Discussion Paper

Proposed Amendments to the Corporations Act

Making a submission

Interested parties are invited to comment on the issues canvassed in this discussion paper.

While submissions may be lodged electronically, by post or by facsimile, electronic lodgement is preferred. For accessibility reasons, please submit responses sent via email in a Word or RTF format. An **additional** PDF version may also be submitted.

All information **(including name and address details)** contained in submissions will be made available to the public on the Treasury website unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence, should provide this information **marked** as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: Monday, 30 January 2012

Address written submissions to:

> The Manager
> Corporate Reporting and Accountability Unit
> Corporations and Capital Markets Division
> Australian Treasury
> Langton Crescent
> PARKES ACT 2600

Email: corporatereportingreforms@treasury.gov.au

For inquiries please call Les Pascoe on (02) 6263 3989 or email les.pascoe@treasury.gov.au.

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1. Introduction

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.

The key area of stakeholder concern is the new test for payment of dividends. Stakeholders have informed the Government that using accounting standards-based calculations to determine whether assets exceed liabilities places an unreasonable burden on companies that are not otherwise required to comply with the standards and gives rise to some of the problems that existed under the former 'profits' test. Other perceived deficiencies with the dividends test that have been raised with the Government by stakeholders include that: the test can have little relationship to solvency (as it does not take into account the timing and magnitude of funds flows); the use of 'declared' in respect of the timing of the test; and the operation of the franking arrangements for such dividends. This paper examines the issues raised by stakeholders and considers options for addressing them.

In addition, stakeholders have informed the Government that there is a need for amendments to:

- the parent entity reporting requirements, to permit the preparation of the entity's own financial statements where such statements are required or considered desirable; and
- the conditions for changing the financial year of a company, to correct an inconsistency within the Act.

These matters are also considered in this paper.

2. Test for payment of dividends

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.

A brief outline of each of these options is provided below.

Option 1 — Retaining section 254T as drafted

Option 1 would retain section 254T in its current form. As a result, the calculation to determine whether assets exceed liabilities and the excess is sufficient for the payment of the dividends would continue to be undertaken in accordance with the accounting standards.

The use of a link to accounting standards in the dividends test is broadly consistent with the test for determining whether a proprietary company is large or small. Under that test, which has been in use since the end of 1995, subsection 45A(6) of the Act provides that consolidated revenue for the financial year and the value of consolidated gross assets as at the end of the financial year are to be calculated in accordance with accounting standards in force at the relevant time (even if the standard does not otherwise apply to the financial year of some or all of the companies concerned). A similar approach was adopted in 2010 for determining whether or not a company limited by guarantee is small.

Benefits of this option include:

- it provides certainty, reliability and objectivity in determining whether a company's assets exceed its liabilities;
- it provides a high level of comfort to directors in complying with their obligation under section 588G of the Act to prevent insolvent trading by the company;
- it is consistent with the requirement in section 286 of the Act for every company to keep written financial records that correctly record and explain its transactions and financial position and performance and would enable true and fair financial statements to be prepared and audited; and
- the link to accounting standards, as used in this option, is consistent with the approach adopted in sections 45A and 45B of the Act.

Disadvantages of this option include that it does not specifically address stakeholder concerns that:

- companies that do not currently have to comply with some or all of the accounting standards may incur compliance costs in deciding whether they satisfy the test for paying a dividend; and
- the test may suffer from deficiencies similar to those of the former profits test, because of the non-cash adjustments to fair values that are required to be reflected in companies' balance sheets.

Option 2 — Adopting a solvency test

Under this option, which is based on the New Zealand approach, a company must not pay a dividend unless the directors are satisfied that:

- the company's assets will exceed its liabilities after the dividend is declared; and
- the company will continue to be able to pay all the company's debts, as and when they become due and payable (see section 95A of the Act — the solvency test).

In determining whether the company's assets will exceed its liabilities after the dividend is declared, the directors shall have regard to:

- the most recent financial statements prepared in accordance with section 295 of the Act; or
- the financial records kept by the company under section 286.

By way of background, features of the New Zealand test include:

- the board of directors of a company may authorise the payment of a dividend if, and only if, the company remains solvent after the distribution (section 52 of the *Companies Act 1993*);
- a company satisfies the solvency test if the company is able to pay its debts as they become due in the normal course of business and the value of the company's assets is greater than the value of its liabilities (including its contingent liabilities) after the distribution of the dividends to its shareholders (section 4 of the *Financial Reporting Act 1993*); and
- for the purpose of deciding whether the previous requirement has been satisfied, reference is to be made to the company's most recent financial statements prepared in accordance with generally accepted accounting practice (sections 4, 10 and 11 of the *Financial Reporting Act 1993*). Consideration should also be given to all circumstances which may affect the value of the company's assets and liabilities. In this regard, the directors may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances.

