A, Companies Act 1955, as inserted by section 2, Companies Amendment Act (No. 2) 1965.

(33) Peter Buchanan Limited v. McVey, a decision of the Courts of Eire, approved by the House of Lords in Government of India v. Taylor [1955] A.C. 491 and reported by way of note to that case in [1955] A.C. 516.
See also Permakraft (N.Z.) Ltd. (In Liquidation) v. Nicholson (1982) 1 N.Z.C.L.C. 98,358.

(34) [1955] A.C. at 521/522.

(35) [1955] A.C. at 523.

(36) Tolley, op.cit. para. 9.06. In a different context, no less than eleven different meanings of the term "net assets" have been isolated - J.R. Hoggett, "The Capital Maintenance Concept in Current Value Accounting" -

University of Waikato, 1982; para. 4.30. - and he thinks there may be more.

(37) Section 39(2) Companies Act 1980 (U.K.)

(38) Section 45(4) Companies Act 1980 (U.K.) The policy for the exception of investment companies is not apparent from the Act.

(39) Section 39(2) Companies Act 1980 (U.K.).

(40) Dimbula Valley (Ceylon) Tea Co. Ltd. v. Laurie [1961] Ch. 353.

(41) re N.Z. Flock & Textiles Ltd. [1976] 1 N.Z.L.R. 192.

(42) The exemption in section 4(5) Income Tax Act 1976 relates only to distributions from realised capital profits. Mardon Trust v. Commissioner of Inland Revenue (1982) 5 N.Z.T.C. 61,151. Cf. Smout v. Commissioner of Inland Revenue (1982) 5 N.Z.T.C. 61,158.

(43) Davison C.J. in Mardon Trust, supra. at p.61,157.

(44) New Zealand Society of Accountants, "Statements of Standard Accounting Practice on Current Cost Accounting" March 1982.

(45) J.B. Macaulay, "History of England", Chapter 21.

(46) Associated Portland Cement Manufacturers Ltd. v. Price Commission [1975] I.C.R. 27.

(47) Lowe v. Commissioner of Inland Revenue (1983) 6 N.Z.T.C. 61,712.

(48) Drower v. Minister of Works and Development [1984] 1 N.Z.L.R. 26.

(49) Companies Act 1981 (U.K.). Schedule I, Part II, "Accounting Principles and Rules".

(50) ibid. paras. 16 and 29(1). These are discussed by Pennington, op.cit. page 194.

(51) This company was formally called "The Mysterie & Companie of the Marchants Adventurers for the Discoverie of Regions, Dominions, Islands and Places Unknown". The explorer, Sebastian Cabot, was one of the founders of the venture - W.R. Scott "The Constitution and Finance of English, Scottish and Irish Joint Stock Companies to 1720", Cambridge University Press 1912, reprinted by Peter Smith, New York 1951, Reprint, Vol.1, page 18.

(52) Scott, op.cit. Vol.1, page 44. Formoy, "The Historical Foundations of Modern Company Law", Sweet & Maxwell 1923 does not even refer to borrowings. It was not uncommon for companies to have no express power to borrow, but late in the Nineteenth Century it was held that trading companies had an implied power to borrow - General Auction Estate & Monetary Company v. Smith [1891] 3 Ch. 432. When express powers to borrow began to be included in the constitution, they were usually qualified or

limited, at least in respect of exercise by the directors. This practice subsisted until very recent times - see, for example, Article 69 of Table A in the Second Schedule to the Companies Act 1933, which provided as follows:-

> "69. The amount for the time being remaining undischarged of moneys borrowed or raised by the directors for the purposes of the company (otherwise than by the issue of share capital) shall not at any time exceed the issued share capital of the company without the sanction of the company in general meeting."

(53) This was pointed out by D.J. White in an unpublished thesis on "The Law Relating to Associations Registered under the Incorporated Societies Act 1908", Victoria University of Wellington, March 1972, at page 158. It is interesting to reflect that the whole of the debate described by Gower, op.cit. 43, as "the struggle for limited liability" appears to have taken place at the time on a false premise that the members of an incorporated company were indeed personally liable on its contracts. On White's thesis, which I support, the company alone would be liable on its contracts with third parties, and would have rights against its members only in accordance with the contracts constituted between the company and the members. Confusion with the law of partnership appears to have been a major contributor to the pressure for an express statutory declaration of limited liability. Moreover, it appears to be the

general rule that even in the case of an unincorporated club, the liability of members to contribute towards funds needed by the club is limited to the annual subscriptions the members have agreed to pay. (Wise v. Perpetual Trustee Company [1903] A.C. 139.)

