



BUSINESS LAW

FINANCIAL REPORTING OF FOREIGN CONTROLLED COMPANIES

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The financial and accounting recording and reporting obligations of foreign controlled companies are generally governed by taxation and corporate laws and regulations. Where the foreign controlled company is part of a group, often group policies on reporting and auditing requirements are imposed on companies by their foreign controller to facilitate financial supervision by the parent company and to allow reasonably reliable commercial and financial comparisons between various subsidiaries. A group policy on financial reporting may also be imposed to comply with corporate governance requirements and standards in the jurisdiction of the parent company. Additionally, if the company has borrowed monies from banks and other financial institutions, the terms of the lending facility may require the company to prepare audited financial reports.

There may be sound commercial reasons why a company should prepare audited financial reports. This paper, however, is only concerned with the circumstances under which the Corporations Act 2001 (the “Act”) imposes an obligation to prepare and lodge audited financial reports and the conditions that must be met to obtain relief from preparing and lodging an audited financial report and a directors’ report.

Record Keeping

All companies must 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 audited¹. Those financial records may be kept in any language but an English translation of all financial records not kept in English must be made available within a reasonable time to a person who is entitled to inspect the records and asks for the English translation.

Financial Reporting

Certain companies must not only comply with recording provisions but additionally must comply also with the annual financial reporting provisions of Part 2M.3 of the Act.

The financial report, to be compliant, must consist of:

- (a) financial statements for the year;

- (b) notes to the financial statements; and
- (c) directors' declaration about the statements and notes.

The financial statements are a profit and loss statement for the relevant financial year, a balance sheet as at the end of that year, a statement of cash flows for that year and, if required by the accounting standards, a consolidated profit and loss statement, balance sheet and statement of cash flows. The notes to the financial statements are disclosures required by the regulations, notes required by the accounting standards and any other information necessary to give a true and fair view. The directors' declaration is a declaration by the directors that the financial statements and the notes referred to above comply with the accounting standards, the financial statements and notes give a true and fair view (see section 297 of the Act) and whether, in the directors' opinion, there are reasonable grounds to believe that the company will be able to pay its debts as and when they become due and payable and further whether, in the directors' opinion, the financial statements and notes are in accordance with the Act, including:

- (i) section 296 of the Act (compliance with accounting standards); and
- (ii) section 297 of the Act (true and fair view).

The annual directors' report must be made in accordance with a resolution of the directors, specify the date on which the report is made and be signed by a director. The report must include general information about operations and activities and, in particular, must contain a review of the operations in the relevant year and the result of those operations, give details of any significant changes in the company's state of affairs, state the company's principal activities during the year and any significant changes in the nature of those activities during the year². The report must give details of any matter or circumstance that has arisen since the end of the year that has significantly effected or may significantly affect the company's operations, the results of those operations or the company's state of affairs in future financial years. The report must also refer to likely developments in the company's operations in future years and the expected results of those operations and, if the company's operations are subject to any particular and significant environmental regulation under Federal or State law give details of the company's performance in relation to the environmental regulation. The specific information which must be included in the annual directors' includes details of dividends or distributions recommended, paid or declared for payment to members, the names of all directors of the company during relevant year and the periods for which they were a director³. The specific information also includes options that are granted for unissued shares or unissued interest or granted to any other directors or any of the five most highly remunerated officers of the company and granted to them as part of their remuneration.

The directors' report must also contain details of unissued shares and interests under options as at the date the report is made and of shares or interests issued during the relevant year as a result of the exercise of an option of unissued shares or interests. Lastly, the directors' report must include details of any indemnities given and insurance premiums paid during the relevant year for a person who has been an officer or auditor of the company.

Companies subject to Reporting

In general, all public companies and certain proprietary companies must comply with the annual financial reporting provisions of Part 2M.3 of the Act.

A financial report and a directors' report must be prepared for each financial year by all public companies and all large proprietary companies⁴. The term "large proprietary companies" is defined as follows⁵:

"Proprietary companies are a large proprietary company for a financial year which satisfied at least two of the following paragraphs:

- (a) the consolidated gross operating revenue for the financial year of the company and the entity it controls (if any) is \$25 million or more;
- (b) the value of the consolidated gross assets at the end of the financial year of the company and the entity it controls (if any) is \$12.5 million or more;
- (c) the company and the entity it controls (if any) have 50 or more employees at the end of the financial year."

A small proprietary company has to prepare the financial years and directors' report only if:

- (a) it is directed to do so under sections 293 or 294 of the Act;
- (b) it was controlled by a foreign company for all or part of the year and is not consolidated for that period in the financial statement for that year lodged with the Australian Securities and Investments Commission by:
 - (i) a registered foreign company; or
 - (ii) a company, registered scheme or disclosing entity⁶.

