CHARTERED SECRETARIES
AUSTRALIA

Leaders in governance

30 January 2012

The Manager
Corporate Reporting and Accountability Unit
Corporations and Capital Markets Division
Australian Treasury
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By email: corporatereportingreforms@treasury.gov.au

Dear Treasury

Proposed Amendments to the Corporations Act: dividend payments

Chartered Secretaries Australia (CSA) is the independent leader in governance and risk management. As the peak professional body delivering accredited education and the most practical and authoritative training and information in the field, we are focused on improving organisational performance and transparency.

Our Members have primary responsibility to develop and implement governance frameworks in public listed, unlisted and private companies, and not-for-profit and public sector organisations. In listed companies they have primary responsibility to deal with the Australian Securities Exchange (ASX) and interpret and implement the Listing Rules. Our Members have a thorough working knowledge of the operations of the markets and the needs of investors, as well as compliance with the Corporations Act (the Act). We have drawn on their experience in our submission.

General comments

CSA welcomes the discussion paper, *Proposed amendments to the Corporations Act* (the discussion paper) setting out options for changing the amendments to the Act made by the *Corporations Amendment (Corporate Reporting Reform) Act 2010*. CSA is on record as having supported the repeal of the 'profits test' in the Act and its replacement with a more flexible requirement allowing a company to pay dividends. However, there are unforeseen consequences attaching to the current provisions, making compliance with them very challenging, and CSA has written to the government previously to express its concerns and provide feedback on why the provisions as drafted are problematic. CSA is therefore pleased to respond to the call for comments on how to address the shortcomings in the current drafting.

The current provisions have been in place for more than 12 months and companies have been seeking legal, accounting, tax and auditing advice to try to ensure they comply with the law. While CSA is pleased to see that the discussion paper raises a number of options for consultation, thereby clearly seeking to establish in conjunction with stakeholders the best solution to the difficulties posed by the current provisions, CSA would be concerned if the reform process was to be lengthy and drawn-out. While CSA is a supporter of appropriate time frames for consultation, and is frequently concerned that insufficient time is granted to consultation on substantial legislative reform, this is one time when CSA recommends a degree of swiftness. CSA notes that the issues have been under discussion for more than 12 months and that there is a great deal of consensus from stakeholders as to the changes required to ensure compliance with the law is feasible and not subject to ongoing, expensive professional advice.

Our comments on the issues raised in the discussion paper follow.

Options for dealing with the dividends test

Option 1: retaining s 254T of the Act as currently drafted

The changes introduced by the *Corporations Amendment (Corporate Reporting Reform) Act 2010* allow a company to pay a dividend other than out of profits, subject to meeting the three tests that:

1. the company's assets must exceed its liabilities immediately before the dividend is declared and the excess is sufficient for payment of the dividend
2. the payment of the dividend is fair and reasonable to the company's shareholders as a whole
3. the payment of the dividend does not materially prejudice the company's ability to pay its creditors.

While CSA supported the repeal of the 'profits test' in the Act and its replacement with a more flexible requirement allowing a company to pay dividends, that support was subject to an understanding that the profits test would be replaced by a basic solvency test, so that a company could pay a dividend provided it did not affect its ability to pay its debts as and when they become due. However, CSA notes that the first test is a balance sheet test, rather than a solvency test. The second and third tests are additional requirements to those required for dividends paid out of profits.

We have noted in two previous submissions that there are some very real practical concerns as to how companies can meet the requirements of these tests and the discussion paper sets out a variety of issues that the current provision gives rise to. CSA is strongly of the view that the current provisions as drafted do not work.

The discussion paper also states that the current drafting of s 254T provides a high level of comfort to directors in complying with their obligations under s 588G. It is not readily apparent why this is the case as s 588G, which states that a company incurs a debt when the dividend is paid or declared, is not subject to s 254T.

CSA opposes retaining s 254T of the Act as currently drafted.

Option 2: adopting a modified solvency test

The introduction of a more flexible requirement allowing a company to pay dividends works if it is subject to a basic solvency test. This ensures that a company can only pay a dividend provided that payment does not affect its ability to pay its debts as and when they become due.

We note that Option 2 is a solvency and net assets test. CSA notes that such a test follows the New Zealand model, and would support the single economic initiative Australia is pursuing with New Zealand. However, if a net assets test is included with a solvency test, it is vital that the legislative provision does not tie the calculation of 'assets' and 'liabilities' to the International Financial Reporting Standards (IFRS). By tying the calculation of assets and liabilities to IFRS, the Act would (as it now does) require companies that are not currently obliged to prepare their financial statements in accordance with IFRS to consider and apply IFRS before paying a dividend.

This creates a new and unreasonable compliance and cost burden for a great many companies (many of which are small businesses), which defeats the policy objective of the reform to reduce the regulatory burden on companies. Such cost impost is of overwhelming economic detriment to a great many small proprietary companies and of no legitimate probative value to the spirit and intent of the legislation.

