

**CORPORATE AND FINANCIAL SERVICES REGULATION
REVIEW PROPOSALS PAPER 2006**

DRAFT REGULATION IMPACT STATEMENT

CHAPTER 2 – COMPANY REPORTING OBLIGATIONS

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1. BACKGROUND

A proprietary company is a company incorporated under the Corporations Act that is limited by share capital, has no more than 50 non-employee shareholders and has not raised money from the public. Under the *Corporations Act 2001*, a proprietary company is large for a financial year if it satisfies at least two of the following tests:

- the consolidated gross operating revenue for the financial year of the company and the entities it controls is \$10 million or more;
- the value of the consolidated gross assets at the end of the financial year of the company and the entities it controls is \$5 million or more; and
- the company and the entities it controls have 50 or more employees at the end of the financial year.

A large proprietary company is required to prepare and lodge an annual report with the Australian Securities and Investments Commission (ASIC). The annual report is made of up an audited financial report and a directors' report. Once they are lodged with ASIC, they are made available to members of the public for a prescribed fee (\$17 if the report is less than 10 pages and \$33 if it is 10 pages or more).

There are currently about 3,900 large proprietary companies which lodge annual reports with ASIC. The thresholds were introduced in the *First Corporate Law Simplification Act 1995* to focus regulation on the financial affairs of proprietary companies which have a significant economic influence. Requiring these companies to lodge annual reports is in the public interest for the following reasons:

- The collapse of an economically significant company could have a wider impact on the community in general particularly in regional areas. As such, the community has an interest in the financial position of large proprietary companies.
- Smaller trade creditors are not in a position to demand financial information before doing business with a company. In most cases, trade creditors spread their risk by supplying goods or services to a large number of companies. However, the larger a company gets, the more likely it is that trade creditors will be supplying goods or services only to that company.
- Employees and representative groups are not in a position to demand financial information from a company. The ability to access public information on the financial position of the company ensures they have some comfort that the company is able to guarantee their ongoing operations. It also ensures that they are not disadvantaged in the negotiation of employment contracts. These types of agreements are more likely to be negotiated with large employers.

These users derive a direct benefit to the extent that they act on the information in the annual report and an indirect benefit because they derive confidence in the knowledge

that they can access the information if they desire it. It is arguable that all companies should be required to prepare and lodge annual reports because companies, unlike other business entities, have the benefit of limited liability. However, it is considered that the costs of imposing financial reporting obligations on small proprietary companies would outweigh the benefits given their operations are not economically significant.

There are exceptions to the general requirement for large proprietary companies to lodge annual reports.

Grandfathered proprietary companies

Grandfathered proprietary companies are those which were not required to report under the test which was applied before 1995. To avoid disrupting established commercial arrangements, those companies could elect to continue under the pre-1995 rules. Under this relief, grandfathered proprietary companies are required to prepare an annual report but are exempt from the requirement to lodge that report.

Wholly-owned subsidiaries

ASIC Class Order 98/1418 provides relief to certain wholly-owned entities from the requirements to prepare and lodge annual reports. To be eligible for this relief the subsidiary must be a party to a deed of cross-guarantee with its parent entity. This means that if the subsidiary went into liquidation, the creditors of the subsidiary could sue the parent to recover their debts. The subsidiary can only take advantage of this relief if its parent lodges consolidated financial statements. As creditors are protected by the cross-guarantee, they do not need access to separate financial statements of the subsidiary.

Small proprietary companies – shareholder or ASIC direction

Shareholders in proprietary companies below the thresholds ('small' proprietary companies) are able to direct the company to prepare a financial report if they have five per cent of the voting capital. This is to ensure that shareholders in small proprietary companies have adequate access to financial information without imposing an unreasonable burden on small companies. In addition, ASIC is able to direct a company to prepare and lodge a financial report with ASIC and to have that report audited. These powers would remain unchanged in all the options below.

2. PROBLEM IDENTIFICATION

There are three elements of financial reporting by proprietary companies which are to be addressed:

1. Under the current thresholds, 3,900 proprietary companies are required to prepare and lodge annual reports. In addition, there are 1,750 grandfathered proprietary companies that are required to prepare, but not lodge their annual reports. This is out of a total population of proprietary companies of

1.4 million. As outlined in the analysis of the impact of options section, it is estimated that, on average, it costs \$60,000 for a company to produce an annual report. The thresholds for a large proprietary company have not been adjusted since 1995. As a result, the current thresholds are set at too low a level to determine economic significance. This means that financial reporting obligations are unnecessarily being imposed on a proportion of the proprietary companies that are currently preparing annual reports.

