AUSTRALIAN INSTITUTE
of COMPANY DIRECTORS

Level 30
20 Bond Street
Sydney NSW 2000
www.companydirectors.com.au
ABN 11 008 484 197

T: +61 2 8248 6600
F: +61 2 8248 6633
E: contact@companydirectors.com.au

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The Manager
Corporate Reporting and Accountability Unit
Corporations and Capital Markets Division
The Treasury
Langton Crescent
Parkes ACT 2600

Email: corporatereportingreforms@treasury.gov.au

Dear Mr Pascoe,

Discussion Paper: Proposed Amendments to the Corporations Act

The Australian Institute of Company Directors welcomes the opportunity to comment on the discussion paper, *Proposed Amendments to the Corporations Act* (Discussion Paper) relating to the dividends payment test in s254T, proposed amendments to the parent entity reporting requirements and changing the financial year of a company, released by the Federal Treasury on 28 November 2011.

The Australian Institute of Company Directors (Company Directors) is the second largest member-based director association worldwide, with over 30,000 individual members from a wide range of corporations; publicly-listed companies, private companies, not-for-profit organisations, charities and government and semi-government bodies. As the principal Australian professional body representing a diverse membership of directors, we offer world class education services and provide a broad-based director perspective to current director issues in the policy debate.

We would like to express our concern at the now annual practice of the Government and Treasury releasing numerous drafts of legislation and regulations in the weeks prior to Christmas with responses due in a compressed time frame that spans the traditional holiday period. Our concerns have been set out in letters to Federal Government Treasury Ministers.[1]

We acknowledge that a one week extension of time was given to us to make submissions in respect of this consultation. While this extension is welcomed, there has still been insufficient time, given the number of consultations on foot over January, for us to provide comprehensive responses to the questions raised.

1. Executive summary

In summary, Company Directors is of the view that:

(a) section 254T should be amended to include an express solvency test for the payment of dividends by a company;

[1] These letters are available at http://www.companydirectors.com.au/Director-Resource-Centre/Policy-on-director-issues/Policy-Submissions/2011/Letters-to-Government-Ministers-on-Consultation-Issue.

(b) we have concerns about the proposed formulation of the "solvency test" as set out in Option 2 of the Discussion Paper;

(c) the linkage to the accounting standards in section 254T of the Corporations Act should be removed; and

(d) we agree that section 295(2) should be amended to allow companies to prepare parent entity financial statements alongside their consolidated financial statements, if they so elect.

2. Feedback to questions posed in Discussion Paper

2.1 Test for payment of dividends

Stakeholders are invited to provide their views about each of the four options listed in this paper (including an indication of their preferred option or options).

Are there other options for dealing with the dividends test that could be considered by Treasury?

Company Directors has long been of the view that a solvency based test for the payment of dividends is preferred. This position is consistent with our previous submission to Treasury on 3 February 2010[2] and our position paper 7, *A Solvency Based Test for Dividends*, published in February 2008[3]. Although we are supportive of a solvency test for the payment of dividends, we have some concerns about the proposed formulation of the test referred to in Option 2 of the Discussion Paper.

We note that our previous submissions have called for the removal of section 254T from the Corporations Act 2001 (C'th)(the Act), on the basis that companies would then be free to pay a dividend so long as the payment did not cause the company to trade while insolvent. However, to alleviate stakeholder concerns about the application of the capital maintenance provisions in Part 2J of the Act potentially applying if there is no express exception authorising the payment, we would be content for an express solvency test to be inserted at section 254T of the Act.[4]

Thus we would recommend that section 254T be repealed and substituted with, a well formulated and express solvency test.

In our previous submissions calling for the removal of the profits test (which has now been replaced by the net assets test) we stated that the "need for this change increased with the introduction of the of International Financial Reporting Standards (IFRS) into Australia which, amongst other things, require that reported profits be reduced as part of asset write downs under certain circumstances, notwithstanding that there may not be any impact on the company's solvency."

