

Frank Clarke and Graeme Dean*

Submission in response to the 29 November 2011 Treasury Discussion Paper related to the June 2010 Corporations Amendment (Corporate Reporting Reform) Act 2010, *Improving Australia's Corporate Reporting Framework*

What follows in bold, single-space type is reproduced from the 29 November 2011 Treasury Discussion Paper, and other text in unbolded roman, generally 1.5 spaced, is our response. Augmenting this response in the Appendix (single-spaced type) is our original submission to which we make reference throughout. In general we argue that providing options is inappropriate. The matters considered here should mesh with a wider notion of the function of the financial information disclosed in published accounts and how that links with accepted notions of what is meant by financial position and financial performance. This would eliminate the suggestion of responses being deemed ad-hoc.

The DP addressed matters related to Company law changes introduced on 29 June 2010. A major change entailed replacing the requirement that 'dividends be paid out of profits' with a test based on 'balance sheet solvency'. It was stated that the catalyst for this change was that average corporate dividend payments slumped 25 per cent in 2009 in the global financial crisis aftermath. Another major proposed change was to relieve parent companies from their reporting obligations, on the premise that consolidated group accounting information would suffice.

The following extract from the DP summarises all issues canvassed in the 2011 Discussion Paper.

1. Introduction	
2. Test for payment of dividends	
Options for dealing with the dividends test	
Other Corporations Act issues in respect of the dividends test Error! Bookmark not defined.	
Taxation issues	
Regulation Impact Statement	
3. Other amendments	
-Parent entity reporting requirements	
-Changing the financial year of a company	
-Regulation Impact Statement	

The DP begins by noting:

“In June 2010, amendments were made to the *Corporations Act 2001* (the Act) by the *Corporations Amendment (Corporate Reporting Reform) Act 2010* (the Reform Act) with the objective of improving Australia’s corporate reporting framework, [by]: reducing unnecessary red tape and regulatory burden on companies; and implementing a number of other important refinements to the regulatory framework. Amendments made by the Reform Act included:

- substantive changes to the reporting and auditing requirements applicable to companies limited by guarantee;**
- relieving parent entities that are required by the accounting standards to prepare consolidated financial statements from the obligation to prepare their own financial statements;**
- replacing the requirement that dividends be paid out of profits with more flexible requirements including that, immediately before the dividend is declared, assets exceed liabilities and the excess is sufficient for the payment of the dividends;**
- allowing entities to more easily change their year-end date;**
- extending the operating review-type disclosure requirements in section 299A of the Act to apply to listed registered schemes;**
- refining the statement of compliance with International Financial Reporting Standards (IFRS) contained in the directors’ declaration; and**
- clarifying the circumstances in which a company can cancel its share capital.**

While these reforms were generally well received, there have been calls by some stakeholders for changes to a number of the amendments made by the Reform Act.”

Our response addresses seriatim the two 29 June 2010 major changes just noted, and the related proposed (29 November 2011) amendments to address criticisms of the 2010 legislative changes:

1. relieving parent entities that are required by the accounting standards to prepare consolidated financial statements from the obligation to prepare their own financial statements;
2. replacing the requirement that dividends be paid out of profits with more flexible requirements including that, immediately before the dividend is declared, assets exceed liabilities and the excess is sufficient for the payment of the dividends;

Regarding 1. Parent entity reporting requirements

Following several earlier regulatory attempts purportedly to reduce the reporting burden for groups of companies (see Bosch, 1990 and Cotter, 2003), the November 2011 DP noted:

The Reform Act amended subsection 295(2) of the Act to relieve companies, registered schemes and disclosing entities that are parent entities from the requirement to prepare financial statements for both the parent entity and the consolidated group in circumstances where the preparation of financial statements in relation to the consolidated entity is required by the accounting standards. This relief is subject to a condition that summary financial information about the parent entity is to be disclosed in a note to the consolidated financial statements.

A number of stakeholders have informed the Treasury that they believe subsection 295(2) should also be amended to:

- permit the preparation of parent entity financial statements by entities that are subject- to prudential supervision by the Australian Prudential Regulation Authority (APRA), where such statements are [otherwise] required; and**
- allow the preparation of parent entity financial statements in other circumstances where the directors of an entity consider it would be appropriate or necessary to prepare such statements (for example, to satisfy conditions contained in a financial instrument).**

On 26 July 2010, as an interim measure pending the Government's consideration of these views, the Australian Securities and Investments Commission (ASIC) issued a Class Order (CO 10/654 *Inclusion of parent entity financial statements in financial reports*), which allows companies, registered schemes and disclosing entities that are required to present consolidated financial statements to also include parent entity financial statements as part of their financial report under Chapter 2M of the Act. Entities taking advantage of the modified reporting requirements permitted under this class order are relieved of the requirement to present the summary parent entity information required by regulation 2M.3.01 of the Corporations Regulations.

