CHAPTER 4

CONCLUSIONS AND RECOMMENDATIONS

General conclusions

4.1 The PJSC concluded that there are fundamental conceptual and practical problems with the new financial reporting system for proprietary companies. Because of these problems the new system has not achieved the objectives set for it. While the new system has eliminated reporting requirements under the Corporations Law for 99.4 per cent of all proprietary companies, small proprietary companies are still subject to the full requirements of the Accounting Standards if they meet the definition of a 'reporting entity' as defined in the Standards. At the same time, small proprietary companies are less accountable in a public manner. On the other hand, proprietary companies which are classified as large according to the large/small test but are non-reporting entities can disregard the full requirements of the Standards. Other objectives of the system, such as reducing compliance costs and eliminating the complexity of the reporting rules, have not been met for the same reasons.

4.2 The PJSC was particularly concerned about the complexity of the rules for determining the reporting requirements of proprietary companies. Although in many cases applying the requirements of the Law, that is the large/small test, involves the application of threshold limits, the rules for determining reporting obligations have proven to be complex, unnecessarily onerous and costly. This is largely due to:

- an inconsistency between the reporting requirements under the Law and the reporting entity concept of the existing accounting standards;
- the existence of ASIC Class Orders which are not widely understood; and
- the ASIC's discretion to grant relief from the reporting requirements.

Inconsistent requirements

4.3 As the ASIC and the accounting bodies noted in their submissions, the introduction of the large/small test has created an inconsistency in relation to the reporting requirements of proprietary companies.[1] The inconsistency arises because the Accounting Standards contain a separate test for determining a company's financial reporting obligations. As the Law stands, large proprietary companies are required to prepare financial reports, which include financial statements made out in accordance with the Standards. However, the Standards apply the reporting entity test

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1 See Australian Securities and Investments Commission, Submission 6, p 7 and CPA Australia and the Institute of Chartered Accountants in Australia, Submission 10, pp 7-9.

to determine which companies must comply with the full requirements of the Standards when preparing their accounts. As the accounting firm, Ernst & Young noted, "since the reporting entity concept is recognised in the Accounting Standards, it is still possible for a large proprietary company to argue that it is not a reporting entity and therefore prepare financial statements that do not comply with the Accounting Standards."[2] According to the ASIC, many companies appear to take the view that they can disregard those requirements completely as the full requirements of many Accounting Standards apply only to reporting entities.[3] Conversely, small proprietary companies, which no have reporting requirements under the Law, are required to prepare general purpose financial statements if they are reporting entities, regardless of whether it is a small or large proprietary company. While in many cases applying the large/small test and the reporting entity concept result in the same outcome, and hence the reporting requirements are the same, there are often situations where this is not the case.

4.4 The ASIC has recently reviewed the application of the reporting entity test and issued a draft information release which outlines the accounting requirements applicable to both reporting and non-reporting entities.[4] The draft release advises that all entities reporting under Chapter 2M of the Corporations Law, whether classified as reporting or non-reporting entities, must apply the recognition and measurement requirements of the Standards "in order to determine the financial position and profit or loss of the entity." Non-reporting entities must also consider disclosures that are necessary to give a "true and fair view" even though they may not be directly prescribed by the Standards. This would include disclosure according to Accounting Standards of significant related party transactions (AASB 1017) and the classification of financial instruments (AASB 1033). In its written submission and evidence to the PJSC, the ASIC expressed concern over the incorrect classification of some entities and the level of disclosure in financial statements:

> ASIC reviews of financial reports have revealed that some companies which claimed to be non-reporting entities should have been classified as reporting entities. The practices of some companies that claimed not to be reporting entities included not recording liabilities for employee entitlements and not depreciating non-current assets. The draft release outlines ASIC's view that the current Law requires the measurement and recognition requirements of accounting standards to be applied to both reporting entities and non-reporting entities so that financial reports reflect all assets, liabilities, revenues and expenses. If the measurement and recognition requirements are not applied, there is no assurance that a company's balance sheet reflects all and only all assets and liabilities, and that a company's profit and loss statement reflects all and only all revenues and expenses. The net assets and

