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Dr Kathieen Dermody
Secretary
Joint Committee on Corporations and Financial Services
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By email: frank.donnan@aph.gov.au & mail

Dear Dr Dermody

Inquiry into Australia's Insolvency Laws

In CPA Australia's presentation to the public hearing of the Committee held in Melbourne on Friday 8 August 2003, an undertaking was given to provide **supplementary** comment on financial disclosure issues associated with the treatment of employee **termination/redundancy** entitlements which might affect assessment of either financial viability or commitment crystallizing upon corporate liquidation.

Additionally, in our written submission of 5 August 2003, under the heading Retention of Title (ROT), comment was made concerning the potential for variability in accounting statement disclosures of these contractual devices which might distort assessment of asset availability. It is noted also that the Insolvency Practitioners Association of Australia, in its written submission to the Committee under a recommendation concerning registration of ROTs, suggested further that the Australian Accounting Standards Board examine the adequacy of current disclosure practices in this area.

In response to the above two issues, CPA Australia has had prepared, through an external reporting specialist consultant (Mr David Boymal, a past CPA Australia President) the attached analysis. To summarise, in both instances, the currently existing regulation of external reporting and associated professional pronouncements, which necessarily operate within a broader framework of user needs, does not warrant alteration to contend with the specifics of insolvency. The view is taken that the departure from the generally accepted framework that such change would necessarily involve, is potentially detrimental to the wider utility of external reporting. As such, the established framework of reporting through its correct application adequately addresses these issues such that, where difficulties arise, these are largely the consequence of deficient application in individual cases,

If required, CPA Australia is willing to provide the Committee with additional clarification. Questions concerning this supplementary submission should be directed to Catherine Mulcare, Corporate Reporting Policy Adviser, on Tel: (03) 9606 9770 or John Purcell, Management and Business Technical Adviser, on Tel: (03) 9606 9826.

Yours sincerely


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1. TERMINATION / REDUNDANCY ENTITLEMENTS

1.1 Introduction

in the course of their giving evidence before the Joint Committee on Corporations and Financial Services, representatives of CPA Australia were asked their view of the extent, if any, or whether the provision for employee entitlements including redundancy entitlements should be reported to employees and unions.

CPA Australia undertook to provide a supplementary submission to explain how employee entitlements, and in particular redundancy entitlements, are dealt with in the books of companies. This paper discusses these issues in response to that undertaking.

1.2 Who Must Follow Accounting Standards?

Before discussing the details of accounting standards covering employee entitlements, it is important to observe that under the present laws, not all businesses must adhere to accounting standards. Accordingly, a solution to the perceived problem via accounting standards will have no impact on those businesses which are not obliged to follow accounting standards.

Under the Corporations Act 2001 at section 292, a financial report must be prepared for each financial year by:

- (a) All public companies;
- (b) All large proprietary companies; and
- (c) All registered schemes.

Small proprietary companies, on the other hand, do not have to prepare a financial report unless at least 5% of the shareholders so direct, or ASIC directs, or unless it was controlled by a foreign company and is not consolidated into accounts lodged with ASIC.

Under the Corporations Act, a company is a small proprietary company if it satisfies at least two of the following:

- (a) Gross revenue is less than \$10 million;
- (b) The value of gross assets at the end of the year is less than \$5 million; and
- (c) It has fewer than 50 employees at the end of the year.

In addition, there are no financial reporting obligations (apart from lodging a taxation return) for businesses conducted under non-corporate structures, such as partnerships and family trusts.

Under Section 296 of the Corporations Act 2001, the financial report (of disclosing entities, public companies and registered schemes) must comply with the accounting standards and any further requirements in the regulations. In addition, however, Accounting Standards issued by the Australian Accounting Standards Board (AASB) generally apply the Reporting Entity Concept, in that they are applicable only to reporting entities. Reporting entities are defined as "an entity in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources and includes but is not limited to the following:

- (a) A disclosing entity;
- (b) A company, which is not a subsidiary of a holding company incorporated in Australia and which is a subsidiary of a foreign company where that foreign company has its securities listed for quotation on a stock market or those securities are traded on a stock market.

For example Accounting Standard AASB 1028 "Employee Benefits" applies to:

- (a) Each entity that is required to prepare financial reports in accordance with Part 2M.3 of the Corporations Law that is a reporting entity;
- (b) General purpose financial reports of each other reporting entity; and
- (c) Financial reports that are or are held out to be general purpose financial reports".

The overall effect of the application of the Reporting Entity Concept is that many large proprietary companies also do not have to comply with accounting standards even though they do have to prepare a financial report under the Corporations Act 2001.

In summary therefore, non-corporate entities, small proprietary companies and non-reporting entities all are not required to comply with accounting standards. These exclusions cover the majority of small to medium businesses in Australia.