In light of the comments from stakeholders referred to above and the action subsequently taken by ASIC, the Treasury considers that there may be merit in amending subsection 295(2) to restore the ability of a company, registered scheme or disclosing entity that is required to present consolidated financial statements to also include parent entity financial statements as part of its financial report. Under this arrangement, an entity that includes parent

entity financial statements in its financial report would be relieved of the requirement to present the summary parent entity information required by regulation 2M.3.01.

Issues for consideration

Stakeholders' are invited to comment on:

- *whether an amendment which allows companies, registered schemes and disclosing entities that are required to present consolidated financial statements to also include parent entity financial statements as part of their financial report under Chapter 2M of the Act would adequately address their concerns about parent entity financial reporting?*
- *Under such an amendment, the preparation of parent entity financial statements would be optional for all entities that are required to present consolidated financial statements. Should any restrictions be placed on the circumstances in which an entity may decide to prepare parent entity financial statements?*
- *whether there are other parent entity financial statement-related issues that they consider should be brought to the Treasury's attention?*

Our position on this latest *preferred* change to section 295(2) in respect of parent entity reporting, making optional the 29 June 2010 change, is that whilst this move is positive, it does not address the fundamental issue of what generally relevant (meaningful and interpretable) financial information can be reported by a group of related companies. This requires consideration of what is the function of financial information disclosed in published accounts of separate legal entities and how that meshes with accepted notions of the *financial position* and *financial performance* of such entities. We are particularly keen to stress that a corporate group cannot possess the characteristics of financial position or financial performance. Groups do not own assets, incur liabilities, or indeed have a capital fund – these are unique characteristics of individuals - human and legal non- human (artificial) entities (separate corporations). Being able to own assets and incur liabilities is essential to a workable notion of financial position – the relationship between the nature composition and money's worth of one's assets, and nature, amounts and when due of one's liabilities. For these are the financial characteristics that distinguish one entity's solvency, liquidity, capacity to borrow, capacity to invest, to diversify, indeed its capacity to adapt to its financial environment, relative to that of another . This matter has been addressed by us in several books and articles, including, Clarke *et al.*, *Corporate*

Collapse ..., 1997 and 2003, especially chapters 16, 17), Clarke and Dean, *Indecent Disclosure ...*, 2007, especially chapters 7-9). These chapters were provided in our original 2010 submission.

In sum. Our view is that for a group of related entities, *more not less* aggregated information ought to be provided to the market. The necessary information is currently collected by the set of related companies as they prepare data necessary for the preparation of conventional consolidated accounting reports. But, as we have shown in our books noted above, technical accounting consolidation accounting causes much pertinent information to be lost in that process, through the conventional group accounting consolidation elimination procedures for intra-group transactions and balances. Our alternative group accounting approach would see the necessary (for decision making about specific entities within the corporate group) information about a set of related entities provided to the market. We show that in order for effective audit the information must be available, and in any event with the advent of X-BRL reporting it would be virtually costless to produce.

At this point we refer the Committee to issues raised in our 2010 submission (with some amendments/embellishments) to what we then said:

Eliminating the necessity that a parent company, especially a listed parent company, prepare and disclose audited financial statements means that interested parties will be denied properly articulated balance sheets and statements of their financial performances. This is a curious move, bearing in mind that the shareholders of the parent, especially a listed parent, usually hold directly shares in it and likely as not in none of the other related companies. Curiously under the current regulatory regime they thus have access to the aggregated group entity (in which they nor anyone) do not hold shares, and are denied access to the separate financial information of the company in which they do. The aggregative data proposed for various classes of assets and equities is the basis for only a limited form of financial analysis. Similar proposals have been made in the past. We provided arguments against such a proposal when it was considered in the 2003 Cotter Discussion Paper, 'Relevance of Parent Entity Reports' commissioned by AASB, as did many others in their submissions (see www.aasb.com.au – in particular, especially our submission to that Discussion paper which we attach here (it was provided as item (c) in the Appendix to our original 2010 submission).

Of course the suggested financial reporting regime applies in some other countries (see that previous 2003 AASB Discussion paper for details). We argue that it rests upon a misunderstanding of how consolidated financial

statements are prepared, of how the separate financial data of group companies are massaged in the consolidation process according to intra-group elimination processing rules which produce aggregated data other than what might be implied from examination of the separate data. In some instances no separate company data comparable to the aggregate data exist, and classes of separate data do not have counterparts in the aggregated data. We are yet to see cogent arguments in support of conventional consolidated accounting or defensible evidence of the overall virtues claimed for consolidation of the kind currently undertaken. This is especially so when one considers issues of solvency. The proposal appears to draw upon a belief that consolidated data refer to an identifiable legal entity, the *group*, and that consolidated financial statements can provide information superior to what is to be gleaned from a parent company's accounts and those of its separate subsidiaries.