2 Ernst & Young, Submission 14, p 2.

3 See Australian Securities and Investments Commission, Submission 6, p 7.

4 See Australian Securities and Investments Commission, Submission 6, Attachment 4.

profit/loss of each entity could be determined at the whim of their directors and the results of different entities would not be comparable.[5]

4.5 The submissions from Incat Tasmania Pty Ltd, the National Institute of Accountants (NIA) and the accounting bodies also addressed at length the inconsistency in reporting requirements. In the view of the PJSC, this inconsistency is the main reason for the complexity that exists in determining the reporting requirements of proprietary companies. It has also lead to the incorrect classification of entities as non-reporting entities and the resulting non-compliance with the relevant accounting standards. The existence of the anomaly also has implications for the accountability of proprietary companies in a public manner and the quality of financial information lodged with the ASIC. As the ASIC draft release noted, many companies that were incorrectly classified as non-reporting entities had a large number of creditors and employees and it was "reasonable to expect the existence of users dependent on general purpose financial reports."[6] The PJSC believes that reporting and non-reporting entities, which hold out their financial reports to be general purpose financial statements, must comply with the recognition and measurement requirements of the Standards. This would be consistent with the provisions of the Law requiring financial reports to give a "true and fair view".

ASIC's discretionary powers to grant relief

4.6 Section 342(1) states that to make an order under section 340 (specific exemption orders) or 341 (Class Orders), the ASIC must be satisfied that complying with the relevant requirements of Parts 2M.2, 2M.3 and 2M.4 relating to financial records, financial reporting, and the appointment and removal of auditors would:

(a) make the financial report or other reports misleading; or

(b) be inappropriate in the circumstances; or

(c) impose unreasonable burdens.

4.7 Section 342(2) sets out the criteria which the ASIC must have regard to in deciding whether the audit requirement would impose unreasonable burdens. They include the expected cost/benefits of compliance and any practical difficulties faced by the company in complying with the audit requirement. Section 342(3) requires the ASIC to take account of several factors in assessing the benefits under section 342(2).[7]

4.8 The majority of submissions advised that the criteria for audit relief in sections 342(2) and (3) are appropriate, although the NIA suggested two additional criteria to which the ASIC should have regard, namely the company's past compliance

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5 Australian Securities and Investments Commission, Submission 6, p 8. See also Mr David Knott, Committee Hansard, 30 June 2000, CS 51.

6 Australian Securities and Investments Commission, Submission 6, Attachment 4, p 4.

7 These provisions reflect the recommendations by the PJSC in its 30 August 1995 report.

history and the type of relationship between shareholders. But the real issues in relation to the granting of relief were the ASIC's discretionary powers to grant relief from the lodgement of financial statements and its interpretation of the criteria in section 342.[8] As stated by the accounting firm, Atkinson Gibson, the ASIC's discretionary powers and the process of applying for relief are a disincentive for many companies to seek relief:

> Some of my clients have little faith in the exemption process given their perception that exemptions are rarely granted. This does not provide any incentive for them to engage in the exemption process.[9]

4.9 Submissions drew attention to two cases where a company sought relief from the lodgement of its financial statements: Incat Australian Pty Ltd and D G Brims and Sons Pty Ltd. As noted in Chapter 3 of this report, both cases were similar in so far as the claim for relief was based on the issue of unreasonable burden in that by lodging financial statements the companies would be at a disadvantage with their competitors. The AAT upheld the ASIC's decision not grant relief in one case but found that relief should be granted to the applicant in the other case. Although the subject of both decisions was based on the Law as it was prior to the *Company Law Review Act 1998* (prior to 1 July 1998), they illustrate the difficulties that still apply in the Law, in particular to section 342.

