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HOUSE OF REPRESENTATIVES

CORPORATIONS AMENDMENT (CORPORATE REPORTING REFORM) BILL 2010

DRAFT

EXPLANATORY MATERIAL

(Circulated by the authority of the
Minister for Financial Services, Superannuation, Corporate Law and Human Services,
the Hon Chris Bowen)

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	***Definition***
AASB	Australian Accounting Standards Board
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASIC Act	*Australian Securities and Investments Commission Act 2001*
AUASB	Auditing and Assurance Standards Board
CAC Act	*Commonwealth Authorities and Companies Act 1997*
CALDB	Company Auditors and Liquidators Disciplinary Board
Corporations Act	*Corporations Act 2001*
CPAA	CPA Australia
FMA Act	*Financial Management and Accountability Act 1997*
FRC	Financial Reporting Council
GRI Act	*Governance Review Implementation (AASB and AUASB) Act 2008*
IASB	International Accounting Standards Board
ICAA	Institute of Chartered Accountants in Australia
IFRS	International Financial Reporting Standards
IPAA	Insolvency Practitioners Association of Australia
NIA	National Institute of Accountants
RIS	Regulation Impact Statement

General outline and financial impact

General outline

A robust financial reporting framework is an essential component of an efficient market. The Corporations Amendment (Corporate Reporting Reform) Bill 2010 will improve Australia's corporate reporting framework by reducing unnecessary red-tape and regulatory burden on companies, improving disclosure requirements and implementing a number of other important refinements to the corporate regulatory framework.

Date of effect: The Act commences on the day it receives the Royal Assent.

Summary of regulation impact statement

Regulation impact on business

Impact: A draft Regulation Impact Statement (RIS) has been prepared in accordance with the Government's best practice regulation requirements. The draft RIS has been released publicly as part of the consultation process.

Chapter 1
Companies limited by guarantee

Context of amendments

1.1 Under the existing reporting framework, all companies limited by guarantee are required to prepare an audited financial report in accordance with the Australian accounting standards and a directors' report in accordance with the *Corporations Act 2001* (Corporations Act), regardless of their size.

1.2 The company limited by guarantee structure is used predominantly by not-for-profit entities to incorporate their operations. Research conducted by The University of Melbourne found that approximately 21 per cent of companies limited by guarantee were sports and recreation related organisations, 19 per cent were community service organisations, 15 per cent were education-related institutions and 10 per cent were religious organisations.

1.3 The vast majority of companies limited by guarantee are relatively small. The table below outlines the relative size of companies limited by guarantee based on a sample of companies that lodged financial reports with Australian Securities and Investments Commission (ASIC). The small size of companies limited by guarantee means that they may not have the capacity to comply with extensive reporting requirements. However, as discussed below, it is recognised that reporting by companies limited by guarantee is an important governance and transparency mechanism given the public nature of these companies.

Table 1.1: Size of companies limited by guarantee[1]

	Revenue (%)	Cumulative Total: Revenue (%)	Assets (%)	Cumulative Total: Assets (%)
Less than $20,000	14	14	12	12
Between $20,000 and $50,000	9	23	9	21
Between $50,001 and $250,000	24	47	16	37
Between $250,001 and $500,000	7	54	8	45
Between $500,001 and $1,000,000	14	68	18	63
Between $1,000,000 and $12,500,000	28	96	30	93
Greater than $12,500,000	4	100	5	100

1.4 In June 2007, Treasury released a discussion paper on financial reporting by unlisted public companies. The paper sought comments on whether the existing reporting framework was appropriate for the 11,000 companies limited by guarantee and the 7,000 unlisted public companies limited by shares preparing financial reports under the Corporations Act.

1.5 The majority of respondents to the discussion paper indicated that for reporting purposes, companies limited by guarantee could be differentiated on the basis of the size of their operating revenue. Tests based on assets or number of employees may not be accurate indicators of the 'size' of the company. For example, a company limited by guarantee may have a large number of assets, but there may be restrictions on the company disposing of these assets. In addition, indicators based on employee numbers are likely to be distorted by the large number of volunteers that generally participate in not-for-profit entities.

1.6 The submissions also noted that some types of companies limited by guarantee will have a higher level of public interest due to the nature of their activities. Charities, for instance, were identified as being in this category because of their public fundraising activities (for example, donation drives) and significant community involvement. In contrast, member-focused companies limited by guarantee (for example, sporting clubs) may have a significantly lower level of public interest. Such factors need to be considered when differentiating between companies limited by guarantee for reporting purposes.

[1] Based on sample data provided by ASIC on 3 November 2006.

1.7 Any differentiation between companies limited by guarantee on the basis of the nature of their activities needs to be sufficiently clear to ensure that companies are certain of their reporting obligations. For this reason, it is proposed that classification as a deductible gift recipient for the purposes of the *Income Tax Assessment Act 1997* be used to differentiate between companies limited by guarantee in terms of the nature of their activities. Deductible gift recipients may receive tax deductible donations from the public. As such, it is considered to be indicative of a high degree of public interest in the activities of the company.

Summary of new law

1.8 A three tiered differential reporting framework will be introduced exempting small companies limited by guarantee from reporting and auditing requirements and providing other companies limited by guarantee with streamlined assurance requirements and simplified disclosures in the directors' report. In addition, the process for companies to distribute the annual report to their members will be streamlined.

1.9 Companies limited by guarantee will be prohibited from paying a dividend, as the corporate structure of companies limited by guarantee means that they are not suited for conducting for-profit activities which could legitimately warrant the payment of dividends to members.

1.10 This proposal is aimed at introducing a tailored financial reporting regime for companies limited by guarantee that will reduce the regulatory burden on these entities while ensuring that appropriate levels of financial transparency and governance are maintained.

