AMENDMENTS TO THE COMPANIES ACT 1993

THE LIQUIDATOR’S PERSPECTIVE

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1 Introduction

Over the last year or so substantial change has been made to company, securities and financial reporting law. An overview of the all the changes is beyond the scope of this paper. Accordingly, the aim here is to provide a summary of changes that are likely to impinge on the conduct of liquidation. The areas, in respect to companies, which will be considered here comprise:

- Changes to the nature of records to be kept.
- Changes to the reporting obligations to shareholders and the Registrar.
- Changes to the audit regime.

After a summary of the changes has been outlined, some observations will be made on how this impinges on the practice of liquidation.

These notes will then conclude with some observations about changes in respect to directorial obligations.

2 The law reform package

The Financial Reporting Act 1993 has been replaced by the ***Financial Reporting Act 2013*** and the Securities Act 1978 has been replaced by the ***Financial Markets Conduct Act 2013*** (FMCA). There is a range of related legislation such as the ***Audit Regulation Act 2011*** and the ***Financial Markets Authority Act 2011*** (FMAA).

Securities law itself has undergone momentous change. The Securities Act and related statutes and regulations have been repealed and replaced by the FMCA with 597 sections and the FMAA with 85 sections plus schedules.

The principal consequential amending Act for companies is the ***Financial Reporting (Amendments to Other Enactments) Act 2013*** (FRAOE). Whilst this enactment is primarily concerned with the Companies Act 1993, it makes changes to an array of laws such as those relating to friendly societies and credit unions, industrial and provident societies and building societies as well as to gambling and tax law.

Parallel with the changes to the Companies Act, the accounting aspects of the Tax Administration Act 1994 have been amended, principally in parallel with the introduction of the ***Tax Administration (Financial Statements) Order 2014*** (TAFSO).

Unrelated to matters financial reporting there is yet another change of importance to liquidation in the form of the ***Companies Amendment Act 2014*** (CAA14) which, amongst other things, criminalises certain directorial conduct.

3 Changes to record keeping requirements

3.1 Introduction

At first sight the most fundamental change impacting upon small, closely held companies[1] is the amendment to **s194** of the Act. This part of the notes will outline the nature of the change. The consequences of the change will be considered below (see 3.3 below).

3.2 History

S194 originally was a continuation of the equivalent provision in the Companies Act 1955, modified to take account of the effective substitution of generally accepted accounting practice (GAAP) for the notion of 'true and fair'. GAAP comprised primarily the accounting standards and supporting pronouncements as they existed at the time.

In about 2005 New Zealand was effectively compelled, due its trans-Tasman obligations, to abandon its own accounting standards and adopt those of the recently founded International Accounting Standards Board (IASB). The IASB's standards, based as they are in large measure on US GAAP, are highly complex in terms of recognition (the process by which assets and liabilities are identified for inclusion), measurement (the ascription of carrying values to those assets and liabilities), presentation (the mode of representation of assets and liabilities in financial statements) and, particularly, disclosure (the notes to the financial statements in the main).

The Society of Chartered Accountants (as it was then called) at the time had sought to exclude those companies which were closely held. The rationale being that GAAP was general purpose in nature – meaning that it accommodated those persons without the power to compel the reporting entity to provide information. It reckoned that the affairs of closely held companies ought to be represented in special purpose form, presupposing that anyone with a legitimate interest was able to command information to suit their needs.

The Government of the day designed the unsatisfactory exempt company regime in an attempt to reduce the so-called compliance burden. For companies above a certain size it was left to the then Institute to design what was then called differential reporting (now reduced disclosure[2]) for larger but closely held companies. The IASB attempted to devise a reduced disclosure regime. It was a failure and was, in some ways, even more complex than the standards it was supposed to provide exemption from.

The other impetus for change was the need to align with Australia and indeed the changes about to be described bear a strong resemblance to the Corporations Act 2001 (see part 2M.3

[1] These notes will use the expression closely held company to describe the circumstances where the shareholders are few in number. As will be seen the term is now imprecise but is intended to refer to the type of company which is typically liquidated where the director(s) and shareholder(s) are substantially the same person or persons.

[2] The difference might be that the differential reporting regime gave measurement as well as disclosure exemptions.

Financial Reporting). However, alignment has NOT taken place in one fundamental respect. S286 of the Corporations Act 2001 is the equivalent of s194. It imposes an obligation to:

- Correctly record and explain its transactions and financial position and performance; and
- Enable true and fair financial statements to be prepared and audited.

It does not follow that the Australian small proprietary company is obliged to prepare 'true and fair[3]' financial statements. However, it can only mean that such companies must configure their accounting records so as to enable it to be done. The New Zealand position is not written this way.

3.3 The changes

S194, prior to amendment, required (in sum) records that:

- Correctly record and explain transactions.
- Enable financial position to be determined.
- Enable compliance with the Financial Report Act 1993 (FRA93).
- Enable audit to be completed.

In addition there were specific and detailed rules for accounting for inventory. These rules have been rescinded.

The relevant part of the new s194 is:

> **194 Accounting records must be kept**
> (1)The board of a company must ensure that there are kept at all times accounting records that—
> (a) correctly record the transactions of the company; and
> (b) will enable the company to ensure that the financial statements or group financial statements of the company comply with generally accepted accounting practice (if the company is required to prepare such statements under this Act or any other enactment); and
> (c) will enable the financial statements or group financial statements of the company to be readily and properly audited (if those statements are required to be audited).
> (2)The board of a company must establish and maintain a satisfactory system of control of its accounting records.

The first substantial change is that it appears the board of directors no longer has to explain transactions (in marked contrast to the Corporations Act 2001 with which the Act is supposed to have been aligned).