In that context, the proposed 2010 amendment (and embedded also in the optional proposed 29 November 2011 rules) appears to rest heavily upon the notion that the set of related companies whose data are combined to create consolidated financial statements comprise in some way a legal entity capable of owning assets and incurring liabilities; that, talk of *consolidated* assets, *consolidated* liabilities, of a *group* equity and the like, have a valid financial resonance. But the supposed *group* of related companies is not an entity of the kind to which the Corporations Act otherwise refers, or to which the notion of *assets*, *liabilities*, and *group equity* have other than metaphorical meanings. The so-called group is an accounting fiction, a *description of convenience* referring to a set of subsidiaries and their parent company. As such, by virtue of the separate legal entity principle enunciated in *Salomon v. Salomon* (1896), a group, generally (and without covenants to that effect such as *effective* cross guarantees) is incapable of owning assets and incurring liabilities. Hence the notions of consolidated group assets, consolidated group liabilities and group equity are misnomers — such assets and obligations are the legal property and obligations of the separate companies.

Corporate groups of this kind are thus incapable (as themselves) of earning profits or incurring financial losses – the notions of groups profits and losses are absolute fiction; we note that in the proposed 29 November 2011 optional arrangements the DP made reference to whether there were concerns about group solvency and the impact of deeds of cross guarantee – such expressions of an aggregative group solvency or insolvency are meaningless in the absence of an effective Deed of Cross Guarantee between the related companies (see, *Indecent Disclosure . . .*, Chapter 8 for an explanation of the effect of deeds of Cross Guarantee. There we note that especially, where ASIC-type deeds of cross guarantee exist, the commercial implications of those Deeds is problematic. We provided in Chapter 8 survey data about analysts' and financial officers' perceptions about the lack of serviceability of 'closed-group' consolidated data currently (before the 29 June 2010 amendments) provided in listed companies' financial statements – in the Notes to the Accounts.). The assets of the separate companies are not automatically available to meet the liabilities of the others; and the

financial ratios commonly calculated in financial statement analysis using group data – debt to equity, rate of return, debt cover, classes of one asset to another asset class, the relation of one liability class to another, aggregates of assets and equities, aggregates such as asset backing, etc., - are likely to be grossly misleading insofar as they imply financial relationships within a group, capacities to combine and offset, that ordinarily (*cet. par.*) legally do not exist.

Some of the above matters are explained more fully in chapters 16 and 17 (forming part (a) of the Appendix to this submission) of our *Corporate Collapse . . .* (1997, 2003). There we argue and illustrate the misleading use of the corporate group notion and the misleading nature of consolidated financial statements. Also, those matters are explored further in Chapter 9 (see part (b) of the Appendix below) of our *Indecent Disclosure . . .* (2007).

We accept that frequently information is sought regarding the overall level of indebtedness of the related companies. This concern underpins the misleading notion of *group solvency* discussed above. By eliminating (some) intra-group indebtedness in the consolidation process, conventional consolidated financial statements (at best) disclose indebtedness (of companies within the group) only to non-group companies. The aggregating mechanism we describe in the appendix to Chapter 17 of *Corporate Collapse . . .* and Chapter 9 of *Indecent Disclosure . . .* (see Appendix, Parts (a) and (b) to our 2010 submission reproduced below) has the potential to disclose the detail necessary for determining the balance-sheet derived solvency of each of the related companies, detailing the source and destination of their borrowings and lending – this, in a matrix of all borrowing and lending by the companies reveals which are net-borrowers and which are net-lenders, regarding both related and non-related companies. Debt exposure both within and outside the ‘group’ is revealed. The Appendix to Chapter 17 illustrates using data from the liquidation of a high profile 1980s Australian company. Since the publication of this reform proposal advances in computer technology and the increasing use of XBRL reporting makes this idea even more compelling on a cost-benefit basis, than when it was proposed originally.

The *Draft Regulatory Impact Statement* of the 2010 Bill declared that the parent entity’s full audited financials ‘clutters the annual report with unnecessary detail and is potentially confusing’ (p.11). There, ‘clutters’ and ‘unnecessary’ are arguably disingenuous comments, bearing in mind that no evidence is provided in support of either claim. The preferred Option in the 2010 Bill (which became law on 29 June 2010) not only is sanctioning the inclusion of non-audited parent company data in the consolidated financial statements, but also possibly the non-audit of the proposed parent aggregative data. How are regulatory agencies ‘that rely upon financial statements to conduct their supervisory duties’ (p.12) to do so with unaudited parent data in the consolidated financials? And how, under the proposed regime, are the current annual regulatory attempts at tracking listed companies’ ‘solvency’ positions likely to be enhanced by not having access to the relevant parents’ financial statements?