Again, the term "small proprietary company" is defined in the Act⁷ as a company which satisfies not more than one of the three revenue, asset and staff criteria and basically means any proprietary

company which is not a large proprietary company.

Shareholders with at least 5% of the voting shares in a small proprietary company may direct the company to prepare a financial report and directors' report for a financial year and further direction to send those reports to all shareholders⁸. The direction may also specify that the financial reports and the directors' report must be audited. Similarly, the Act⁹ gives the Australian Securities and Investments Commission the right to direct a small proprietary company to comply with the reporting and auditing requirements of Part 2M of the Act.

A small proprietary company is "controlled" as defined in the Act¹⁰ if the foreign company has the capacity to determine the outcome of decisions about the company's financial or operating policies. In this regard, various factors must be considered in order to determine whether the necessary control capacity exists, in particular, the practical influence the foreign company can exert (rather than the rights it can enforce) and any practice or pattern of behaviour affecting the company's financial operating policies. In practice, the capacity to appoint or remove directors or otherwise dominate the composition of the board of the company will generally amount to a capacity to control.

Audit of Financial Reports

Generally, a company which must prepare financial reports under Part 2M.3 of the Act, must also have those financial reports audited and must obtain an auditor's report.

The auditor who conducts the audit must form an opinion about whether:

- (a) the financial report is in accordance with this Act, including:
 - (i) sections 296 or 304 of the Act (compliance with accounting standards); and
 - (ii) sections 297 or 305 of the Act (true and fair view);
- (b) the auditor has been given all information, explanation and assistance necessary for the conduct of the audit;
- (c) the company has kept financial records sufficient to enable a financial report to be prepared and audited;
- (d) the company has kept other records and registers as required by the Act¹¹.

The auditor must be given access to the books of the company and must given all reasonable assistance by the company and its officers to perform the audit.

The objective of an audit of a financial report is to enable an auditor to express an opinion as to whether the financial report is prepared, in all material respects, according to an identified financial reporting framework¹². The persons most likely to benefit from an audit include shareholders, directors, actual and potential creditors. For these persons an audit enhances the credibility and reliability of a company's financial report.

Lodgement of Financial Reports

A company that has to prepare a financial report under Division 1 of Part 2M.3, must lodge the report with the Australian Investments and Securities Commission¹³.

Exemption from Financial Reporting, Auditing and Lodging

If financial reports have been prepared in response to a shareholder's direction¹⁴ but the direction did not specify that those financial reports be audited¹⁵, the audit obligations under section 301 (1) of the Act do not apply to that company. In those circumstances, the Act expressly provides that the company is also not required to lodge financial reports¹⁶.

The Australian Securities and Investments Commission has been given power¹⁷ to make specific exemption orders and class exemption orders. To make an order the Australian Securities and Investments Commission must be satisfied that complying with the relevant requirements of Parts 2M.2, 2M.3 and 2M.4 would:

- (a) make the financial report or other reports misleading;
- (b) be inappropriate in the circumstances; or
- (c) impose unreasonable burdens.

Financial or other reports may be misleading if they would, in all probability, result in a reader's forming an incorrect conclusion or if compliance would distort particular information required by the Act. Proof that the required disclosure is uninformative or irrelevant is, in itself, insufficient to establish that the accounts or reports would be misleading¹⁸. Relief on this ground will not be granted unless it is established that the difficulty could not reasonably be remedied by the provision of appropriate additional information so as to give a true and fair view of the financial statements¹⁹. Directors are under a statutory obligation to ensure the entity's financial statements give a true and fair view of the entity's financial position and performance.

An applicant must show either an anomaly in the Act or that compliance would result in an application of the Act unintended by the legislature to establish that compliance with the Act would be “inappropriate in the circumstances”²⁰. The Federal Court of Australia confirmed in an appeal from the Administrative Appeals Tribunal that assertion that the company is not a “reporting entity” within the meaning of the accounting standards is not sufficient to justify the conclusion that lodgment of the financial reports with the Australian Securities and Investments Commission (and therefore accessible by the public) is “inappropriate in the circumstances”²¹. The argument was raised that, being non-reporting entities, their financial statements were special purpose financial statements that had been prepared for particular users, such as the group's financiers. The AAT rejected this argument and stated that the requirement to lodge financial statements was not based upon whether the company was a reporting entity, but rather upon whether the company was a large proprietary company as defined in the Act. The classification between small and large proprietary companies was based upon economic significance. As the Incat Group was clearly economically significant in the market in which it operated, lodgment of financial statements was appropriate in the circumstances.

