CHAPTER 3

ISSUES ARISING FROM THE LARGE/SMALL TEST

General criticisms

3.1 The PJSC received 14 written submissions from accounting firms and individual practitioners, large proprietary companies, professional organisations and the ASIC. Although a number of submissions expressed support for the large/small test, the majority gave either qualified support or was critical of the new reporting system. The most common criticisms related to the arbitrary nature and amounts of the threshold limits and the differential reporting for large 'grandfathered' proprietary companies. These submissions highlighted the practical difficulties in distinguishing between companies on the basis of size and financial circumstances and the costs associated with preparing and lodging financial statements.

3.2 A consistent theme of submissions was that the audit requirement applicable to proprietary companies should be based on a cost/benefit of the requirement. If the audit requirement is considered necessary or desirable in terms of public policy, the benefits to the community must be realised and costs to business minimised. For those large proprietary companies that are not exempted the cost burden can be onerous and unwarranted. Several submissions questioned the cost/benefit of the audit requirement for large proprietary companies. These included the Office of Small Business, which commented:

> It is important that the reasons for requiring an audit at all are fully considered and justified. Unless the benefits of retaining the existing audit requirements can be clearly demonstrated as outweighing the costs, the audit requirement should be removed for all proprietary companies. If an audit is considered necessary or desirable on public policy grounds, any benefits must be realised and costs to small business minimised.[1]

Audit costs

3.3 Several submissions focussed on the compliance costs for companies that are required to lodge audited accounts with the ASIC. The Office of Small Business estimated the average audit costs for medium-sized companies at $25,000.[2] The Motor Trades Association of Australia (MTAA), which represents franchised new motor

---

1 Office of Small Business, Department of Employment, Workplace Relations and Small Business, Submission 5, p 3.

2 Office of Small Business, Department of Employment, Workplace Relations and Small Business, Submission 5, p 2.

vehicle dealers, estimated the additional audit cost in excess of $20,000.[3] Submissions also referred to the indirect costs to business, including the time spent and resources allocated to non-profitable outcomes. The MTAA commented:

> What has resulted is that many hundreds of family owned Australian companies which are trading profitably and meeting their debts as they fall due are now required to fulfil onerous and costly audit conditions for no real purpose.[4]

3.4 The accounting bodies also presented the results of a 1995 survey by the Institute of Chartered Accountants. The Institute undertook a survey of its members, to which 1,252 responded out of a total of 3,500. The survey identified 3,735 large proprietary companies of which 2,797 (or 75 per cent) were non-reporting entities. The number of large proprietary companies which had not appointed an auditor and were non-reporting entities was 2,132. The majority of these companies (2,068 or 97 per cent) had five or fewer members. The average cost of having the accounts audited was $12,600. Based on these estimates, if a company has only two members but is classified as large, the annual audit costs are $6,300 per shareholder.[5]

3.5 To reduce compliance costs it was proposed that all proprietary companies should be exempted from the requirement.[6] Alternatively, large proprietary companies should be required to provide a simplified profit/loss statement and end of year balance sheet to each shareholder which has been reviewed by a qualified accountant.[7]

Benefits of audit requirement

3.6 Although submissions did not address the benefits of the audit requirement in as much detail, they presented a broad overview of the perceived benefits. The main benefits are summarised as follows:

- improved business operations;
- maintenance of checks and balances;
- evidence of a company's solvency;
- accurate record keeping.

---

3 Motor Trades Association of Australia, Submission 7, p 15.

4 Motor Trades Association of Australia, Submission 7, p 8.

5 Correspondence to the Chairman of the PJSC, 7 July 2000.

6 Office of Small Business, Department of Employment, Workplace Relations and Small Business, Submission 5, p 3.

7 National Institute of Accountants, Submission 8, p 8.

3.7 To some degree however the benefits were less apparent where there was no separation between ownership and management of a company as occurs in many large proprietary companies. Unlike public companies, proprietary companies have a restricted ownership. This limited shareholding means that owners of the business are involved, at least in some way, with the management of the business or are closely related to someone who is. As the National Institute of Accountants (NIA) observed, shareholders are more like directors of the company than normal shareholders and as such "they have a greater responsibility to make themselves aware of the position of the business and have greater access to such information. This suggests that there is less of a need to make public reports that would be expensive and provide no more than what should already be known".[8]