The benefits claimed in the 2010 proposal (p.13) for the preferred amendment (Option (b), p.12) are unsubstantiated there and otherwise difficult to fathom. *Complexity* is unproven. Those who understand consolidation procedures might argue that the parent company's accounts enhance an understanding of the consolidated data. Or the reverse, as was originally the stated intention of consolidated statements that they enhance the understanding of the data in the parent companies' accounts (see R.G. Walker, *Consolidated Statements*, Arno, Press, 1976; and Walker's 1984 NCSC submission, "Accounting requirements for groups of companies" (reproduced here as Appendix (d)) ; Chapter 16 of *Corporate Collapse ...* and Chapter 7 of *Indecent Disclosure ..* .) *Reduced compliance costs* can be deemed a benefit only if the reduction exceeds the financial benefits of providing access to the information withheld and is not offset by the costs of providing the disaggregated parent data as proposed.

The point of the above is that our concerns raised when it was suggested in the 2010 Bill that there would only be conventional consolidated financial reports prepared and audited is only partially improved by allowing the option for those reports and the parent data to be prepared, audited and reported. The fundamental problems with the conventional consolidated data persist. Most importantly, no individual holding shares in listed companies hold shares in a group – they hold, and trade in shares in individual companies (that may or may not be) part of what is conventionally called a *group*. Exercising the option could result in an investor being deprived of the financial statements of the company in which he have invested. An alternative group accounting solution has been discussed briefly above and noted in detail in our books listed in the Appendix. We commend that alternative for Treasury's consideration.

Regarding 2 —Test for payment of dividends — the 29 November 201 DP observed:

“The Reform Act amended the Act by replacing the requirement in section 254T for dividends to be paid out of profits with a more flexible test that allows a company to pay a dividend if, among other things, the company’s assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend. For the purpose of providing guidance on whether a company’s assets exceed its liabilities, the Reform Act also provides that ‘assets’ and ‘liabilities’ are to be calculated in accordance with the accounting standards.

Stakeholders have raised the following concerns about the new dividends test:

- **linking the test to the accounting standards places an unreasonable burden on those companies that are not otherwise required to comply with the standards (for example, small proprietary companies that do not have to prepare financial statements, or companies that are not reporting entities and thus do not have to comply with the full suite of accounting standards);**
- **an ‘assets greater than liabilities’ test is inappropriate, as it can have little relationship to solvency because it does not take into account the timing and magnitude of flows of funds. In addition, having a test using accounting standards-based calculations may give rise to some of the problems that existed under the former ‘profits’ test;**
- **the test requires assets to exceed liabilities immediately before the dividend is ‘declared’. However, section 254U of the Act and most company constitutions now provide for the board to ‘determine’ that dividends are payable. Under section 254V of the Act, if the dividend is ‘declared’ it is a debt owing to the shareholders at the time it is declared rather than at the payment date; and**
- **the inter-relationship between the dividends test and the capital maintenance requirements in Chapter 2J of the Act needs to be clarified.**

In conjunction with the introduction of the new dividends test, section 44 of the *Income Tax Assessment Act 1936* was amended to provide that a dividend paid out of an amount other than profits is taken to be a dividend paid out of profits. The primary objective of this amendment is to ensure that shareholders include these distributions in their assessable income. However, some stakeholders have raised concerns about the manner, and extent to which, the franking arrangements apply to some dividends paid under the new test.

Options for dealing with the dividends test

Treasury has identified the following options for dealing with the dividends test:

- (1) retaining section 254T of the Act as currently drafted;**
- (2) adopting a solvency test;**
- (3) reinstating the former profits test; or**

(4) adopting an arrangement under which a company would have a choice of two ways of determining whether it is able to pay a dividend.

Firstly, it should be expected that there will be some duplication of ideas with respect to the matter discussed immediately above. In that respect the Committee should consider some history and evidence in Mumford and Katz, *Making Creditor Protection Effective*, (2010) about these issues (albeit mainly in a UK setting) that appeared not long after the 29 June 2010 Bill was enacted. That work canvasses issues of capital maintenance, solvency and the various asset-test regimes, in countries like the UK, Canada, Australia and NZ. The evidence adduced there suggests caution in accepting conventional asset-based solvency tests, especially using conventional consolidated accounting data.

