ORGANISATION

Financial reporting requirements

The *Corporations Act 2001* (Cth) (Act) sets out statutory requirements for financial reporting. The main requirements are to:

- maintain financial records (s 286);
- prepare an annual financial report and a directors' report (s 292);
- have the financial report audited (s 301);
- send the financial report, directors' report and auditor's report to members (ss 314 – 315);
- lodge those documents with ASIC (ASX where appropriate) (ss 319 – 322);
- lay those documents before the annual general meeting (s 317);
- prepare a half-year financial report and directors' report (ss 302 – 306);
- have the half-year financial report audited or reviewed by the auditor (s 309);
- lodge the half-year report and auditor's report with ASIC (ASX where appropriate) (s 320).

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Financial records

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The nature and form of records will vary from company to company but the Australian Securities and Investments Commission (ASIC) has suggested that the basic financial records that accountants will expect a company to keep include:

- financial statements: financial performance (profit and loss), financial position (balance sheet), cash flows, taxation returns, depreciation schedules;
- general ledger;
- general journal;
- assets register;
- computer backup;
- cash records–cash receipts journal, cash deposit books, cash payments journal, cheque butts, petty cash books;
- bank account statements, bank reconciliations and bank loan documents;
- sales/debtor records: sales journal, debtors ledger, list of debtors, invoices and statements issued, delivery dockets;

- work in progress records;
- job/customer files;
- stock listings;
- creditors records: invoices and statements received and paid, creditors ledger, unpaid invoices;
- correspondence, annual returns and ASIC forms;
- wages and superannuation records;
- registers: members, options, debenture holders, prescribed interests;
- minutes: directors and/or members meetings;
- deeds: trust, debentures, contracts and agreements, inter-company transactions.

Who has to prepare financial reports?

All companies must keep appropriate and adequate financial records (s 286) but only some need to produce a financial report. Financial reports and directors' reports must be prepared for each financial year by:

- all disclosing entities incorporated or formed in Australia;
- all public companies, except small companies limited by guarantee, unless directed to do so under s 294A or s 294B;
- all large proprietary companies – according to s 45A, a large proprietary company is defined as meeting two out of three of the following criteria:
  - consolidated gross operating revenue of more than $50 million; and/or
  - consolidated gross assets of over $25 million; and/or
  - more than 100 employees;
- all registered schemes (s 292).

Financial reports must comply with accounting standards and regulations (s 296), however there are some exceptions for small proprietary companies and small companies limited by guarantee where there are specific member or shareholder directions (s 296 (1A) and s 296 (1B)).

For an examination of the financial literacy directors need to have in order to implement sound financial governance practices, refer to Dianne Azoor Hughes' *Financial Fundamentals for Directors*.[1]

What are the key documents?

- financial report for a financial year, consisting of financial statements for the year and notes to the financial statements;
- directors' declaration that there are reasonable grounds to believe that the company is solvent and that the financial statements and notes comply with the accounting standards and give a true and fair view;
- directors' report for a financial year;
- auditor's report on the company's financial report for a financial year;
- auditor's independence declaration;
- half-year report where required;
- auditor's audit report or review of the half-year report;
- half-year financial reports only need be prepared by disclosing entities (s 302).

Small proprietary companies must produce financial reports only if:

- they are controlled by a foreign company for all or part of the accounting period and their profit or loss for the period is not covered by accounts of the foreign company lodged with ASIC (s 292(2));
- it has one or more crowd-sourced funding (CSF) shareholders;
- shareholders holding five per cent or more of the voting shares in the company give it a direction to prepare financial statements and reports no later than 12 months after the end of the financial year concerned (s 293);
- ASIC gives a direction that financial statements be prepared (s 294).