Comparison of key features of new law and current law

New law	*Current law*
A three tiered differential reporting framework will be introduced exempting small companies limited by guarantee from reporting and auditing requirements and providing other companies limited by guarantee with streamlined assurance requirements and simplified disclosures in the directors' report.	Companies limited by guarantee must prepare a full audited financial report in accordance with accounting standards and a directors' report in accordance with the Corporations Act.

New law	*Current law*
The process for companies to distribute the annual report to their members will be streamlined, by allowing companies limited by guarantee to write to members informing them that an annual report has been prepared and how they can obtain a copy.	Companies limited by guarantee must comply with section 314 of the Corporations Act, which allows companies to distribute their annual report to members via the Internet, and if the company does not maintain a website, it must send members a hard copy report.
Companies limited by guarantee will be prohibited from paying a dividend.	The Corporations Act does not prohibit companies limited by guarantee from paying dividends.

Detailed explanation of new law

Differential reporting framework

1.11 Under the proposed new law, a three tiered differential reporting framework would be introduced for companies limited by guarantee.

1.12 Under the first tier, companies would be exempt from preparing the financial report and the directors' report. This tier comprises of companies limited by guarantee with annual revenue less than $250,000 which do not have deductible gift recipient status.

1.13 Under the second tier, companies would:

- prepare a financial report, which they could elect to have reviewed rather than audited;
- prepare a streamlined directors' report, rather than a full director's report; and
- be subject to a streamlined process for distributing the annual report to members.

The second tier comprises of the following companies limited by guarantee:

- companies with an annual revenue of less than $250,000 that are a deductible gift recipient; and
- companies with an annual revenue of $250,000 or more but less than $1 million, irrespective of whether the company is a deductible gift recipient.

1.14 Under the third tier, companies would:

- continue to prepare an audited financial report;
- prepare a streamlined directors' report, rather than a full director's report; and
- be subject to a streamlined process for distributing the annual report to members.

The third tier comprises of companies limited by guarantee with an annual revenue of $1 million or more, irrespective of whether the company is a deductible gift recipient.

[Schedule 1, Part 1, item 14, section 285A]

Exception where direction by ASIC or members

1.15 Appropriate safeguards would be put in place requiring companies limited by guarantee to prepare a financial report or a directors' report if they are directed to by ASIC or by at least five per cent of members ***[Schedule 1, Part 1, item 16, sections 294A and 294B].*** The requirements relating to a direction from ASIC or at least five per cent of members are similar to the existing requirements applying to small proprietary companies in sections 293 and 294 of the Corporations Act.

Exception for Commonwealth companies or subsidiaries of Commonwealth companies and Commonwealth authorities

1.16 The following entities are excluded from the proposed reforms applying to companies limited by guarantee:

- a Commonwealth company;
- a subsidiary of a Commonwealth company; or
- a subsidiary of a Commonwealth authority.

[Schedule 1, Part 1, items 4 and 30, paragraphs 45B(d) and 301(3)(a)]

1.17 The directors of a Commonwealth company (a company subject to the Corporations Act that the Commonwealth controls, whether they are companies limited by shares or companies limited by guarantee) are required to comply with the annual reporting requirements in the *Commonwealth Authorities and Companies Act 1997* (CAC Act).

1.18 The annual reporting requirements in the CAC Act currently require the directors of a Commonwealth company to provide to their responsible Minister the company's financial report, directors' report and auditor's report required by the Corporations Act for a financial year, as if the company were a public company under the Corporations Act.

1.19 The CAC Act also requires the directors of Commonwealth authorities and companies to ensure that certain information regarding subsidiaries is included in their reports and that the financial statements of those subsidiaries are audited by the Auditor-General.

1.20 By excluding Commonwealth companies and subsidiaries of Commonwealth companies and Commonwealth authorities from the coverage of these reforms, such entities will continue to maintain the higher level of reporting that is appropriate given that the entity is controlled by the Commonwealth, and their reports are tabled in Parliament.

Audits and reviews

1.21 The current framework requires companies limited by guarantee to have their financial reports audited by a registered company auditor in accordance with Australian auditing standards. Stakeholders have suggested that many small companies limited by guarantee are currently spending a disproportionate amount on audit fees. This reduces the resources that the company has available for member services.

1.22 Under the new law, companies falling within the second tier would be given the option of having their annual report subject to a review, rather than an audit. ***[Schedule 1, Part 1, item 30, subsection 301(3)]***

1.23 A review, in contrast to an audit, is not designed to obtain reasonable assurance that the financial information reported by the company is free from material misstatement. A review consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review may bring significant matters affecting the financial information to the assurance practitioner's attention, but it does not provide all of the evidence that would be required in an audit.

1.24 This measure is intended to reduce the time and costs associated with having the financial statements audited, whilst ensuring that the financial information is still subject to an appropriate degree of assurance.

1.25 The review would be conducted in accordance with a standard on review engagements developed (and modified as appropriate) by the Auditing and Assurance Standards Board (AUASB).

1.26 The review could be undertaken by either a registered company auditor, or a member of a professional accounting body that holds a prescribed practising certificate. ***[Schedule 1, Part 1, item 46, section 324BE]***

1.27 The associated regulations prescribe the following practising certificates:

- the Certificate of Public Practice issued by the Institute of Chartered Accountants in Australia (ICAA);
- the Public Practice Certificate issued by CPA Australia Ltd or the National Institute of Accountants (NIA).

1.28 This measure will expand the category of individuals that are permitted to undertake a review, which will provide greater flexibility and reduce unnecessary burden on companies limited by guarantee and their auditors, particularly during peak periods.

Streamlined directors' report

1.29 Currently, all companies limited by guarantee are required to prepare a directors' report. The existing directors' report disclosure requirements for companies include a large number of provisions that are not relevant for not-for-profit companies. These include disclosures relating to the payment of dividends and options issued to directors as remuneration. In addition, not-for-profit companies are generally purpose or objective driven. As such, stakeholders in not-for-profit companies are likely to be particularly interested in the objectives of the organisation and how the activities conducted during the period contributed to achieving those objectives.