(54) G.B. Battersby, "The Analysis and Interpretation of Financial Accounts", 34, The Accountants' Journal (N.Z.) (June 1956) at page 394.

(55) "New Zealand Corporate Financial Statistics", published as supplements to the Reserve Bank of New Zealand Bulletin.

(56) The effects of inflation on borrowers and lenders has been well described by R.W.R. White, then Governor of the Reserve Bank, who advocated the adoption of a constant value unit of account in place of the dollar. Under his proposal, the dollar would become merely the unit of payment, and the number of dollars required to satisfy an obligation would be derived by a process of indexation. His recommendations had some features in common with the proposal for CPP accounting. (ED 10, 1975). - See R.W.R. White, "The need for a constant value unit of account: Savings", "The concept of a constant value unit of account", and "The use of a constant value unit of account in business accounts", Reserve Bank of New Zealand Bulletins, November and December 1979, May 1980. The economist, Alfred Marshall, raised a remarkably

similar suggestion in 1887 in very different circumstances - "Remedies for Fluctuations in Prices", 51 Contemporary Review 355.

(57) Statement by the Securities Commission on the accounts of Mosgiel Limited (Receiver appointed) for the year end 30 June 1979 - issued 28 November 1980.

(58) PA Management Consultants, "Company Profitability" (1984), page 13.

(59) Statement of Standard Accounting Practice No. 2, "Accounting for Associated Companies (Equity Accounting)", New Zealand Society of Accountants.

(60) The impossible position of common directors of conflicting or competing companies has been well described by Lord Denning in Scottish Co-operative Wholesale Society Limited v. Meyer [1959] A.C. 324.

(61) See Charles Carslaw, "Accounting for Mutual Cross-holdings", 1984, The Accountants' Journal (N.Z.) 31. Roger Phillips "Equity Accounting - Some Current Issues", Journal of the New Zealand Society of Investment Analysts Inc., July 1984, p.8.
Professor D.G. Trow of Victoria University has provided me with a note on the subject which he is developing into a paper for publication.

(62) Report of the Task Force on Tax Reform (chaired by P.M. McCaw) (April 1982) para. 7.94.

(63) New Zealand Institute of Economic Research, "Equity Investment in New Zealand", January 1983 - Contract Research Unit Paper No. 18.

(64) New Zealand Institute of Economic Research, op.cit. page 52.

(65) New Zealand Institute of Economic Research, op.cit. pages 49/50.

(66) The Institute relied on the work of Professor G. Fogelberg, especially his "Changing Patterns of Share Ownership in New Zealand", New Zealand Economic Papers, Vol.13, and subsequent unpublished data collected by him (The Institute, op.cit. section 2.4). The Task Force on Tax Reform observed this trend also - op.cit. para. 7.39.

(67) Section 153B Land and Income Tax Act 1954 as inserted by s.20(1) Land and Income Tax Amendment Act 1960 - see now s.211 Income Tax Act 1976.

(68) M. Martin, "The Quebec Stock Savings Plan", a paper presented to the 9th Annual Conference of the International Association of Securities Commissions and similar Organisations, 1984.

(69) Section 160, Income Tax Act 1976.

(70) P.A. Management Consultants, "Company Profitability" (1984) pages 10, 11, 27. Ivon Watkins-Dow Limited reported an effective tax rate of 40.5% of operating

profit on the historical cost basis which amounted to 77.1% of operating profit on the current cost basis.

(71) <u>P.A. Management Consultants</u>, op.cit. pages 20, 21.

(72) <u>Task Force on Tax Reform</u>, op.cit. paras. 7.13 to 7.15.

(73) ibid., para. 7.16.

(74) Lord Jenkins' Committee, op.cit. para. 152.

(75) The arrangements are described and discussed in an unpublished research paper by David Patterson, "Lion Breweries and Androcles - The validity of an allotment for shares to defeat a takeover", Victoria University of Wellington, 1982.

(76) Securities Commission recommendations for legislation on nominee shareholdings, May 1982. These have not been enacted.

(77) Lord Jenkins' Committee, op.cit. para. 156.

(78) Section 37 Companies Act 1980 (U.K.).