

**COMMONWEALTH GOVERNMENT RESPONSE
TO THE
PARLIAMENTARY JOINT STATUTORY COMMITTEE ON
CORPORATIONS AND SECURITIES
REPORT ON
ASPECTS OF THE REGULATION OF PROPRIETARY
COMPANIES**

GOVERNMENT RESPONSE TO THE REPORT OF THE PARLIAMENTARY JOINT STATUTORY COMMITTEE ON CORPORATIONS AND SECURITIES — *ASPECTS OF THE REGULATION OF PROPRIETARY COMPANIES*

BACKGROUND

On 27 January 2000, the then Minister for Financial Services and Regulation, the Hon Joe Hockey MP, asked the then Parliamentary Joint Statutory Committee on Corporations and Securities (the Committee) — now known as the Parliamentary Joint Committee on Corporations and Financial Services — to examine certain matters arising from the thresholds used to differentiate between the financial reporting obligations of small and large proprietary companies (known as the ‘small/large’ test). The Committee’s report, entitled *Aspects of the Regulation of Proprietary Companies*, was tabled in the Parliament on 8 March 2001.

The Committee’s report contains four recommendations, the principal recommendation being the removal of the thresholds contained in section 45A of the *Corporations Act 2001* (the Corporations Act) used to define a proprietary company and the reinstatement of the previous exempt and non-exempt proprietary company regime.

Under the approach recommended by the Committee, all non-exempt proprietary companies would be required to lodge audited financial statements with ASIC. The other recommendations contained in the report related to requirements for directors of proprietary companies to sign and lodge a declaration of solvency with their annual reports, the application of accounting standards and audit requirements.

The report also includes a minority report by the then Labor Party members of the Committee which contains four recommendations. These recommendations are that the existing small/large test be continued, removing the grandfathering provision or making it subject to a sunset provision, requiring each proprietary company to inform ASIC each year whether it is small or large and to require ASIC to collect statistics on the number of companies that are small or large.

The Government’s response to each of these recommendations is outlined below.

THE GOVERNMENT'S RESPONSE TO THE COMMITTEE'S RECOMMENDATIONS

RECOMMENDATION 1

The previous distinction between exempt and non-exempt proprietary companies be reinstated, to replace section 45A of the Corporations Act.

The Government **does not support** this recommendation.

The current financial reporting requirements were introduced in 1995 by the Keating Government. These changes removed the distinction between non-exempt and exempt companies and replaced it with a threshold test. Since that time, the policy of successive Governments has been that financial reporting requirements should generally be based on an entity's economic significance rather than ownership characteristics. Economically significant proprietary companies have considerable influence on the economy and community more broadly and as such should be required to prepare audited financial statements.

In 2007, the thresholds used to define a large proprietary company were increased as part of a range of amendments made to the Corporations Act by the *Corporations Legislation Amendment (Simpler Regulatory System) Act 2007* (SRS Act). The amendments resulted in the monetary thresholds (revenue and assets) being increased by 150 per cent to ensure that only those companies that are of genuine economic significance continue to be required to prepare financial statements. It is estimated that this amendment reduces the number of proprietary companies with financial reporting obligations by 35 per cent.

The amendments contained in the SRS Act also allow for changes to the thresholds to be prescribed by regulation to enable the thresholds to be more readily adjusted in the future. This amendment will ensure that the thresholds continue to accurately reflect genuine economic significance during periods of sustained economic growth.

The Government supports the threshold criteria used to define large proprietary companies and determine their financial reporting obligations.

RECOMMENDATION 2

All directors of proprietary companies be required to sign and lodge a declaration of solvency with their annual reports.

The Government **does not support** this recommendation.

The Corporations Act already prohibits company directors from engaging in insolvent trading (section 588G) and there are penalties for any directors who breach these provisions.

In addition, introducing a requirement for directors of proprietary companies to sign and lodge a declaration of solvency with their annual reports would be a departure from the policy principle, underlying the reforms in the seventh phase of the *Corporate Law Economic Reform Program* (CLERP 7), that companies should only be required to notify ASIC when a change in details has occurred.

The CLERP 7 reforms removed the requirement for companies to lodge an annual return with ASIC. However, companies are still required to notify ASIC of changes in particulars, as they

occur, within the statutory period. Companies are also required to conduct an annual review. As part of the annual review, companies are required to check the information contained on an extract of particulars issued by ASIC, ensuring they are correct and up-to-date. Again, companies are only required to notify ASIC if a change occurs.

Directors are still required to pass an annual resolution of solvency under section 346 of the Corporations Act, before the due date for payment of the annual fee. Failure by directors to resolve each year that the company is solvent is an offence. As such, the Government believes that the current requirements are sufficient without imposing any further regulatory burden on company directors to indicate the company's solvency.

RECOMMENDATION 3

In preparing financial statements, reporting and non-reporting entities apply all the recognition and measurement requirements of the Accounting Standards.

The Government **supports** this recommendation.