Secondly, our position on this matter is well canvassed in our original 2010 submission. There we noted: ‘We find the proposed amendments curious, in that rather than define the term *profit* it is proposed to drop it, and allow the primary test for the appropriateness of a dividend payment to be whether those paying can argue successfully that: their company has *an excess of assets over liabilities* (a kind of rough and limited balance sheet solvency test, is *fair and reasonable* (a sort of *business judgement* test), and that such a payment does not *materially prejudice the company’s ability to pay creditors*. We note here, *materially*, potentially a watering-down of the solvency criterion. In our opinion the proposed amendment will be inoperable insofar as it is incapable of being properly regulated and administered, for the following [see Appendix below] reasons.’ In sum those reasons coalesce into (as noted in our 2010 Submission):

The suggested amendment to 254T will be at best ineffective, misleading, and most likely to result in unreasonable dividends being paid, as a consequence of:

- (i) Except in very limited circumstances, it is impossible to determine whether ‘assets exceed liabilities’ under current accounting practice compulsorily complying with the AIFRS; accordingly
- (ii) the notions of fair and reasonable if drawing upon conventionally prepared (AASB compliant) financial statements, are inoperative, ungovernable, hence ineffective tests; and

- (iii) a company's ability to pay creditors drawing upon the circumstances of financial and assessments of what is fair and (or) reasonable outlined in (i) and (ii) above, is likely to be problematic."

We especially wish to comment on the matters raised when this preferred change is operationalised in a corporate group setting (which we have partially considered already above). In this respect the 29 November 2011 DP observes:

Application of test to group companies

Some stakeholders have raised concerns about the application of the net assets test to group companies, where dividends could be 'streamed up' to the ultimate holding company in a corporate group.

The concern of stakeholders is that a wholly owned subsidiary in the group may not meet the net assets test, even though the group as a whole does. If there is a deficiency of assets in an intermediate holding company, the parent company may not be able to access the dividends from the profitable subsidiary to permit the parent company to pay dividends to its shareholders.

However, in many corporate groups a deed or deeds of cross-guarantee may be in place effectively providing comfort that the group as a whole will meet the debts of each company in the group. Consideration needs to be given to the effectiveness of any deeds and to ensuring that they do not create arrangements which may prejudice creditors of one group entity to the benefit of another group entity.

In view of concerns raised by stakeholders, Treasury believes that consideration should be given to whether an amendment is needed to clarify the manner in which the assets exceed liabilities test applies to group companies.

Issue for consideration

Stakeholders' comments are sought on whether a modification is needed to the manner in which the dividends test applies to group companies to address the situation where an intermediate holding company cannot satisfy the net assets test and, potentially, stops dividends flowing to the parent company.

It is noted that in respect of this specific issue the attention of Treasury is drawn to work done by CAMAC in 1998-2000 on *Corporate Groups* where we made a submission including evidence about the effectiveness or otherwise of the regulatory-approved ASIC Deeds of Cross Guarantees in a group liquidation setting. The Deeds (and their predecessor NCSC Deed of Indemnity and ASC Deed of Cross Guarantee)

have proven problematic as a means of protecting creditors within group liquidations. It was shown that directors' schizophrenia exist when it comes to their considering a corporate group in an ongoing versus a liquidating setting. Accordingly, we are of the view that Treasury should give consideration, given the amendment, to clarify the manner in which the assets exceed liabilities test applies to group companies –(not the group) – this was an issue in the HIH case – and in other ASIC-administered group matters – such as where licenses operate in respect of a group and there is need for recourse to consideration of solvency issues regarding the licensee.

In our discussion about whether, as suggested in the 29 November DP, that the *Parent entity reporting requirements*, should be made optional, we rehearsed our concerns about fictional 'group' asset and liability matters. These are further exacerbated when the issue of cross guarantees within a large holding-sub-holding company group structure operates. The complexities and issues were noted in that earlier discussion.

This is just another instance of where, once financial reporting becomes divorced from the legal structures involved, then it is more likely to result in commercial chaos than order.

References (as well as those at the end of the Appendix below):

Bosch, H., *Workings of a Watchdog*, Heinemann: Sydney, 19090

Cotter, J., *Relevance of Parent Entity Reports* (AASB Discussion Paper), AASB: Melbourne, 2003.

Mumford, M.M. J and A.J. Katz, *Making Creditor Protection Effective*, ICAEW: London, (2010)

Appendix:

Dean and Clarke Submission to the Original 2010 Draft Bill

Summary

This submission addresses the matters relating to the proposed amendment of the revised approach to determining a company's dividend payment decisions, and to the amendment proposing relief in respect of the preparation and provision of a parent company's financial statements.