Policy Statement 43 provides other examples where compliance with the provisions of Chapter 2M may be inappropriate. Compliance with the Act may be inappropriate where it would be inconsistent with other Australian statutory requirements (eg the Banking Act)²². However, the Australian Securities and Investments Commission notes that the mere fact that compliance is irrelevant or of no use to users of the financial information such as shareholders, does not necessarily make it inappropriate.

The Australian Securities and Investments Commission will be inclined to grant relief to companies in receivership where a receiver (or receiver and manager) takes over the management of all, or a significant part of the day-to-day operation of the company. Such relief would be granted on the basis that doubts surrounding the company's viability rendered general financial information on the company (eg statutory financial statements) unsuitable.

The Australian Securities and Investments Commission must, when deciding whether audit requirements for a proprietary company, or a class of proprietary companies impose an unreasonable burden on a company, have regard to:

- (a) the expected costs of complying with the audit requirements;
- (b) the expected benefits of having the company to comply with the audit requirements;

- (c) any practical difficulties that the company faces in complying effectively with the audit requirements (in particular, any difficulties that arise because a financial year is the first one for which the audit requirements apply or because the company is likely to move frequently between the small and large proprietary company categories from one financial year to the other;
- (d) any unusual aspects of the operation of the company during the financial year concerned;
- (e) any others matters that Australian Securities and Investments Commission considers relevant²³.

The expected costs of complying with the audit requirements are an unreasonable burden if these costs are out of all proportion to the expected benefits resulting from the audit²⁴. The benchmark applied by the Australian Securities and Investments Commission is the legislative policy that in general for large proprietary companies the expected costs of an audit are worth incurring for the sake of the expected benefits they bring. Policy Statement 115 is therefore principally concerned with cases where the expected costs are out of proportion because the benefits are expected to be minimal. The additional costs and administrative burdens of complying with the audit requirements are not in themselves unreasonable.

The expected benefits must be assessed by the Australian Securities and Investments Commission by taking into account the number and position of actual and potential creditors of the company and their ability to independently obtain financial information about the company and the nature and extent of the liabilities of the company.

When considering the position of the persons most likely to benefit from an audit such as shareholders, directors and actual and potential creditors, the objective of the Australian Securities and Investments Commission is to minimise the potential for these persons to be disadvantaged by the audit relief. To achieve this objective the Australian Securities and Investments Commission will not generally give audit relief unless:

- (a) shareholders and directors of the company agree that an audit of the company's financial report is not required; and
- (b) the Australian Securities and Investments Commission is satisfied that the company is well managed and in a sound financial condition, in respects most directly relevant to the interests of the creditors.

The Australian Securities and Investments Commission outlined in Policy Statement 58 the

circumstances in which the Australian Securities and Investments Commission will provide relief to small companies controlled by foreign companies. In accordance with this Policy Statement, the Australian Securities and Investments Commission issued Class Order 98/98 which provides relief for those small proprietary companies from the requirement to prepare and lodge an audited financial report provided that they are not part of large group.

The Class Order relieves a small proprietary company which otherwise²⁵ would be required to comply with Parts 2M.2 and 2M.3 of the Act provided that the company is not part of large group.

In monetary terms, the three applicable revenue, asset and staff criteria of the definition of “large” are identical to the definition of a large company, however, on a “combined” group basis. “Combined” in this context means the result of aggregating the financial information of the entities in the group, being the financial information in respect of each entity for that part of the relevant financial year that each entity is part of the group, and making all such adjustments as would be required in preparing consolidated financial statements in accordance with relevant accounting standards.

Policy Statement 58 explains that combining the financial information of the group is a process similar to the consolidation, except that foreign parent companies which do not carry on business in Australia are excluded from the consolidation²⁶. The combination process also excludes any controlled entities of the foreign controlling company that do not carry on business in Australia and are not registered or formed in Australia, unless they are controlled by an entity operating or incorporated in Australia.

“Group” means the Company together with all of the following:

- (a) any entity which controlled the Company at any time during the relevant financial year and which was registered or formed in Australia or carries on business in Australia;
- (b) any other entity (an “Other Party”) which is both:
 - (i) controlled any time during the relevant financial year by any foreign company which at the same time controls the Company;
 - (ii) registered or formed in Australia or carries on business in Australia during the relevant part of financial year when it is controlled by the same foreign company that controls the Company;
- (c) any entity which is controlled at any time during the relevant financial year by the Company;

- (d) any entity which is controlled at any time during the relevant financial year by an Other Entity when the Other Entity is controlled by the same foreign company (whether it carries on business in Australia or registered or formed in Australia) that controls the Company.