The second substantial change is that the determination of financial position is, on its face, no longer required for small, closely held companies. Further, the reason for the change is now apparent – as there is no FRA93 there cannot be a requirement to comply with it. Similarly, the need to be able to audit has gone other than for large companies and certain others (see below at 4.4 and 5.2). There has always been an ambiguity in this regard as it was not clear

[3] Authoritative British legal opinion would suggest that 'true and fair' essentially means compliance with financial reporting standards.

what the nature of audit was. It was certainly the traditional financial attest audit but might have included audit by the Crown such as for tax purposes. This has now been clarified.

The third, and highly significant change, is that there is now a clear obligation to maintain systems of control. A more narrowly cast provision was always in the Act in the form of s190 and that remains unchanged. However, the possibilities available to liquidators (see discussion of s300 of the Act below at 7.3) may be substantially enhanced. Certainly, no control system can be said to exist unless the board ensures the accounting records explain the transactions. The new s194 may therefore be more onerous than its predecessor.

3.4 Comparison with other record keeping requirements

Leaving aside the matter of s300 of the Act, in essence from a practical day-to-day point of view nothing has changed. S22 of the Tax Administration Act 1994 remains intact, including the detailed rules pertaining to inventory. S22, with subtle variations, was closely aligned with the now repealed s194. The *status quo ante* remains for boards and their accountants.

3.5 Other consequential amendments

S189 of the Act – the wider obligation to keep formal statutory records – needed amendment as it referred to FRA93. However, it does not, in effect, relieve the obligation to keep financial statements for 7 years as it refers to the Act itself and 'any other enactment'.

4 Changes to financial and statutory reporting regimes

4.1 Introduction

This section of the notes will consider the dramatic changes that have been enacted with respect to financial and statutory reporting, filing obligations and audit.

4.2 The previous position

In the original company law package obligations in respect to the preparation of financial statements and the obligation to publicly file those statements were set out in the FRA93. In certain fundamental respects the Companies Act 1993 was cross-referred to that Act. The obligation to audit, or otherwise, was shared between those two Acts. FRA93 has been repealed and replaced with the Financial Reporting Act 2013 (FRA13).

FRA13 now confines itself to prescribing the basis for financial reporting upon those companies with a public accountability or, perhaps, a deemed public accountability obligation. For example, it deals with what generally accepted accounting practice (GAAP) comprises and how it is formulated. In that sense its changes are procedural. Where it differs substantially is that it wholly omits provisions for what might be called closely held companies, these being, in the main, the primary concern of liquidators. Most notably the exempt company regime has been dispensed with.

Of course, given s258A of the Act amongst other things, it might be important for a liquidator to know if FRA13 did apply and the directors had failed to so act.

The burden of distinguishing between the obligations of different classes of company has now been included within the Act itself.

4.3 Dates of effect

The amendments inserted by FRAOE took effect from 1 April 2014. Amendments under CAA14 are being phased in over the next year. Dates of application can be determined by reference to legislation.govt.nz, selecting Companies Act 1993 and then clicking on tab 'versions and amendments'.

Accordingly, it can be inferred that the financial reporting changes take effect for accounting periods ending after 31 March 2014.

4.4 The configuration of the new reporting regime: determining company status

The new Part 11 identifies five classes of company:

- Large companies.
- Public entities.
- Companies, not being large, with a broad based shareholding.
- Companies, not being large, with a narrowly based shareholding.
- Overseas companies[4].

The relevant definitions are set out in **Appendix 1**. The primary definition section is the new s198 which then cross-refers to other, related legislation. The relevant definitions have elaborate definitions of the term 'group'. The purpose of the definition is to deal with the basis for the preparation of group financial statements (see s202 of the Act). Whilst this may have implications for s258A of the Act, these notes adopt the view that 'group financial statements' (meaning a line-by-line consolidation) are not directly relevant to the practice of insolvency on the basis that liquidators deal only in legal entities and not the fiction of a group.

A large company is one which is measured by either turnover or scale of assets. A public entity is essentially an entity that is the Crown or is owned by the Crown. Everything else is neither of these two classes. The distinction of the two remaining classes depends upon the number of shareholders.

In addition to the demise of the exempt company the term 'issuer'[5] has also disappeared to be replaced, in essence, by the term 'large company'.

[4] As overseas companies will not be considered further specifically because they are not companies within the meaning of the Act (see s2). Consequently, New Zealand liquidators do not deal with such companies unless, of course, s17 of the Judicature Act 1908 were to be invoked. But that possibility is outside the scope of these notes.

[5] At least so far as it is a term defined by the FRA13. It is still a feature of the FMCA.

5 Selecting an appropriate reporting regime

5.1 Introduction

The decisions that need to be made are not restricted to the financial reporting basis for financial reporting alone. It is also necessary to make decisions about audit, public filing (registration) and the composition of annual reports. Where all these classes of activity are referred to collectively they will be referred to as ‘reporting’.

5.2 Decision chart

There is attached as **Appendix 2** a decision flow chart that aids in the factors that need to be considered in selecting financial reporting, audit, annual report and registration.

The decision nodes cross refer to the following matters.

Note 1: the determination of a ‘large company’. As noted above the distinction between a large company and its opposite is critical to determining the appropriate regime to apply in all aspects. See **s198** of the Act and **s45** of the FRA13 (refer to Appendix 1).

Discussion on implementation of the criteria is set out at 5.6 below.

Note 2: the right to vary reporting obligation from the default position (see notes 4 and 6 below) can be pre-empted by an appropriate clause in the constitution. It is unlikely that shareholders would wish to include such a clause.

Note 3: an important change pertains to the time limits within which votes in respect to matters of reporting can be taken. A new concept is introduced known as the **opting period**. This is set out in **s207H** of the Act. The opting period begins on the start of the accounting period and ends on the **earliest** of:

- 6 months after the start.
- The date of the annual meeting within the accounting period.
- For accounting periods shorter than 6 months, the balance date.