2. The rationale underpinning the size test is that large proprietary companies attract public accountability because they are economically significant. Providing relief to grandfathered proprietary companies is inconsistent with this rationale because there are many economically significant grandfathered proprietary companies. It also creates an unlevel regulatory environment for proprietary companies. There are approximately 1,750 proprietary companies that take advantage of this relief.
3. The existing relief for wholly-owned subsidiaries available to large proprietary companies and unlisted public companies will be considered along with the thresholds. The requirements for relief are complex and could be simplified by incorporating the relief into the Corporations Act. There are approximately 2,300 proprietary companies and 500 unlisted public companies that take advantage of this relief.

3. OBJECTIVES

The objective is to ensure that all economically significant proprietary companies are required to prepare and lodge annual reports. Economically significant entities are publicly accountable because of their size and potential to affect the community and the economy. Adjusting the thresholds to an appropriate level will reduce the compliance cost burden for proprietary companies that are not economically significant as they would no longer be required to prepare annual reports.

4. OPTIONS

Outlined below are the options that have been identified for addressing the problems identified above.

Option 1

Under this option, the monetary thresholds for the definition of a large proprietary company would be increased to reflect changes in inflation (as measured by movements in the gross domestic product deflator) since they were introduced in 1995. This would mean that the thresholds increase to:

- consolidated gross operating revenue for the financial year of the company and the entities it controls of \$13 million or more; and
- consolidated gross assets at the end of the financial year of the company and the entities it controls of \$6.5 million or more.

In addition, the Government would remove the employee threshold because the revenue and asset tests provide the most relevant indicators of company size. A proprietary company would be large if it satisfies either of the monetary tests above.

Grandfathered companies

The relief granted to grandfathered proprietary companies would be removed. This would mean that they would be subject to identical requirements to those imposed on other proprietary companies.

Wholly-owned subsidiaries

To simplify the arrangements, the relief for wholly-owned subsidiaries would be incorporated into the Corporations Act. This would involve amending the Act so that the requirement to lodge annual reports does not apply to wholly-owned entities who lodge an election notice with ASIC, provided their parent company also lodges an election notice. The Act would also be amended to provide a statutory cross-guarantee for companies within the group that lodge an election notice, removing the current need for deeds of cross-guarantee. The statutory cross-guarantee would mean that on winding up, all entities within the relevant group who lodge an election notice and their parent company can be sued for each other's debts.

Small proprietary companies – shareholder or ASIC direction

Shareholders in small proprietary companies would continue to be able to direct the company to prepare an annual report if they have five per cent of the voting capital. This is to ensure that shareholders in small proprietary company have adequate access to financial information without imposing an unreasonable burden on small companies. In addition, ASIC would continue to be able to direct a company to prepare and lodge an annual report with ASIC and to have that report audited.

Option 2

Under this option, the monetary thresholds for the definition of a large proprietary company would be doubled to account for nominal economic growth (as measured by changes in nominal gross domestic product) since they were introduced in 1995. Adjusting the thresholds for nominal economic growth (instead of real economic growth) means that the increase in the thresholds will include a component for inflation as well as economic growth. Under this option, the thresholds increase to:

- consolidated gross operating revenue for the financial year of the company and the entities it controls of \$20 million or more; and
- consolidated gross assets at the end of the financial year of the company and the entities it controls of \$10 million or more.

In addition, the Government would remove the employee threshold because the revenue and asset tests provide the most relevant indicators of company size. A proprietary company would be large if it satisfies either of the monetary tests above.

Grandfathered companies

As for Option 1.

Wholly-owned subsidiaries

As for Option 1.

Small proprietary companies – shareholder or ASIC direction

As for Option 1.

Option 3

Under this option, the monetary thresholds would be increased by a multiple of 2.5. This would result in increases to the revenue and assets thresholds of \$5 million and \$2.5 million respectively in addition to adjusting the thresholds for nominal economic growth. Under this option, the thresholds increase to:

- consolidated gross operating revenue for the financial year of the company and the entities it controls of \$25 million or more; and
- consolidated gross assets at the end of the financial year of the company and the entities it controls of \$12.5 million or more.

