SETTING A RISKY PRECEDENT

The spotlight had been turned on the controversial and much debated Puttalam Cement / Tawakkal transaction not from any political considerations, but purely in the interests of educating the investing public and assisting them to analyse and understand what had actually transpired, after the dust has settled, and to probe an scrutinise in the public interest, what had happened.

After all, even two eminent men, learned in the law, who had gone through the portals of the famous law faculty of the Oxford University, holding the highest positions of public office in this country, Foreign Minister Lakshman Kadirgamar, P.C., and Justice and Constitutional Affairs Minister Prof. G.L. Peiris, seem to have got completely entangled and confused, in understanding the application of the elementary law, that governed this transaction.

If such erroneous analyses and opinions, propounded by such men learned in the law, go unchecked and uncorrected, it would be a tragedy for our society that is expecting to emerge as a free and open economy, with competition on a level playing field, with justice and fair play.

On the contrary, glossing over such transactions as mere technical breaches of presumably fossilised statutory provisions, while in fact the cardinals of basic book-keeping, accounting, company and common law practices have been patently transgressed, would only open the floodgates for others to emulate and cite such sanctification, as precedents upheld by the government. Would not others in society be entitled to claim that they have a right to follow such dangerous precedents?

The receipts of the Rs. 900 million by Puttalam Cement (PCL) from the lenders and the subsequent payment of such Rs.900 million by PCL to the treasury secretary on behalf of the Thawakkal Group, surely had to be recorded in the books of accounts of the company in conformity with the very basics of elementary book-keeping, leaving aside the compulsion by section 143 (1) of the Companies Act no. 17 of 1982, which mandates companies to record in proper books of accounts, all sums of monies received and expended by a company, without any question, whatsoever.

Furthermore, would it not be a grave and serious violation of the Inland Revenue Act, not to record transactions in the books of accounts of a company?

ACTUAL TRANSACTION

Let us probe in depth what had initially transpired. PCL re-values its fixed assets and credits the surplus of Rs.1,292.8 million, on such revaluation to a revaluation reserve, which is a credit on the balance sheet of PCL. Then, Rs. 900 million of this credit is simply separated and shown as the liability of Rs. 900 million due to the lenders, who had advanced such money to PCL, to be given by PCL to the treasury secretary on behalf of the Thawakkal Group.

The transaction that ought to have got recorded in the books of accounts of PCL in the first instance, is the receipt of the Rs. 900 million by PCL, being credited as a loan repayable by PCL and debiting same to the cash balance of PCL, thereby increasing the cash funds of PCL, by such monies borrowed.

Thereafter, the payment by PCL of this Rs. 900 million, to the treasury secretary, on behalf of the Thawakkal Group, ought to have been credited to the PCL cash balance, there being consequently no such cash balance left in PCL, and such payment debited to the Thawakkal Group, on whose behalf PCL had paid out such funds borrowed by PCL.

The debit that ought to have been made to Thawakkal, in effect has been debited to the revaluation reserve, reducing it by Rs.900 million. Only the resultant position of such transaction has been shown, i.e. the revaluation reserve reduced by Rs.900 million and the loan repayable by PCL of Rs.900 million.

In actual fact, it had been far worse that this. An identical sum of Rs.900 million of the revaluation reserve of Rs.1,292.8 million had been first transferred to share capital, by way of issue of bonus shares. As a result, only a balance credit of Rs.392.8 million was left in the revaluation reserve.

So when the other Rs. 900 million, that had been paid out to the treasury secretary on behalf of the Thawakkal Group, was in effect debited to the revaluation reserve, such revaluation reserve thereby became a debit balance of Rs.507.2 million which debit balance was reported to have been shown as 'goodwill' in the PCL balance sheet.

RELEVANT ACCOUNTING ENTRIES ILLUSIRATED ON THE BALANCE SHEET OF PUTTALAM CEMENT LTD.

	Rs. Mn.		Rs. Mn.
SHARE CAPITAL		FIXED ASSETS	
Increase by … Shares Allotted	+ 900.0 [B]	Increase on Revaluation of Fixed Assets	11292.8 [A]
REVELATION RESERVES		GOODWILL	
Surplus on Revaluation Of Fixed Assets	44292.8 [A]	Transfer of Debit on Revaluation Reserve	1507.2 [E]
Transfer of Share Capital For Shares	-900.0 [B]	CASH & BANK	
	+392.8	Add: Money Received as Loan	+900.0 [C]

In other words, the money that had in effect been taken out of the company. PCL had been shown as 'goodwill' ! Would this not be making a mockery of basic accounting, and cocking a snook at the much talked of accounting standards ??

Whilst bonus shares may be issued against such unrealised revaluation reserves, as to whether even distribution of profits could be charged against such unrealised revaluation reserves is an issue. The accounting standards of the Institute of Chartered Accountants definitely rule it out. Would it not be far worse, when directors or shareholders of a company, take out funds from a company and debit such withdrawals to a revaluation reserve or any reserve for that matter?