1. D Azoor Hughes, 2019, *Financial Fundamentals for Directors*, 2nd edition, AICD.

Small companies limited by guarantee must only produce financial reports if:

- members with at least five per cent of the votes in the company give a direction to prepare financial reports, and send them to members who have elected to receive them no later than 12 months after the end of the financial year concerned (s 294A);
- ASIC or a member gives a direction that financial statements be prepared (s 294B).

What are the financial statements?

Australian accounting standards require companies to prepare statements of profit and loss and comprehensive income, financial position (formerly balance sheet), cash flows and changes in equity. These are collectively referred to as 'financial statements'.

The statement of profit and loss and comprehensive income may be in a single statement or set out in two separate statements. The statement of profit and loss summarises revenue generated and expenses (including tax expenses) incurred during the financial year. The statement of comprehensive income shows a more complete view of the company's performance, reflecting the change in equity of the company from transactions other than the effects of changing ownership interests, incorporating unrealised gains and losses due to changes in values during the period.

The statement of financial position shows assets, liabilities and shareholder equity (equivalent to net assets) at a certain date. Assets and liabilities may be split into current and non-current, (referring to those which in the normal course of events would be converted to cash/payable within the next twelve months and those longer-term assets/liabilities) or in order of liquidity where presentation as such is more reliable and relevant. Details of specific types of assets and liabilities are contained in the notes.

The statement of changes in equity reports all changes to equity (including shareholder capital, reserves and retained profits) during the reporting period including changes as a result of owners acting in their capacity as owners (share issue, dividends) and total comprehensive income (net profit after tax and other comprehensive income income).

The statement of cash flows shows historical cash in and out over the financial year under the three broad categories of operating, investing and financing activities. They help provide an indication of the company's ability to pay its debts as and when they fall due, so is important when considering solvency.

The notes to the financial statements are often overlooked but are important when reading and understanding the four key statements above. They include specific detail on the basis on which the financial reports have been prepared, the accounting policies which have been applied and assumptions that have been made in the preparation of the accounts. Any changes to accounting policies and new accounting standards which have been applied are included in the notes.

What is contained in the directors' report?

The directors' report contains information, as outlined in ss 299 and 300, including:

- review of operations;
- significant changes in the state of affairs;
- principal activities and any significant changes to them;
- new matters which will or might significantly affect future operations wand therefore financial performance;
- likely future developments;
- dividends paid during the year plus those recommended or declared but not yet paid;
- the name of each director and the period for which they were a director, the names of other company officers or partners in the firm which audits the company;
- information on options and unissued shares;
- indemnities and insurance premiums paid for officers and auditors;
- operations subject to environmental regulations (only applicable to some companies).

There are differing requirements for the contents of the directors' report depending on the entity type, with the Act separating requirements for public companies, listed companies (s 300A) and companies limited by guarantee (s 300B).

Public companies must include in their directors' report:

- the name of each director, their qualifications, experience and special responsibilities;
- each director's attendance of board and board committee meetings;
- name of other officers and auditors plus the qualifications and experience of the company secretary.

There are also further special rules for listed companies as to information that must be included:

- the relevant interests of each director in shares, debentures, rights and options in the company plus any contracts with the company which will benefit them;
- all other directorships held by a serving director within the last three years;
- amounts paid or payable to the auditor for non-audit services provided during the year by the auditor;
- a statement as to whether the directors are satisfied that the provision of non-audit services is compatible with the general standard of independence for auditors imposed by the act and the directors' reasons for being satisfied;
- compliance with general standards of auditor independence;
- the auditor's declaration (s 307c) that there have been no contraventions of their independence requirements or codes of professional conduct in relation to the audit or the review;
- any additional information needed to give a true and fair view and to include reasons for sharing this information and where it can be found in the accounts;
- a discussion of board policies for the nature and amount of remuneration paid to directors, the company secretary and senior managers;
- a discussion of the relationship between this policy and the company's performance;
- a discussion of performance hurdles which directors, the company secretary and senior managers must attain for remuneration purposes;
- remuneration of each member of the key management personnel and details of certain elements of remuneration;
- details of AGM comments on the remuneration report and any associated resolution
- details of consultants who provided remuneration recommendations.

