TELLING THE TRUTH ABOUT YOUR ASSETS

HOW THE RECESSION AMBUSHED THE BOARDROOM

By ALEX PAIOR

A Corporations Law demand for "true" balance-sheet valuations may be a threat to some companies with assets whose worth has been undermined by the recession.

THERE has been considerable recent debate about what values should be taken up in balance sheets, given the depressed state of the economy. It has been argued (wrongly, in my opinion) that neither the Corporations Law, Schedule 5 to the Corporations Regulations (which prescribes the requirements for financial statements) nor the Australian Accounting Standards set out the basis on which company assets should be valued.

Most directors are aware that the Corporations Law imposes obligations on them to prepare a balance sheet which gives a "true and fair view" of the company's state of affairs at the end of that financial year.[1] Directors of companies whose balance sheets do not give a "true and fair view" are guilty of a criminal offence and may be personally liable for losses incurred by people who rely on those accounts.

The average investor could be forgiven for believing that a balance sheet is a document showing the net worth of the company at a particular time. However, the official position of the accounting profession has been that a balance sheet is "not a statement of the net worth of the undertaking . . . rather, it is mainly an historical document which does not purport to show the realisable value of assets such as goodwill, land and buildings, plant and machinery . . ."[2]

Recently, courts have tended to the view that balance sheets should be a statement of net worth setting out the "true financial position of a company".[3]

Most discussions about the value of a company's real estate and other assets have focused on the meaning of the phrase "true and fair view". However, little or no consideration has been given to a section of the Corporations Law which (if strictly applied) could force companies to make massive provisions for writing down the value of the assets, including real estate. In many cases these write-downs would dramatically reduce, or even wipe out, the shareholders' funds.

A number of methods can be used to show the value of an asset in a balance sheet. The most common are:

- **Historical cost.** If an asset is shown in a company's balance sheet at its "historical cost", it records the cost of acquisition and allows for depreciation but gives no information about the net worth of the company.
- **Current market value.** This is a "value" arrived at through certain assumptions which were established by an early High Court decision.[4] Those assumptions may or may not be applicable at any given time. For

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example, in determining "current market value" the valuer must assume a prudent and willing (but not anxious) seller and buyer. In the current market, where there are few willing buyers but many anxious (indeed, desperate) sellers, the concept of "current market value" is of little help in assessing net worth.

Some accountants have sought to justify continued use of "current market value" by maintaining that it is appropriate if the company is a "going concern" (ie, not forced to sell those assets at the present time). This approach may have some merit in the case of current assets but it is inappropriate when considering the value of non-current assets.

Current actual realisable value. This method involves the valuation of an asset where a sale is forced or urgent. For example, a number of national real estate firms have noted that the value of industrial and commercial properties has dropped dramatically in the past few years.

Although there is little recent hard evidence—because of the absence of sales in the past six months—it seems likely that the value of these properties has fallen by about 30 per cent and the value of development properties by about 50 per cent.

A city office building bought by a company for $15 million in the past few years might have a current realisable value of only $10 million to $12 million. If that real estate had to be sold today the company would incur a loss of between $3 million to $5 million.

Directors' responsibilities

Section 294 of the Corporations Law requires directors to consider the value of company assets before their company's accounts are made out. This section has a number of unique features.

In relation to *bad debts*, directors must take reasonable steps:

- to find out what has been done about writing off bad debts and making provisions for doubtful debts; and
- to cause all known bad debts to be written off and adequate provisions to be made for doubtful debts.

In relation to *current assets*, directors must take reasonable steps:

- to find out whether any current assets, other than bad or doubtful debts, are unlikely to realise (whether directly or indirectly) *in the ordinary course of business* their value as shown in the company's accounting records and, if so, to cause:

(a) the value of those assets to be written down to an amount that they might be expected so to realise; or

(b) adequate provision to be made for the difference between their value as so shown and the amount that they might be expected to realise. (My emphasis.)

Unless a company would, in the ordinary course of business, dispose of a particular asset within 12 months after the end of the financial year, the asset must be treated as a non-current asset. These will normally include investment real estate, licences, motor vehicles etc.

In relation to *non-current assets* directors must take reasonable steps:

– to find out whether the value of any non-current asset is shown in the company's accounting records at an amount that, having regard to the asset's value to the company as a going concern, exceeds the amount that it would have been reasonable for the company to spend to acquire the asset as at the end of the financial year; and

– unless adequate provision for writing down the value of that asset is made, to cause to be included in the accounts such information and explanations as will prevent the accounts from being misleading because of the overstatement of the value of that asset.

It seems likely that the value of industrial and commercial properties has fallen by about 30% and the value of development properties by about 50%

This last provision—Section 294(4)—appears to be the only reference in the Corporations Law or Regulations which sets out the basis on which directors are to value the assets of a company. For the purposes of Section 294(4), the value of a non-current asset is the amount that the company would reasonably have to spend to acquire that asset at the balance date.

Concepts such as "current market value" and "historical cost" have little effect on the question which directors must ask about each item of non-current real estate: What would be a reasonable price for the company to pay in today's market?

However, directors are able to take into account any special features of a non-current asset which would make it reasonable for the company to spend more than its current realisable value. For example, a company which operates a service station may consider it reasonable to spend more than the current actual realisable value to secure the site from which it operates its business.

