Australian Institute of Company Directors

ORGANISATION

What to consider before approving financial statements

Companies have a legal responsibility to keep written financial records and to regularly report to members their financial performance and position. This duty is placed on companies, not directors. Directors, however, in effect represent the company and have a duty of care to ensure that these statements are an accurate representation of the company's financial affairs. In confirmation of this, a director is required to sign a declaration to this effect.

Responsibility for monitoring financial affairs is often delegated to the board's audit committee. The audit committee reviews the financial integrity of the company via effective internal control processes and accounting policies that reduce the risk of irregularities or fraud. Although authority is delegated, the board retains collective responsibility for financial matters. This was emphasised in the Centro case (discussed in a later section of this paper): approving financial statements is a core duty for all directors and one requiring them to apply their overall knowledge of the company's affairs in forming an opinion as to approving financial statements.

Directors must make a declaration in the Directors' Report that the financial statements comply with accounting standards, are true and fair and that the company is solvent. When signing financial statements, directors should keep in mind that they can face civil and criminal penalties for failing in their duties. These penalties may take the form of fines, disqualification or a compensation order. Directors are responsible to take reasonable steps (s 344 of the *Corporations Act 2001*) and those steps will depend upon "the company, the complexity of the company's business, the internal reporting procedures within the company, and the nature of the task the director is obliged to undertake".[1]

1. ASIC v Healey 83 ACSR 484 cited by R Austin and I Ramsay, *Ford, Austin & Ramsay's Principles of Corporations Law*, 17th edition, 2018, LexisNexis Australia, p 898.

Directors can become aware of potential financial issues through:

- their own analysis of financial reports;
- reports of the audit committee and external auditors;
- regular management reports to the board;
- investigations conducted by internal auditors.

Recommendation 2.6 of the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations*[2] suggests that "a listed entity should have a program for inducting new directors and for periodically reviewing whether there is a need for existing directors to undertake professional development to maintain the skills and knowledge needed to perform their role as directors effectively" that reinforces the important relation between directors exercising the governance function effectively and the entity's financial statements.

ASIC Information Sheet 183 Directors and financial reporting (p 2), 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.*

What are the specific questions to ask?

The following checklist is provided in Dianne Azoor Hughes' *Financial Fundamentals for Directors*, 2nd edition:[3]

Nature and purpose of the review

The starting point for any review is to understand the reason why the financial statements have been prepared, and then to confirm that the accounting framework applied in the preparation and presentation of the financial statement is the most appropriate in the circumstances.

1. Why have the financial statements been prepared?
2. Is the company publicly accountable and, if not, who are the major stakeholders who will use the financial information presented in the financial statements?
3. Having identified the major stakeholders, have general purpose or special purpose financial statements been prepared and described as appropriate in the accounting policy notes?
4. What are the major areas involving a higher degree of subjectivity, discretion and/or judgment, and have these areas been subject to additional scrutiny and disclosed properly?

Compliance with accounting standards

Accounting standards have the force of the law and must be followed when preparing statutory financial statements.

5. How has it been confirmed that the requirements of Australian Accounting Standards have been properly applied, including selection of the applicable accounting framework?
6. Have external auditors raised any issues regarding non-compliance with accounting standards?
7. What are the key accounting standards and accounting policy choices that affect the company and how does management ascertain compliance with these standards?
8. Have there been any other major amendments to existing accounting standards, or issues of new accounting standards in the last year that affect the financial statements? If so, how?
9. Could the company's treatment of any accounting issues be reasonably challenged?

2. ASX Corporate Governance Council, 2019, *Corporate Governance Principles and Recommendations*, 4th edition, February, **https://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-fourth-edn.pdf**, (accessed 8 May 2019).
3. D Azoor Hughes, 2019, *Financial Fundamentals for Directors*, 2nd edition, AICD.

Compliance with government regulations

Directors take final responsibility for the company's adherence to the law and government regulations.