The additional general requirements for listed companies (s 299A) including any information that members need to make an informed assessment of the operations, financial position, business strategy and future prospects. This is the operating and financial review (OFR) and is sometimes referred to as 'management discussion and analysis' or 'management commentary'.

ASIC's Regulatory Guide 247 *Effective disclosure in an operating and financial review* provides guidance in relation to the following specific content:

- operations, financial position, and business strategies and prospects for future financial years;
- use of the unreasonable prejudice exemption;
- presentation of analysis and narrative;
- integrated reporting.

What are the half-year financial report requirements?

Only disclosing entities have to prepare a half-yearly report (s 302). A disclosing entity must:

- Prepare a financial report and directors' report for each half-year;
- Have the financial report audited or reviewed and obtain an auditor's report;
- Lodge the financial report, the directors' report and the auditor's report with ASIC.

These obligations do not apply if the company is not a disclosing entity when lodgement is due. Lodgement is due within 75 days after the end of the half-year (s 320). Half-year financial statements must comply with accounting standards and regulations (s 304).

What is a director's responsibility in approving financial statements?

Directors' declaration

The directors' declaration is a declaration by the directors:

- whether, in the directors' opinion, there are reasonable grounds to believe that the company will be able to pay its debts as and when they become due and payable;
- whether, in the directors' opinion, the financial statements and notes are in accordance with the Act, including compliance with the accounting standards and providing a 'true and fair' view;
- if applicable, the company has included in the notes an explicit and unreserved statement of compliance with international financial reporting standards.

This declaration must be made in accordance with a resolution of the directors, specify the date on which the declaration is made and be signed by a director.

If the company is a listed company, the directors must also declare that they have been given declarations by the chief executive officer and the chief financial officer whether, in that officer's opinion:

- the company's financial records have been properly maintained;
- the company's financial statements and notes for the financial year comply with the accounting standards and give a 'true and fair' view.

The directors' report must be made in accordance with a resolution of the directors. The Act does not specify which particular director has to sign it, just that it be signed by "a director" (s 298(2)(c)).

Considerations for directors in approving financial statements

The directors' approval of financial statements is a core responsibility. The Federal Court in the Centro case (*ASIC v Healey* (2011)) made it clear that directors, in approving financial statements, must bring their own knowledge of the company situation to bear and cannot simply rely on auditors or management. If in doubt about anything in the financial statements, the directors must ask questions.

ASIC Information Sheet 183 *Directors and financial reporting*, states that:

> *You must read, understand and focus on the contents of the financial report. You must apply your own mind to, and carry out a careful review of, the financial report and directors' report, determine that the information they contain is consistent with your knowledge of the company's financial position and affairs, and ensure that material matters known to you, or that should be known to you, are not omitted.*
>
> *In reading the financial report, you should:*
>
> - *ensure, as far as reasonable and possible, that the information included is accurate,*
> - *question the accounting treatments applied, and*
> - *examine the adequacy of disclosures and whether any matters have not been disclosed that should be disclosed*
>
> *When reviewing the financial report, you should inquire further into any matters revealed by that financial report.*

Note the comments of the then ASIC deputy chair Belinda Gibson on this case:[2]

ASIC expects directors to have sufficient knowledge of the basic accounting concepts in a financial statement to enable them to carry out their responsibilities of monitoring and guiding management. If they do not have these skills, they should get them.

In the Centro case, ASIC did not argue directors needed to check the accuracy of figures or the accounting treatment in the company's financial statements. Nor did the Centro judgment decide directors must have knowledge of every accounting practice and accounting standard. However, some common accounting concepts must be grappled with. One is solvency and another is classification of debt as current or otherwise.

Directors must consider relevant information provided to them. They must ensure they have access to board papers and use the information gained in considering all matters put to the board. The Centro decision highlights that directors must review matters against their knowledge of the company, including knowledge obtained from different or earlier board papers.