Our general propositions in response to the proposed amendments are, re:

254T The suggested amendment will be at best ineffective, misleading, and most likely to result in unreasonable dividends being paid, as a consequence of:

- (i) Except in very limited circumstances, it is impossible to determine whether 'assets exceed liabilities' under current accounting practice compulsorily complying with the AIFRS; accordingly**
- (ii) the notions of *fair* and *reasonable* if drawing upon conventionally prepared financial statements, are inoperative, ungovernable, hence ineffective tests; and**
- (iii) a company's ability to pay creditors drawing upon the circumstances of financial and assessments of what is fair and (or) reasonable outlined in (i) and (ii) above, is likely to be problematic.**

& 295(2) The suggested amendment has the effect of denying shareholders, creditors and other interested stakeholders, the financial statements of 303(2) a listed company in which they have such an interest. In particular, it limits their access to the aggregative data (though presentable in a disaggregated format) specified, and provides solely consolidated financial statements not relating to any specific legal entity in and against which (in ordinary circumstances) their shareholders or creditors have any enforceable claims. Consolidated statements are prepared in accord with highly questionable accounting practices that generally mask, rather than elaborate, their financial relationships. Shareholders in listed companies will not have access to the financials of the parent companies in which they have invested.

Re: Amendments to 254T

We find the proposed amendments curious, in that rather than define the term *profit* it is proposed to drop it, and allow the primary test for the appropriateness of a dividend payment to be whether those paying can argue successfully that: their company has *an excess of assets over liabilities* (a kind of rough and limited balance

sheet solvency test, is *fair and reasonable* (a sort of *business judgement* test), and that such a payment does not *materially prejudice the company's ability to pay creditors*. Here, *materially*, potentially watering-down the solvency criterion. In our opinion the proposed amendment will be inoperable insofar as it is incapable of being properly regulated and administered, for the following reasons.

(a) *An excess of assets over liabilities*

The problem here lies not in the sentiment most likely underpinning the requirement. No doubt the intention is to inject the regime with a 'balance sheet solvency test'. Intuitively, that makes sense. Especially when contemplating a monetary outflow decision like when one is deciding on whether to pay a dividend. But conventional accounting statements, whether fully or partially complying with the AIFRS, rarely yield financial data that are *fair and reasonable*, meaningfully indicative of either a company's wealth or financial progress. Conventional balance sheets prepared under the AIFRS may include actual amounts of cash held, amounts expected to be collected from debtors, physical assets stated at what it originally cost to acquire them in the past (money long gone), physical assets stated at their fair values – ranging from historical cost, through what it might cost to replace them (money wanted, not held), to current selling prices (potentially money close at hand), or their *impaired value* – the product of, inter alia, discounting estimates of future revenue streams of cash generating units of which the assets are part (the theoretical current worth of cash that might (but might not) be received in the future); and amounts stated for assets and liabilities that are merely artifacts of the system – for example, tax effect accounting balances and goodwill on consolidation (difficulties with these latter 'balances' was well highlighted in the Royal Commissioners' observations in respect of HIH). The accounting mechanisms by which those valuations enter the balance sheet clearly flow into every statement of financial performance, making income statements extremely unreliable bases for determining the extent to which a company is better or worse off financially at the end of a period than it was at its beginning. We have explained these defects in accounting, and particularly recently the claims made for AIFRS in numerous places. We draw your attention in particular to Chapters 17 of *Corporate Collapse: Accounting, regulatory and ethical failure* (CUP, 2003) and Chapters, 4,5, 6 and 9 of *Indecent Disclosure: Gilding the corporate lily* (CUP, 2007). These chapters are reproduced in the Appendix, parts (a) and (b).

We draw your particular attention to Chapter 4 of our *Indecent Disclosure*. . . "A Very Peculiar Practice: Accounting Under Scrutiny". There, the impacts of some of the above practices are illustrated. Table 4.2 (p.82) analyses the financial *insignificance* of the data in a top 500 Australian company's balance sheet for determining the salient characteristics of its wealth and financial performance, namely solvency, liquidity, profitability and the like.

The first limb of the proposed test would be in most instances inoperable and certainly impossible to regulate.

(b) *Fair and reasonable to pay a dividend*

Here again reliance is placed on a form of *business judgement* rule. We have no argument with the sentiment. Fairness and good judgement are admirable qualities. But it seems unnecessary to specify such in directors' activities, including dividend decisions, as these are covered by existing obligations that directors act in good faith and in the interests of the company. But, what are the *criteria* of fairness and *reasonableness* to be applied in a dividend decision? At least one would think financial criteria would loom large. As noted above and supported by the detailed argument and evidence in the material to which we have drawn your attention, it is unlikely that it can be drawn from data derived from conventional financial statements prepared in compliance with the current AASB accounting standards. Below (in respect of the proposed amendment) we argue that reliable data are almost certainly not coming from conventional consolidated financial statements.

We can only conclude that the fair and reasonable test is inoperable, that no viable criteria exist and it is therefore incapable of a just and predictable regulation.