10. What are the major government regulations affecting the company's operations? How does management satisfy compliance requirements with these regulations?
11. Have there been any investigations/audits undertaken for compliance with government regulations during the year? If so, what was the outcome?
12. Has any legal action been taken, or threatened, for non-compliance with government regulations and, in particular, environmental or safety regulations?

Listed companies

13. Do disclosure and reporting procedures comply with ASX listing rules?
14. Has senior management (CEO and CFO) provided written assurance in some detail of compliance with accounting standards, proper financial records have been maintained, interpretations, listing requirements, board policies?
15. For internal controls, how have the directors satisfied themselves about adequacy? Consider declaration from and process followed by CEO/CFO, views of internal auditors, and management letter from external auditor.
16. Have all topics/issues/events, which were the subject of continuous disclosure notices during the year, been properly reflected and disclosed in the financial statements? Conversely, with the benefit of hindsight, have all material issues/topics/events reflected in the financial statements been properly announced through continuous disclosure notices?
17. Has there been a proper determination of the segments of business activity so appropriate disclosures can be made?
18. Has the director considered the calculation of earnings per share and diluted earnings per share?
19. Does the statutory directors' report include a remuneration report? What procedures have been followed to satisfy the directors that the remuneration report has been properly compiled?

Preparation of financial statements for non-statutory reasons

Financial statements may be prepared under a different basis of accounting to meet particular requirements under contractual agreements. Directors should ensure that the financial statements presented are prepared under the appropriate basis of accounting.

20. Have the financial statements been prepared in accordance with contractual terms and conditions?
21. Do those terms and conditions refer to the basis of preparation of the financial statements?
22. Is the basis of preparation as described consistent with the basis of preparation disclosed in the accounting policy notes?

Overview of financial results and financial position

The financial statements should provide an explanation of the company's financial performance and financial position. Therefore, at the start of the review, directors should examine the financial statements to obtain answers to certain basic financial questions, which will then provide the terms of reference for the rest of the review. These basic questions are likely to include:

23. Has management provided the board with a financial analysis showing the main reasons for the change in this year's result when compared with last year?
24. Has management provided the board with a financial analysis showing the main reasons for any differences between results for internal and external reporting purposes?
25. Is the business making a profit or a loss, and how much?
    - Is the profit or loss consistent with the individual director's expectations based on the financial information provided to the board during the year?
26. How is the company performing relative to last year and to the budget?
    - Is the explanation received consistent with the individual director's expectations based on the financial information provided to board meetings during the year?
27. Is the profit or loss realised or unrealised?
    - Are realised/unrealised profits or losses consistent with the individual director's expectations based on the financial information provided to the board during the year?

28. If there are unrealised profits or losses, how do they impact operations?
    - Are there any plans to convert unrealised profits or unrealised losses to realised profits or realised losses in the foreseeable future?
    - Are such plans consistent with the company's business strategy and business plan?
    - Where an underlying profit result is disclosed, have the directors considered whether the reconciliation between statutory profit and the underlying profit, is consistent with the individual directors understanding of the adjustments?
29. How have major events and transactions been reported in the financial statements?
    - Is separate disclosure required?
30. Are the proposed disclosures consistent with the individual director's understanding of those events and transactions?
31. How do assets compare with the liabilities?
    - Does the company have positive net assets or how will a deficiency of net assets be addressed?
32. How do current assets compare with current liabilities?
    - Is working capital adequate or how will a deficiency of working capital be addressed?
33. How much funding did the business generate through operations? How much from debt and equity capital? Do funds appear to have been used efficiently and consistently in line with the individual director's understanding of business activities and the company's financial management strategy?
34. How does the cash flow generated compare to the profits?
35. Does the company have sufficient capital for growth?
36. Do the results indicate there may be a going concern problem?
37. What returns did shareholders get?

Internal auditors

Not all companies will have or need an internal audit function. However, where there is an effective internal audit program that operates independently of management, the internal audit findings can give directors an insight into the effectiveness of the internal control environment and the efficiency of operations that underlie the integrity of the financial reporting systems.