It is necessary, therefore, to understand the term **accounting period** which, in turn, necessitates understanding the term **balance date**. These are set out in **s2** of the Act.

Note 4: a super-super majority (95%) of a large company’s shareholders are entitled to opt out of an obligation to audit. See **s207J** of the Act.

Note 5: Public entities are defined in s198 of the Act and s5 of the Public Audit Act 2011 (refer to Appendix 1). Essentially, such entities are those owned by the Crown.

Note 6: provided that the conditions in regard to the constitution and rule in regard to opting out are met or adhered to, a company with 10 or more shareholders is compelled to obtain a super-super majority (95%) to opt out of reporting obligations. See **s207I** of the Act.

A key decision point, therefore, is the determination of the number of shareholders. See **s199** of the Act.

Note 7: for companies with fewer than 10 shareholders a super-super minority (5%) can cause the company to opt into reporting obligation. See **s207K** of the Act.

5.3 The reporting obligations

For all but the closely held company (less than 10 shareholders), the obligation to prepare financial statements in accordance with GAAP are set out at **s200** and **s201** of the Act. It is this obligation that small more widely held companies can escape as a matter of default and widely held companies that are not large can opt out of.

For completeness sake it is noted that all companies caught within the scope of s200, they are also obliged to prepare group financial statements. In other words, to be caught within the obligation to prepare GAAP based financial statements means that the traditional four column requirement is retained. That is, parent current and prior and group current and prior.

The obligation to have an audit, when not opted out in appropriate cases or opted in in other cases, is set by **s206** and **s207** of the Act.

5.4 Matters not covered in the decision chart

In addition to the matter of overseas companies, the following matters are not covered in the decision chart:

- The mechanics of auditor appointment, reporting and resignation.
- Registration of financial statements.

Sub-part 3 of part 11 (**s207P to s207W**) deals with appointment and resignation of auditors amongst other things.

The obligation to register financial statements is set out at **s207D** and **s207E**. There are exemptions of various sorts, notably large subsidiaries. The period of time in which registration is to take place has been slightly truncated. FRA93 required registration 20 working days after the final date for preparing financial statements which was 5 months, meaning that a registering company was obliged to register 5 months plus 20 working days after balance date (essentially 6 months). S207E requires registration within 5 months of balance date, meaning the period has been shortened by almost a month.

5.5 Rights of shareholders of closely held companies

S207F of the Act entitles shareholders in companies which have opted out of GAAP as a matter of default or a matter of choice to request financial statements prepared for tax purposes.

The rights available under s178 remain unaffected. However, s207F is unconditional in that the company cannot decline to comply as is the case with s178.

The important question then pertains to what s207F is referring to. It would seem that due to the abandonment of the small, closely held company by the Act, Inland Revenue (IR) has had to step into the breach.

5.6 Analysis and commentary or those who cannot remember history are condemned to repeat it

Leaving aside the special issues relating to the Crown, there are two decisions nodes. The first relates to whether a company is large or otherwise and then it is necessary to understand the nature of a company's shareholding.

The more complex problem arises with respect to the notion of a 'large' company. There is a scale of assets criterion and a scale of revenue criterion. These operate conjunctively in that to fail one is to fail all. The difficulty is establishing a border between classes is the perennial problem of precise application. The same problems prevailed previously with respect to the divisions amongst exempt companies and the various iterations of GAAP compliant companies. It would seem that the lessons from the refinements of the size criteria in the previous regime have not been learnt.

S45 of the FRA13 refers to total assets. The term, 'total assets', is less clear than might first appear. These questions arise and remain unanswered:

- Are the relevant assets those appearing on the balance sheet as prepared in accordance with GAAP?
- What happens if GAAP does not apply?
- What if it was applied but inaccurately?
- What about problems of set-off (e.g. trust moneys funding liabilities)?
- If it is not a GAAP based test (as must be the case for companies falling below the criterion), what valuations apply?

It is the opinion of the author that the arbiter must be GAAP irrespective of whether a circularity ensues.

The problems compound when the need to consider which assets are to be included arises. The definition refers to the total assets of the entity and its subsidiaries. It probably doesn't mean that because, as even the most junior accountant knows, the aggregate of assets of members of a group are frequently substantially greater than that shown on aggregation through consolidation. The difference pertains to eliminations. The same matter arises with revenue of course. The author believes that it must mean consolidated assets and revenue but that is not what it says.

The difficulties in respect to the second limb of the size test, 'total revenue', are, if anything, even more severe. Again, the origin of the revenue figures against which to measure scale is not defined. It can only be inferred that the same rule applies. Such a figure is to be calculated in accordance with GAAP even if the same circularity ensues.

Revenue is not defined directly within New International Equivalents to International Financial Reporting Standards (IFRS) even though that term is used, for example, in NZIAS 1 *Presentation of Financial Statements*. To find a definition it is necessary to widen the search to the *NZIAS 18 Revenue*. At paragraph 7 the term 'revenue' is defined by reference to increases in assets or decreases of liabilities arising in *the ordinary course of events* (see Appendix 1).

The definition gives guidance but the accountant need take great care. It is customary to display some income gross of its related expense and other income net. For example, sales of goods and services are stated gross of their related costs and net of taxes (GST). Whereas sale of plant and equipment are stated net of cost, where the cost is the carrying value prior to sale. This is referred to as the gain. Such a gain is outside the normal course of events and is probably excluded. However, the position might differ if the company traded in the plant or, more likely, financial assets. In that case it would be necessary to pay close attention to the off-setting rules set out at NZIAS1.34.