INCOME TAX

What arises is a very interesting situation concerning the incidence of taxation. Of course, the commissioner general of inland revenue and the inland revenue law are unconcerned with the legality or illegality of the sources of incomes or gains, when it comes to the question of taxation of such incomes or gains.

Section 39 of the Inland Revenue Act No.28 of 1979, as amended, provides authority that enables an assessor, to deem as profits distributed by a company, in the case of certain transactions referred to in such section, where more than 50% of the share capital of such company is controlled by not more than 5 persons. One circumstance of such transaction, is money lent to a shareholder or a director of such company.

Section 40 of the Inland Revenue Act goes further and provides that in the case of any company, where profits are appropriated, *interalia*, by a director or a shareholder, then such profits would form a part of the income of the person, by whom such profits were appropriated.

PCL was incorporated as a company, under the provisions of Conversion of Public Corporations or Government Owned Business Undertaking into Public Companies Act no. 23 of 1987.

Thereafter, the Thawakkal Group under the privatisation programme purchased 90% of its shareholdings. Of the purchase consideration, Rs. 900 million was not paid by the Thawakkal Group, but paid by the company PCL, borrowing such funds by way of debenture loans. Vanik Incorporation Ltd. (Vanik), who had handled this privatisation transaction is reported to have been paid a professional fee of Rs. 21 million.

The Thawakkal Group, however, registered the shares in their names. Is this not clearly a benefit or gain in the hands of the Thawakkal Group? When such shareholding is subsequently disposed of, what would be the cost of acquisition of such shareholding for the computation of any profit or loss on such sale ?

Every person is entitled under the law to legitimately arrange his or her business affairs in such a way to avoid or minimise the incidence of taxation – that's what tax consultants are for. Conversely, if persons arrange their business affairs in such a way, whether legal or illegal, attracting or maximising the incidence of tax, then the commissioner-general of inland revenue would be entitled to and obliged under the law, to enforce such taxation.

The application of such monies taken out the funds belonging to the company, PCL by the Thawakkal Group, to buy shares in the very company, PCL, in the names of the Thawakkal Group or its nominees, is a secondary aspect. Whatever purpose such funds were applied for would be another matter.

LEGALLY FLAWED

The first transaction, of the appropriation of funds that belonged to the company, PCL, is in itself legally flawed. This is not permissible under very basic company law practices and accounting. This would amount to the enrichment of one group of shareholders by funds that belonged to all the Shareholders; thereby expropriating the funds of the other shareholders, which is flawed by simple canons of common law. One simply cannot appropriate another's property.

What is made unlawful by section 55 of the Companies Act is that such funds of the company, PCL, could not have been taken out from the company PCL, even by way of loans, to buy shares in PCL, except by employees, whereas here was a case where such funds had been appropriated outright, with no intention, whatsoever, by the Thawakkal Group of refunding such funds to the company, PCL. Thus such transaction by no means was loan by the company PCL to the Thawakkal Group to be flawed by section 55 of the Companies Act.

The naïve assertion that section 55 is a fossilised statutory provision, or that such provision is not prevalent in developed countries, is misleading and only gives rise to further confusion in the minds of the public. What is permitted in developed countries, is that a company conforming to requisite norms, is permitted to purchase its own shares in the share market, in effect reducing its shareholdings available for sale in the share market.

In such a case, the company funds are used to buy such shares, to be held by the company, i.e. on behalf of and for the benefit of all the shareholders of the company. :But on the contrary, here was a case of applying company funds to buy shares in the name of only one group of shareholders. Is it not naïve to entertain the idea that developed countries would permit such misdemeanour?

How did the leading firm of chartered accountants, Ernst & Young, the auditors of PCL, deal with the above transactions and situation ? What would the president of the Instituted of Chartered Accountants and also thereby, an ex-officio member of the Securities and Exchange Commission (SEC) Reyaz Mihular have to say on this matter ?

What would SEC Chairman, C.P. de Sliva and SEC director-general Kumar Paul statutorily do about this matter ? Should they be stifled and stultified by decisions made by the cabinet, whereas the SEC is an autonomous regulatory authority that is statutorily bound to uphold the law and ensure that listed public companies conform to the law? What would the attorney general advise?