4.10 The two cases also highlight the inconsistencies that can occur when the determination of a company's reporting requirements are left to the interpretation of the criteria in section 342 by the ASIC and the AAT. There was also a general view among the submissions that in many instances relief should be granted and the requirements for relief, which are set out in the ASIC policy statements, are unnecessarily onerous and restrictive.[10] The NIA reflected the comments of submissions in stating that:

> Most firms would not seek the relief if they did not honestly believe it is required. Related to this is the issue of what factors ASIC takes into account when coming to its conclusion. The NIA believes that paragraph 342(2)(e) of the Corporations Law should be interpreted as widely as possible to give companies every opportunity to prove that it would be an unreasonable burden or is inappropriate in the circumstances to require them to comply. Further, the requirements themselves for seeking relief should not be made so onerous as to make it difficult to seek relief, they should be simplified and be inexpensive to comply with. There is no point requesting relief from

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8 See for example Mr Ian Langfield-Smith, Committee Hansard, 28 June 2000, CS 15-17 and Mr Reece Agland, Committee Hansard, 30 June 2000, CS 43.

9 Atkinson Gibson, Submission 2, p 2. See also National Institute of Accountants, Submission 8, p 10.

10 For example, ASIC Policy Statement 43, *Accounts and audit relief*, paragraph 27, describes the only circumstance where it will grant relief on the grounds of 'competitive disadvantage'.

> one set of requirements if to do so requires the same amount of time and expense.[11]

Unlevel playing field and 'grandfathered' large proprietary companies

4.11 In its August 1995 report, the PJSC recommended that the "grandfathering clause" in the First Corporate Law Simplification Bill should be subject to a three-year sunset provision. This would have the effect of eliminating the differential regulation of large proprietary companies. The PJSC could see no basis for regulating some large proprietary companies differently from other large proprietary companies. If the rationale for requiring large proprietary companies to lodge audited accounts was that they exercised significant economic influence and it was therefore reasonable to expect potential users of their accounts, then all large proprietary companies should be subject to the same reporting requirements. Exemptions or the granting of relief for large proprietary companies, the PJSC argued, should only be available if, in the particular circumstances of the company, the requirements imposed an unreasonable burden.[12] The principal recommendations in the August 1995 report addressed these circumstances.

4.12 The PJSC concluded that the grandfathering arrangements are a significant shortcoming of the new reporting system, particularly as these companies comprise a high proportion of the population of large proprietary companies. According to the ASIC report to the Senate, approximately 42 per cent of all large proprietary companies are 'grandfathered'.[13] As the ASIC report to the Senate acknowledges, this situation has created an unlevel playing field through information asymmetry. The grandfathering of certain large proprietary companies has placed new entrants and smaller, less diversified companies at a competitive disadvantage and encouraged a market in grandfathered companies.

4.13 The unlevel playing field has also imposed barriers to effective competition and increased the likelihood of market inefficiencies. The accounting firm Atkinson Gibson described the anti-competitive impact of the reporting requirements on large proprietary companies which are not grandfathered:

> Some of my clients are competing against large Australian companies and/or multi-national companies. Some are finding the commercial marketplace a very hostile environment. They are concerned that they could be the target of a takeover by a larger predatory company/and or "squeezed"

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11 National Institute of Accountants, Submission 8, p 10.

12 See Parliamentary Joint Committee on Corporations and Securities, *Report on Items 1-4, Schedule 4 of the First Corporate Law Simplification Bill 1995*, 30 August 1995, pp 15-16.

13 Australian Securities Commission, *Report to the Senate: Review of the First Two years of Operation of Certain Amendments to the Corporations Law by the First Corporate Law Simplification Act 1995*, 5 June 1998, p 18.