1.30 Under the new law, companies falling within the second and third tiers would be exempt from complying with the existing directors' report disclosure requirements, and would instead prepare a simplified directors' report. ***[Schedule 1, Part 1, item 14, section 285A]***

1.31 The simplified directors' report would contain the following disclosures:

- a description of the short and long term objectives of the entity;
- the entity's strategy for achieving those objectives;

- the entity's principal activities during the year;
- how those activities assisted in achieving the entity's objectives; and
- how the entity measures its performance, including any key performance indicators used by the entity.

[Schedule 1, Part 1, item 29, subsections 300B(1) and (2)]

1.32 In addition, the simplified directors report would contain details of:

- the name of each person who has been a director of the company at any time during or since the end of the year and the period for which the person was a director;
- each director's qualifications, experience and special responsibilities;
- the number of meetings of the board of directors held during the year and each director's attendance at those meetings;
- for each class of membership in the company, the amount which a member of that class is liable to contribute if the company is wound up; and
- the total amount that members of the company are liable to contribute if the company is wound up.

[Schedule 1, Part 1, item 29, subsection 300B(3)]

1.33 By creating a set of tailored, non-financial disclosure requirements for companies limited by guarantee that recognises the not-for-profit nature of these entities, the measure will result in more relevant information being provided to stakeholders. In addition, it will reduce the range of reporting requirements currently imposed on companies limited by guarantee.

Distribution of annual reports

1.34 The Corporations Act currently allows companies limited by guarantee to distribute their annual reports to members via the Internet. However, small companies limited by guarantee may not have sufficient resources to maintain a website. In these circumstances, companies are required to send members a hard copy of the annual report. This can be a

considerable burden if the company limited by guarantee has a large number of members.

1.35 Under the new law, companies falling within the second and third tiers would be required to write to members informing them that an annual report has been prepared and how they can obtain a copy (including by directing members to the company website where available). Members wishing to obtain a hard copy or an electronic copy of the company's latest annual report can elect to obtain this from the company free of charge. ***[Schedule 1, Part 1, item 41, section 316A]***

1.36 An election made by members to either receive a hard copy or an electronic copy is a standing election for subsequent financial years until the member changes the election ***[Schedule 1, Part 1, item 41, subsection 316A(3)]***. This will ensure that members do not need to repeat their requests for a copy of the report each year. It will also ensure that companies will not need to send a notification each year to shareholders that have already made an election, and instead, send a copy of the report in compliance with the election.

Payment of dividends

1.37 Currently, the Corporations Act does not prohibit companies limited by guarantee from paying dividends. Despite this, the corporate structure of companies limited by guarantee means that they are not suited for conducting for-profit activities which could legitimately warrant the payment of dividends to members. Some companies limited by guarantee have already remedied this situation by providing in their constitution a prohibition on the payment of dividends.

1.38 In order to address this situation for all companies limited by guarantee, the new law prohibits companies limited by guarantee from paying dividends to members. ***[Schedule 1, Part 1, item 6, section 254SA]***

Chapter 2
Parent-entity financial statements

Context of amendments

2.1 Under the Corporations Act, each public company, large proprietary company, registered scheme and disclosing entity (subsequently referred to as 'entity') is required to prepare a financial statement in relation to the entity reported on for each financial year. In addition, where an entity is a parent entity it is required to prepare financial statements in relation to the consolidated entity if the preparation of such statements is required by the accounting standards. The Act also contains equivalent requirements in respect of the half-year financial statements of a disclosing entity.

2.2 This results in parent entities having to include a minimum of four columns in their financial statements (that is, figures for the current financial year and the preceding financial year for both the parent entity and the consolidated entity).

2.3 The issue of the usefulness of separate parent entity financial statements has been debated in Australia for a number of years. In 2003, the Australian Accounting Standards Board (AASB) commissioned a research project on the relevance of parent entity financial reports and issued a discussion paper titled *The Relevance of Parent Entity Financial Reports*. The AASB believes that there is a need for revision in respect of parent entity reporting.

2.4 An industry group, the Group of 100 (comprising the Chief Financial Officers of Australia's largest entities) has also noted, in a submission to Treasury, that the replacement of full parent entity financial statements with summary information would reduce the burden of regulation on business, reduce business costs and remove unnecessary disclosures from an entity's annual report.

Summary of new law

2.5 It is proposed that subsections 295(2) and 303(2) of the Corporations Act be repealed and replaced by new provisions that provide that, where the accounting standards require an entity to prepare financial

statements in relation to a consolidated entity, separate financial statements do not have to be prepared in relation to the entity itself.

2.6 It is also proposed that regulations will be made for the purposes of paragraphs 295(3)(a) and 303(3)(a) of the Corporations Act requiring the inclusion of a note in the consolidated financial statements containing the following supplementary information about the parent entity:

- current and total assets;
- current and total liabilities;
- shareholders' equity, showing separately issued capital and reserves;
- profit or loss;
- details of any guarantees entered into by the parent entity in relation to the debts of its subsidiaries;
- details of any contingent liabilities; and
- details of its capital commitments.

Comparison of key features of new law and current law

New law	***Current law***
Under the new law, an entity would be required to prepare financial statements either: in relation to itself (if the accounting standards did not require the preparation of consolidated financial statements); or in relation to the consolidated entity (if the preparation of such statements is required by the accounting standards). Where the entity is required to prepare financial statements in relation to the consolidated entity, the Corporations Regulations will specify supplementary information about the parent entity that is to be included in a note to the consolidated financial statements.	Under the current law, an entity is required to prepare a financial statement in relation to itself. In addition, where an entity is a parent entity it is required to prepare financial statements in relation to the consolidated entity if the preparation of such statements is required by the accounting standards.