This definition includes all Australian subsidiaries of a foreign parent company and also all Australian and non-Australian subsidiaries of those Australian subsidiaries. However, the parent company itself, provided it does not carry on business in Australia, and other non-Australian subsidiaries of the foreign parent company do not form part of the group.

Policy statement 115 the Australian Securities and Investments Commission outlines further circumstances in which relief will be provided to proprietary companies including small companies controlled by foreign companies. In accordance with policy statement 115, the Australian Securities and Investments Commission issued Class Order 98/1417. Please note that the relief is limited to remove audit requirements but does not affect any reporting obligations.

The Class Order relieves a company which otherwise would be required to comply with ordinary audit requirements if the Australian Securities and Investments Commission is satisfied that the company is well managed²⁷ and in a sound financial condition²⁸. The criteria of the Australian and Securities Investments Commission has used to determine that companies are well managed, requires that directors have appropriate internal management systems and procedures which allow them to assess the financial condition and the solvency of the company. The nature of the systems and the frequency of these procedures must be adequate for this purpose and appropriate to the company's business and financial circumstances. As a minimum, however, the assessment by directors must include a quarterly assessment of a profit and loss statement, balance sheet and cash flow statement of the company prepared for management purposes.

The criteria on the Australian and Securities and Investments Commission has used to determine if a company is in sound financial condition requires that the company has all the following characteristics:

- (a) its total liabilities do not exceed 70% of its total assets, excluding intangible assets. This ratio must be satisfied at the end of each quarter during the relevant financial year, at the end of the relevant financial year and at the time the directors and shareholders resolved to apply for the relief;
- (b) it makes a profit from ordinary activities after related income tax expenses for other relevant financial year or the immediately preceding financial year; and
- (c) it is able to pay all its debts as and when they become due and payable each quarter during the

relevant financial year.

The relief granted under Class Order 98/1417 does not relieve the company from preparing financial reports. The relief is limited to have those financial reports audited. In order that professional competence and due care are used in compiling the year and financial report, must be compiled by a prescribed accountant in accordance with the miscellaneous professional statement²⁹. A prescribed accountant is either a member of CPA Australia, the Institute of Chartered Accountants in Australia or the National Institute of Accountants³⁰.

The relief from the audited requirements is only available if the company lodges its financial report and director's report for the relevant financial year and the immediately preceding financial year within the deadlines in the Act³¹ or the additional time³² as is approved by the Australian Securities and Investments Commission.

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¹ s286 (1) of the Corporations Act 2001

² s299(1) of the Corporations Act 2001

³ s298(1)(b) and s300 of the Corporations Act 2001

⁴ s292 (1) of the Corporations Act 2001

⁵ s45A of the Corporations Act 2001

⁶ s292(2) of the Corporations Act 2001

⁷ s45A of the Corporations Act 2001

⁸ s293 (1) of the Corporations Act 2001

⁹ s294 of the Corporations Act 2001

¹⁰ s50AA of the Corporations Act 2001

¹¹ s307 of the Corporations Act 2001

¹² para 115.10 of Policy Statement 115

¹³ s319 (1) of the Corporations Act 2001

¹⁴ s293 (1) of the Corporations Act 2001

¹⁵ s293 (3) (c) of the Corporations Act 2001

¹⁶ s319 (2) (c) of the Corporations Act 2001

¹⁷ s340 and 341 of the Corporations Act 2001

¹⁸ para 43.18 of Policy Statement 43; para 115.8 of Policy Statement 115

¹⁹ *QBE Insurance Group Ltd & Ors v Australian Securities Commission & Anor* (1992) 10 ACLC 1490

²⁰ *Mazda Australia Pty Ltd & Ors v Australian Securities Commission* (1992) 10 ACLC 1479

²¹ *Incat Australia Pty Ltd & Anor v Australian Securities and Investments Commission* (2000) 18 ACLC 69

²² para 43.19 of Policy Statement 43

²³ para 115.9 of Policy Statement 115

²⁴ para 115.16 of Policy Statement 115

²⁵ s292 (2) (b) of the Corporations Act 2001

²⁶ para 58.22 of Policy Statement 58

²⁷ para 115.43 of Policy Statement 115

²⁸ para 115.45 of Policy Statement 115

²⁹ para 115.50 of Policy Statement 115

³⁰ para 115.51 of Policy Statement 115

³¹ para 115.31 of Policy Statement 115

³² paras 115.39A-G and 115.55 of Policy Statement 115