In July 2005, the Australian Securities and Investments Commission (ASIC) issued a Regulatory Guide entitled *Reporting Requirements for Non-Reporting Entities* [RG 85] to assist non-reporting entities prepare their financial reports. The Regulatory Guide states that all non-reporting entities, which are required to prepare financial statements in accordance with Chapter 2M of the Corporations Act, should comply with the recognition and measurement requirements contained in the full suite of accounting standards. These requirements supersede ASIC's Information Release [00/025], released in July 2000, which provided guidance on how to apply the 'reporting entity' test and the reporting obligations for non-reporting entities, including compliance with the recognition and measurement requirements.

In addition, the Australian Accounting Standards Board (AASB) is currently considering the potential application in Australia of a proposed International Financial Reporting Standard (IFRS) specifically developed by the International Accounting Standards Board (IASB) to meet the financial reporting needs of private entities. This work also includes an assessment of the reporting entity concept.

During 2007, the AASB released for public consultation a revised differential reporting framework for Australia. The AASB's constituents expressed mixed views on the proposals and, in November 2007, the AASB informed the IASB that it was considering how it might use the IFRS for private entities in its differential reporting regime. The AASB indicated that the extent to which it might use an IFRS for private entities will depend on a number of domestic factors and the extent to which the final IFRS for private entities standard meets the needs of Australian constituents. The IASB is expected to issue its final standard during the fourth quarter of 2008.

RECOMMENDATION 4

All company financial statements, which are required to be lodged with ASIC, should be required to be audited.

The Government **supports** this recommendation.

The Government recognises that audits improve the reliability of financial statements. Audits represent the principal external check on the integrity of financial statements. As such, audited financial statements are an important element of effective corporate governance.

Under the Corporations Act, companies, registered schemes and disclosing entities are required to prepare financial statements which have been audited by a registered company auditor. ASIC can provide, in limited circumstances, relief to proprietary companies from this requirement if the audit imposes an unreasonable burden on the entity. The Government endorses these requirements.

GOVERNMENT'S RESPONSE TO RECOMMENDATIONS IN MINORITY REPORT BY LABOR PARTY MEMBERS OF THE COMMITTEE

RECOMMENDATION

The minority report recommended that the existing 'small/large' test continue for the time being.

The Government **supports** this recommendation.

In 1995, the basis for determining the financial reporting requirements of proprietary companies was changed from one based on the entity's ownership characteristics to one based on its economic significance. Economically significant proprietary companies have considerable influence on the economy and community more broadly and as such should be required to prepare audited financial statements.

In 2007, the thresholds used to define a large proprietary company were increased by 150 per cent to ensure that only those companies that are of genuine economic significance continue to be required to prepare financial statements.

The Government supports the threshold criteria used to define large proprietary companies and determine their financial reporting obligations.

RECOMMENDATION

The minority report recommended that the Government examine the consequences of removing the grandfathering provisions or making it subject to a sunset provision.

The Government **supports** this recommendation.

The grandfathering provisions apply to those proprietary companies which were not required to disclose financial information under the ownership-based test that applied before the threshold test was introduced in 1995. Under these provisions, the grandfathered exempt proprietary companies are required to prepare an audited financial report but are exempt from the requirement to lodge that report.

The relief granted to grandfathered exempt proprietary companies creates an inconsistent regulatory framework for proprietary companies that potentially gives grandfathered exempt proprietary companies an unfair competitive advantage. Providing relief to these companies also conflicts with the policy of successive Governments that proprietary companies with economically significant operations should be required to lodge financial reports.

In 2006, as part of the Corporate and Financial Services Regulation Review, views of stakeholders were sought on a proposal that the relief given to grandfathered exempt proprietary companies be repealed so that these entities are subject to the same requirements as other proprietary companies. Many stakeholders were not supportive of this proposal at that time and the proposed amendment did not proceed.

The Government proposes that the consequences of either removing the grandfathering provisions or making them subject to a sunset requirement should be re-examined in conjunction with any future proposals to amend the financial reporting requirements of the Corporations Act.

RECOMMENDATION

That the Corporations Act be amended to require each proprietary company to report annually to ASIC that the directors have considered whether the company is large or small for its last financial year, and to state whether the company was small or large.

The Government **does not support** this recommendation.

Introducing a requirement for directors of proprietary companies to report annually to ASIC that they have considered whether their companies are large or small would be a departure from the policy principle, underlying the CLERP 7 reforms, that companies should only be required to notify ASIC when a change in details has occurred.

Companies are no longer required to lodge annual returns and an annual notification requirement as to whether a proprietary company is large or small would impose a new administrative requirement on approximately 1.5 million companies. ASIC has indicated that approximately 11,000 proprietary companies prepared financial reports under Chapter 2M of the Corporations Act for financial years that ended during the 12 months to 30 June 2007.

In these circumstances, the Government believes that ASIC already has reliable information about the number of large proprietary companies and that it would impose a significant regulatory burden on the corporate community to require every proprietary company to advise ASIC each year whether the company is large or small.

RECOMMENDATION

The minority report recommended that ASIC continue to collect and review, to the best of its resources, the statistics of the kind presented to it by the Committee and also, if the previous recommendation is adopted, the number of companies which state they are large or small each year.

The Government **supports** this recommendation.

ASIC is able to estimate the number of large proprietary companies on the basis of the number of proprietary companies that lodge annual reports and the number of former exempt proprietary companies that have lodged a notice indicating that they are taking the relief from the requirement to lodge their reports.