1.3 The Conceptual Framework

The present accounting standards are based upon a Conceptual Framework which was written in the early 1990's. The Conceptual Framework comprises four Statements of Accounting Concepts (SAC's 1-4), which outline the objectives of general purpose financial reporting, the qualitative characteristics of financial information, the reporting entity concept, and in SAC 4, the definition and recognition of the elements of financial statements (assets, liabilities, equity, revenue and expense). This discussion will focus on the definition and recognition of liabilities as presented in SAC 4.

SAC 4 defines liabilities as "future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events." Each part of this definition is explained in detail in SAC 4. SAC 4 explains that the idea of a present obligation extends beyond legally enforceable contracts, and that obligations can also be equitable or constructive. An equitable obligation is governed by social or moral sanctions or custom rather than legal sanctions. A constructive obligation is created inferred or construed from the facts in a particular situation rather than contracted by agreement with another entity.

SAC 4 then goes on to distinguish between present obligations and future commitments to ensure that too wide a definition of liabilities is not adopted. The mere intention to sacrifice economic benefit in the future is not sufficient to give rise to a liability. Furthermore, the action of an entity in setting aside reserves for a future event does not give rise to a liability if an obligation would only arise when a future event occurred which would necessitate the sacrifice of economic benefits by the company.

SAC 4 then sets further rules for the recognition (i.e. the recording) of liabilities in the statement of financial position. "A liability should be recognised in the statement of financial position when and only when:

- (a) It is probable that the future sacrifice of economic benefits is required, and
- (b) The amount of the liability can be measured reliably"

It is therefore possible for an entity to have liabilities but which do not satisfy the recognition requirements for recording in the accounts.

1.4 Going Concern Basis of Accounting

Accounting Standard AASB1001 "Accounting Policies" provides as follows:

"7.1 Going Concern Basis

When preparing the financial report an assessment must be made of the entity's ability to continue as a going concern. The financial report must be prepared on a going concern basis unless it is intended to either liquidate the entity or to otherwise wind up its operations, or there is no realistic alternative but to liquidate the entity or to otherwise wind up its operations.

7.1.1 in assessing whether the going concern basis is appropriate it is necessary to consider all available information for *the* foreseeable future, which is at least but *is* not limited to twelve months from the reporting date...

7.1.3 where it *is* apparent that the going concern basis is *not* appropriate, the financial report is generally prepared on a liquidation basis.

Going concern basis means the accounting basis whereby in the preparation of the *financial* report the entity is viewed as a going concern, that is the entity is expected to

- (a) Be able to pay its debts as and when they become due and payable; and
- (b) Continue in operation without any intention or necessity to liquidate or otherwise wind up its operations."

The Corporations Act 2001 also requires the directors of the company to make a formal statement as to the solvency of the entity which is included as part of the financial report.

It can be seen from the above that accounting standards and the Corporations Law require the preparer of the financial report to make a single decision as to whether or not the going concern basis is appropriate, and then to account accordingly, either on a going concern basis or on a liquidation basis. Once this decision is made the other alternative is not addressed or reported on.

This is most relevant to redundancy or termination payments which might be payable upon the winding up of a business. If the business is considered to be a going concern, then the potential termination payments would not satisfy the definition of liabilities and would not be reportable. Furthermore, as the termination payments are entirely contingent upon the business ceasing to be a going concern, the recognition criteria would also not be satisfied as the sacrifice of economic benefits would not be regarded as probable.

The only other authoritative Australian accounting literature on going concern is to be found in the auditing standards. Australian Auditing Standard AUS 708 "Going Concern" provides that "if going concern questions are not satisfactorily resolved there will remain significant uncertainty regarding the appropriateness of the going concern basis."

AUS 708 requires that this uncertainty be referred to in both the financial report and in the audit report, stating clearly;

- (a) That there is significant uncertainty whether the entity *will* continue as a going concern and therefore whether it *will realise its* assets and extinguish its *liabilities* in the normal course of business
- (b) The principal *conditions* that raise doubt about the entity's *ability* to continue as a going concern
- (c) The extent to which the financial report includes appropriate adjustments, *if any, relating* to the *recoverability* and classification of recorded asset amounts or to the amounts and *classification* of liabilities that might be necessary *should* the entity not continue as a going concern.

The important observation is that even where an uncertainty exists about going concern, the standards do not require specific disclosure and quantification of the additional liabilities and the asset write downs that would arise in the event of a winding up. Instead, only a very general warning is contemplated by the standards.

1.5 AASB 1028 “Employee Benefits”

Australian Accounting Standard *AASB1028* deals explicitly with accounting for employee benefits

It requires that benefits expected to be paid within 12 months of the reporting date be measured at their nominal amounts and that benefits expected to be paid beyond 12 months of the reporting date must be measured as the present value of the estimated future cash flows. Present value measurement requires an estimate of the timing of the **outflows** and a determination of an appropriate discount rate.

