CHAPTER 2

OPERATION OF THE LARGE/SMALL TEST

Rationale for new classification

2.1 Prior to the 1995 amendments the Corporations Law required all proprietary companies, regardless of size, to prepare financial statements. However, exempt proprietary companies, unless their accounts were audited, were required to lodge key financial data with the ASIC including current assets, non-current intangible assets and non-current liabilities. This information, as the PJSC noted in its report of 2 March 1995, served little or no public purpose.[1] It was often unreliable and was provided up to seven months after it was current. On the other hand, non-exempt proprietary companies were required to lodge full accounts. The basis for the requirement was that these companies, which are ultimately wholly or partly owned by public companies, should be accountable in a public manner.

2.2 While the classification of companies as exempt and non-exempt reflected the status of the company, there was no consistent rationale for identifying companies in which there was a public interest. For example, very large companies, in which there may be a substantial public interest because they employed a large number of people, could be classified as exempt while minor enterprises could be non-exempt. The policy approach adopted was to establish an objective three-part test that reflected the size and economic influence of the company. At the same time, removing the requirement to lodge key financial data would reduce the burden of regulation for the majority of proprietary companies. The policy underlying the new system was stated in the Explanatory Memorandum to the First Corporate Law Simplification Bill 1995:

> Financial reporting requirements under the Law have been reduced for most proprietary companies, but strengthened for companies which have a significant economic impact. The Bill streamlines the regulation of all proprietary companies. Under the new rules, small proprietary companies face a regulatory burden that is no greater, and in significant respects less, than the burden currently faced by exempt proprietary companies.[2]

Summary of proprietary company accounting requirements

2.3 Under the *First Corporate Law Simplification Act 1995*, all large proprietary companies are required to lodge audited accounts with the ASIC within four months

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1 Parliamentary Joint Committee on Corporations and Securities, *Report on the First Corporate Law Simplification Bill 1994*, 2 March 1995, p 31.

2 Explanatory Memorandum, paragraphs 3.15, 6.11.

of the end of the financial year. A proprietary company will be ‘large’ if it satisfies at least two of the following criteria:

- The consolidated gross operating revenue of the company and the entities it controls (if any) is $10 million or more.
- The value of the consolidated gross assets at the end of the financial year of the company and the entities it controls (if any) is $5 million or more.
- The company and the entities it controls (if any) have more than 50 employees at the end of the financial year.

2.4 The amount of a company’s consolidated gross operating revenue for a financial year and the value of its consolidated gross assets are to be calculated in accordance with the Accounting Standards.[3] In counting employees for the purpose of the test, part-time employees are to be counted at an appropriate fraction of the full-time equivalent.[4] Unless exempted by the ASIC, large proprietary companies that were not previously required to lodge audited accounts were required to lodge financial statements for the 1995/96 financial year. However, for these companies the requirement that the lodged financial statements be audited applied in respect of financial statements for the 1996/97 financial year. The ASIC further deferred the audit requirement for these companies to years ending on or after 9 December 1997.

2.5 In deciding whether to exercise its discretion to exempt a large proprietary company from the audit requirement, the ASIC is required to take into account factors such as the expected costs and benefits of the company complying with the audit requirement, and any practical difficulties the company faces in complying with the requirement. ASIC Policy Statement 115, *Audit Relief for Proprietary Companies*, and Policy Statement 43, *Accounts and Audit Relief*, outline the circumstances in which the ASIC will consider audit relief.

2.6 Some large proprietary companies are exempt from lodging accounts under section 319(4) of the Law. This provision allows a large proprietary company not to lodge financial statements with the ASIC if it was an exempt proprietary company on 30 June 1994, which has its accounts audited and satisfies certain other conditions. However, the ASIC may require such a company to lodge financial statements and auditor’s reports.

2.7 A small proprietary company that is controlled by a foreign company is required to prepare and lodge its own accounts unless the foreign company has lodged consolidated accounts with the ASIC.[5]

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3 Section 45A(6).