Consider an example. Company X makes sales of goods to a value of $34.35 million (including GST) and sells a piece of plant for $1.15 million (including GST). The carrying value of the plant was $0.5 million. The following steps need to be taken:

- GST is stripped from the gross consideration on sales, leaving a net sum of $29 million (this of course is a natural outcome of the GST accounting process).
- GST is stripped from the gross consideration of the sale of plant, leaving a net sum of $1 million.

What then is the 'total revenue'? It is either:

a) $29 million (sales proceeds only)
b) $30 million ($29 million of sales + $1 million of plant disposal proceeds); or
c) $29.5 million ($29 million of sales + $1 million of plant disposal proceeds - $0.5 million carrying cost).

Given that the FRA13 definition is governed by GAAP, and therefore IFRS, the value to apply in the application of the definition is likely to be a). In the event that the company bought and sold investments with the same facts other than investment was substituted for the plant, the answer is more likely to be b) though c) is a possibility.

The basis for the alternative sub-heading may now become apparent. It pertains to the propensity for officialdom not to learn from experience of others. When borders had to be defined between classes of companies in the aftermath of the enactment of the first FRA, the problems were solved after some trial and error. For instance, the exempt company definition was modified as was the *Framework for Differential Reporting*[6] due to ambiguity in

[6] See FDR paragraphs 2.7 and 2.8.

the originals. Officialdom will always make such mistakes unless they consult with people who practice[7].

6 Tax Administration (Financial Statements) Order 2014 (TAFSO)

6.1 Introduction

In virtue of the demise of the exempt company regime and, in effect, the differential GAAP regime for small, closely held companies IR has formulated TAFSO as a substitute. This took effect on 1 April 2014 (see **cl.2**) for accounting periods ending after that date.

The primary purpose of this part of the notes is to discuss implementation of TAFSO.

6.2 Importance of TAFSO

Clearly TAFSO has significance in the administration of the various taxation regimes. However, it does appear to have a direct role in the administration of the Act, particularly the amended s4 pertaining to the solvency test and with respect to s189 in respect to the core records to be kept. This will be discussed further at 7.2 below.

6.3 The structure of TAFSO

TAFSO is configured as follows:

- Definitions.
- Exemptions.
- The core financial statement requirements.
- Ancillary disclosures.

6.4 Exemptions

Small companies and non-active companies are exempt (cl.5 and 6). There is a special provision for 'look-through' companies (cl.7). This third is specialised and will not be considered further.

A small company is one that is not part of a group (not a defined term and therefore presumably reliant upon the Act itself – see s198) and does not have income greater than $30,000 and, more importantly, has not incurred expenditure greater than $30,000 in any income year.

A non-active company is as defined in the Income Tax Act 2007 (ITA).

[7] No doubt we will have, in due course, an amending enactment to correct the amending enactment or otherwise an expensive court case to resolve the ambiguity. One day officials will be held accountable and Santa Claus and the tooth fairy will be real.

The term company has the meaning ascribed to the term by YA1 of the ITA. The term encompasses more than a company as defined by the Act. However, it does not seem to encompass an unincorporated business, but that matter is beyond the scope of these notes.

6.6 Financial statement requirements

6.6.1 Introduction

The 'minimum requirements' are set out at cl.8.

The basic requirement (at (a)) is permissive:

- A balance sheet is required at the end of the income year.
- A profit and loss statement is required for the income year.

TAFSO does not specify what is to be included and how. Presumably therefore the old formats established under the previous financial reporting regime are allowed to prevail.

At (b) it is specified that:

- The financial statements must be based on double-entry – perhaps surprising but no harm in mentioning it.
- The accrual basis is to be applied.

6.6.2 The vexed issues of recognition and measurement

The term 'double entry' and the term 'accrual accounting' are said in the interpretation clause to have the meaning given them by 'accounting principles'. It is not clear what the source of accounting principles precisely is. Certainly, the *NZ Framework* discusses accrual accounting (at paragraph 22) which if it is the source of 'accounting principle' (and it is difficult to see how it should not be) it provides a basis for understanding what is required. This might have far-reaching consequences. For example, it is certainly consistent with accrual accounting that complex liability recognition falls within its scope (see especially 7.3.2 below).

The problem might come when 'assets' are considered. This is a term that is also to be understood within the meaning of 'accounting principles'. Certainly that might mean matters pertaining to when to recognise and when not to, and important consideration when considering, say, intangible assets. However, TAFSO at cl. 8(c) does specify valuation (measurement) rules. Or, at least, it appears to do so.

The valuation rules leave the decision about market or historic cost values when 'in the preparer's opinion [the appropriate basis] provides a better basis of valuation[8]'. The question is begged: better than what?

Better entails a comparison. The author would argue, and no doubt will at some future date, that 'better' is equivalent to 'truer'. Where that might arise would be, for example, if an asset was impaired but carried at a higher historic cost value. The opinion of the preparer might

[8] There is an explanatory note attached to TAFSO, not forming part of the requirements, that attempts to resolve the valuation issue. However, it is largely repetitive and not binding anyway.

appear to be sacrosanct but, in the way of such things, it is far more objective than meets the eye. A preparer must have a reasonable foundation for his or her view.

As can be seen, all roads lead to Rome. A set of financial statements cannot be devoid of meaning because it was the unjustified whim of a preparer.

What has been discussed hitherto are problems of recognition and measurement of certain classes of assets – plant and equipment, real property of one sort or another, intangibles, financial assets of various kinds. The position with respect to inventory is categorically *status quo ante*. Sub-part EB of the ITA, subject to a host of rules providing exemptions, specifically links inventory, including agricultural produce, to the rules established by IFRS and specifically NZIAS 2 *Inventory* and NZIAS 41 *Agriculture*. There has been no consequential amendment to the ITA. The GAAP based rules prevail, including, of course, the need to take account of impairment (even if in the guise of the lower of cost or net realisable value rule).