In addition, the employee threshold would be removed because the revenue and asset tests provide the most relevant indicators of company size. A proprietary company would be large if it satisfies either of the monetary tests above.

Grandfathered companies

As for Option 1.

Wholly-owned subsidiaries

As for Option 1.

Small proprietary companies – shareholder or ASIC direction

As for Option 1.

Option 4

Under this option, proprietary companies would not be required to prepare an annual report.

Grandfathered companies

Grandfathered exempt proprietary companies would no longer be required to prepare an annual report.

Wholly-owned subsidiaries

To simplify the arrangements, the relief for wholly-owned subsidiaries would be incorporated into the Corporations Act. Even though proprietary companies would no longer have financial reporting obligations, there is a need for this relief to continue to be available to assist wholly-owned subsidiaries that are public companies.

Proprietary companies – shareholder or ASIC direction

For proprietary companies, shareholders with 5 per cent of the voting capital in a company would be able to direct the company to prepare an annual report, to have that report audited and to provide it to shareholders. In addition, ASIC would be able to direct a proprietary company to prepare and lodge an annual report with ASIC.

5. IMPACT ANALYSIS

These options are being evaluated against each other as well as the status quo. The following discussion of costs and benefits of the options is largely qualitative, with some estimates where information is available. Information, particularly quantitative information, is being sought to enable more accurate comparison of the costs and benefits of requiring proprietary company financial reporting.

Option 1

Benefits

Under this option, approximately 210 fewer large proprietary companies would be required to prepare and lodge annual reports. This means that there would be 3,690 large proprietary companies plus the proportion of the 1,750 grandfather proprietary company that meet the new thresholds lodging annual reports with ASIC.

It is estimated that the average cost of preparing an annual report is \$60,000. This figure is based on the assumption that the average cost to audit the financial report of a large proprietary company is \$40,000 (this figure would vary depending on the size and complexity of the audit) and it costs a large proprietary company, on average, \$20,000 to prepare a financial report and directors' report (this figure attempts to take into account that companies will already be preparing some financial information for internal reporting and taxation purposes). The saving to business as a result of this option would be \$12.6 million per year.

Some grandfathered proprietary companies would no longer be required to prepare annual reports. It is difficult to estimate the number of grandfathered companies which exceed the thresholds because information on their size is not publicly available. Removing the lodgement relief given to grandfathered proprietary companies has additional benefits as it ensures that post-1995 proprietary companies

are not placed at a competitive disadvantage because of the favourable regulatory treatment given to grandfathered proprietary companies.

Costs

Users would no longer be able to access the annual reports of 210 proprietary companies. This is a cost for direct users of the annual reports and an indirect cost to the market as a whole as people no longer have the confidence in knowing that annual reports are available. It will also disadvantage people who benefited from the information being disseminated in the market as identified in the background section (for example, a credit-rating agency would no longer be able make recommendations on these companies because they will not have access to the necessary financial information). The benefit that users would lose because they are no longer able to access those reports is difficult to estimate. However, it is expected that the costs will not be significant because the 210 companies that would no longer be required to report are not economically significant, so it is unlikely that the public would be currently accessing their annual reports. **Information is sought to enable an estimate to be developed.**

There would be an additional burden on grandfathered exempt proprietary companies that are above the thresholds. These companies would be required to lodge their annual reports with ASIC. Given they are required to prepare these statements, the additional burden of lodgement would be minimal as it only requires the company to send the report to ASIC (ASIC does not impose a fee to lodge an annual report).

Option 2

Benefits

Under this option, 700 fewer large proprietary companies would be required to lodge annual reports with ASIC. This means that there would be 3,200 large proprietary companies plus the proportion of the 1,750 grandfather proprietary company that meet the new thresholds lodging annual reports with ASIC. Using the assumptions presented under Option 1, the benefit to business would be \$42 million per year.

Some grandfathered proprietary companies would no longer be required to prepare annual reports. It is difficult to estimate the number of grandfathered companies which exceed the thresholds because information on their size is not publicly available. However, more grandfathered proprietary companies will benefit under this Option than Option 1. Removing the lodgement relief given to grandfathered proprietary companies has additional benefits as it ensures that post-1995 proprietary companies are not placed at a competitive disadvantage because of the favourable regulatory treatment given to grandfathered proprietary companies.