38. Which operations have been audited by internal audit and did any operations receive an unsatisfactory rating? If so, what action has been taken to rectify the problem?
39. Do any matters raised by internal audit impact on the integrity of the financial reporting systems and processes?

Compliance with the company's policies and procedures

40. Is there a detailed accounting procedures manual? If so, how often is it updated?
41. How recently have the internal or external auditors reviewed the manual? Was it satisfactory?
42. How does management ensure compliance, by all operations, with the company's established accounting policies and procedures?
43. How does management satisfy itself that there have been no major breakdowns in internal controls that may have a material effect on the financial statements, either now or in the future?

Assets

The major concern in this area is whether assets are recorded in the financial statements at an appropriate amount, not exceeding their recoverable amount. An assessment is required to determine the non-current and current portions of assets.

Investments

44. How has the fair value of investments been assessed? Have amounts been disclosed under the fair value hierarchy and is there reasonable explanation as to why investments might not be valued at quoted prices in active markets (being the application of level 1 inputs)?
45. Are any investments carried at cost and if so, why?

Property, plant and equipment, intangible assets and other non-current assets

The recoverable amount of non-current assets and the rigour demonstrated in impairment testing has been a focus of regulatory scrutiny over many years. Directors need to be satisfied that the assumptions used in determining fair value, or the cash flow forecasts used in present value calculations (including growth rates and discount rates), are consistent with the company's business plans.

46. Have non-current assets been measured at cost or fair value?
47. Where non-current assets are measured at fair value, has an independent valuation been obtained? Has fair value been determined based on highest and best use, in an orderly transaction in the most advantageous market, from the perspective of a market participant?
48. Does the fair value measurement support a determination that the asset is currently used in its highest and best use? Is there a need to re-examine the company's strategy regarding efficient use of certain assets in the business?
49. Are there any additions to intangible assets during the year? Are these additions consistent with the director's understanding of business activities?
50. How has the carrying amount of additions to intangibles assets been determined?
51. Are there any indications of impairment for non-current tangible assets measured at cost or for intangible assets with a finite useful life?
52. Where there are indications of impairment, have impairment tests been carried out? Has an impairment loss been recognized and if so, have appropriate disclosures been made in the notes to the financial statements?
53. Where impairment testing is based on fair value less costs to sell, how has that amount been determined? Was it independently assessed?
54. Have impairment tests been carried out for all intangible assets (including goodwill) with an indefinite useful life?
55. Where impairment testing is based on the present value of cash flows from a cash generating unit, how have the cash flow forecasts and discount rate been determined? Has an expert carried out these calculations? Are the assumptions consistent with the director's understanding of the company's business plans?
56. Where businesses or assets have been acquired through the issue of equity instruments (for example, shares), how has the fair value of those instruments been determined?
57. What procedures have been followed to satisfy the directors that the requirements of acquisition accounting have been properly applied?

Inventories

58. What steps have been taken to satisfy the requirements that inventory is recorded at the lower of cost and net realisable value?
59. What physical checks have been made to confirm inventories?

Receivables and loans

60. What steps have been taken to confirm that the book values of receivables and loans are recoverable in full?
61. Has the aging profile of receivables and loans been considered?

Liabilities

The major concern in this area is whether all liabilities of the company are included in the financial statements.

62. How has it been determined that all creditors have been included in the financial statements?
63. How has management satisfied themselves that appropriate risk management systems are in place?
64. What are the major risks facing the company and, where warranted, have these risks been provided for?
65. How has it been determined that amounts of provisions, including provisions against current, pending or threatened legal action against the company, are adequate?
66. How does management review the financing terms of borrowing arrangements and determine current, non-current disclosures and the importance of unconditional commitments?
67. How does management determine that there has been no breach of any terms and conditions imposed by borrowing arrangements? Has the impact of any such breaches been reflected in the current/non-current classifications in the balance sheet, as well as in the notes to the financial statements?
68. Have all material contracts, obligations, and contingent liabilities been assessed in order to determine the appropriate disclosure in the financial statements?