6.6.3 Accounting policies and other disclosures

There is a requirement (cl.8(d)) that accounting policies are to be disclosed, including whether the inclusive or exclusive of GST bases of accounting has been used (cl.8(e)). Presumably therefore both methods are permissible

Comparative (prior year) figures must be disclosed (cl.8(g)).

There are then some tax specific disclosure obligations:

- Matters pertaining to interest and dividend (cl.8(h) and (i).
- Tax reconciliation (Schedule 1(a)).
- A reconciliation of the plant register (Schedule 1(b)).
- A requirement to align with Form IR10 (a highly sensible requirement).
- Associated party disclosures (though this has a delayed implementation date).

What has been omitted from, say, the exempt company regime includes:

- Contingent liabilities.
- Securities.

Neither of these is significant. Given the author’s view of the need for complex liability recognition due to accrual accounting, contingent liabilities fades as an issue. Securities, whether on personalty or realty, is available (in the main) from the public record.

7 Impact on the practice of insolvency

7.1 Introduction

Either explicitly or implicitly the maintenance of records (or its converse) is central to the execution of liquidation. The express provisions which were linked to FRA93 and are no more, are any remedy involving s4 (e.g. s56) of the Act and s300. Amendment has been necessary.

The purpose of this part of the notes is to identify the amendments and discuss the implications.

7.2 S4 The Solvency Test

To recapitulate, s4 informs a range of sections – s52, s67, s70, s77 and through them s56 of the Act. It also plays a role in s108, s221 and s222 of the Act. Its terms are also referred to in case law dealing with the more implicit provisions of interest to liquidators, particularly the provisions relating to the directorial duties (s131 to s137 of the Act).

S4 is a two limb test comprising:

- A liquidity limb (able to pay debts as they become due).
- A balance sheet test (assets are greater in value than liabilities).

The second limb was linked to FRA93. It has been amended as follows.

> **4 Meaning of solvency test**
>
> (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.
>
> (2)Without limiting sections 52 and 55(3), in determining for the purposes of this Act … whether the value of a company's assets is greater than the value of its liabilities, including contingent liabilities, the directors—
>
> (a) must have regard to—
>
> (i) the most recent financial statements of the company that are prepared under this Act or any other enactment (if any); and
>
> (ia)the accounting records of the company; and
>
> (ii) all other circumstances that the directors know or ought to know affect, or may affect, the value of the company's assets and the value of the company's liabilities, including its contingent liabilities:
>
> (b)may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances … (*material related to amalgamations omitted*)

What has changed is s4(2). It has changed in two ways. Firstly, the linkage to FRA93 has gone and has been replaced by the financial statements required by the Act or any other enactment. Secondly, there has been inserted an obligation to have 'regard to' accounting records which means those records prepared for compliance with s194.

For large companies and public entities the effect is basically nil. The Act requires them to prepare financial statements in accordance with GAAP. For all other companies it is no longer an obligation to refer to either exempt company financial statements or GAAP based financial statements (whether differential or otherwise). Instead the directors need to consider any other financial statements required by an enactment – TAA for example – and the accounting records. Given the dictates of double entry and the accounting process, it is unlikely that these two sources of information would differ over time.

The discussion of s300 will address what the content of the accounting records might entail. Leaving that discussion aside for the moment, it might appear that the TAFSO 'other enactment' financial statements are ill-suited to the purpose of determining solvency or otherwise. This is probably not the case for two reasons.

First, as was demonstrated, TAFSO is configured so that a set of financial statements reflecting market based valuation (measurement) principles is permissible and it is hard to argue that recognition principles set out in GAAP do not apply. There is some ambiguity but that should broadly be the effect. If that is the case the financial statements should be amenable to use as a basis for determining balance sheet solvency.

Second, if that is not the case then the balance sheet test will be redundant. The solvency test is conjunctive in that to be solvent a company must be liquid and balance sheet solvent. If the rules permit a balance sheet to record values greater than their propensity to generate cash then the company will always fail the liquidity limb. Consequently, the issue of the balance sheet – and its ability to be used as a device to prove solvency – falls away.

If this was the case then serious damage has been done to the ease with which s4 can be considered. A balance sheet, properly configured, is a 'short-hand' way to avoid the extreme difficulty of projecting cash flow forward. In essence, a balance sheet with complete liabilities and assets stated at no more than impairment value will tell the directors in most circumstances whether the company is solvent or not. It is difficult to see that TAFSO with its emphasis on what is 'better' could mean anything other than this.

7.3 S300 Directors liability for failure to keep proper records

7.3.1 Introduction

S300 has a reasonably long history. It was brought forward from the Companies Act 1955 but fell largely into disuse due to its failure one of the last 1955 Act cases (*Re Pacific Wools Ltd (in rec & in liq): Crott v Touche Ross* [1992] 6 NZCLC 67,824). There have been intermittent uses of it since (*Re Cellar House Ltd (in liq): Walker v Allen* HC Nelson, CP 13/00, 18 March 2004, *Mason v Lewis* [2006] 3 NZLR 225, *Re Ariya Limited (in liq): Walker v Ariyathas* CIV 2011-404-1894 [2012] NZHC1648) all of which were successful by and large.

Part of the reason that the set-back in *Re Pacific Wools* arose was because of the conservatism of the judge, who found it difficult to believe that people would account on other than a cash basis[9]. The overt linkage to GAAP changed all that.

[9] The issue was accounting for over-the-counter forward contracts on wool and the failure to include those contracts badly 'out of the money' in a year end accounting.

7.3.2 The text

The operative change to s300 lies in this text.