We re-iterated that the assets greater than liabilities test gave rise to some of the problems that existed with the earlier profits test, for example:

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[2] The Australian Institute of Company Directors response on The Draft Corporations Amendment (Corporate Reporting Reform) Bill 2010 and explanatory Materials

[3] Policy Position Paper - A Solvency Based Test for Dividends

[4] If a dividend payment is not 'otherwise authorised' under the Act, section 256B of the Act potentially requires the payment to be the subject of shareholder approval. This would result in an increase in the regulatory burden for companies when wishing to make a dividend distribution.

- Accounting practices, such as marking asset values to market, may unduly restrict the ability to pay dividends; and
- The net assets test ignores the timing and magnitude of incoming and outgoing cash flows.

Further we stated that the proposed linkage of the test to IFRS places an unreasonable burden on companies that are not otherwise required to comply with IFRS (many of which are small businesses) and had the opposite effect of what was intended by increasing rather than decreasing red tape costs.[5]

The introduction of a well formulated and express solvency test in section 254T removes many of these issues including the need to have the assets and liabilities of the company being determined in compliance with the accounting standards when determining or declaring a dividend. The benefits to removing the net asset test and replacing it with a solvency based test include:

- companies would not be subject to unrealised fair value adjustments under the accounting standards that result in volatility of earnings and the asset base of the company when determining or declaring a dividend;
- given that the assets and liabilities of a company are also determined at a point in time (for example, when the end of year balance sheet is prepared), companies would not need to prepare additional balance sheets at the time of declaring, determining or paying a dividend; and
- If the reference to the accounting standards is removed, the difficulties faced by companies that are not required to prepare financial statements in accordance with the accounting standards would be eliminated, when declaring, determining or paying a dividend.

The Discussion Paper makes reference to the New Zealand test and we are particularly concerned with the reference "a company satisfies the solvency test if the company is able to pay its debts as they become due in the normal course of business **and** the value of the company's assets is greater than the value of its liabilities (including its contingent liabilities) after the distribution of the dividends to its shareholders." We are concerned because this again brings a net asset test into the determination of the dividend, and extends the liability threshold to include contingent liabilities within the net assets test.

Contingent liabilities by their very nature are uncertain and may not crystallise to become a present obligation of the company. To include them as part of the company's liabilities would result in a lower net asset amount that would be available to be distributed as a dividend to the company's shareholders. The inclusion of the net asset test as part of the determination of the companies solvency test, would again bring in the requirement for the assets and liabilities of the company to be drawn up, and would potentially require the company to consider their values with reference to the accounting standards and could result in the complications highlighted previously in the Discussion Paper.

Company Directors do not believe that the net assets test should be incorporated within the express solvency test in section 254T.

In summary, we support an express solvency test that allows a company to pay a dividend if the company is able to pay all of its debts, as and when they become due and payable. We do not support the linkage of this test to the accounting standards (whether by way of express inclusions such as that currently set out in section 254T (2) or indirectly by the inclusion of further criteria such as an 'assets greater than liability test').

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5 See Letter from Australian Institute of Company Directors to the Hon Chris Bowen MP, the then Minister for Financial Services, Superannuation and Corporate Law dated 9 June 2010 available at www.companydirectors.com.au

Further, we note the lack of consensus between Treasury and the Australian Tax Office (ATO) with regards to the tax treatment of dividends and the franking thereof. We urge Treasury and the ATO to urgently address this issue, as the uncertainty is having a negative impact on the ability of companies to understand their obligations with respect to the payment of dividends.

Stakeholders' views are sought on whether the terminology used in section 254T should continue to use "declared" or be brought in line with that used in section 254U.

This question arises because it is necessary to establish the point (or points in time) that the test must be satisfied.

The process for paying a dividend is generally as follows:

- A company will declare a dividend and then pay the dividend at a later date;

  When a company declares a dividend, the company incurs a debt (see section 254V of the Act).

- Alternatively, a company will determine a dividend and then pay the dividend at a later date.

  When a dividend is determined the company does not incur a debt until the dividend is paid (see section 254U which is a replaceable rule).

The approach adopted is usually dependent on the approach set out in the company's constitution. More commonly than not, companies determine rather than declare a dividend.

We are of the view that the solvency test should be applied at the time of payment of the dividend, irrespective of whether the dividend is determined or declared in accordance with the company's constitution.