Detailed explanation of new law

2.7 Subsection 295(2) will be replaced by a new provision that provides that the financial statements of the entity for the year are either the financial statements in relation to the entity or, where the accounting standards require the preparation of financial statements in relation to the consolidated entity, the financial statements in relation to the consolidated entity.

2.8 An equivalent amendment will be made to subsection 303(2) in respect of the half-year financial statements of a disclosing entity. ***[Schedule 1, Part 1, items 17 and 31]***

2.9 In addition, regulations made for the purposes of paragraphs 295(3)(a) and 303(3)(a) will specify supplementary information about the parent entity to be included in the notes to the financial statements for the consolidated entity prepared under proposed paragraphs 295(2)(b) and 303(2)(b).

Application and transitional provisions

2.10 Proposed subsection 1500(5) provides that the proposed amendment to subsection 295(2) will apply to a financial report of an entity for financial years of the entity ending on or after 30 June 2010.

2.11 Similarly, proposed subsection 1500(8) provides that the proposed amendment to subsection 303(2) will apply to a financial report of a disclosing entity for half-years of the disclosing entity ending on or after 30 June 2010.

2.12 Proposed subsections 1500(4) and (7) are savings provisions that provide that the substitution of subsections 295(2) and 303(2) respectively do not affect the operation of the accounting standards made for the purposes of those subsections. ***[Schedule 1, Part 2, item 55]***

Chapter 3
Requirements for paying dividends

Context of amendments

3.1 Currently, section 254T of the Corporations Act provides that a dividend may only be paid out of company profits. This is commonly referred to as the 'profits test'.

3.2 Industry has raised the following concerns with the profits test:

- the Corporations Act does not provide guidance about, or a definition of, the term 'profits'. In addition, the legal precedents on this issue are outdated and complex and not in line with current accounting principles. This makes it difficult for directors to understand the legal requirements when paying dividends;
- the nature of accounting principles for the calculation of profits has changed over time. Australian accounting standards, particularly following the adoption of International Financial Reporting Standards (IFRS), are increasingly linked to the fair value (whether realised or unrealised) impacting on the profitability of the company. This makes the profitability of Australian companies increasingly volatile with a large number of non-cash expenses being included in the net result. In these circumstances a company may have sufficient cash to pay a dividend to shareholders but is unable to do so because the accounting profits of the company have been eliminated by non-cash expenses; and
- the requirement for companies to pay dividends only out of profits is inconsistent with the trend to lessen the capital maintenance doctrine in Australia.

3.3 In 2002, the Australian Accounting Research Foundation released a discussion paper recommending that Australia move away from the current profits test.

Summary of new law

3.4 The profits test will be repealed and replaced with a more flexible requirement that allows a company to pay dividends if:

- the company's assets exceed its liabilities and the excess is sufficient for the payment of the dividend;
- it is fair and reasonable to the company's shareholders as a whole;
- it does not materially prejudice the company's ability to pay its creditors.
  - Where the payment results in the company becoming insolvent, it will clearly prejudice the company's ability to pay its creditors.

[Schedule 1, Part 1, item 7, section 254T]

3.5 The existing directors' duty to prevent insolvent trading in section 588G of the Corporations Act will continue to apply.

3.6 See 'detailed explanation of new law' below for an overview of the taxation issues relating to this proposal.

Comparison of key features of new law and current law

New law	*Current law*
A company may pay a dividend if: • the company's assets exceed its liabilities and the excess is sufficient for the payment of the dividend; • it is fair and reasonable to the company's shareholders as a whole; and • it does not materially prejudice the company's ability to pay its creditors. The existing directors' duty to prevent insolvent trading in section 588G will continue to apply.	A company may pay a dividend only from profit. In addition, section 588G sets out the directors' duty to prevent insolvent trading.

Detailed explanation of new law

3.7 The first limb of the new test establishes an important safeguard by requiring companies to have sufficient assets in excess of their liabilities in order to pay the dividend. This is similar to the balance sheet tests currently in operation in New Zealand and Canada.

3.8 The second and third limbs of the new test align with the requirements imposed on companies in relation to conducting share capital reductions and share buy-backs under Part 2J of the Corporations Act.

3.9 The new test is designed to ensure that creditors and shareholders who are not entitled to dividends are sufficiently protected.

3.10 In addition to the limbs outlined above, companies may also be subject to additional regulatory requirements. For example, prudentially regulated entities must comply with regulatory requirements governing the payment of a dividend or reduction in capital. The proposal outlined above will in no way impact upon these requirements.

Taxation issues

3.11 This proposal will allow companies to pay dividends to shareholders that include share capital. However, the ‘share capital’ concept will remain in the Corporations Act for other purposes, such as the provisions dealing with share buy-backs in Part 2J of the Act.

3.12 Under the income tax law, a central feature is that, to the extent that a company makes a distribution out of profits, that distribution is generally taxed as a dividend (and can usually have franking credits attached to it). Otherwise, the distribution is generally treated as a tax deferred return of capital. A number of integrity provisions in the income tax law reinforce this principle. While the definition of a ‘dividend’ under the income tax law is broadly consistent with the current Corporations Act definition, it is already the case that in some cases a distribution that is treated as a dividend for taxation purposes may not be a dividend under the Corporations Act.

3.13 In this context, it is envisaged that minor consequential amendments may be required to the income tax law to ensure that there is no change in taxing arrangements as a result of this reform (for example, to ensure that companies cannot attach franking credits where the dividend is from a source other than profit). Interested parties are encouraged to comment on this issue.

Companies not required to prepare an audited financial report

3.14 If a company is not required to prepare an audited financial report (for example, because it is a small proprietary company), then the first component of the test which requires the company to be balance sheet solvent can be determined by reference to the accounting records which are required to be kept under section 286 of the Corporations Act.