Commercial privacy

3.8 Many private companies are operated by owner/managers who closely guard their financial information from competitors. Several submissions raised the issues of privacy and the use of a company's financial statements by rival companies. Although these companies previously lodged key financial data they are now concerned about commercial privacy and the effects of providing price sensitive information to their competitors.[9] Prior to the introduction of the large/small test, the criteria for reporting was based on the status of the company in question. The classification of companies as exempt proprietary companies enabled those companies that were privately owned to maintain their commercial privacy. Mr Ron Mann, the sole shareholder/director of Gram Engineering Pty Ltd, stated that as a consequence of the disclosure of his company's financial details his business was vulnerable to industry competitors who were larger and more diversified:

> In my case, I can see the negative effects of placing all my company's financial information on public record. I have no objections to my financial reports being held by ASIC, but not placed on public record. As I have mentioned earlier, my company specialises in the manufacturing of pre-painted steel fencing. My two major competitors, BHP Building Products – a part of the total BHP Steel Group and Metroll Pty Ltd – a major roofing/other steel products supplier, will have access to all my detailed financial information and able to use them to their advantage. The financial information (re fencing) of the company's competitors are hidden amongst all their other business activities, therefore putting my company at a strategic disadvantage.[10]

8 National Institute of Accountants, Submission 8, p 8. See also Mr Gerard Meade, Committee Hansard, 30 June 2000, CS32.

9 Mr Stuart Grant, Committee Hansard, 28 June 2000, CS2-3.

10 Gram Engineering Pty Ltd, Submission 13, p 2.

ASIC Class Orders

3.9 Under section 341 of the Corporations Law, the ASIC has the power to make Class Orders relieving companies from some or all of the requirements to prepare, lodge and have audited a financial report. The following is a list of current ASIC Class Orders in relation to the reporting requirements of proprietary companies:

- Class Order 98/0098, *Small proprietary companies which are controlled by a foreign company but which are not part of a large group*;
- Class Order 98/0099, *Anomalies preventing certain large proprietary companies from being grandfathered*;
- Class Order 98/1417, *Audit relief for proprietary companies*; and
- Class Order 98/1418, *Wholly-owned entities*.

3.10 While these Class Orders have reduced financial reporting requirements for some proprietary companies, they have also added to the complexity of the reporting rules. In some cases the conditions of the Class Orders have been unnecessarily onerous. Several submissions pointed to the requirements in CO 98/0098 and 98/1417 as particularly onerous and lacking flexibility.[11] In particular, the Office of Small Business noted that the gearing ratio of 70 per cent in CO 98/1417 was arbitrary and precluded some large proprietary companies from applying for audit relief which would otherwise meet the conditions of the Class Order.[12]

Relief from lodging financial statements - Incat Australia Pty Ltd and D G Brims and Son Pty Ltd

3.11 One of the companies that sought relief from the reporting requirements was the Incat group of companies (Incat Australia Pty Ltd, Incat Chartering Pty Ltd and Incat Tasmania Pty Ltd). The companies, which are categorised as large proprietary companies, are builders of aluminium passenger ferries for the export market and employ 1,000 people. The Incat companies sought relief from lodging financial statements for the years ending 30 June 1996, 1997 and 1998 on the grounds that the requirement to lodge financial reports:

- imposed an unreasonable burden on the companies and created a “competitive disadvantage”;
- imposed an unreasonable burden on an officer of the companies; and
- was inappropriate in the circumstances of the companies.

---

11 See Price Waterhouse Coopers, Submission 1, pp 5-7.

12 Office of Small Business, Department of Employment, Workplace Relations and Small Business, Submission 5, p 3.

3.12 Incat's rationale was that such lodgement would lead to a 'competitive disadvantage' in that its customers and competitors in the market would be able to establish Incat's profit margin.[13] While the ASIC accepted that customers would be able to make precise estimates of Incat's average profit margin on ferries built, the more precise information would not disadvantage Incat because its customers could already make an approximate estimate of its profit margin. The ASIC also accepted that it would be possible for Incat's competitors to estimate Incat's profit margins from its accounts, albeit with less precision than its customers. The ASIC concluded that even without access to Incat's financial statements, customers and competitors could make a rough but valid estimate of Incat's costs and profit margins. The ASIC's decision not to grant relief was affirmed by the Administrative Appeals Tribunal (AAT).[14] An appeal by Incat to the Federal Court was dismissed on 4 February 2000.[15]