Directors must be sceptical. ASIC expects board members to ask management questions and to challenge recommendations put to them. They must apply their minds to critically review the information given to them against their knowledge of the company. If the information is not consistent with that knowledge, they must probe management until they are satisfied. It is vital that directors do not uncritically adopt the work of management and advisers on issues of fundamental importance to the company.

Directors are expected to bring their expertise and experience to the board's deliberations on all matters. They cannot abdicate responsibility in areas where they have less expertise than others on the board. However, ASIC accepts that much of a company's activities must necessarily be delegated from the board to management and from management to employees.

Nevertheless, there will be some matters that cannot be delegated. One is where the director's opinion is required. Where an opinion is required by law – as in approving financial reports – directors must apply their own knowledge to the information provided and form their own opinion. This does not exclude relying on others to inform that opinion, but directors must provide the "final filter".

Checklist for approving and adopting the financial report of a public company

The following highlights the takeaway considerations, from *Fifty Matters to be Considered Before Signing a Company's Financial Statements*[3] and the checklist provided by James Lonie's *Approving the financial report*[4] when a preparing, approving and adopting financial reports for a public company.

Has the director:

1. sufficient financial literacy and knowledge of accounting principles and practices?
2. a fundamental understanding of the company's business and how it is reflected in the financial report?
3. ensured that the company's risk and audit structures and processes are appropriate?
4. reasonable grounds to believe the company will be able to pay its debts as and when they become due and payable?
5. not delegated the responsibilities of the financial report beyond the board of directors?
6. read, understood and reviewed the contents of the financial report?
7. determined that the financial report is consistent with their understanding of the business and its financial position and that the financial statements make sense and provide a 'true and fair' view of the financial performance, position and cash flows of the company?

2. B Gibson, 2011, "ASIC Report: What ASIC expects of NEDs", *Company Director*, 1 November, **http://www.companydirectors.com.au/director-resource-centre/publications/company-director-magazine/2011-back-editions/november/asic-report-what-asic-expects-of-neds**, (accessed 18 February 2019).
3. AICD, 2016, *Fifty Matters to be Considered Before Signing a Company's Financial Statements, 3rd edition*, **https://www.companydirectors.com.au/~/media/cd2/resources/Director-Resources/Book-store/pdf/05631-PUB_fifty-matters-book-WEB_FINAL.ashx**, (accessed 18 February 2019).
4. J Lonie, 2013, "Approving the financial report", *Company Director*, February, **http://www.companydirectors.com.au/director-resource-centre/publications/company-director-magazine/2013-back-editions/february/checklist-approving-the-financial-report**, (accessed 18 February 2019).

8. ensured that, as far as possible and reasonable, the information included is accurate?
9. identified any major areas involving a higher degree of subjectivity, discretion and/or judgement, and have these areas been subjected to additional scrutiny and disclosed properly?
10. ensured the report been prepared in compliance with the company's policies and procedures (and able to explain how compliance is ensured)?
11. determined areas of the report requiring a higher degree of subjectivity, discretion, or judgement and given them the appropriate scrutiny required?
12. identified the major government regulations affecting the company's operations, and determined the process that management ensures compliance with these regulations?
13. determined the key accounting standards and accounting policy choices that affect the company?
14. ensured the accounting treatments applied are compliant with the relevant accounting policy and standards?
15. determined the means that the fair value of assets, both current and non-current, will be assessed?
16. examined the adequacy of disclosures and whether there are any material matters known to the director that have been omitted?
17. ensured the independence of the auditor is not compromised in fact or appearance?
18. ensured that the application of the company's accounting systems is adequate?
19. obtained independent expert advice if needed and reflected on the adequacy of their own knowledge and skill?
20. ensured appropriate time to review the report, and additional time to make changes for proper understanding prior to before passing directors' resolutions?

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