Costs

Users would no longer be able to access the annual reports of 700 proprietary companies. This is a cost for direct users of the annual reports and an indirect cost to the market as a whole as people no longer have the confidence in knowing that annual reports are available. It will also disadvantage people who benefited from the information being disseminated in the market as identified in the background section

(for example, a credit-rating agency would no longer be able make recommendations on these companies because they will not have access to the necessary financial information). The benefit that users would lose because they are no longer able to access those reports is difficult to estimate. However, the costs will be greater than the costs for Option 1, but are still unlikely to be significant because the additional 490 companies (700 less the 210 excluded as a result of Option 1) that would no longer be required to report are also not economically significant. This means it is unlikely that the public would be currently accessing the information. **Information is sought to enable an estimate to be developed.**

There would be an additional burden on grandfathered exempt proprietary companies that are above the thresholds. These companies would be required to lodge their annual reports with ASIC. Given they are required to prepare these statements, the additional burden of lodgement would be minimal as it only requires the company to send the report to ASIC (ASIC does not impose a fee to lodge an annual report).

Option 3

Benefits

Under this option, 1,000 fewer large proprietary companies would be required to lodge annual reports with ASIC. This means that there would be 2,900 large proprietary companies plus the proportion of the 1,750 grandfather proprietary company that meet the new thresholds lodging annual reports with ASIC. Using the assumptions presented under Option 1, the benefit to business would be \$60 million per year.

Some grandfathered proprietary companies would no longer be required to prepare annual reports. It is difficult to estimate the number of grandfathered companies which exceed the thresholds because information on their size is not publicly available. However, more grandfathered proprietary companies will benefit under this Option than Options 1 and 2. Removing the lodgement relief given to grandfathered proprietary companies has additional benefits as it ensures that post-1995 proprietary companies are not placed at a competitive disadvantage because of the favourable regulatory treatment given to grandfathered proprietary companies.

Costs

Users would no longer be able to access the annual reports of 1,000 proprietary companies. This is a cost for direct users of the annual reports and an indirect cost to the market as a whole as people no longer have the confidence in knowing that annual reports are available. It will also disadvantage people who benefited from the information being disseminated in the market as identified in the background section (for example, a credit-rating agency would no longer be able make recommendations on these companies because they will not have access to the necessary financial information). The benefit that users would lose because they are no longer able to access those reports is difficult to estimate. However, the costs will be greater than the costs for Options 1 and 2, but are still unlikely to be significant because the additional 300 companies (1000 less the 700 excluded as a result of Option 2) that would no longer be required to report are also not economically significant. This

means it is unlikely that the public would be currently accessing the information.
Information is sought to enable an estimate to be developed.

There would be an additional burden on grandfathered exempt proprietary companies that are above the thresholds. These companies would be required to lodge their annual reports with ASIC. Given they are required to prepare these statements, the additional burden of lodgement would be minimal as it only requires the company to send the report to ASIC (ASIC does not impose a fee to lodge an annual report).

Option 4

Benefits

This option would result in 3,900 fewer large proprietary companies being required to prepare and lodge annual reports. Using the assumptions presented under Option 1, the benefit to business would be \$234 million per year. In addition, 1,750 grandfathered exempt proprietary companies would no longer be required to prepare annual reports. Using the assumptions presented under Option 1, the benefit to business would be a further \$105 million per year.

It would also remove the unfair competitive advantage that grandfathered proprietary companies have by ensuring that all proprietary companies are subject to the same regulatory framework.

Costs

Under this option, all large proprietary companies would be exempt from the requirements to prepare and lodge annual reports. On top of the costs outlined in options 1, 2 and 3, removing the mandatory requirements is likely to result in additional costs that could affect the wider economy through the inefficient allocation of resources and loss of confidence and by constraining the ability of large proprietary companies to access capital. These costs are unlikely to be significant for the earlier options. However, they are likely to be substantive for large proprietary companies with revenues in excess of \$25 million.

Economy wide effects

Under the current regime, economically significant proprietary companies are required to prepare and lodge annual reports. The reports provide a means to access and understand the company's economic behaviour and bring together fragmented sources of information into a more informed medium. The information contained in these reports can provide valuable signals to the market, particularly about the underlying state of the business, which could affect its on-going operations or financial viability.