Consequential amendments

3.15 Consequential amendments to other provisions that currently refer to profits are made to Part 1.5 of the Corporations Act and other statutes such as the *Medibank Private Sale Act 2006* and the *Financial Sector (Business Transfer and Group Restructure) Act 1999*. ***[Schedule 1, Part 1, items 5, 52 to 54]***

3.16 As noted above, consequential amendments to the income tax law may be required to ensure that there is no change to taxing arrangements as a result of this proposed amendment (for example, to ensure that companies cannot attach franking credits where the dividend is from a source other than profit). Interested parties are encouraged to comment on this issue.

3.17 Importantly, the share capital concept will remain in the Corporations Act for other purposes, such as the provisions dealing with share buy-backs in Part 2J of the Act.

Chapter 4
Changing reporting periods

Context of amendments

4.1 In Australia, close to 33,000 companies, registered schemes and disclosing entities (entities) have financial reporting obligations as outlined in Chapter 2M of the Corporations Act.

4.2 Under section 323D of the Act, a financial year is 12 months long (plus or minus seven days). The balance date can normally only be changed by up to seven days each year to accommodate entities with week-based internal reporting. The restrictions on changing financial years were introduced by the *Company Law Review Act 1988*, which came into effect on 1 July 1998.

4.3 The existing arrangements in Australia make it difficult for entities to change their year-end date for reasons other than those contained in the Corporations Act – generally, to synchronise the financial years of an entity and its controlled entities to facilitate the preparation of consolidated financial statements. In this regard, the Australian requirements are more stringent than the requirements of comparable jurisdictions.

Summary of new law

4.4 It is proposed that section 323D be amended to allow a financial year of an entity subsequent to the first year to last for a period other than 12 months provided that the period is not longer than 18 months, there has not been a period during the last five financial years in which there was a financial year of other than 12 months, and the change to the subsequent financial year is made in good faith in the best interests of the entity.

Comparison of key features of new law and current law

New law	***Current law***
The amended law will retain the existing requirements.	Under the current law, the financial year of an entity is to be 12 months long (plus or minus seven days). An entity that is required to prepare consolidated financial statements is to ensure that the financial years of its consolidated entities are synchronised with its own financial year.
Under the amended law, an entity will be permitted to vary the length of a financial year subsequent to its first financial year provided that: the financial year is not longer than 18 months, the previous five financial years have all been of 12 months duration, and the change in the length of the subsequent financial year is made in good faith in the best interests of the entity.	There is no equivalent provision in the current law.

Detailed explanation of new law

4.5 The Bill provides for the insertion of a proposed subsection 323D(2A) which provides a more flexible regime for changing an entity's financial year. Subsection 323D(2) will also be amended to provide a cross-reference to proposed subsection 323D(2A). ***[Schedule 1, Part 1, items 44 and 45]***

4.6 Proposed subsection 323D(2A) provides that a subsequent financial year of an entity may last for a period other than 12 months provided the following requirements are satisfied:

- the financial year commences at the end of the previous financial year and it not longer than 18 months;
- during the previous five financial years each financial year has been of 12 months duration; and
- the change in length of the subsequent financial year is made in good faith in the best interests of the entity.

Application and transitional provisions

4.7 Proposed subsection 1500(10) provides that the proposed amendments to section 323D apply where the previous financial year of the entity ends on or after 30 June 2010 (that is, the amendments apply to subsequent financial years commencing on or after 1 July 2010). ***[Schedule 1, Part 2, item 55]***

Chapter 5
Extending section 299A of the Corporations Act

Context of amendments

5.1 Under section 299A of the Corporations Act, a listed public company is required to provide, in its director's report, all information reasonably required to allow an informed assessment of its operations, financial conditional and business strategies and prospects for future financial years. Guidance on this requirement refers to it as a review of operations and financial condition.

5.2 The requirement for companies to disclose a review of operations and financial condition was introduced as a result of the recommendations of the HIH Royal Commission. The rationale for its introduction was to address a lack of contextual information which explained the results set out in a company's financial statements. Accordingly, the review of operations and financial condition was introduced to provide stakeholders with an overview which would enable users to understand a business' performance and the factors underlying its results and financial position.

5.3 Extending the application of section 299A to all listed entities was a recommendation of the Corporations and Markets Advisory Committee (CAMAC)'s 2006 report *The social responsibility of corporations*.

Summary of new law

5.4 All listed entities, that is both listed registered schemes and listed companies will be required to report under section 299A.

Comparison of key features of new law and current law

New law	*Current law*
All listed entities will be required to report under section 299A.	Only listed public companies are required to report under section 299A. Listed registered schemes are not.

Detailed explanation of new law

5.5 The Bill amends subsection 299A(1) and paragraph 299A(2)(a) to provide that listed registered schemes, in addition to listed companies, are required to disclose the information that members would reasonably require to make an informed assessment of the operations, financial position and business strategies and prospects for future financial years of the entity reported on. ***[Schedule 1, Part 1, items 24 and 27]***

5.6 The Bill amends paragraphs 299A(1)(b)(c) to make the phrasing consistent with that which is used paragraph 299A(1)(a) and subsection 299A(2) with respect to using the term ‘entity reported on’ rather than the term entity. ***[Schedule 1, Part 1, items 25 and 26]***

5.7 The Bill amends subsection 299(3) to provide that listed registered schemes, in addition to listed companies, may omit material that would otherwise need to be disclosed under paragraph 299A(1)(c) if it is likely to result in unreasonable prejudice to the listed registered scheme or listed company or if consolidated financial statements are required, the consolidated entity or entity (including the company, registered scheme or disclosing entity) that is part of the consolidated entity. ***[Schedule 1, Part 1, item 28]***

Chapter 6
Solicitors' representation letters

Context of amendments

6.1 In preparing their financial statements, entities are required to make provisions for, or disclose in the notes, probable or possible liabilities in accordance with Accounting Standard AASB 137 Provisions, Contingent Liabilities and Contingent Assets. Such disclosure should include liabilities which may arise from pending or current litigation. In auditing this information, auditors are required to obtain appropriate audit evidence of the director's assessments of any litigation, by obtaining a solicitor's representation letter from the entity's lawyers.