3.13 In another similar case D G Brims and Sons Pty Ltd sought relief from lodging its 30 June 1997 financial statements. The basis for seeking relief was that it would impose unreasonable burdens, in that by lodging the financial report the company would be left at a competitive disadvantage with suppliers and customers. Following the ASIC's decision not to grant relief, the company sought a review of the decision by the AAT. In this situation the applicant was successful, with the AAT finding that the company had met the criteria for relief. The AAT decided that the compliance with the requirement "would be inappropriate because the public interest in the lodgement of accounts is outweighed in this case by the potential for the company to be subjected to price competition from major competitors with the inherent potential to make the company no longer financially viable."[16]

Overall compliance

3.14 As acknowledged in the ASIC report to the Senate, there is currently no means of identifying which large proprietary companies have failed to comply with the reporting requirements. In particular, non-grandfathered proprietary companies, which do not lodge accounts and are not granted relief, are not required to confirm they are small and not controlled by a foreign company. Although there is no estimate of the number of large proprietary companies affected, the ASIC believed that some companies may not have fully understood their obligations and consequently failed to lodge accounts or other information.

3.15 A further concern is the use of trusts and the restructuring of companies to avoid financial reporting obligations, a practice confirmed by the accounting firm

---

13 Mr Lance Balcombe, Committee Hansard, 30 June 2000, CS 65.

14 AAT No T98/130, 9 September 1999.

15 *Incat Australia Pty & Anor v Australian Securities and Investments Commission*, No T23 of 1999, 4 February 2000.

16 AAT No Q1998/296, 25 June 1999, paragraph 27.

Atkinson Gibson.[17] Some proprietary companies may restructure their businesses to bring them below the threshold limits in the large/small test and hence avoid the reporting requirements of the Law:

> Anecdotal evidence suggests that many economically significant businesses are conducted through trusts and other structures which are neither companies nor disclosing entities. These trust and other structures are not required to prepare or lodge accounts under the Corporations Law…It is possible that some proprietary companies may reorganise their affairs such that they cease to be large and are no longer subject to the reporting requirements of the Law. For example, the business could be transferred into a trust or a large business could be spread across a number of companies owned directly by individuals, each of which is a small proprietary company.[18]

Unlevel playing field and compliance with the Accounting Standards

3.16 The ASIC report to the Senate also advised that the existing Law has created an unlevel playing field between different types of entities in terms of their financial reporting obligations. In particular, non-corporate entities such as family trusts and grandfathered large proprietary companies are not required to lodge financial statements.[19] Several submissions expressed concern that some non-grandfathered large proprietary companies could be placed at a disadvantage to their competitors who are grandfathered and are not required to lodge financial statements.[20] According to the ASIC, there are 1,592 non-grandfathered proprietary companies which were previously exempt that are now required to lodge financial statements. Mr Gerard Meade, Chairman of the Legislative Review Board, Australian Accounting Research Foundation, stated that differential reporting was not in the public interest:

> **Mr Meade**—In terms of grandfathering, a number of people who have put in submissions have contended that grandfathering creates an unlevel playing field. We would certainly support that contention in that we have two levels of disclosure by large proprietary companies. Those that were not grandfathered—that is, they were not previously exempt proprietary, they did not have audits conducted—are required to prepare financial reports under the Corporations Law, whereas grandfathered large proprietary companies are not. Having that differential level is seen as something which is really not in the public interest. In terms of companies restructuring, there certainly have been examples where companies and groups have

17 See Atkinson Gibson, Submission 2, p 2.

18 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, pp 18-19.

19 Australian Securities and Investments Commission, Submission 6, pp 5-6.

20 See for example CPA Australia and the Institute of Chartered Accountants in Australia, Submission 10, pp 9-10 and Atkinson Gibson, Submission 2, pp 1-2.

> restructured with the objective of avoiding classification as a large proprietary company. Once again, that is something that is not desirable, but it is one implication of the small and large test.[21]

3.17 The ASIC also commented on the quality of financial statements lodged and the need for all entities lodging financial statements to comply with at least certain minimum requirements of Accounting Standards to ensure financial statements are prepared on a comparable basis.[22] The ASIC advised that as the full requirements of the Accounting Standards applied only to reporting entities it was possible for large proprietary companies, which claim not to be reporting entities, to disregard those requirements in preparing financial statements.[23] Some of the practices included not recording liabilities for employee entitlements and not depreciating non-current assets. Mr Tom Ravlic, a financial commentator, noted by way of example that two comparable large proprietary companies could produce different financial results depending on their compliance with the Standards:

> Problems have emerged in the past few years with companies required to lodge documents with the Commission putting forward documents that do not comply fully with accounting standards. The Australian Securities and Investments Commission highlighted a handful of companies almost two years ago in a private meeting with the Big Five accounting firms to indicate the sort of non-compliance they found objectionable. The companies looked at were clearly large proprietary companies, but because they considered themselves non-reporting entities they chose not to comply with accounting rules that produce a lower reported result. Two companies with the same assets, same revenues and same expenses could end up with different reported results because one chose to comply – quite properly – with the complete suite of accounting standards and the other sought to apply cosmetic surgery to its numbers for a better look.[24]

3.18 However, as the ASIC advised the PJSC, the reports of companies must still give a true and fair view. The ASIC is of the opinion that this would require all large proprietary companies to observe the recognition and measurement provisions of the Accounting Standards.

Availability of Accounting Standards

3.19 The NIA advised that the Accounting Standards are important for the production of financial reports and are designed to improve the running of businesses. Although the Standards are statutory instruments and referred to in the Corporations Law, they are not freely available on the Internet as are other forms of legislation:

---

21 Mr Gerard Meade, Committee Hansard, 30 June 2000, CS 33.

22 Australian Securities and Investments Commission, Submission 6, p 7.

23 See Mr David Knott, Committee Hansard, 30 June 2000, CS 51.

24 Mr Tom Ravlic, Submission 3, p 1.

> This can lead to companies either ignoring them or being oblivious to the existence of the Standards. Neither is a welcome outcome. Free access through the Internet is essential to improve the performance of business and encourage compliance. Maintaining barriers to accessing Standards allows private legislation to govern a public duty. If tax and other legislation that affects business is relatively accessible, then why are the Standards instruments not in a similar position? It seems wholly unfair to expect compliance with the Standards when so few have access to them. In order to reverse this anomaly, the NIA believes the Accounting and Audit Standards should be made freely available on the Internet, this will help reduce compliance costs and improve compliance with the Standards.[25]

3.20 Although it did not seek a response to the NIA's proposal from the Australian Accounting Standards Board, the PJSC believes that the proposal has considerable merit. The improved accessibility of the Standards will enhance the quality of information in financial reports and encourage compliance by proprietary companies as well as public companies.

Alternative reform options

3.21 In addressing the effectiveness of the new reporting system, submissions recommended various changes to the large/small test that would exempt a larger number of proprietary companies or extend the scope of the test to include companies which are presently exempt. Other options for reform included the reinstatement of the previous test of 'exempt proprietary company' and replacing the large/small test with the reporting entity concept.

Reporting entity concept

3.22 The accounting bodies proposed replacing the current test with the reporting entity concept as the basis for financial reporting. The main advantage of the reporting entity concept was that it was generally recognised as the most appropriate test for determining reporting obligations, and, in addition, was not based on arbitrary criteria.[26] The AASB Accounting Standards define a reporting entity as:

> *An entity (including an economic entity) in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources, and includes but is not limited to the following:*
>
> *(a) a listed corporation*

---

25 National Institute of Accountants, Submission 8, pp11-12. See also Mr Gavan Ord, Committee Hansard, 30 June 2000, CS 44.

26 See Mr Gerard Meade, Committee Hansard, 30 June 2000, CS 33.

(b) a borrowing corporation

(c) a company which is not a subsidiary of a holding company incorporated in Australia and which is a subsidiary of a foreign company where that foreign company has its securities listed for quotation on a stock market or those securities are traded on a stock market.

3.23 Underlying the rationale for adopting the reporting entity concept is the view that the Law should only impose reporting obligations on companies that are reporting entities, as it is only these entities that have dependent users of financial reports. Some entities will almost always be characterised as reporting entities, for example, disclosing entities, publicly listed companies, listed trusts and other companies which raise funds from the public. However, there are other types of entities that do not exhibit the characteristics of a reporting entity. They include some small proprietary companies, sole traders, family trusts, partnerships and wholly-owned subsidiaries of Australian reporting entities. These entities are outside the scope of the Corporations Law and are normally exempt from preparing general purpose financial reports in accordance with the Accounting Standards:

> If a proprietary company either does not have readily identifiable users who are dependent on the company providing them with financial information, or it has users, but they are able to demand financial information from the company (e.g. a major lender), then there should be no requirement for these companies to prepare and lodge financial reports. Alternatively, where there are users who do not have access to financial information from a proprietary company tailored to their specific needs, the company should prepare general purpose financial reports.[27]