AASB 1028 requires disclosure of amounts of employee benefits recognised in the financial statements in the following terms:

“The *financial* report must disclose the aggregate *liability* and the aggregate asset arising from *employee* benefits and related on-costs that have been recognised *in* the financial statements, *identifying* current and non current portions where applicable’:

in the case of liabilities for long service leave, *AASE 1028* requires measurement of both the unconditional vested benefits (which are in fact present **legal** obligations) and conditional benefits which are not yet present **legal** obligations, but which are constructive obligations, to the extent and only to the extent that it is probable that they will be paid. This treatment of liabilities for long service leave also provides many indications as to the appropriate accounting treatment for termination benefits.

AASE 1028 also makes specific reference to termination benefits in order to assist in determining whether there is a “present obligation” as required in **SAC 4** for the recognition of liabilities. The relevant reference is;

“ 4.8An entity is presently *obliged* to provide termination benefits when and *only* when the entity has:

- (a) developed a detailed formal plan for the terminations, identifying at least (i) the location, function and approximate number of employees who will be compensated for terminating their services (ii) the termination benefits for each job classification or function, and (iii) when ~~the~~ terminations will occur, and
- (b) Raised a *valid* expectation in those employees affected that it will carry out the terminations.’

1.6 Conclusion

Clearly the accounting standards do not contemplate the recording of termination benefits in financial reports unless either

- (a) the terminations are expected to occur, are part of a detailed plan of terminations and the terminations *have* been *in* some way announced, or
- (b) the entity is already not expected to remain a going concern

As recording of termination benefits other than in the above circumstances is contrary to current accounting standards and is also contrary to the conceptual framework upon which all accounting standards are based, it is highly probable that the **AASB/IRSB** would not **contemplate** the recording of such termination benefits.

The accounting standards do not make any reference to disclosure of the quantum of termination payments should the going concern basis of accounting cease to be appropriate. However, notwithstanding that this might in certain circumstances be useful information to employees and unions, it could also be potentially misleading because:

(a) it is *only* one of a number of factors that could arise should the entity cease to be a going concern. Fails in asset *values*, ongoing lease obligations and reduction in long service leave obligations to the vested benefits only, are other factors that probably would simultaneously arise.

(b) references to ceasing being a going concern in entities that are expected to remain a going concern *could* cause unnecessary *alarm*.

(c) hypothetical calculations without proper basis [such as when the payments *might* be made, what the potential arrangement may be, *etc*]*could* result in significantly inaccurate information.

Accordingly it is also very unlikely that the AASB would agree to such supplementary disclosure about termination benefits where there is no reasonable indication that they might be likely to be paid.

2. RETENTION OF TITLE CLAUSES

2.1 Background

Retention of title clauses (ROT) are clauses in contracts for the sale of goods which purport to leave the legal title to the goods with the seller of those goods until such time as the buyer pays for them or some other act occurs (such as on-sale or use in a manufacturing process),

Submissions made to the Inquiry have suggested that the Australian Accounting Standards Board (AASB) should examine appropriate accounts disclosure in the financial statements of companies where assets are potentially subject to ROT.

2.2 Accounting for ROT

Even though the existence of an ROT might mean in law that the purchase/sale is in some manner not yet completed, in the normal course of events neither the buyer nor the seller would deny that in substance a purchase/sale and a debt/obligation has arisen from the time that the goods subject to ROT were invoiced and delivered to the possession of the buyer.

Accounting rules require that transactions should be accounted for in accordance with their economic substance rather than their legal form, where substance and form appear to differ.

The "substance over form" rule is explained in Australian Accounting Standard AASB1001 "Accounting Policies" and in fact, ROT is used as an example in AASB1001 to explain the application of the rule. Relevant paragraphs of AASB1001 are as follows:

"4.1 To ensure that the *substance* of the underlying transactions or other events is reported in the *financial* report, accounting policies must be selected and applied in a manner which ensures that the resulting financial information satisfies the concepts of relevance and reliability.

4.1.8. For financial information to satisfy both the relevance and reliability concepts it is necessary that the substance rather than the form of a transaction or other event be reported where the substance and form differ.

4.1.10. However where the substance of *certain transactions of other events is not adequately* expressed by their legal form it is inappropriate to account for them in accordance with their form. For example an entity may transfer legal ownership of an asset to another party but have arrangements in *place* which ensures that it continues to enjoy future economic benefits embodied in that asset. If the entity were to account for such a transfer as a *disposal* of the future economic benefits embodied in that asset, its financial *report* would be unreliable, as it would not faithfully represent the economic effect of the transaction.