6.2 The solicitor's representation letter requests the entity's lawyers to confirm, among other things, whether the director's view of the description and estimates of the amounts of financial settlement which might arise in the litigation are reasonable. Auditing Standard ASA 508 Enquiry Regarding Litigation and Claims provides that the auditor must request management to obtain the solicitor's representation letter from the entity's lawyers, with a request that the lawyers respond directly to the auditor. The solicitor's representation letter must be sent from the lawyer directly to the auditor to maintain the integrity and independence of the lawyer's corroboration.

The Westpac Decision

6.3 In September 2005, the NSW Court of Appeal in *Westpac Banking Corporation v 789 Ten Pty Ltd* [2005] NSWCA 321 held that solicitor's representation letters are not subject to legal professional privilege because they do not satisfy the 'dominant purpose' test in sections 118 and 119 of the *Evidence Act 1995 (Cth)*. That is, the solicitor's representation letter is not prepared for the dominant purpose of providing legal advice to a client, or for an anticipated or pending proceeding, rather, it is prepared for the purpose of conducting an audit.

6.4 In the first instance, the judgment explored whether this issue could be resolved by the lawyer providing the letter directly to the client, who would then provide it to the auditor. However, on appeal, the court held that the communication would not be privileged even if the lawyer or the client provided the communication to the auditor. In any event, if this information is not independently communicated by the lawyer directly to

the auditor, it would significantly diminish the reliability of the audit evidence.

6.5 The Westpac judgment noted that 'there is obviously a problem which may require legislative intervention…for instance, by amendment to the Evidence Act or the Corporations Act…'. The decision is authoritative, as the High Court refused special leave to appeal the decision in December 2005.

Implications of the Westpac decision

6.6 The audit function represents the principal external check on the integrity of financial statements. The obligation to advise auditors of all contingent liabilities is an essential requirement to ensure auditors are aware of all matters relevant to an entity's financial position, and are in a position to corroborate management's assertions concerning contingent liabilities. However, as a result of the Westpac decision, entities may be exposed to further liability by granting their opponent a strategic advantage in the legal proceedings.

6.7 Entities that do not request their solicitors to prepare a solicitor's representation letter may receive a qualified audit opinion if the auditor believes there is insufficient audit evidence to verify the contingent liabilities. Alternatively, an auditor may limit the scope of the audit to exclude an audit of any potential liabilities arising from litigation.

6.8 The solicitor's representation letter may contain sensitive information that is not already disclosed in the financial report. Potential liabilities arising from legal proceedings may be aggregated into a single class in the financial report, so that the amount reported in the financial report may not be discernable to any particular proceedings. In addition, an entity is not required to disclose in its financial report information required by AASB 137 if it could be expected to prejudice seriously the position of the entity in a dispute with other parties. In such cases, an entity must disclose the general nature of the dispute and explain why the information has not been disclosed. In confirming whether the director's view on the description and financial estimates of the legal matter are reasonable, a lawyer may need to reveal the contents of sensitive legal advice or legal opinions in the solicitor's representation letter, which are unlikely to have been disclosed in the entity's financial report, and therefore, would not be publicly available.

6.9 As a result, entities may be placed at a disadvantage in current or pending litigation if they are required to disclose the directors' view of the entity's prospects in the litigation, and the view of its solicitors, without such correspondence being protected from disclosure. If solicitors'

representation letters were protected from disclosure, lawyers would be able to provide full and frank advice in the solicitor's representation letter without prejudicing their client's prospects of success in the litigation, or their ability to negotiate a settlement.

Summary of new law

6.10 Solicitors' representation letters and associated communications will be protected from disclosure to another person or to a court.

6.11 Exceptions exist to ensure that the ASIC, the APRA and the Companies Auditors and Liquidators Board (CALDB) can continue to access these communications for the purpose of performing their functions.

Comparison of key features of new law and current law

New law	***Current law***
Solicitors' representation letters are protected from disclosure to another person or to a court. Exceptions exist to ensure that the ASIC, APRA and CALDB can continue to access these communications for the purpose of performing their functions.	Solicitors' representation letters are not protected by client legal privilege.

Detailed explanation of new law

6.12 Under the new law, a person is not required to produce or disclose to another person or to a court information relating to the contingent liabilities for an entity in relation to an Australian or overseas proceeding, or an anticipated or pending Australian or overseas proceeding, which was disclosed or obtained in connection with an audit or review of the entity's financial report.

6.13 Exceptions exist where disclosure of the information is necessary to give effect to the Corporations Act, the *Australian Prudential Regulation Authority Act 1998* or the *Australian Securities and Investments Commission Act 2001* (ASIC Act). This will ensure that ASIC, APRA and CALDB would be permitted to access these communications for the purpose of performing their functions.

6.14 Section 127 of the ASIC Act, which sets out circumstances where the disclosure of information by ASIC is authorised, will not be affected by this amendment.

6.15 Similarly, section 213 of the ASIC Act, which sets out circumstances where the disclosure of information by CALDB is authorised, will not be affected by this amendment.

Chapter 7
IFRS declaration

Context of amendments

7.1 Some feedback from foreign jurisdictions has suggested there is a lack of awareness that the financial statements of Australian companies and other reporting entities are compliant with IFRS made by the International Accounting Standards Board (IASB). In particular, as accounting standards in Australia are commonly referred to as 'Australian-equivalent International Financial Reporting Standards (AIFRS)', there is a perception that they are not identical to IFRS.

7.2 Lack of international recognition of Australia's IFRS adoption prevents Australia from realising the full benefits of IFRS in relation to the facilitation of foreign investment.

7.3 Companies are already required by the accounting standards to make a statement of IFRS compliance in the notes to their financial statements. Auditing standards also require auditors to make a declaration of IFRS compliance in the audit report. However, there is no corresponding requirement in the directors' declaration and this may create some confusion.