> in the market place by a large competitor who has a disproportionately larger financial resource.
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> Such activity is not uncommon and involves predatory pricing and poaching of staff. Thus the issue makes some of my clients feel very vulnerable and view the requirement by government for them to make financial information public as an act which at the very least weakens their position and at worst could lead to the demise of their business. This is a serious issue to them.[14]

Insolvent trading

4.14 Financial accounts and the auditing of them are important measures of corporate governance. Quite apart from their value to directors and shareholders, they help to ensure that those who deal with the company, for example, creditors and employees, can be confident in their dealings with it. Creditors and other users of financial statements are interested in knowing a company's revenues, assets and liabilities, and, if the company is trading actively, whether the company is solvent regardless of its size and economic impact. Employees also have an expectation that the company can meet its current and future obligations and their entitlements will not be threatened. It is important therefore that creditors, potential creditors and others are able to make appropriate decisions confident in the information that is disclosed by the company.

4.15 The PJSC believes that as a result of recent changes to the Law there is a greater need for directors to address their current obligations for solvency. One of the changes to the Law introduced by the *Corporations Law Amendment (Employee Entitlements) Act 2000* was to extend the existing duty on directors not to engage in insolvent trading. Section 588G of the Law prohibits insolvent trading by directors. The Employee Entitlements Act extends that prohibition so as to place directors under a duty not to engage in a non-debt uncommercial transaction.[15] Directors who breach this new duty are personally liable for the uncommercial transaction. This new duty on directors provides creditors and employees with an additional safeguard beyond the existing prohibition on insolvent trading. As the PJSC's report on the Employee Entitlements Bill noted, the amending legislation was aimed at companies that are structured and managed so as to deliberately fail and therefore avoid their obligations to creditors and employees.[16]

4.16 A shortcoming of the large/small test is the exclusion of companies in which there may be a significant public interest. These companies are not required to prepare

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14 Atkinson Gibson, Submission 2, pp 1-2.

15 Section 588FB of the Law defines 'uncommercial transaction' as a transaction that a reasonable person in the company's circumstances would not have entered into having regard to the benefits and detriment to the company of entering into a transaction and the respective benefits to other parties to the transaction.

16 See Parliamentary Joint Statutory Committee on Corporations and Securities, *Report on the Corporations Law Amendment (Employee Entitlements) Bill* 2000, April 2000.

or lodge accounts, and hence are less accountable in a public manner. As the ASIC report to the Senate acknowledges, there are likely to be companies that are excluded because they do meet the current threshold limits which have creditors, potential creditors, employees and others who would access those companies' accounts if they were publicly available.[17] Conversely, where a company has prepared and lodged accounts, there is the question of the value of the financial report to creditors and other users.

Reform options

4.17 A number of reform options were proposed to address the shortcomings in the new system. The first option was to replace the large/small test with the reporting entity concept. The option advocated by the accounting bodies would require only those companies meeting the reporting entity test in the Accounting Standards to prepare and lodge audited accounts. If the reporting entity concept is not adopted, the second option would be to retain the existing large/small test with minor changes. Several submissions favoured maintaining the large/small test and improving its efficacy. This would be achieved by removing the grandfathering provisions and increasing the threshold limits for large proprietary companies. The third option was to reinstate the previous distinction between exempt and non-exempt proprietary companies as advocated by the AICD. Under this option, all company financial statements that are required to be lodged with the ASIC would be audited.

4.18 The PJSC was not persuaded that the large/small test should be retained either in its current form or with the changes suggested to improve the efficacy of the test. The use of an arbitrary albeit quantitative test can result in some companies being incorrectly classified and some companies, in which there is a significant public interest, not having to prepare and lodge financial statements. The PJSC believes that the operation of the large/small test will continue to be ineffective if the reporting requirements can be circumvented and if the ASIC is unable to identify which large proprietary companies have failed to comply with their reporting obligations.