Removing the mandatory requirements would restrict information flows. This limits the ability to make judgements about the financial or general well-being of these companies, which may provide early warning signals about any underlying problems. The potential economic costs if a large proprietary company enters administration include increased unemployment, the need to re-skill displaced workers and lower taxation receipts. This outcome may be avoided if competitors or other interested

parties were able to use the information contained in the annual report to gauge whether it would be a strategic fit to merge their operations with any troubled company, therefore limiting the negative employment effects on the economy.

In addition, the preparation of financial reports provides confidence in this market sector by providing greater financial transparency. For example, investors may obtain comfort in knowing the specific factors behind a company going into administration that can be derived from the company's annual report. This will help ensure that the collapse of one company does not reduce confidence in the market more generally. The effects from any market wide loss of confidence could have a significant impact on the economy and future economic growth. For example, investors may divert their savings into other investment forms which are less productive, reduce liquidity and the depth of the domestic capital markets and lead to volatility in asset prices. This may also have a flow on effect of reducing consumption and investments.

Large proprietary companies — accessing capital

Removing obligations to prepare financial reports may limit access to alternative forms of capital and therefore restrict a company's ability to expand. For example, in order to list on a stock exchange, a company must provide audited accounts for the last three financial years. By requiring large proprietary companies to prepare audited financial reports, it is more likely that they would be able to satisfy this requirement in the short-term. If they were unable to access capital through a public listing, they would have to rely on more traditional forms of financing facilities, such as bank financing. Access to capital markets enables them to expand their operations beyond that which would normally be available through bank finance and pursue innovative ideas. Therefore, removing the requirements to prepare financial reports could restrict access to varying forms of capital, leading to a sub-optimal allocation of resources.

Total costs

The total cost associated with large proprietary companies not preparing financial reports for all purposes is difficult to estimate. However, given the wider economic effects, the potential impact on large proprietary companies accessing capital and general user concerns, these costs would be significantly greater than the costs under Options 1, 2, and 3. It is expected that the costs of this Option would be considerable and outweigh the benefits. **Information is sought to enable an estimate to be developed.**

6. CONSULTATION

In the *Corporations and Financial Services Regulation Review Consultation Paper*, comments were sought on whether the thresholds should be increased. Most respondents were supportive of an increase in the thresholds with a number of stakeholders proposed that the thresholds be doubled to account for economic growth since the thresholds were introduced.

7. CONCLUSION AND RECOMMENDATION

Option 3 is the recommended option.

There is significant public interest in the annual reports of proprietary companies that are economically significant. As identified in the background section, potential users of annual reports include trade creditors, employees, credit-rating agencies, journalists and the wider community. In addition, requiring economically significant proprietary companies to report promotes greater confidence in the market place and facilitates the public listing of large proprietary companies as a means of access alternative forms of capital. A size test provides a simple objective test which a company can apply to determine whether it is required to lodge an annual report.

The existing size test has not kept pace with economic growth and inflation because it has not been adjusted since 1995. This has increased the regulatory burden on proprietary companies as more companies exceed the threshold. Because the thresholds are used to test economic significance, it is considered that the thresholds should be adjusted for nominal economic growth since 1995. In addition, an additional increase of \$5 million and \$2.5 million to the revenue and asset thresholds respectively above that required to adjust the thresholds for nominal economic growth is considered appropriate to ensure only economically significant large proprietary companies are required to report. Based on this, it is proposed that the thresholds be increased to companies with turnover of \$25 million or assets of \$12.5 million. It is considered that this represents the appropriate threshold for determining economic significance. Based on these thresholds, 1,000 fewer proprietary companies will be required to lodge annual reports representing a saving to companies of \$60 million per year. In addition, a proportion of the 1,750 grandfathered proprietary companies will no longer be required to prepare annual reports. This will further reduce the financial reporting costs for proprietary companies. There was considerable support from stakeholders for adjusting the thresholds to approximately this level expressed in previous consultations.

Abolishing proprietary company financial reporting as outlined in Option 4 would result in economically significant proprietary companies no longer reporting. The overall costs of not requiring the preparation of annual reports of economically significant proprietary companies is considered to significantly outweigh the benefits that would flow to these companies from reducing the compliance burden.

Applying the thresholds to all proprietary companies, including grandfathered proprietary companies, will remove an inconsistency in the current law and create a level regulatory environment for all proprietary companies to operate in.

8. IMPLEMENTATION AND REVIEW

The recommended actions all require legislative amendments to the *Corporations Act 2001*.

The operation of the Corporations Act will continue to be monitored to ensure it operates as intended.