4 Section 45A(5).

5 Section 292(2).

2.8 Shareholders with at least 5 per cent of the voting shares in a small proprietary company may require the company to prepare accounts and have them audited.[6] Any financial statements prepared by the company at the request of shareholders must be sent to all shareholders. The ASIC may also require a small company to prepare accounts, have them audited and lodged. It must specify the date by which the documents have to be prepared or lodged.

2.9 All companies nevertheless are required to keep accounting records. These records must correctly explain their transactions and financial position to enable true and fair accounts to be prepared and properly audited in accordance with the Law.[7]

1998 ASIC Report to the Senate

2.10 In accordance with a motion passed by the Senate on 28 September 1995, the ASIC was required to prepare a report on the operation of the large/small test two years and six months after the commencement of the Act. The ASIC's response to the Senate order was dated 5 June 1998 and tabled on 22 June 1998. The 1998 ASIC report was not debated by the Senate. The following is a summary of the findings of the 1998 report:

- 99.3% of all proprietary companies (1,027,146 proprietary companies) which would have been required to prepare financial statements prior to the Act have no financial reporting requirements.
- The reporting requirements for the following companies were unchanged as a result of the Act:
  - (a) 2,101 grandfathered large proprietary companies;
  - (b) 1,215 non-grandfathered large proprietary companies which were previously non-exempt; and
  - (c) 973 small proprietary companies which are controlled by foreign companies and which were previously non-exempt.
- The following proprietary companies are required to lodge financial statements and many will be required to have them audited:
  - (a) 1,592 non-grandfathered large proprietary companies which were previously exempt; and
  - (b) 718 small proprietary companies that are controlled by foreign companies and were previously exempt.[8]

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6 Section 293(1).

7 Section 286(1).

8 Australian Securities Commission, *Report to the Senate: Review of the First Two years of Operation of Certain Amendments to the Corporations Law by the First Corporate Law Simplification Act 1995*, 5 June 1998, p 1.

2.11 Since the tabling of the 1998 report the number of companies which have no financial reporting requirements has increased from 1,027,146 to 1,152,403.[9]

Operation of the large/small test

2.12 According to the 1998 report, the majority of companies supplying information about the large/small test exceeded all the criteria, not just the two criteria necessary to be classified as large proprietary companies. The majority of these companies were well above the criteria comprising the large/small test. Half the companies reported consolidated gross operating revenue which was at least three times the $10 million threshold. Half the companies also reported consolidated gross assets which were at least three times the $5 million criterion. Less than half of the companies had at least two times the 50 employees criterion.[10] In its submission to the PJSC, the ASIC provided updated information on revenue, assets and employees, as well as the number of members, for the year to 8 December 1999:

	Consolidated Gross Operating Revenue	Consolidated Gross Assets	Employees	Members
Number reporting information	1,934	1,934	1,934	1,934
Average	$95.5m	$150.2m	198	2
% not meeting criterion	5.9%	2.8%	36.9%	n/a
First Quartile (25% lower than)	$16.9m	$11.2m	20	1
Second Quartile (50% lower than)	$31.7m	$23.9m	71	2
Third Quartile (75% lower than)	$74.0m	$79.1m	165	3
Highest	$6,312.6m	$31,490.0m	7,835	240

Source: Australian Securities and Investments Commission, Submission 6, Attachment 2, p 4.

9 Australian Securities and Investments Commission, Submission 6, p 3.

10 Australian Securities Commission, *Report to the Senate: Review of the First Two years of Operation of Certain Amendments to the Corporations Law by the First Corporate Law Simplification Act 1995*, 5 June 1998, p 13.