Benefits of adopting this option include:

- it provides a high level of comfort to directors in complying with their obligation under section 588G to prevent insolvent trading by the company;
- it provides certainty, reliability and objectivity in determining whether a company's assets will exceed its liabilities following the declaration of the dividend;
- it inserts in the legislation a mechanism for reducing the regulatory burden on those companies that are not required to prepare financial statements; and
- it would bring the Australian dividends test broadly into line with the New Zealand test.

A disadvantage of adopting a dividends test based on the New Zealand model would be the absence of an express link to the accounting standards. The absence of such a link could result in less objectivity and consistency in determining a company's ability to pay a dividend.

Option 3 — Reinstating the profits-based test

Under this option, a profits-based dividends test would be reintroduced, either as a replacement for the current net assets test (see option 1) or in conjunction with it (see option 4).

Prior to the Reform Act amendments in 2010, section 254T of the Act provided that a dividend could only be paid out of a company's profits. Over time industry, raised a number of concerns about this requirement, including:

- the Act does not provide guidance about, or a definition of, the term 'profits'. In addition, the legal precedents on this issue are outdated and complex and not in line with current accounting principles. This makes it difficult for directors to understand the legal requirements when paying dividends;

- the nature of accounting principles for the calculation of profits has changed over time. Australian accounting standards, particularly following the adoption of IFRS, are increasingly linked to the fair value of assets and liabilities (whether realised or unrealised) impacting on the profitability of the company. This makes the profitability of Australian companies increasingly volatile with a large number of non-cash expenses being included in the net result. In these circumstances, a company may have sufficient cash to pay a dividend to shareholders but is unable to do so because the accounting profits of the company have been eliminated by non-cash expenses; and

- the requirement for companies to pay dividends only out of profits is inconsistent with the trend to lessen the capital maintenance doctrine in Australia.

Notwithstanding these concerns about the profits-based dividends test, companies generally have been comfortable with the test, as:

- it is easy to understand; and

- companies that are not required to prepare financial statements can use information prepared for other purposes (for example, to satisfy taxation requirements) to determine an amount that can be used as a proxy of their accounting profit.

Option 4 — Adopting new arrangements under which a company would have two ways of determining whether it could pay a dividend

Another option is for section 254T to be redrafted to provide that a company must not pay a dividend unless:

- the company pays the dividend out of its profits; or

- all of the following are satisfied:

  - the company's assets exceeded its liabilities immediately before the time either the dividend is declared or for payment of the dividend and the excess is sufficient for the payment of the dividend,

  - the payment of the dividend is fair and reasonable to the company's shareholders as a whole, having regard to the provisions of section 254W of the Act, and

  - the payment of the dividend does not materially prejudice the company's ability to pay its creditors.

It has been suggested that the assets and liabilities should be calculated in the following manner:

- in the case of a company which is not required to prepare a financial report in accordance with the Act — in accordance with the written financial records required to be kept under section 286 of the Act at the time either the dividend is declared or for payment of the dividend;

- in the case of any other company — in accordance with the accounting standards which are in force and apply to the company at the time either the dividend is declared or for payment of the dividend.

This option, which combines elements of options 1, 2 and 3, has most of the benefits associated with option 1. However, because this option would give companies the ability to use either alternative ways of calculating whether assets exceed liabilities or a profits-based test, it avoids the burden that an assets exceeds liabilities test places on those companies that are not required to prepare financial statements.

Issues for consideration

Stakeholders are invited to provide their views about each of the four options listed in this paper (including an indication of their preferred option or options).

Are there other options for dealing with the dividends test that could be considered by Treasury?

Other Corporations Act issues in respect of the dividends test

Stakeholders have raised a number of technical issues about matters associated with the dividends test, including:

- the terminology used in the legislation;
- the inter-relationship between the dividends test and capital maintenance provisions; and
- the application of the test to group companies.

Use of 'declared'

Section 254T of the Corporations Act requires a company's assets to exceed its liabilities immediately before the dividend is *declared*.

However, section 254U and most company constitutions now provide for the board to 'determine' that dividends are payable rather than 'declare' a dividend. (The 'declaration' of a dividend also has financial implications for an entity, as subsection 254V(2) provides that 'if the company has a constitution and it provides for the declaration of dividends, the company incurs a debt when the dividend is declared.')

In these circumstances, the Treasury has come to the view that, for dividends tests that do not include a solvency test along the lines of that described in option 2, there may be merit in bringing the terminology used in section 254T into line with that used in section 254U and most company constitutions.

In the event that stakeholders consider that the dividends test should include a solvency test, it is Treasury's view that section 254T should continue to use 'declared' as an element of the test will be that a company must not pay a dividend unless the directors are satisfied that the company's assets will exceed its liabilities after the dividend is declared.

Issue for consideration

Stakeholders' views are sought on whether the terminology used in section 254T should continue to use 'declared' or be brought into line with that used in section 254U.