CSA strongly recommends the adoption of a solvency test to be determined on the basis that a company will be able to continue to pay its debts as and when they become due. In this submission, where CSA refers to the solvency test, it is to option 2 with the modifications recommended above.

CSA also recommends that any reference to solvency in the Act in the relevant provisions must accord with the well accepted law of insolvency already in place. There is a large body of law on insolvency that can be applied — the same language and definitions need to be used so as not to create confusion. CSA would be very concerned if new definitions were introduced in any legislative amendments, as such new concepts would see companies needing to seek legal advice as to how the provision should operate.

CSA also notes Treasury's view in the paper that, except where the dividend test is a solvency test (option 2), there may be merit in bringing the terminology in line with that used in s 254U and most company constitutions. CSA supports this view but considers that the confusion created by the current drafting of s 254T should not be perpetuated if a solvency test is introduced.

CSA submits that the critical time for considering solvency is not when the dividend is declared but when it is paid.

Directors need to be able to 'determine' that a dividend is to be paid, as the liability then arises at the time of the payment (as opposed to, under s 254V(2), when it is declared), which could be some weeks after the board resolution is taken to pay a dividend.

We set out our views on this in more detail later in this submission, but wish to stress the point that the adoption of a solvency test cannot be undertaken without also confirming that the continued use of 'declared' is inappropriate. The two issues are entwined.

Option 3: reinstating the former profits test

CSA notes that reinstating the former profits test would herald a return to the capital maintenance doctrine, which is the opposite of what the move away from an 'out of profits' test was designed to facilitate. It also reduces the flexibility that the *Corporations Amendment (Corporate Reporting Reform) Act 2010* was designed to introduce.

CSA opposes reinstating the former profits test.

Option 4: adopting an arrangement under which a company would have a choice of two ways of determining whether it is able to pay a dividend

CSA would be very concerned if a choice as to how to determine whether a company is able to pay a dividend was introduced. Such an approach raises very real concerns as it would have a negative impact on investors.

It would be unclear to investors as to whether a company could adopt one method in one year and another in the next year. This would introduce confusion and uncertainty as to how to analyse the financial statements year-to-year.

Furthermore, this approach retains all the disadvantages of both the ‘out of profits’ test and the current balance sheet test. It does not address solvency, which should be the core determinant of whether a dividend can be paid.

CSA opposes adopting an arrangement under which a company would have a choice between two ways of determining whether it is able to pay a dividend.

Use of ‘declared’

As noted above, any provision relating to the payment of dividends needs to use the term ‘determine’, rather than ‘declared’. This is critical to the application of a solvency test.

Under s 254V a company does not incur a debt merely by fixing the amount of time for payment of a dividend. The debt arises only when the time fixed for payment arises and the decision to revoke payment may be made at any time.

However, if the company has a constitution and it provides for the declaration of dividends, the company incurs a debt when the dividend is declared.

Section 254T currently requires that a company’s assets exceed its liabilities immediately before the dividend is ‘declared’, ignoring the distinction between declaring a dividend and determining that it be paid (s 254U).

Most company constitutions currently provide for the board to ‘determine’ that dividends are payable rather than declare a dividend. This raises the issue as to whether many companies would be constitutionally able to declare a dividend without amending the constitution if the solvency test requires dividends to be declared.

Once dividends are ‘declared’, the liability arises at the time of declaration. In turn, this means that the issue of solvency applies at the time of the declaration and not at the time of payment.

There are practical difficulties in attaching the liability to the time of the declaration. It can take four to six weeks between the date of the determination to pay a dividend and the date of payment. Payment does not take place immediately following a board resolution. The boards of most listed companies will determine to pay a dividend, if one is to be paid, for example, early in February, but the payment of the dividend will not be made until the end of February or early in March.

There is a process that listed companies follow in relation to the payment of dividends, some of which is mandated by the ASX Listing Rules, and some of which is not, but which accommodates the time needed for the share registry to implement the payment (the larger the shareholder base, the more time is required).

Under the Listing Rules, a listed company is required to announce a dividend and a record date. The record date to identity security holders entitled to the dividend must be at least seven business days after the announcement of the record date. However, the payment date may be any time after the record date.

It is therefore critical that the solvency test apply at the date of payment, given that this can fall some weeks after the board resolution to pay a dividend.

Moreover, given that the liability arises when the dividend is ‘declared’, even if the directors decide not to proceed with the payment due to changed circumstances, a contingent liability is in place once the dividend is declared. This would herald a return to the capital maintenance doctrine, yet the reform to dividend payment law is expressly designed to move away from this doctrine.

CSA notes that Treasury considers that, if stakeholders are of the view that a dividends test should include a solvency test, s 254T should continue to use ‘declared’ as an element of the test. However, as shown, the use of ‘declared’ is inconsistent with market practice.