4.1.11. Determining the *substance* of a transaction or other event involves identifying *all of its aspects and implications*, and considering the position of each of the parties to it, including their expectations and motivations for entering into the transaction or other event. For example, where goods are sold subject to retention of title pending *settlement*, the buyer or seller is not prevented from recognising the transaction as a purchase or sale at the time of delivery where it is probable that the transaction will be settled in the normal course of business”

The final few words quoted above, referring to settlement in the normal course of business, is in fact a reference to the going concern basis of accounting. The going concern basis of accounting is also explained in AASB1001 as follows:

“7.1. When preparing the financial report, an assessment must be made of the entity’s *ability* to continue as a going concern. The financial report must be prepared on a going concern *basis unless* it is intended to either *liquidate* the entity or otherwise wind up its operations, or there is no realistic alternative but to liquidate the entity or *otherwise* wind up its operations”

The going concern basis is defined as:

“The accounting basis whereby in the preparation of the financial report the *entity* is viewed as a going concern, that is the entity is expected to

(a) Be able to pay *its* debts as and when they become *due* and payable; and

(b) Continue in operation without any intention or necessity to liquidate or otherwise wind up its operations”

In evaluating the appropriateness of an accounting policy, it is often useful to *also* consider the effects of applying an alternative policy. In relation to ROT, the only viable alternative accounting policy would be to not yet account for the purchase/sale and debt liability on the basis that the title to the goods has not yet passed. This would have the effect that the goods would *not* be disclosed as inventory of the buyer and the obligation of the buyer to pay for those goods would not yet be recorded. This would appear to contradict the intent of the parties in the normal course of events in anticipation of the buyer continuing as a going concern. In addition, all ROT inventory held would need to be able to be separately physically distinguishable from *non* ROT inventory in order that periodic stock takes could be successfully performed, thus adding a further practical problem to the alternative accounting.

It would appear therefore that the accounting for ROT is already well prescribed and it is unlikely that the AASB would be prepared to contemplate any change.

2.3 Disclosures of ROT

Australian Accounting Standard AASB1040 “Statement of Financial Position” deals with the classifications and disclosures relating to assets, liabilities and equity (that is, the balance sheet items).

If ROT inventory is to be treated as an asset of the buyer, then it is reasonable to assume that the purpose of the ROT contract is to provide the seller with security for the indebtedness.

At paragraph 8.1.(d), AASB1040 requires disclosure of:

“the carrying amount of any non-current assets pledged as security for liabilities and the related existence and amounts of restrictions on *title*”.

Unfortunately, most goods subject to ROT are inventory items, which are usually (but not entirely) classified as current assets. Therefore, paragraph 8.1 (d) is not very effective in identifying the assets subject to ROT,

At paragraph 8.3.(c), AASB1040 requires disclosure of:

"where liabilities have been secured, including security *by* a negative pledge or by a trust deed which specifies the amount the entity can borrow is limited to a proportion *of* its assets:

- (i) the amount of each liability secured
- (ii) the nature and adequacy ~~of~~ the security *in relation* to each *liability* item.

This requirement would envisage disclosure of ROT along the following lines:

"\$ of trade accounts payable are secured by retention of title contracts over assets classified as inventory"

Such a disclosure requirement creates some system problems for companies, in order for them to distinguish trade accounts payable subject to ROT from trade accounts payable not subject to ROT. However, AASB1040 provides no "out" for this system inconvenience. Of course this required disclosure does not greatly assist a creditor attempting to enforce ROT in identifying particular assets subject to ROT; but in reality no financial statement disclosure would assist in this level of detail.

Notwithstanding that disclosure of ROT is already required in respect to liabilities, further disclosure also in respect of assets (inventory) by amendment to AASB1040 paragraph 8.1.(d) would provide slightly more information as the value of assets secured could differ from the secured liability because:

- (a) some of the inventory could have been on sold, and
- (b) some of the inventory could have been written down below its original cost.

However, if insolvency practitioners are having problems with lack of disclosure of ROT, it could be as a consequence of lack of compliance with AASB1040 paragraph 8.3.(c). This then would be a matter of compliance, auditing and regulation, rather than a matter for the AASB.

2.4 Accounts *Presentation* by Administrators

When a company falls under administration, it is then a responsibility of the administrator to present the accounts of the company. At this stage it may no longer be appropriate to apply the going concern basis of accounting and instead a liquidation basis might be more appropriate. Should the administrator continue to apply the substance over form rule and thus continue to include ROT amounts in inventory and as a liability? This may depend very much on individual circumstances: but if the expectation is that the creditors entitled to ROT will take possession of certain items of inventory, then the same paragraph 4.1.11 of AASB1001 would suggest that the administrator should restate the financial report by excluding the ROT assets and liabilities from the statement of financial position. Whilst AASB1040 does not specify the need for any related disclosure, best practice would require disclosure of the amounts of assets and liabilities so excluded.

Once again, the exclusion and the disclosure would necessitate some system alterations in order to quantify the relevant information.