Another interesting feature of Section 294(4) is that it requires directors to "write down" or "inform and explain" *overstatements* of value but not *understatements*.

The steps directors must take in determining the value of real-estate assets are:

Find out the value (on a going-concern basis) of each item as shown in the company's accounting records. The value shown in the company's records will be either the acquisition cost or some other figure based on a valuation made or obtained by directors after its acquisition.

Determine what would be a reasonable amount for the company to spend to acquire that item at the end of the financial year. (As already noted, the realisable value of commercial and industrial real estate has generally fallen substantially over the past few years. Few, if any, companies would pay today the prices they paid three or four years ago.)

- Make adequate provision in the company's accounts for the write-down of the value of the asset or include as notes in the accounts any information and explanations necessary to prevent the accounts from being misleading because of the overstatement of the value of the asset.

Failure to comply with the provisions of Section 294(4) is a criminal offence.[5] In addition, a breach of that sub-section could result in a director breaching his duties under other provisions of common law and the Corporations Law—for example, Section 232(2), which requires a director to "at all times act honestly in the exercise of his or her powers and the discharge of duties of his or her office", and Section 232(4), which requires a director to "at all times exercise a reasonable degree of care and diligence in the exercise of his or her powers and the discharge of his or her duties".

These breaches are also criminal offences and directors could be personally liable to their companies and to parties who incur losses as a result of relying on the balance sheets prepared under their authority. All directors, whether executive or non-executive, are legally obliged to participate actively in this valuation process. Two leading cases illustrate this:

- *Leeds Estate, Building & Investment Company v Shepherd (1887) 36 CHD 787:* In that case, directors played no part in the valuation of assets of the company. They exercised no judgment in relation to the accounts but relied entirely on he manager and the auditor. The court held that the directors had fallen short of the standard of care which they ought to apply to the affairs of the company and were jointly and individually liable for all money paid out of capital as dividends to the shareholders, directors' remuneration and bonuses to the manager.

This case is of further interest because the court also held that it was the duty of the auditor "in auditing the accounts of the company not to confine himself to verifying the arithmetical accuracy of the balance sheet, but to inquire into its substantial accuracy, and to ascertain that it contains particulars specified in the Articles of Association, and was properly drawn up so as to contain a true and correct representation of the state of the company's affairs".

- *Re City Equitable Fire Insurance Company Limited (1925) Ch 407:* This held that before presenting the annual report and balance sheet to their shareholders, the directors "should have a complete and detailed list of the company's assets and investments prepared for their own use and information, and/or not be satisfied as to the value of their company's assets merely by the assurance of their Chairman, however apparently distinguished and honourable, nor with the expression of the belief of their auditors, however competent and trustworthy".

Conclusion

The debate on what balance-sheet values should be shown for a company's assets appears to have overlooked the specific obligations imposed on directors by Section 294(4) of the Corporations Law.

Because of the profound potential effects of Section 294(4) on companies' balance sheets, and on directors' liabilities, directors in any doubt about what would be a "reasonable" acquisition price for each non-current asset would be well advised to take the advice of competent independent valuers. □

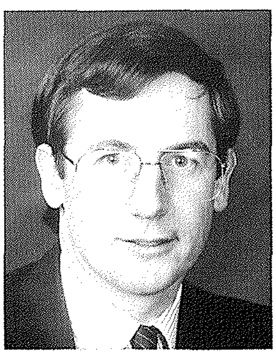
NOTES

1. Section 292 of the Corporations Law.
2. Accounting Practice D1.1, "Presentation of Balance Sheets", of the Institute of Chartered Accountants in Australia (issued December 1963).
3. See "Correspondence with the Facts", P.W. Wolnizer, 1985, *Companies and Securities Law Journal*, p 147.
4. Spencer's Case 5 CLR 418.
5. Section 318 of the Corporations Law.

HOW THE BALL-GAME CHANGED

IN commenting on the accompanying article, Mr Tim Lebbon, executive director of the Adelaide-based corporate advisers Leadenhall Australia Limited, questioned whether Australian company directors had come to grips with the issue of asset values.

"I applaud Alex Paior for raising an issue which has apparently been overlooked by some of the most observant and astute minds in the country," Mr Lebbon said.



Tim Lebbon

"The issue is that the value of non-current assets carried in company accounts must be no more than 'it would have been reasonable for the company to spend to acquire the assets as at the end of the financial year'."Historical cost may no longer be good enough under the Corporations Act."

In times of falling prices and low inflation, many companies were carrying assets and businesses at values far higher than the cost of replacement in the current market, Mr Lebbon said.

And, with the events of the past 12 to 18 months and continuing economic malaise, there were increasing prospects of assets being worth less than their historical cost.

Mr Lebbon referred to the debate about the meanings of "true and fair" and "value" and quoted the observation by Ray Chambers in a recent issue of Australian Accountant: *Corporate accounting does not do violence to the truth occasionally and trivially, but comprehensively, systematically and universally, annually and perennially.*

"This is hardly a comforting thought for independent directors or shareholders," Mr Lebbon said.

"If the carrying value of an asset is wrong and this can be demonstrated, directors could face prosecution and litigation.

"Many assets which sit in the accounts year after year need a thorough assessment." □