

Financial Reporting of Foreign-Controlled Companies

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 the company by its 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 article, however, is only concerned with the circumstances under which the *Corporations Act 2001* (Cth) (the “Act”) imposes an obligation on foreign controlled companies 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 their transactions and financial position and performance and would enable true and fair financial statements to be prepared and audited.¹ 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 also comply with the annual financial reporting provisions of Part 2M.3 of the Act.

In order to be compliant, the financial report 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

¹ Corporations Act 2001 (Cth), s 286(1).

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 of the financial position and performance of the company. The directors' declaration is a declaration by the directors that the financial statements and the notes referred to above comply with the accounting standards, that the financial statements and notes give a true and fair view (see section 297 of the Act), 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:

- (a) section 296 of the Act (compliance with accounting standards); and
- (b) 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 year.² The report must give details of any matter or circumstance that has arisen since the end of the year that has significantly affected 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' report 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 director.³ 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 that 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 companies.⁴ The term "large proprietary companies" is defined as follows:⁵

² *Ibid.*, s 299(1).

³ *Ibid.*, ss 298(1)(b) and 300.

⁴ *Ibid.*, s 292(1).

⁵ *Ibid.*, s 45A.

A Proprietary company is 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; and/or
- (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; or
- (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 ASIC by:
 - (i) a registered foreign company; or
 - (ii) a company, registered scheme or disclosing entity.⁶

Again, the term "small proprietary company" is defined in the Act 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.⁷

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 shareholders.⁸ The direction may also specify that the financial reports and the directors' report must be audited. Similarly, the Act gives ASIC the right to direct a small proprietary company to comply with the reporting and auditing requirements of Part 2M of the Act.⁹

A small proprietary company is "controlled" as defined in the Act if the foreign company has the capacity to determine the outcome of decisions about the company's financial or operating policies.¹⁰ 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:

⁶ *Ibid.*, s 292(2).

⁷ *Ibid.*, s 45A.

⁸ *Ibid.*, s 293(1).

⁹ *Ibid.*, s 294.

¹⁰ *Ibid.*, s 50AA.

- (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; and
- (d) the company has kept other records and registers as required by the Act.¹¹

The auditor must be given access to the books of the company and must be 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, in all material respects the financial report is prepared according to an identified financial reporting framework.¹² The persons most likely to benefit from an audit include shareholders, directors and actual and potential creditors. For these people, 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 ASIC.¹³

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 audited,¹⁵ 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 reports.¹⁶

ASIC has been given power to make specific exemption orders and class exemption orders¹⁷. To make such an order, ASIC must be satisfied that the order in compliance with the relevant requirements of Parts 2M.2, 2M.3 and 2M.4 would:

- (a) not 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 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 misleading.¹⁸ Relief on this ground will not be

¹¹ *Ibid.*, s 307.

¹² Policy Statement 115, para 115.10.

¹³ *Corporations Act*, s 319(1).

¹⁴ *Ibid.*, s 293(1).

¹⁵ *Ibid.*, s 293(3)(c).

¹⁶ *Ibid.*, s 319(2)(c).

¹⁷ *Ibid.*, ss 340 and 341.

¹⁸ Policy Statement 43, para 43.18; and Policy Statement 115, para 115.8.

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 statements.¹⁹ 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 who opposes an exemption order must show either an anomaly in the Act or that compliance would result in an application of the Act unintended by the legislature or establish that compliance with the Act would be "inappropriate in the circumstances".²⁰ The Federal Court of Australia has 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 lodgement of the financial reports with ASIC (and therefore making the reports accessible by the public) is "inappropriate in the circumstances".²¹ The argument was raised that, being non-reporting entities, the companies' 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 on whether the company was a reporting entity, but rather on whether the company was a large proprietary company as defined in the Act. The classification between small and large proprietary companies was based on economic significance. As the companies concerned were clearly economically significant in the market in which they operated, lodgment of financial statements was appropriate in the circumstances.

ASIC 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 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.

ASIC 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 (e.g. statutory financial statements) unsuitable.

ASIC 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 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; and
- (e) any other matters that ASIC considers relevant.²³

¹⁹ *QBE Insurance Group Ltd v ASC* (1992) 10 ACLC 1490.

²⁰ *Mazda Australia Pty Ltd v ASC* (1992) 10 ACLC 1479.

²¹ *Incat Australia Pty Ltd v ASIC* (2000) 18 ACLC 69.

²² Policy Statement 43, para 43.19.

²³ Policy Statement 115, para 115.9.

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 audit.²⁴ The benchmark applied by ASIC 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. ASIC 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 ASIC 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 ASIC is to minimise the potential for these persons to be disadvantaged by the audit relief. To achieve this objective ASIC 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) ASIC itself 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.

ASIC Policy Statement 58 outlines the circumstances in which ASIC will provide relief to small companies controlled by foreign companies. Pursuant to this Policy Statement, ASIC 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 would otherwise be required to comply with Parts 2M.2 and 2M.3 of the Act provided that the company is not part of large group.²⁵

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.

ASIC Policy Statement 58 explains that combining the financial information of the group is a process similar to consolidation, except that foreign parent companies which do not carry on business in Australia are excluded from the consolidation.²⁶ 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.

²⁴ *Ibid.*, para 115.16.

²⁵ *Corporations Act*, s 292(2)(b).

²⁶ Policy Statement 58, para 58.22.

“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; and
- (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.

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

A Class Order relieves a company which would otherwise be required to comply with ordinary audit requirements if ASIC is satisfied that the company is well managed²⁷ and in a sound financial condition.²⁸ The criteria of ASIC 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, 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 which ASIC 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.

²⁷ Policy Statement 115, para 115.43.

²⁸ *Ibid.*, para 115.45.

The relief granted under ASIC Class Order 98/1417 does not relieve the company from preparing financial reports. The relief is limited to not having those financial reports audited. In order that professional competence and due care are used in compiling the year and financial report, they must be compiled by a prescribed accountant in accordance with the miscellaneous professional statement.²⁹ A prescribed accountant is either a member of CPA Australia, the Institute of Chartered Accountants in Australia or the National Institute of Accountants.³⁰

Relief from audit requirements is only available if the company lodges its financial report and directors' 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 ASIC.

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²⁹ *Ibid.*, para 115.50.

³⁰ *Ibid.*, para 115.51.

³¹ *Ibid.*, para 115.31.

³² *Ibid.*, para 115.39A-G and 115.55.