> **300 Liability if proper accounting records not kept**
> (1)Subject to subsection (2), if—
> (a)a company that is in liquidation and is unable to pay all its debts has failed to comply with—
> (i)section 194 (which relates to the keeping of accounting records); or
> (ii)section 201 or 202 (which relates to the preparation of financial statements or group financial statements) or any other enactment that requires the company to prepare financial statements or group financial statements …

As it no longer exists the essential change is to remove reference to s10 of the FRA93 and substitute the references to s201 and s202 which relate to the obligation to prepare financial statements for legal entities and groups respectively as imposed on large companies, public entities, and small widely held companies (foolish enough to not engage the optional exemption).

No longer is it the case that a director of company, not required to prepare financial statements, is able to be held accountable for erroneous financial statements. Errant directors should draw little comfort from this change as the sins are generally perpetrated at the more detailed level of the general ledger than it is abstraction and summarisation.

Directors of large companies etc., on the other hand, have had their responsibilities expanded as s10 referred only to legal entity financial statements and not to groups. A legal nonsense has, in a sense, ensued in that the directors of a company with subsidiaries can be held accountable for events occurring outside the company he or she immediately directs. The author thinks this is likely to be of academic interest only. However, it is certainly the case that liquidators take action in respect to actual legal persons not accounting fictions such as groups.

Taking the case then of the typical closely held small company what is the effect of the change? It first needs to be noted that s194 and s300 are joined at the hip like Siamese twins. There are two aspects of the now truncated s194 (in one sense) and the expanded s194 (in another). It will be recalled that s194 requires:

- Records to correctly record transactions – the truncation; and
- For there to be control systems of some kind – the expansion.

Dealing with truncated limb first of s194 the words at issue are:

- The meaning of correct.
- The meaning of record.
- The meaning of transaction.

‘Correct’ is a stronger word than the phrase ‘true and fair’. The second concept entails some latitude with respect to materiality. Correct implies a more binary orientation. Something is either true or it is false.

‘Record’ might mean filing an invoice. But it doesn’t mean that as the preamble refers to accounting records and that can only mean the general ledger. Accounting means double entry, something now serendipitously reinforced by TAFSO. In other words, s194 requires that transactions are ascribed the appropriate entries within the context of accounting notation.

A transaction is an event whereby one party (in this company) enters into economic relations with another, external party. Therefore in the typical purchase cycle there is order, delivery, invoice, settlement. Seen from a contractual perspective that is a single transaction. Seen from another there are three transactions. The accounting, arguably, entails three transactions but four entries, as follows[10]:

Dr Items to be delivered
Cr Obligation to pay supplier
Order

Dr Inventory
Cr Items to be delivered
Delivery

Dr Obligation to pay supplier
Cr Payables
Invoice

Dr Payables
Cr Bank
Settlement

The entry that might not qualify as a transaction is the entry to payables on the basis that it is a shuffle of obligations to creditors already recorded as the transaction. The receipt of a confirmatory document, in such a view, is incidental (ignoring GST of course).

To explore further the notion of a transaction, consider a simpler example where all of the phases of acquisition are conflated – the purchase for cash of Item X. Assume Item X was a consumable then the ‘correct’ accounting is:

Dr Expense
Cr Cash

However, if Item X is of enduring rather than momentary effect the ‘correct’ accounting is:

[10] See commitment accounting in Yuji Ijiri *Theory of Accounting Measurement* AAA 1974].

Dr
Asset

Cr
Cash

There are two ways to view the notion of recording the 'transaction'. The first view would be the historic cost view in its purest sense. Once the record is made 'correctly' there is no need to vary it. The transaction has been recorded. However, a second view is that encompassed in the modified historic cost model or its total abandonment in market value accounting. That is transactions that endure require constant application of the recording (accounting) art.

No accountant would be surprised by the characterisation of recording as an activity that happens more than once. No accountant does otherwise nor gives it a second thought. Assume Item X is inventory the recording cannot be complete until, upon sale, the inventory is transferred to cost of sales. Assume the sale is cash, the accounting entries are:

Dr Cash
Cr Revenue
and
Dr Cost of sales
Cr Inventory

What element of these entries pertains to the transaction? The revenue certainly is. The transfer of inventory arguably as there is a dual aspect to the transaction. But otherwise the second entry is a continuation of the recording of the initial transaction arising at acquisition. The notion that constant recording activity in respect to a 'transaction' is thereby established. This is clearly in evidence in the idea of marking inventory down to NRV.

For a 'transaction' as a past event to be constantly operated upon to ensure it is correct is utterly routine. Assume that Item X was a piece of plant, it would need to be subject to depreciation at the very least. Such is obligatory to comply with TAFSO if for no other reason the notion of accrual accounting demands it. However, once the idea of depreciation is accepted so too must be the more accurate, if more difficult, assessment of impairment.

The same principle will apply to simple financial assets. For example, it would not be to properly record an uncollectible debt at the unpaid original amount recorded in the receivables ledger for time immemorial. Correctly recording of the debt demands that reality is faced and it is written down to its true value. If that is true of a simple financial asset, it is true of all financial assets.

Whilst the logic by which it is suggested that the reforms to the Act have not freed the director and his or her accountant from the complexities of asset accounting is arguable, the same is not true of complex liabilities[11]. Many companies engage in extended contracts.

[11] One issue that is dear to the heart of a liquidator is the matter of voidable preference. How many directors or their accountants would, for instance, consider that a receipt from a debtor may be subject to a claw-back and

Such contracts are transactions and must be recorded correctly. When those contracts are in the executory stage the accounting is difficult but, given the sole remaining requirement of s194 for the small, closely held company, obligatory.

There are many such examples whether they be imposed by statute (tax or in relation to employees), or arising from contracts such warranties, forward financial contracts such as for currency. Take just one example: warranties. If a company commits to repair over an extended period to correctly record the exchange necessitates an actuarial assessment of its likely future cost. That idea is wholly consistent with the notion of accrual as espoused by TAFSO. In the event the contract has a material consequence, it must be recognised and valued to ensure compliance with s194.