Modifying the threshold limits

3.24 There was a general view that the criteria comprising the large/small test are somewhat arbitrary. The MTAA, which was concerned about the additional costs associated with the audit requirement, recommended that the current assets, revenue and employee threshold limits should be doubled.[28] This change was strongly supported by the Office of Small Business, which noted that the current assets and revenue limits are too low and did not take account of high volume/low margin businesses. As a result manufacturing companies that are capital and labour intensive have a higher representation in the large category compared to other industry sectors.[29] The accounting firm Price Waterhouse Coopers also raised the practical difficulties in classifying a proprietary company as large or small on the basis of threshold limits that are applied only at the end of the financial year:

---

27 CPA Australia and the Institute of Chartered Accountants in Australia, Submission 10, p 6.

28 Motor Trades Association of Australia, Submission 7, p 17.

29 Office of Small Business, Department of Employment, Workplace Relations and Small Business, Submission 5, p 3.

> There are some proprietary companies whose activities are seasonal or who, for example, may negotiate significant new business immediately prior to the end of their financial year which cannot be deferred until after the end of the financial year for commercial reasons. Such proprietary companies may then be caught under either of these tests. Whereas we acknowledge that, within certain limits, the tests also provide an opportunity for proprietary companies to structure their affairs in such a way as to avoid being classified as large, the classification can be somewhat artificial for proprietary companies that are temporarily affected by seasonal or other changes and which at other times throughout the financial year would be no different from many other proprietary companies which, on the basis of the criteria, are classed as small.[30]

3.25 Mr Ian Langfield-Smith, Lecturer at the Department of Accounting and Finance, Monash University, recommended that companies classed as large should also include any proprietary company that has more than 20 members.[31] Other suggestions for improvement involved incorporating the following additional criteria to the large/small test:

- a return on capital, to take account of businesses which have large capital outlays but fluctuating margins[32]; and
- a debt to equity ratio, to bring small proprietary companies that are highly geared within the reporting system.[33]

Exempt proprietary company

3.26 The Australian Institute of Company Directors (AICD) strongly supported the reinstatement of the previous test. It advised that proprietary companies should be classified according to the shareholding of the entity. In particular, there appeared to be two broad groups of proprietary companies based on ownership:

- family-owned types of companies; and
- subsidiaries of disclosing entities.

3.27 The AICD recommended that the requirement to prepare and lodge audited financial statements with the ASIC should only apply to subsidiaries of disclosing entities, while companies in the first group should be required to apply all the measurement requirements of the Accounting Standards. The existing exemption to wholly owned subsidiaries should continue.[34] In addition, the AICD recommended

30 Price Waterhouse Coopers, Submission 1, p 2.

31 Mr Ian Langfield-Smith, Submission 11, p 5.

32 National Institute of Accountants, Submission 8, p 2.

33 Price Waterhouse Coopers, Submission 1, p 2.

34 Australian Institute of Company Directors, Submission 9, p 2.

that as part of a reversion to the previous test, all directors of companies be required to sign and lodge a declaration of the company's solvency with the annual return. The AICD acknowledged that a declaration of solvency would provide some assurance to the community at large that the company is a solvent entity and is able to meet its future obligations. This may also reassure creditors and employees about the company's financial position, as well as making directors more responsible for the affairs of the company by focussing attention on their current obligations for solvency:

> **Mr Service**—We have been discussing this issue, because the institute is very committed to transparency in those organisations which have a general responsibility to the public; that is, those who raise capital, borrowings or deal with the public on a large scale where there is a wide interest in their solvency. One of the things we believe ought to happen, particularly if the committee is of a mind to get rid of the present large/small definition, is that every company should have to have all its directors sign and lodge with its annual return a declaration of solvency. We think that that, amongst other things that are of public importance, will actually make directors really think about this solvency issue. We are all seeing situations in the courts where directors simply have not addressed their minds to whether or not their companies are solvent. Whilst as shareholders they may suffer, very often a lot of other people suffer as well.
>
> I think it is fair to say the institute would not even be uncomfortable if you were to recommend that proposal and that part of it ought to be that, when a company has signed its declaration of solvency, it should have an obligation to give a copy of that declaration to every one of its employees. They are one of the groups of people that need protection and, I have to say, are not adequately protected in fact by the law at the moment. The average employee does not go to ASIC and say, 'Can I look at this company's accounts?' Employees ought to know that their employer is solvent. We think, in terms of public policy, that would be quite effective in really making directors think about what their responsibilities are. They already have those responsibilities but, clearly, some of them do not address them.[35]

35 Mr James Service, Committee Hansard, 28 June 2000, CS 4.