69. What independent expert advice has been received about the calculation and disclosure of income tax?

70. How have the procedures for GST been comprehensively reviewed to confirm that all requirements have been met and all recoveries have been made?

71. Are there any disputes with major customers or suppliers or with the Australian Taxation Office (ATO), Australian Competition and Consumer Commission (ACCC), Australian Securities and Investment Commission (ASIC), or any other regulatory authorities that could lead to the need for provisions?

Foreign exchange exposure/derivatives

Foreign exchange exposures have the potential to cause loss and directors need to be especially watchful of management policies and procedures in this complex area.

72. What is the policy for hedging of foreign exchange risks; who sets the policy, and how often is it reviewed?

73. Are speculative foreign exchange transactions prohibited? If so, how does management guard against speculative transactions?

74. How does management monitor and control the company's foreign exchange risk, for example, use of limits and authorised counterparties?

75. What management procedures are in place so that the appropriate limits and controls are applied to other derivatives? For example, interest rate swaps, commodity futures contracts.

76. Are there any unrealised losses at year-end not recorded in the accounts?

Related party transactions

Directors must be especially careful in discharging their duty of care in transactions between related parties (including directors and director related entities) and the company.

77. How is management satisfied that all transactions with directors and director-related entities have been disclosed, irrespective of amount?

78. How is it determined that all related party transactions are on a proper commercial basis?

79. Have all directors signed a statement acknowledging that they have disclosed all related party transactions to the board and CEO?

80. Were all related party transactions documented and approved as appropriate?

Going concern

Before signing financial statements, directors must be satisfied the company can meet its debts as and when they fall due.

81. Has a detailed cash flow forecast for a period of at least 12 months from the date of signing been prepared and reviewed by senior management and the board?

82. What are the major assumptions underlying the cash flow forecast and are all loan repayments and capital commitments included?

83. Are the assumptions used in the preparation of these cash flow forecasts the same as the assumptions used for impairment testing?

84. Are the borrowing facilities predicted to be used in cash flow forecasts committed or uncommitted?

85. What other issues are relevant in determining that the company can pay its debts as and when they fall due, particularly during the next twelve months?

Dividend policy/capital management

Dividends should only be paid where profits and cash are sufficient.

86. Does the company have sufficient cash to pay the dividend with regard to future cash commitments?

87. How is the franking account managed to confirm that movements are properly recorded?

88. Have directors reviewed the financial position to assess whether the appropriate capital management steps could be taken? For example, special dividends and share buy-back.

External auditors

External auditors provide management and/or directors with an independent view of the company's operations and control environment in addition to the auditor's opinion on the statutory financial statements.

89. With whom has the external auditor met to discuss matters arising during the course of the audit and is it appropriate for the full board to also meet with the auditor?

90. Has the external auditor identified any significant deficiencies in internal controls during the course of the audit? What action is required by the board?

91. Has the external auditor communicated any observations arising during the audit to those charged with governance that are significant and relevant to the board's responsibility to oversee the financial reporting process?

92. Does the external auditor intend to issue a 'clean' opinion on the statutory financial statements or is the auditor proposing a modified or qualified audit opinion?

93. Has the external auditor confirmed that he/she has enjoyed full cooperation and frank discussions with senior management? Consider private discussions in the absence of management.

94. Have appropriate inquiries been made and declaration been received on the independence of the auditor? Have the appropriate disclosures on the independence of the external auditors been included in the financial report?

General

95. Have all business areas been assessed after balance date to determine whether there have been any events or transactions that require disclosure in the notes?

96. Are there any matters included in the financial statements that could be viewed as misleading or confusing?

97. Are there any material matters that remain unresolved, or where significant uncertainty exists? If so, has there been adequate disclosure of these items in the financial statements?

98. Are any of the directors aware of anything, from their personal knowledge or warnings from outside sources, which should be considered before signing?

99. How have directors/management ascertained that requirements for occupational health and safety been met?

100. Has the company complied with environmental laws and regulations?

A further useful reference is the AICD director tool *Financial reporting requirements*.

What is the overall responsibility outlined in the Centro case?