PCL PROSPECTUS REJECTED

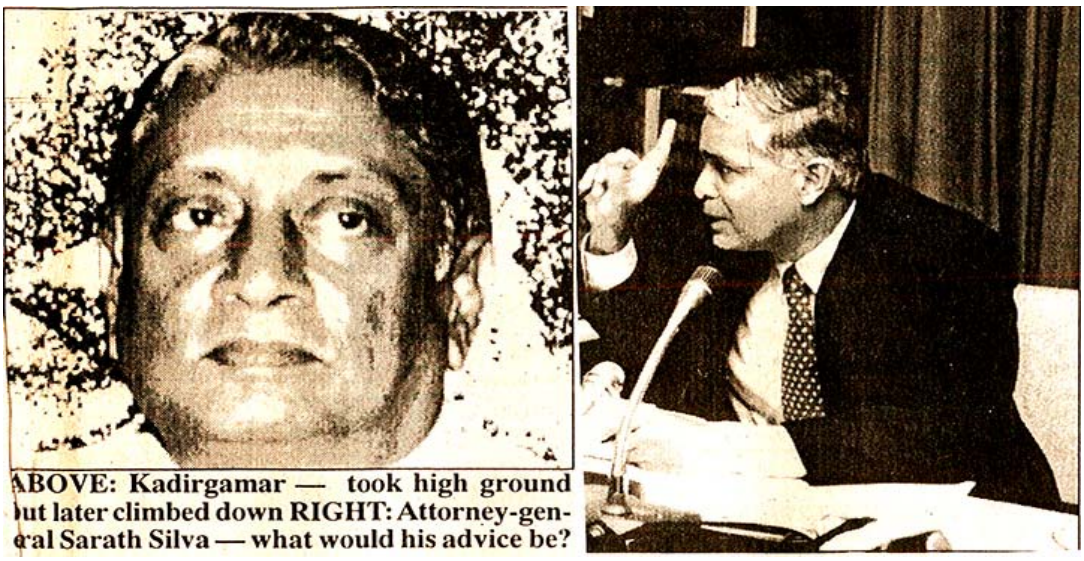
In October 1994, Vanik acting on behalf of PCL had made an application to the SEC, together with the proposed prospectus, to obtain a public listing for PCL, for the purpose of making a public issue of the shares of PCL.

When this matter came up at the meeting of the SEC on October 18,1994, deputy treasury secretary Daya Liyanage, who is thereby an ex-officio member of the SEC, objected to such application by PCL being approved by the SEC, with then sEC director-general Arittha Wikramanayake concurring. It had been revealed that Daya Liyanage had acted on the basis of advice he had received from the former Finance Ministry advisor, Nihal Siri Ameresekere.

Accordingly, the SEC had refused to approve the application made by Vanik on behalf of PCL.

The SEC refusal precipitated a crisis, with various influences and pressures brought to bear to have the matter resolved, with Vanik Chairman, former Secretary, Finance Ministry, Dr. W.M. Tilakaratne, also intervening. Several meetings were held at the Finance Ministry chaired by the then secretary, A.S. Jayawardene, with the attendance of former Finance Ministry advisor Nihal Siri Ameresekere, then SEC director-general Arittha Wikramanayake, Marianne Page, Smith New Court, Hong Kong and Vanik

KADIRGAMAR'S OPINION



ABOVE: Kadirgamar — took high ground but later climbed down RIGHT: Attorney-general Sarath Silva — what would his advice be?

In this background, a draft cabinet paper had been submitted by the Finance Ministry on February 6 1995, which had been referred to Minister Kadirggamr, as a leading commercial lawyer, for his opinion. Lakshman Kadirgamar in his opinion dated March 22, 1995, referring to documents that had been given to him by the former Finance Minister advisor Nihal Siri Ameresekere, in making his recommendations to Cabinet, *inter alia*, then opined:

"I would strongly press on my colleagues, with respect, the fundamental desirability of making clear to the private sector, both local and foreign, that this government means what it says – that it will not tolerate malpractice in the market and that it will not condone and perpetuate (or to use a colloquial expression 'whitewash') malpractice where it has occurred. What has occurred in the Puttalam Cement affair is a gross and calculated fraud on the government and people of this country. This cabinet must not condone it in the name of trying to placate the stock market. In the long run stock exchange and a private sector stimulated by dubious means will again fall into disrepute, to the detriment of the national interest, as it did under the previous regime"

Having taken such high ground, Lakshman Kadirgamar, in the same opinion endeavoured to hold a brief to exonerate and distance the law firm, F.J.&G. De Saram from this transaction, having spoken to their partner, U.L. Kadurugamuwa, whom he had later described to be one of Sri Lankan's foremost company lawyers and a man of the highest integrity.

However, Kadurugamuwa, himself, had given a letter dated December 15, 1994, to Vanik stating, *inter alia*, "We have prepared a draft of a statement that may be signed by an appropriate official of the ministry of finance and we are sending the same to you for you perusal ……We confirm that if a statement in the format of the draft is given by an appropriate person, we could confirm that there was no violation of section 55 of the Companies Act in the transactions mentioned therein."

Finance ministry officials, however, refusing to relent, had not agreed to sign the draft statement that had been prepared by U.L. Kadurugamuwa of the law firm, F.J. & De Saram and submitted by Vanik.

In conformity with the recommendations that had been made by Minister Kadirgamar, the cabinet on March 23,1995 made a decision requiring the Thawakkal Group to pay the balance purchase consideration of Rs.900 million, hereby clearing the loan created for such purpose in the name of the company, PCL and if, the Thawakkal Group refused to do so, to seek the legal advice of the attorney general to reopen the privatisation deal with a view to calling fresh bids.

- Published in The Sunday Leader on 23.3.1997 by Nihal Sri Ameresekere under the pseudonym 'Bismark'