2.13 The ASIC concluded that the information provided in the 1998 report and the updated information "demonstrates that the test satisfies the objectives outlined in the Explanatory Memorandum to the First Corporate Law Simplification Bill."[11]

Applications for audit relief

2.14 As noted earlier, the introduction of the large/small test in 1995 reduced the reporting requirements for 94 per cent of all proprietary companies. However, some previously exempt companies were required to lodge their accounts for the first time, while some were required to have them audited for the first time. Following the release of its policy for audit relief for proprietary companies in November 1996, the ASIC has given some relief to particular classes of companies while a small number of companies have applied for individual relief.

2.15 The table below indicates the number of companies lodging financial statements that are receiving audit relief:

	Financial year ending 9/12/97 to 8/12/98		Financial year ending 9/12/98 to 8/12/99	
	Large proprietary companies	Small proprietary companies controlled by foreign companies	Large proprietary companies	Small proprietary companies controlled by foreign companies
Number of companies lodging notice of audit relief and lodging financial statements	515	13	412	6
Total number of companies lodging financial statements	3,245	1,798	2,501	1,312
Percentage of companies likely to have obtained audit relief	15.9%	0.7%	16.5%	0.5%

Source: Australian Securities and Investments Commission, Submission 6, p 11.

11 Australian Securities and Investments Commission, Submission 6, p 4.

2.16 Under the ASIC Class Order relief, large proprietary companies and small proprietary companies that are controlled by a foreign company may be exempted from the requirement to prepare and lodge financial statements. The ASIC policy also includes class relief for all proprietary companies that meet certain requirements concerning the company being well managed and in a sound financial position. Between 9 December 1995 and 14 July 2000, the ASIC dealt with 102 applications from proprietary companies for audit relief outside its Class Order relief. These applications covered small proprietary companies that are controlled by foreign companies as well as large proprietary companies, but do not include applications which were later withdrawn prior to decision by the ASIC. Of the 102 applications, 81 or 80 per cent of the total were granted. These figures include 41 applications by proprietary companies controlled by foreign companies, 28 of which were granted.[12]

Applications for individual relief

2.17 Since the introduction of the large/small test, the ASIC has only granted relief to two companies that made application for individual relief from a total of 61 applications. The ASIC considered that both companies were effectively small while the remaining applications did not meet the pre-conditions for relief.

2.18 Two of these decisions not to grant relief were appealed to the Administrative Appeals Tribunal. In both cases, the companies argued that the requirement to lodge accounts was inappropriate to their circumstances and imposed unreasonable burdens. (These cases are discussed in Chapter 3 of this report).

2.19 The ASIC advised that its policy for audit relief for proprietary companies was appropriate in the context of the requirements of the Law.

Public access to accounts lodged with the ASIC

2.20 A measure of the importance of the financial statements of large proprietary companies to users of those accounts is how often those documents are accessed on the public record. The ASIC's public database records each access of a company's accounts.

2.21 As the table below shows, the financial statements of the 3,245 non-grandfathered large proprietary companies were accessed 10,549 times on the ASIC database each year, an average of 3.25 accesses per year. This figure is consistent with the information provided in the 1998 report.[13]The following table analyses these accesses by class of proprietary company:

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12 Correspondence to PJSC, 17 July 2000.

13 See Australian Securities Commission, *Report to the Senate: Review of the First Two years of Operation of Certain Amendments to the Corporations Law by the First Corporate Law Simplification Act 1995*, 5 June 1998, p 15.

Class of company	Number of accesses from 8/12/97 to 20/2/00	Annualised number of accesses	Number of companies which lodged financial statements in respect of years ending in the 12 months to 8/12/98	Average number of annualised accesses per company lodging financial statements	Number of companies which lodged for years ending in 12 months to 8/12/98 whose financial statements were accessed at least once from 8/12/97 to 20/2/00
Non-grandfathered large proprietary companies	23,266	10,549	3,245	3.25	2,259
Small proprietary companies controlled by foreign companies	4,882	2,214	1,978	1.23	562
Total	**28,148**	**12,763**	**5,043**	**2.53**	**2,821**

Source: Australian Securities and Investments Commission, Submission 6, Attachment 2, p 4.