A further dimension that needs some consideration is: when is a liability not a liability? The question is, perhaps, a facetious way of considering the place of what is known as the shareholder current account (SCA). Frequently, in the closely held context there are sums due to or from the shareholder or his or her closely relations. If the account is in debit, it is clearly a simple receivable even if the debit was intended to be cleared by an attribution of directorial salary at or near the balance date. It will frequently not be possible to do this as when a company is on or over the cusp of insolvency, it is difficult to satisfy the directorial rules relating to remuneration set out in s161 of the Act. This is even more the case where the remuneration exceeds that which can properly be seen as remuneration as would be set in a market for such things. The spectre of the solvency test and s52 of the Act arises.

It is the solvency test that looms large in the determination of whether an SCA in credit is a liability or a part of equity. Again relying on the definition of GAAP (see *NZ Framework* paragraph 49), a liability cannot exist if there is no *present* obligation amongst other things. It can be seen that settlement of the sum recorded as credit on an SCA is prevented by a host of creditor protections in the Act, including the nature of a distribution (s2), the potential for claw-back (s292) and, in the event of a security (s293 or, failing that, s299). On balance therefore, an SCA is more likely to have the character of equity than it does of a liability. TAFSO does not express a rule. In that case an SCA in the circumstances of insolvency or near insolvency should be regarded as equity, notwithstanding this treatment might defer the point at which insolvency is seen to arise.

The answer, of course, lies in the saying that it is not accounting that is complicated. It is circumstances. Accounting simply follows the event. If a director wishes to avoid the cost of compliance don't enter the contract in the first place. That cannot apply to complexity imposed by statute, but that is another matter. Having failed to comply leaves the director vulnerable to a claim under s300 just as was the case before the reforms.

Perhaps the lament that s194 is not harmonised with s286 of the Corporations Act 2001 is unnecessary because the concept of correctly recording transactions cannot be incompatible with 'truth and fairness' without making s286 impossible to deal with. In other words 'correctly recording transactions' and 'truth and fairness' are the same thing and, because

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record that 'transaction' for its full effect? It is likely to be very few, but to fail to recognise the possibility is not to 'correctly record' the transaction.

‘truth and fairness’ is the same thing as GAAP, correctly recording transactions and GAAP are the same thing in terms of recognition and measurement at least.

The simple truth is that to fail to maintain the books of account – the general ledger – so that it delivers a valid picture of the state of financial affairs is to breach the now truncated version of s194 and to leave a director as vulnerable to a claim under s300 much as before. In short, despite all of the upheaval in the Act, nothing changed.

7.3.3 The matter of control

The overt obligation imposed on directors to operate a system of accounting controls is a small but highly significant change to s194. Unfortunately the Act gives no guidance as to what a system of controls might comprise. It is necessary therefore to look elsewhere.

Perhaps the best place to begin is with audit regulation, control being a matter of central importance to the conduct of an audit. ISA 315 (Revised) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* at paragraph 4(c) gives definition of controls. It states:

> Internal control – The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity’s objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term “controls” refers to any aspects of one or more of the components of internal control.

That may well be too wide as it deals with matters beyond the accounting records such as legal compliance. More narrowly focused is the definition of deficiency in controls as set out in ISA (NZ) 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*. It states at paragraph 6(a):

> Deficiency in internal control – This exists when:
> (i) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or
> (ii) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

From these definitions, and adjusting in relevant respects, the characteristics of a ‘satisfactory system of controls’ can be discerned. Essentially, processes are required that ensure entries (‘transactions’) to the general ledger are recorded completely and accurately when they arise and, if not, error is detected on timely basis. Depending upon the scale and complexity of the company in question such controls will include:

- Reconciliations primarily with the bank but also other external parties (e.g. creditors and debtors).
- Checking of complex calculations (e.g. tax – see in particular Schedule 1(a) of TAFSO).

- Systems to ensure goods and services received and sold are identified at the time they arise and are 'captured' by the accounting records (e.g. sequential controls something that is automatic with modern accounting packages).
- Appropriate delegations are given (see s130 of the Act) and are supervised.
- Budgets are set and variance analysed and explained.

The list could go on. It is true that companies in a fragile state financially are much more likely to not have controls of the sort described either because of ignorance, negligence or wilful intent (fraud). The opportunities available to liquidators to claim under s300 have been greatly enhanced.

8 Miscellaneous

There have been a few amendments that have an impact on liquidators. These include:

- An amendment to s258A of the Act from FRAOE.
- Several changes arising from CAA14

S258A has been amended to remove an obligation upon liquidators to report, in certain circumstances, offenses in relation to breaches of the Securities Act 1978. This is not surprising as there is no such Act any longer. What is, perhaps, surprising is that it has not been replaced with a reference to the new securities law. Incidentally, similar amendments have been made with respect to administrators (s239AI of the Act), receivers under the Receiverships Act 1993, and mortgagors under the Property Law Act 2007.

CAA14 makes several classes of change:

- Criminalisation of certain conduct.
- Directorial place of residence.
- Various others not discussed here.

The Act has been amended to add a criminal offence. At s138A the following has been inserted:

> **138A Offence for serious breach of director's duty to act in good faith and in best interests of company**
> (1)A director of a company commits an offence if the director exercises powers or performs duties as a director of the company—
> (a) in bad faith towards the company and believing that the conduct is not in the best interests of the company; and
> (b) knowing that the conduct will cause serious loss to the company.
> (2) However, a director does not commit an offence under subsection (1) if the power or duty in question is exercised or performed under any of section 131(2) to (4) or is a power exercised under section 132.
> (3)A person who commits an offence under this section is liable on conviction to the penalties set out in section 373(4).