Summary of new law

7.4 The directors' declaration in a company's annual report must include a statement of whether, in the directors opinion, the company's financial statements and the notes to its financial statement are prepared in compliance with IFRS as made by the IASB.

Comparison of key features of new law and current law

New law	*Current law*
Under the new law, the directors' declaration in a company's annual report will have to include a statement of whether, in the directors opinion, the company's financial statements and the notes to its financial statement are prepared in compliance with IFRS as made by the IASB.	Under the current law, no such declaration is required. However, companies are required by accounting standards to make a statement of IFRS compliance in the notes to their financial statements. Auditing standards also require auditors to make a declaration of IFRS compliance in the audit report.

Detailed explanation of new law

7.5 The Bill requires that a new paragraph, 295(4)(ca) be inserted to require the directors declaration to include a statement of whether, in the directors' opinion, the financial statements and notes are in accordance with the IFRS issued by the IASB. ***[Schedule 1, Part 1, Item 18]***

7.6 Subsection 295(1) of the Act provides that a company's financial report for a financial year includes the directors declaration about the statements and notes. The details required in the directors' declaration are provided under subsection 295(4).

7.7 The purpose of this amendment is to ensure international recognition of Australia's adoption of IFRS. This will also create consistency between the auditor's report, directors' declaration and the notes to the financial statements.

Chapter 8
Lost capital reductions

Context of amendments

8.1 Under section 258F of the Corporations Act, companies are allowed to cancel paid-up capital that is lost or not represented by available assets of the company. The provision is intended to allow companies to write down the value of the company's capital in situations where a company incurs certain types of losses. This is done by writing-off past accumulated losses against the share capital of the company.

8.2 However, concerns have been expressed that companies may be able to use section 258F to overstate the profitability of the company by taking expenses directly to share capital rather than recognising them in the statement of financial performance. Such action would be in breach of Australian accounting standards.

Summary of new law

8.3 It is proposed that section 258F be amended to make it clear that a company can only cancel share capital in circumstances where it is not inconsistent with the requirements in Australian accounting standards. The proposed amendment will still allow companies to write off accumulated losses to share capital but will not allow companies to take expenses directly to share capital.

8.4 The proposed amendment is of a technical nature and is designed to clarify the manner in which section 258F is intended to operate.

Comparison of key features of new law and current law

New law	***Current law***
Under the new law, a company may not reduce its share capital by cancelling any paid-up capital that is lost or not represented by available assets if the cancellation is inconsistent with the requirements of any accounting standard.	Under the current law, a company may reduce its share capital by cancelling any paid-up capital that is lost or not represented by available assets.

Detailed explanation of new law

8.5 The Bill provides for section 258F to be recast, with a proposed paragraph 258F(2)(b) providing that a company's ability to reduce its share capital by cancelling any paid-up share capital that is lost or is not represented by available assets will not apply if the cancellation is inconsistent with the requirements of any accounting standard. ***[Schedule 1, Part 1, items 8, 9 and 10]***

Application and transitional provisions

8.6 Proposed subsection 1500(3) provides that the proposed amendments to section 258F apply in relation to the cancellations of paid-up share capital that occur on or after the commencement of items 8, 9 and 10 of Schedule 1. ***[Schedule 1, Part 2, item 55]***

Chapter 9
FRC functions and funding

Context of amendments

9.1 Prior to the enactment of the *Governance Review Implementation (AASB and AUASB) Act 2008* (GRI Act), the AASB and the AUASB were statutory bodies governed by the CAC Act. The GRI Act has transferred the AASB and the AUASB from the CAC Act to the *Financial Management and Accountability Act 1997* (FMA Act) framework.

9.2 As a consequence of the enactment of the GRI Act, the specific accounting and auditing standards functions given to the Financial Reporting Council (FRC) under paragraphs 225(2)(i) and (j) and 225A(2)(i) and (j) of the ASIC Act are now obsolete and unnecessary. These provisions require the FRC to:

- seek contributions towards the costs of the Australian accounting standard and auditing standard setting processes; and
- monitor the level of funding, and the funding arrangements, for those processes.

Summary of new law

9.3 The Bill repeals paragraphs 225(2)(i) and (j) and 225(2A)(2)(i) and (j) of the ASIC Act.

Comparison of key features of new law and current law

New law	*Current law*
Paragraphs 225(2)(i) and (j) and 225(2A)(i) and (j) will be repealed.	Paragraphs 225(2)(i) and (j) and 225(2A)(i) and (j) set out the FRC's functions in relation to the funding arrangements for the AASB and the AUASB.

Detailed explanation of new law

9.4 Paragraphs 225(2)(i) and (j) and 225(2A)(2)(i) and(j) of the ASIC Act will be repealed as they are no longer necessary or appropriate having regard to the fact that the AASB and the AUASB are now financial management and accountability agencies for purpose of the FMA Act. ***[Schedule 2, Part 1, items 9 to 12]***

Chapter 10
CALDB processes

Context of amendments

10.1 The CALDB is a disciplinary body which receives and reviews applications made to it by the ASIC or the Australian Prudential Regulation Authority (APRA) in respect of the conduct of either registered company auditors or liquidators.

10.2 Membership of the CALDB consists of:

- a Chairperson and a Deputy Chairperson, each of whom must be enrolled as a barrister and/or a solicitor or a legal practitioner in Australia;
- three members selected from a panel of seven nominated by the Board of the ICAA;
- three members selected from a panel of seven nominated by the Board of CPA Australia (CPAA); and
- six business members. Business members need not be nominated by any particular body. The Minister must be satisfied that a business representative has knowledge or qualifications in a business or law-related discipline.

10.3 However, there are problems with this approach. There are three professional accounting bodies in Australia, the ICAA, CPAA and the NIA. Additionally, there is also a recognised professional body representing insolvency practitioners, the Insolvency Practitioners Association of Australia (IPAA). Under the current framework, the NIA and other professional and interested parties are unable to nominate members for CALDB.