CSA strongly opposes the use of ‘declared’ and **strongly recommends** that the terminology used in s 254T be brought into line with that used in s 254U and most company constitutions.

Capital maintenance requirements

CSA is pleased to see that Treasury considers that the test for paying a dividend in s 254T of the Act is a circumstance where a reduction in capital is ‘otherwise authorised’ by the law. However, CSA notes that the current drafting of the provision causes confusion, requiring companies to seek legal advice. CSA is therefore of the view that a legislative amendment is required to clarify that satisfying the test for paying a dividend in s 254T of the Act is a circumstance where a reduction in capital is ‘otherwise authorised’ by law.

CSA recommends that a positive statement be inserted in the provision stating that if a company meets the requirements of s 254T it can pay a dividend — notwithstanding that such a payment will reduce the share capital — and that the dividend will be an ‘otherwise authorised’ method of reducing share capital for the purposes of s 256B(1) of the Act.

Application of test to group companies

CSA has previously raised our concerns with the application of the net assets test to group companies, where dividends could be ‘streamed up’ to the ultimate holding company in a corporate group.

To restate our previous submissions, the current net assets test is based on net assets. Where dividends are being ‘streamed up’ to the ultimate holding company in a corporate group, each company within the stream must meet the test. However, a wholly owned subsidiary in the group may not meet the net assets test, even though the group as a whole does. For example, a parent company may have a very profitable wholly owned subsidiary which is held through an intermediate wholly owned holding company. If there is a deficiency of assets in the intermediate holding company, the parent company may not be able to access the dividends from the profitable subsidiary to permit the parent company to pay dividends to its shareholders.

As we have previously noted, and as set out in the discussion paper, in many corporate groups a deed or deeds of cross-guarantee may be in place effectively providing comfort that the group as a whole will meet the debts of each company in the group. Under the current provisions, although the group is solvent and can meet the net assets test on a consolidated basis, the position of an intermediate entity which is deficient in terms of meeting the test can prevent a dividend payment being ‘streamed up’ through the group. Such a prohibition will not affect the ability of the group to pay its debts, but might prevent the parent company in the group paying dividends to its shareholders.

The discussion paper states that: ‘Consideration needs to be given to the effectiveness of any deeds and to ensuring that they do not create arrangements which may prejudice creditors of one group entity to the benefit of another group entity’. CSA is strongly of the view that such consideration is already in place, through the application of ASIC Class Order 98/1418 *Wholly–owned entities*.

ASIC issued the revised Class Order on reporting relief for wholly owned subsidiaries in 2008. This followed consultation with stakeholders as to how to improve the efficacy and effectiveness of the operation of deeds of cross-guarantee. ASIC provides relief only after careful consideration of whether an entity meets all the requirements as set out in Class Order 98/1418 *Wholly–owned entities*.

CSA firmly believes that the deed of cross-guarantee regime is working very well. CSA suggests that Treasury could consult ASIC on the effectiveness of the regime, in order to satisfy itself that any amendment to the Act to clarify the manner in which the assets exceeds liabilities test applies to group companies will be supported by the current regulatory framework.

In relation to legislative amendment to provide the necessary clarification, **CSA recommends** that for wholly owned subsidiaries in corporate groups, the solvency test is the only test that would be applied to payments of dividends and that, provided a deed of cross guarantee is in place, the solvency test should only apply to the consolidated group as a whole.

Taxation issues

CSA notes that the Australian Taxation Office released Draft Taxation Ruling 2011/D8 on 21 December 2011 dealing with the relationship of the corporate law rule for dividends and the tax legislation, along with counsel’s legal opinion that it had obtained as part of the process. If approved, the Taxation Ruling will have retrospective effect from 28 June 2010 (the date of the original amendments to the Act).

There is legal commentary noting that, unfortunately, the draft ruling appears to create as many uncertainties as it solves.

Even if the draft Taxation Ruling is approved, it will not be certain that the taxation issues as noted in the discussion paper have been resolved.

CSA is of the view that the taxation issues need to be resolved urgently to provide certainty to companies and their investors.

Parent entity reporting requirements

CSA notes that some stakeholders have taken the view that s 295(2) should be amended to permit the preparation of parent entity financial statements by entities that are subject to supervision by the Australian Prudential Regulation Authority (APRA) and in other circumstances where directors of an entity consider it would be appropriate or necessary.

CSA considers there is merit in permitting entities that prepare consolidated financial statements to have the option to prepare parent entity financial statements.

Changing the financial year of a company

CSA supports the amendment of subs 323D(2A) of the Act to allow a financial year of less than 12 months (that is, one to 11 months) provided that the length of each of the last five financial years has not been varied by more than plus/minus seven days as permitted by subs 323D.

In preparing this submission, CSA has drawn on the expertise of the members of our national policy committee, the Legislation Review Committee. We are more than happy to discuss with you the issues highlighted in this submission.

Yours sincerely

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CHIEF EXECUTIVE