(c) *Does not materially prejudice . . . ability to pay creditors*

This appears to be a watered-down legally-based solvency criterion. Our concern lies, in particular, first with *materially*. Again, whether something is material is a matter of opinion and judgement. There is no definitive measure of materiality and it is not surprising that accountants have struggled with the notion since it was introduced as an accounting test arguably by Lord Plender in his evidence in the 1920s UK Royal Mail case (see *Indecent Disclosure*. . . , pp. 93-4). A solvency test *per se* would provide a more rigid, less manipulable, less ambiguous test. Second, whatever solvency criterion is injected will require cash flow data and particularly information of the current cash or near-to-cash position of the company, and those data need to be supported by what the financial statements disclose. Those data are supplemented by projected cash flow data. Above (and below, in respect there of consolidated financial statements) we argue and illustrate that current conventional accounting complying with the AIFRS does not provide information about the entity's current financial position.

As with the tests in (a) and (b), we can only conclude that the amendments specify criteria that are inoperable, manipulable, incapable of effective regulation.

Greater protection for shareholders and creditors is claimed in the *Draft Regulatory Impact Statement* (p. 17). We take that to mean regarding the exposure of shareholders and creditors to corporate insolvencies. But it is unfathomable how this will be the case where the assessments of what is *fair and reasonable* and whether *assets exceed liabilities* are to me made on the basis of data in the accounting statements drawn up in compliance with the AIFRS. And especially so, were the amendments proposed to be accepted, thus limiting the articulated financials to consolidated statements in which most intra-group debts are eliminated (this position is elaborated below).

Re: Amendments to sections 202(2) and 303(2)

Eliminating the necessity that parent companies, especially listed parent companies, prepare and disclose audited financial statements means that interested parties will be denied properly articulated balance sheets and statements of their financial performances. This is a curious move, bearing in mind that the shareholders of the parent, especially a listed parent, usually hold shares in it and likely as not in none of the other related companies. The aggregative data proposed for various classes of assets and equities is the basis for only a limited form of financial analysis. Similar proposals have been made in the past. We provided arguments against such a proposal when it was considered in the 2003 Discussion Paper, 'Relevance of Parent Entity Reports' commissioned by AASB, as did many others in their submissions (see www.aasb.com.au – in particular, especially our submission to that Discussion paper which we attach here (item (c) in the Appendix).

Of course the suggested financial reporting regime applies in some other countries (see that previous 2003 AASB Discussion paper for details). We are yet to see cogent arguments in support of it or defensible evidence of the overall virtues claimed for it. The proposal appears to draw upon a belief that consolidated data refer to an identifiable legal entity, and that consolidated financial statements can provide information superior to what is to be gleaned from a parent company's accounts and those of its separate subsidiaries.

In that context, the proposed amendment appears to rest heavily upon the notion that the companies whose data are combined to create consolidated financial statements comprise a legal entity capable of owning assets and incurring liabilities; that, talk of *consolidated* assets, *consolidated* liabilities, *group* equity and the like, have a valid financial resonance. But the supposed *group* of related companies is not an entity of the kind to which the Corporations Act otherwise refers, or to which the notion of *assets*, *liabilities*, and *group equity* have other than metaphorical meanings. The so-called group is an accounting fiction, a *description of convenience* referring to a set of subsidiaries and their parent company. As such, by virtue of the separate legal entity principle enunciated in *Salomon v. Salomon* (1896), a group, generally (and without covenants to that effect) is incapable of owning assets and incurring liabilities. Hence the notions of consolidated group assets, consolidated group liabilities and group equity are misnomers - such assets and obligations are the legal property and obligations of the separate companies.

Corporate groups of this kind are thus incapable (as themselves) of earning profits or incurring financial losses – the notions of groups profits and losses are absolute fictions; expressions of an aggregative group solvency or insolvency are meaningless in the absence of a Deed of Cross Guarantee between the related companies (see, *Indecent Disclosure . . .*, Chapter 8 for an explanation of the effect of deeds of Cross Guarantee. Also provided there are survey data about analysts' and financial officers' perceptions about the lack of serviceability of 'closed-group' consolidated data currently provided in listed companies' financial statements – in the Notes to the Accounts.). The assets of the separate companies are not automatically available to meet the liabilities of the others; and the financial ratios commonly calculated in financial statement analysis using group data – debt to equity, rate of return, debt cover, classes of one asset to another asset class, the relation of one liability class to

another, aggregates of assets and equities, aggregates such as asset backing, etc., - are likely to be grossly misleading insofar as they imply financial relationships within a group, capacities to combine and offset, that ordinarily (*cet. par.*) legally do not exist.

These matters are explained more fully in chapters 16 and 17 (forming part (a) of the Appendix to this submission) of our *Corporate Collapse . . .* (1997, 2003). There we argue and illustrate the misleading use of the corporate group notion and the misleading nature of consolidated financial statements. Those matters are explored further in Chapter 9 (see part (b) of the Appendix below) of our *Indecent Disclosure . . .* (2007).