Capital maintenance requirements

Chapter 2J sets out a test for reducing share capital in sub-section 256B(1) of the Corporations Act, which provides that a company may reduce its share capital *in a way that is not otherwise authorised by law* if the reduction: is fair and reasonable to the company's shareholders as a whole; does not materially prejudice the company's ability to pay its creditors; and is approved by shareholders.

The Treasury considers that the test for paying a dividend in section 254T of the Act is a circumstance where a reduction in capital is 'otherwise authorised' by the law.

- To maintain the integrity of the regulatory framework, the revised section 254T mirrors two of the safeguards contained in Chapter 2J for the reduction of capital, in particular, the requirement to ensure that the payment is fair and reasonable to the company's shareholders as a whole, and that it does not materially prejudice the company's ability to pay its creditors.
- The revised section 254T does not contain a requirement for shareholder approval, and instead includes an additional safeguard not included in Chapter 2J, that the company's assets must exceed its liabilities following the payment.
- Paragraph 3.9 of the explanatory memorandum accompanying the recent reforms notes that two out of three limbs of the revised dividend test in section 254T 'align with the requirements imposed on companies in relation to conducting share capital reductions and share buy-backs under Part 2J...'. This indicates Parliament's intention to introduce a similar, but not identical, test for paying dividends that operates independently from Chapter 2J.

Chapter 2J continues to apply to other types of share capital reductions, such as share buy-backs, the redemption of redeemable preference shares and cancelling uncalled capital.

The Treasury believes the legislative provisions are clear. However, the concern raised by some stakeholders suggests that there may be merit in either amending the legislation or inserting a note to clarify the inter-relationship between the operation of the dividends test and the capital maintenance provisions.

Issue for consideration

Stakeholders' comments are invited on whether a legislative amendment is needed to clarify that satisfying the test for paying a dividend in section 254T of the Act is a circumstance where a reduction in capital is 'otherwise authorised' by the law.

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.

Taxation issues

As noted earlier in this paper, some stakeholders have raised concerns about uncertainty that exists amongst the Australian business community in relation to dividend payments and whether or not they are capable of being franked for tax law purposes.

When the Act was amended in 2010 to allow dividends to be paid in circumstances where a company's assets exceed its liabilities, it was expected that there would be no significant change to the circumstances in which dividends could be franked for income tax purposes. In particular, it was expected that dividends that could be franked prior to the 2010 changes could continue to be franked after those changes.

Concerns about the ability of companies to pay franked dividends since the corporations law amendments arise, at least in part, from draft fact sheets issued by the Australian Taxation Office (ATO) to an industry stakeholder working group that is considering the tax impact of those amendments. Among other things, the draft fact sheets conclude that a company is unable to frank dividends out of current year profits if its net assets are less than its share capital.

In light of the feedback the ATO has received from stakeholders concerning the draft fact sheets, the ATO has advised that a draft Taxation Ruling is being considered by the Public Rulings Panel at the end of November 2011.

Regulation Impact Statement

The Office of Best Practice Regulation has advised the Treasury that, given the potential impacts on businesses, additional analysis (in the form of a Regulation Impact Statement) is required in relation to any amendments to the dividend requirements test. This Statement will be prepared at the conclusion of the consultative process.

3. Other amendments

As indicated in the introductory section of this paper, stakeholders have informed the Government that they consider there is a need for amendments to the parent entity reporting requirements and the conditions for changing the financial year of a company. This section of the paper outlines the Treasury's consideration of the matters raised by stakeholders.

Parent entity reporting requirements

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 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?*

Changing the financial year of a company

In June 2010, the Act was amended by the inclusion of a new subsection 323D(2A), the purpose of which is to facilitate a change of a company's balance date by allowing a financial year subsequent to the first year to last for a period of less than 12 months. One prerequisite that has to be satisfied in order to apply this change is that none of the previous five financial years has been of less than 12 months duration.

Subsequently, stakeholders informed Treasury that the condition in subsection 323D(2A) requiring none of the previous five financial years to be of less than 12 months duration is inconsistent with subsection 323D(2), which provides that the directors may determine that the financial year is to be shorter or longer than 12 months by not more than seven days.

It is proposed that the inconsistency within section 323D be corrected by amending subsection 323D(2A) to allow a financial year of less than 12 months (that is, one to 11 months) provided that the length of each of the last five financial years has not been varied by more than plus/minus seven days as permitted by subsection 323D(2).

Issue for consideration

Stakeholders' are invited to comment on whether there are other issues associated with the requirements for changing the financial year of a company that they consider should be brought to the Treasury's attention?

Regulation Impact Statement

The Office of Best Practice Regulation has advised the Treasury that, based on its preliminary assessment of the proposed changes to parent entity financial reporting requirements and the conditions for changing a financial year, the changes are of a minor nature and no further analysis (in the form of a Regulation Impact Statement) is required.