Liquidators will now need to consider the implications of this amendment in terms of the obligations set out in s258A. There are three conjunctive elements to be proven for a director to be convicted. It is not sufficient, for example, the director acted in bad faith knowing a serious loss will ensue, he or she has to have believed that the conduct is not in the interests of the company. The author believes that the test of 'best interest belief' is not as subjective as it appears. A director cannot believe something in the face of overwhelming evidence to the contrary. However, proof is not the concern of the liquidator they merely need to consider an offence has been committed.

S10 of the Act, pertaining to essential requirements, has been amended to require at least one director to be resident in New Zealand[12]. This is perhaps of little account to liquidators as, by the time he or she is appointed, the matter is academic. However, to the extent a liquidator (or any other person for that matter) wishes to apply to liquidate in accordance with s241(4)(c) of the Act then the failure to have a director living in New Zealand constitutes grounds for liquidation.

[12] The principal Act has not been consolidated on legislation.govt.nz because the implementation of the amendment is not due to take effect until 365 days after royal assent is received.

Appendix 1

Definitions of classes of company

Companies Act 1993

198 Interpretation
In this subpart,—
…
large company means a company that is large under section 45 of the Financial Reporting Act 2013
…
public entity has the same meaning as in section 5 of the Public Audit Act 2001
…
voting share, in relation to a company, means a share in the company that confers a currently exercisable right to cast a vote at meetings of shareholders of the company, not being a right to vote that is exercisable only in 1 or more of the following circumstances:
(a) during a period in which a payment or distribution (or part of a payment or distribution) in respect of the share is in arrears or some other default exists:
(b) on a proposal that affects rights attached to the share:
(c) during the liquidation of the company:
(d) in respect of a special, immaterial, or remote matter that is inconsequential to control of the company.

[See also s199 for determination of what constitutes a single shareholder. Essentially, joint holdings (e.g. by trustees) are a single shareholding.]

Financial Reporting Act 2013

45 Meaning of large
(1)For the purposes of an enactment that refers to this section, an entity (other than an overseas company or a subsidiary of an overseas company) is **large** in respect of an accounting period if at least 1 of the following paragraphs applies:
(a) as at the balance date of each of the 2 preceding accounting periods, the total assets of the entity and its subsidiaries (if any) exceed $60 million:
(b) in each of the 2 preceding accounting periods, the total revenue of the entity and its subsidiaries (if any) exceeds $30 million.

Example
ABC Limited has an accounting period of 1 April 2014 to 31 March 2015.
The balance dates of the 2 preceding periods are 31 March 2013 and 31 March 2014. As at 31 March 2013, ABC Limited and its subsidiaries had total assets of $50 million. As at 31 March 2014, those total assets were $55 million.
During the period 1 April 2012 to 31 March 2013, ABC Limited and its subsidiaries had total revenue of $25 million. During the period 1 April 2013 to 31 March 2014, that total revenue was $35 million. Given that the $30 million threshold in paragraph (b) is crossed in only 1 of those preceding periods, paragraph (b) is not satisfied.
ABC Limited is not a large company in relation to the accounting period of 1 April 2014 to 31 March 2015.

(2) For the purposes of an enactment that refers to this section, an overseas company or a subsidiary of an overseas company is **large** in respect of an accounting period if at least 1 of the following paragraphs applies:
(a) as at the balance date of each of the 2 preceding accounting periods, the total assets of the entity and its subsidiaries (if any) exceed $20 million:
(b)in each of the 2 preceding accounting periods, the total revenue of the entity and its subsidiaries (if any) exceeds $10 million.
(3) Despite subsections (1) and (2), an entity is not large in respect of an accounting period if it was an inactive entity in respect of that period.
(4) In subsection (3), an entity is an **inactive entity** in respect of an accounting period if,—
(a) during that period, the entity—
(i) has not derived, or been deemed to have derived, any income; and
(ii) has no expenses; and
(iii) has not disposed of, or been deemed to have disposed of, any assets; and
(b) at the end of that period, the entity has no subsidiaries or all of its subsidiaries are inactive entities in respect of that period.
(5) In determining whether an entity is an inactive entity, no account may be taken of any—
(a) statutory company filing fees or associated accounting or other costs; or
(b) bank charges or other minimal administration costs totalling not more than $50 in the accounting period; or
(c) interest earned on any bank account during the accounting period, to the extent that the total interest does not exceed the total of any charges or costs incurred by the entity to which paragraph (b) applies.

Ancillary definition: NZIAS 18 *Revenue*

7 The following terms are used in this Standard with the meanings specified:

Revenue **is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.**

Public Audit Act 2011

5 Meaning of public entity

(1) In this Act, **public entity** means each of the following entities:

(a) the Crown:

(b) each office of Parliament, except where another auditor has been appointed for that office under section 45F(1)(b) of the Public Finance Act 1989:

(c) an entity of a class described in Schedule 1:

(d) an entity listed in Schedule 2:

(e) an entity in respect of which the Auditor-General is the auditor under any other enactment (other thansection 19):

(f)an entity which is controlled by 1 or more entities of the kinds referred to in paragraphs (a) to (e).

(2)For the purposes of subsection (1)(f), an entity is controlled by 1 or more other entities if—

(a)the entity is a subsidiary of any of those other entities; or

(b)the other entity or entities together control the entity within the meaning of any relevant financial reporting standard; or

(c)the other entity or entities can together control directly or indirectly the composition of the board of the entity within the meaning of sections 7 and 8 of the Companies Act 1993 (which, for the purposes of this paragraph, are to be read with all necessary modifications).

(3)Despite subsections (1) and (2), an entity is not a public entity if,—

(a) but for this subsection, it would be a public entity only by virtue of the application of both subsection (1)(f) and subsection (2)(c); and

(b) it is specifically referred to in an enactment (either by name or otherwise); and

(c) that enactment expressly requires or permits its financial statements to be audited by a person other than the Auditor-General.

Appendix 2

[See attached decision flowchart]