There, it is noted that a generalised support for conventional consolidated financial statements is couched in terms implying interest in aggregated financial information about the wealth and financial progress of the related companies comprising the so-called *group*. This may well be. Accordingly, we illustrated an alternative method for deriving the appropriate 'group' data in Chapter 17 and the Appendix to Chapter 17 of *Corporate Collapse . . .*, and in Chapter 9 ("An Alternative Group Therapy to Consolidation Accounting" of *Indecent Disclosure . . .* (see Appendix to this submission) a method by which aggregated data might be presented in a form that does not offend the *separate legal entity* doctrine and avoids using the questionable techniques used to prepare conventional consolidated financial statements. The mechanism we illustrate better achieves the objectives usually supporting a need to prepare and report consolidated statements of a group of related companies.

Importantly, we accept that frequently information is sought regarding the overall level of indebtedness of the related companies. This concern underpins the misleading notion of *group solvency*. By eliminating (some) intra-group indebtedness in the consolidation process, conventional consolidated financial statements (at best) disclose indebtedness (of companies within the group) only to non-group companies. The aggregating mechanism we describe in the appendix to Chapter 17 of *Corporate Collapse . . .* and Chapter 9 of *Indecent Disclosure . . .* (see Appendix, Parts (a) and (b) to this submission) has the potential to disclose the detail necessary for determining the balance-sheet derived solvency of each of the related companies, detailing the source and destination of their borrowings and lending – this, in a matrix of all borrowing and lending by the companies reveals which are net-borrowers and which are net-lenders, regarding both related and non-related companies. Debt exposure both within and outside the 'group' is revealed. The Appendix to Chapter 17 illustrates using data from the liquidation of a high profile 1980s Australian company. Since the publication of this reform proposal advances in computer technology and the increasing use of XBRL reporting makes this idea even more compelling on a cost-benefit basis, than when it was proposed originally.

The *Draft Regulatory Impact Statement* declares that the parent entity's full audited financials 'clutters the annual report with unnecessary detail and is potentially confusing' (p.11). There, 'clutters' and 'unnecessary' are arguably disingenuous comments, bearing in mind that no evidence is provided in support of either claim. Indeed, whether the entity's financials are necessary is the issue in question. Likewise the estimated cost of preparing parents' accounts appears a trivial matter. The parent's full audited financials are necessary for the preparation of the consolidated financial statements; alternatively the preferred Option as in the

proposed amendment not only is sanctioning the inclusion of non-audited parent company data in the consolidated financial statements, but also possibly the no-audit of the proposed parent aggregative data. How are regulatory agencies ‘that rely upon financial statements to conduct their supervisory duties’ (p.12) to do so with unaudited parent data in the consolidated financials? And how, under the proposed regime, are the current annual regulatory attempts at tracking listed companies’ ‘solvency’ positions likely to be enhanced by not having access to the relevant parents’ financial statements?

The benefits claimed (p.13) for the preferred amendment (Option (b), p.12) are unsubstantiated there and otherwise difficult to fathom. *Complexity* is unproven. Those who understand consolidation procedures might argue that the parent company’s accounts enhance an understanding of the consolidated data. Or the reverse, as was originally the stated intention of consolidated statements that they enhance the understanding of the data in the parent companies’ accounts (see R.G. Walker, *Consolidated Statements*, Arno, Press, 1976; and Walker’s 1984 NCSC submission, “Accounting requirements for groups of companies” (reproduced here as Appendix (d) ; Chapter 16 of *Corporate Collapse ...* and Chapter 7 of *Indecent Disclosure ...*) *Reduced compliance costs* can be deemed a benefit only if the reduction exceeds the financial benefits of providing access to the information withheld and is not offset by the costs of providing the disaggregated parent data as proposed.

Appendix

(a) **Clarke, F., Dean, G.W. and K.G. Oliver**, *Corporate Collapse: Accounting, regulatory and ethical failure*, CUP, 2003, Chapters 16 and 17.

(b) **Clarke, F. and G.W. Dean**, *Indecent Disclosure: Gilding the corporate lily*, CUP, 2007 Chapters 4, 5, 6, 8, and 9.

(c) **Clarke, F. and G.W. Dean**, submission to the AASB 2003 discussion paper ‘Relevance of Parent Entity Reports’.

(d) **Walker, R.**, “Accounting requirements for groups of companies” submission to NCSC Discussion paper on corporate groups and cross guarantees, 1984. Permission to reproduce given by Professor Walker.

*Frank Clarke is Professor Emeritus at the University of Newcastle and Honorary Professor of Accounting at The University of Sydney. Graeme Dean is Professor of Accounting at The University of Sydney.