All directors should be aware of the Centro case (*ASIC v Healey* (2011) FCA 717) where directors who approved a company's financial statements failed to notice that $2 billion in current liabilities had been classified as non-current. The court held that the directors should have known that these liabilities were payable within 12 months. The directors relied on the fact that the mistake had not been found by management or external auditors and the directors had relied on those other checks that the accounts were correct. The court rejected the directors' arguments and found they had breached their duty, stating:

> *It may be that in the course of this trial the directors have been able to show others had difficulties with the issues confronting the directors in 2007.*
>
> *The first point to observe is that the directors themselves were not distracted by the various so-called complicated issues raised now in this proceeding. Each director relied completely on the processes in place and their advisors. All the directors failed to see the 'obvious errors' because they all took the same approach in relying exclusively upon those processes and advisors. No director stood back, armed with his own knowledge, and looked at and considered for himself the financial statements.*
>
> *The second point to make is that as far as the other persons who fell into error are concerned, the Court in this proceeding cannot adequately determine the reason for this occurring. Every person referred to by the directors as having fallen into error, had different roles to play, and had various levels of information available to them. Some may well have had limited knowledge of the facts, or themselves failed to take sufficient care. Mr Nenna has acknowledged that he failed to take sufficient care. The mere fact that others (perhaps many others) fell into error does not assist in determining the key issue in this proceeding relating to the conduct of the directors.*
>
> *The final point to observe, is that ASIC does not allege, as I have previously indicated, that the directors needed to get it right or that they needed to realise that the information available to them was 'necessarily' indicative of error (as the directors would frame the issue). All that is being alleged is that they should have detected the apparent error, and acted accordingly, by for instance, asking the appropriate question of management. Therefore, I do consider that all that was required of the directors in this proceeding was the financial literacy to understand basic accounting conventions and proper diligence in reading the financial statements. The directors had the required accumulated knowledge of the affairs of Centro, based upon the documents placed before them and discussion at board meetings. Each director then needed to formulate his own opinion and apply that opinion to the task of approving the financial statements.*

Former ASIC deputy chair Belinda Gibson set out ASIC's expectations in this area following the Centro case:[4]

> *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".*

Former ASIC chair Greg Medcraft summarised the effect of the Centro case as follows:[5]

> *There are four simple principles here. Directors need to be sceptical. They must be able to read a set of financial statements, understand the business and understand that delegation does not remove their accountability.*

4. 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).
5. AICD, 2012, "Q&A with Greg Medcraft", *Company Director*, 1 September, **http://www.companydirectors.com.au/director-resource-centre/publications/company-director-magazine/2012-back-editions/september/interview-qa-with-greg-medcraft**, (accessed 18 February 2019).

What are the warning signs for insolvency?

Insolvent trading is a serious breach of the *Corporations Act 2001*. Directors can be held liable and face civil and criminal penalties. According to ASIC's Information Sheet 42 *Insolvency: A guide for directors*, the following factors indicate going concern problems or a risk of, or actual, insolvency:

- ongoing losses;
- poor cash flow;
- absence of a business plan;
- incomplete financial records or disorganised internal accounting procedures;
- lack of cash-flow forecasts and other budgets;
- increasing debt (liabilities greater than assets);
- problems selling stock or collecting debts;
- unrecoverable loans to associated parties;
- creditors unpaid outside usual terms;
- solicitors' letters, demands, summonses, judgements or warrants issued against your company;
- suppliers placing your company on cash-on-delivery (COD) terms;
- issuing post-dated cheques or dishonouring cheques;
- special arrangements with selected creditors;
- payments to creditors of rounded sums that are not reconcilable to specific invoices;
- overdraft limit reached or defaults on loan or interest payments;
- problems obtaining finance;
- change of bank, lender or increased monitoring/involvement by financier;
- inability to raise funds from shareholders;
- overdue taxes and superannuation liabilities;
- board disputes and director resignations, or loss of management personnel;
- increased level of complaints or queries raised with suppliers; and
- an expectation that the 'next' big job/sale/contract will save the company.

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