The Act should also make clear that companies would still be able to declare or determine a dividend in accordance with their constitutions, but that the relevant time for assessing solvency, would be at the date of payment. In addition, the Act should make clear that directors will not become liable in circumstances where the company has declared or determined a dividend but at a later stage (on application of the test) decide not to make the payment.

We note that for the solvency test to be applied at payment date there is a need to revisit and make consequential amendments to sections in the Act so that no debt is incurred when a dividend is declared (see for example: section 254V and the table accompanying section 588G).

We are supportive of the relevant time for the test to be considered being the date of payment because the majority of companies currently determine and then later pay a dividend. Further, it avoids the need for two separate tests to be adopted, dependent upon whether a company determines or declares a dividend (given that under the current legislation the timing of when the 'debt' is incurred will differ).

Stakeholders' comments are invited on whether a legislative amendment is needed to clarify that satisfying the test for paying a dividend in section 254T of the Act is a circumstance where a reduction in capital is "otherwise authorised" by the law.

There would appear to be confusion about the inter-relationship between section 254T of the Corporations Act and the capital maintenance provisions of the Act. If the intention is for section 254T to make clear that the paying of a dividend is a reduction in capital that is "otherwise authorised" by the law, we are of the view that to avoid the confusion a legislative amendment should be made to clarify this in the Act.

Stakeholders' comments are sought on whether a modification is needed to the manner in which the dividends test applies to group companies to address the situation where an intermediate holding company cannot satisfy the net assets test and potentially stops dividends flowing to the parent company.

If an express solvency test were introduced into section 254T of the Act (replacing the current requirement that a company's assets exceed its liabilities), the issue highlighted above would no longer be relevant. The directors of each company within the group would be required to satisfy the solvency test for their respective company before determining whether it is appropriate to distribute a dividend to the parent.

2.2 Other amendments

Stakeholders' are invited to comment on:

- *whether an amendment which allows companies, registered schemes and disclosing entities that are required to present consolidated financial statements to also include parent entity financial statements as part of their financial report under Chapter 2M of the Act would adequately address their concerns about parent entity financial reporting?*
    - *Under such an amendment, the preparation of parent entity financial statements would be optional for all entities that are required to present consolidated financial statements. Should any restrictions be placed on the circumstances in which an entity may decide to prepare parent entity financial statements?*
- *whether there are other parent entity financial statement-related issues that they consider should be brought to the Treasury's attention?*

Our previous submission dated 3 February 2010[6], stated that Company Directors were supportive of the removal of the explicit requirement in section 295(2) of the Act for a parent company to prepare their own financial statements. Our reasons presented in that submission were as follows:

From a cost perspective:

- The requirement to prepare parent company statements in accordance with IFRS requirements leads to some complicated accounting issues that do not arise when preparing consolidated financial statements (e.g. the valuation of inter-company loans, valuation of cross guarantees, tax accounting).
- The Group of 100 in late 2007 estimated in a letter to Treasury, entitled "Review of Parent Entity Financial Statements" that the incremental audit costs for holding (parent) company financial statements prepared by the ASX 150 companies were in the vicinity of $20,000 to $25,000.
- The cost of preparing parent company statements has tended to increase in recent years with the introduction of AASB 7: Financial instruments disclosure.

From a user perspective:

- Replacing full parent entity financial statements with summary information will help make financial statements more relevant and user-friendly, and reduce the volume of information provided.
- Those parties with particular needs for parent company financial statements (e.g. various regulators, secured creditors) will usually be in a position to require the company to produce them.

Company Directors agree that section 295(2) of the Act should be amended to restore the ability of parent companies to elect, if they so wish, to prepare parent entity financial statements alongside their consolidated financial statements.

Stakeholders' are invited to comment on whether there are other issues associated with the requirements for changing the financial year of a company that they consider should be brought to the Treasury's attention?

Company Directors have not identified any other issues that may be associated with the requirements for changing the financial year of a company.

We hope that our comments will be of assistance to you. If you would like to further discuss our views please do not hesitate to contact me on +61 2 8248 6600.

Yours sincerely,

Rob Elliott
General Manager, Policy & General Counsel

[6] The Australian Institute of Company Directors response on The Draft Corporations Amendment (Corporate Reporting Reform) Bill 2010 and explanatory Materials