4.19 Reporting requirements under the Law and those in the Accounting Standards serve different purposes. The former are used to determine which proprietary companies need to prepare financial statements and have them audited, and the latter concept is applied to proprietary companies that are required to prepare financial statements and have them audited. While replacing the large/small test with the reporting entity concept would align reporting requirements under the Law with those in the Accounting Standards, the PJSC believes that the current definition and application of the concept is impractical and relies on a subjective judgement. It is open for different people (directors and auditors who are required to make such a determination) to arrive at different conclusions as to whether a particular company is

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17 Australian Securities Commission, *Report to the Senate: Review of the First Two years of Operation of Certain Amendments to the Corporations Law by the First Corporate Law Simplification Act 1995*, 5 June 1998, p 20.

a reporting entity.[18] In applying the reporting entity test, the PJSC believes that directors and auditors must not only consider the relationship between shareholders and management, but also whether there are existing and potential users of the accounts who may be dependent on the financial reports.

4.20 Of the three options put forward, the PJSC favours the reinstatement of the previous test of 'exempt proprietary company' to reflect the two broad groups of proprietary companies: family-owned type companies and subsidiaries of disclosing entities. The reporting requirements of the Law should reflect these separate groups and the nature and size of share ownership in proprietary companies. While this approach may result in certain non-exempt proprietary companies reporting publicly, even if there may be no significant public interest, the existing reporting requirements create a far greater problem by excluding proprietary companies that are reporting entities from the requirement to prepare and lodge audited general purpose financial reports. The exempt proprietary test should nevertheless recognise that there is a demand for financial information by creditors and others, and recent developments in the Law affecting the duties of directors.

Audit requirement

4.21 While the benefits of the audit requirement are clear, the PJSC found it difficult to assess their magnitude. The arguments for exempting all proprietary companies from the audit requirement focussed solely on the costs a company incurs in preparing accounts and the audit of those financial statements. The arguments have some merit but they ignore the needs of creditors, employees and others in the community who may be affected if the company fails. Audited financial statements assist those outside the company to monitor its performance and to derive some assurance that the company is a solvent entity. It also reduces the potential for managers and other insiders from misusing their inside information. As the NIA observed:

> the larger the company, the greater the damage that can be done by fraud or mismanagement and the greater the temptation to take advantage of a position of power. And while yes they [shareholders] should be more involved, often many shareholders of proprietary companies will leave the day to day running of the company to management, who would be in a position to hide information that would otherwise be available through annual financial reports. [19]

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18 This issue was considered by the PJSC in its March 1995 report. In that report the PJSC stated: "The Committee supports the views put to it…that the reporting entity test does not provide a test of sufficient certainty to allow an objective assessment to be made of whether a company falls within the entity test, when compared with the small/large distinction provided in the Bill." See Parliamentary Joint Committee on Corporations and Securities, *Report on the First Corporate Law Simplification Bill 1994*, 2 March 1995, p 16.

19 National Institute of Accountants, Submission 8, p 8.

4.22 The PJSC believes that it would not be appropriate to relieve all proprietary companies of the audit requirement for several reasons. This option would not be consistent with the reporting entity concept in the Accounting Standards, as some proprietary companies, particularly those that seek to raise equity or loan capital, will almost always exhibit the characteristics of a reporting entity. Users of financial reports, who are unable to access financial information about the entity, depend on high quality financial reports from the company in making their resource allocation decisions. For reporting entities that have dependent users of those reports the need for audited financial statements will always outweigh other considerations. But, as submissions noted, for some proprietary companies the issue is more complex. The PJSC nevertheless concluded that the ownership of the company is a better indicator of the need to impose an audit requirement under the Law than the arbitrary test of a company's economic significance.

Recommendations

4.23 The PJSC recommends that:

1. **The previous distinction between exempt and non-exempt proprietary companies be reinstated, to replace section 45A of the Law;**

2. **All directors of proprietary companies be required to sign and lodge a declaration of solvency with their annual reports;**

3. **In preparing financial statements, reporting and non-reporting entities apply all the recognition and measurement requirements of the Accounting Standards; and**

4. **All company financial statements, which are required to be lodged with the ASIC, should be required to be audited.**

Senator Grant Chapman
Chairman