10.4 Under section 221 of the ASIC Act, immunity consistent with that of a Justice of the High Court is conferred on Panel Members of the CALDB when exercising powers in relation to a hearing. Witness and legal and other representatives receive immunity equivalent to that which they would receive in appearing before the High Court.

10.5 However, section 1294A of the Corporations Act also allows the Chairperson and Deputy Chairperson to conduct pre-conference hearings. This was introduced to streamline the hearing process.

10.6 Under the current framework, the immunity under section 221 of the ASIC Act is not available for pre-conference hearings conducted by the Chairperson of the CALDB. It is only available if the full Panel conducts the pre-conference hearing.

10.7 Given that the protections granted section 221 are already practically available for pre-conference hearings failure to extend these protections to the preconference hearings conducted by just the Chairperson rather than the full Panel appears best characterised as an omission in the legislation.

10.8 The Bill introduces amendments to the ASIC Act to improve both the membership process and pre-conference hearing immunities for the CALDB. These modifications will provide efficiency in the functioning of the CALDB.

Summary of new law

10.9 The Bill modifies the membership requirements of the CALDB by repealing the requirement for three members to be selected from a panel of seven nominated by the Board of the ICAA and for three members to be selected from a panel of seven nominated by the Board of the CPAA. Under the new arrangements, the Minister appoints six members as accounting members of the CALDB.

10.10 The new arrangements will not apply retrospectively to existing members of the CALDB. The new arrangements will apply to members appointed once the provisions commences.

10.11 In addition, the Bill extends the protection and immunities provisions in section 211 of the ASIC Act to include a conference convened by the Chairperson of the CALDB.

10.12 This arrangement will apply both retrospectively and on or after the commencement of the provisions.

Comparison of key features of new law and current law

New law	*Current law*
Six members selected by the Minister who are eligible for appointment as accounting members of the CALDB.	Three members to be selected from a panel of seven nominated by the Board of the ICAA and three members to be selected from a panel of seven nominated by the Board of CPAA.
Immunity under section 221 of the ASIC Act is extended to include pre-conference hearings convened by the Chairperson of the CALDB.	Immunity under section 221 of the ASIC Act is not available for pre-conference hearings conducted by the Chairperson or Deputy Chairperson

Detailed explanation of new law

Definitions

10.13 The Bill repeals some terms used in Schedule 2. ***[Schedule 2, Part 1, items 1 and 2]***

Modifying the membership requirements

10.14 Section 203 of the ASIC Act prescribed the membership conditions of the CALDB. The Bill repeals the existing requirements for the appointment of ICAA and CPAA members and introduces a new provision for the Minister to select 6 members who are eligible for appointment as accounting members of the CALDB ***[Schedule 2, Part 1, items 3 and 4, paragraphs 203(1)(c) and (d), subsection 203(1A)].*** The new arrangement will mean that accounting members are appointed to the CALDB in the same manner in which business members are appointed.

10.15 The Bill sets out the conditions that must be met for a person to be eligible for appointment as an accounting member in subsection 203(1B) ***[Schedule 2, Part 1, item 5, subsection 203(1B)].*** This includes a person who is a resident of Australia and a member of a professional accounting body. The ICAA, CPAA and NIA are taken to be professional accounting bodies in Australia.

10.16 Additionally, the Bill contains a regulation making power to create regulations which prescribe bodies to which a person can be a member of and considered eligible for appointment as an accounting member ***[Schedule 2, Part 1, item 5, subparagraph 203(1B)(b)(ii)].*** This is to ensure

that all relevant professional bodies, for example, the IPAA, are able nominate members for appointment to the CALDB.

10.17 Consequential changes to existing references to ICAA member and CPAA member are made in this Bill. ***[Schedule 2, Part 1, item 6, subsection 210A(5)]***

Protection and immunity for pre-conference hearings

10.18 Section 221 of the ASIC Act confers immunity consistent with that of a Justice of the High Court onto Panel Members of the CALDB when exercising powers in relation to a hearing. Also, witness and legal and other representatives receive immunity equivalent to that which they would receive in appearing before the High Court.

10.19 The Bill extends the scope of the provisions to apply to pre-conference hearings convened by the Chairperson of the CALDB under section 1294A of the Corporations Act ***[Schedule 2, Part 1, item 7, subsection 221(1)]***. This arrangement will make the legislation more complete as the current immunity relies on a full Panel conducting a pre-conference hearing rather than just the Chairperson.

10.20 Consequential changes to section 221(2) are made as a result of the new arrangements in subsection 221(1). ***[Schedule 2, Part 1, item 8, subsection 221(2)]***.

Application and transitional provisions

10.21 Schedule 2, part 2 of the Bill prescribes the application, saving and transitional provisions relevant to the new arrangements. ***[Schedule 2, Part 1, item 13]***

10.22 The Bill defines several terms used in Schedule 2, Part 2. ***[Schedule 2, Part 1, item 13, section 289]***

Application of membership amendments

10.23 The new membership arrangements will not apply retrospectively to existing members of the CALDB. Rather, the Bill provides for a transition period whereby a member appointed after the commencement of the new provisions must be eligible as an accounting member. At the same time, however, persons already appointed as ICAA or CPAA members prior to the commencement of the new provisions continues to hold the position for the remainder of their term. ***[Schedule 2, Part 1, item 13, section 290]***

Application of pre-conference amendments

10.24 The provisions extending immunity to pre-conference hearings convened by the Chairperson of the CALDB will apply to conferences conducted before, on or after the commencement. ***[Schedule 2, Part 1, item 13, section 291]***

10.25 This arrangement will apply retrospectively to ensure that the protections and immunities available for the Chairperson, witness and legal and other representatives cover any conferences that have been convened prior to the commencement of the provisions.