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The Manager
Corporate Reporting and Accountability Unit
Corporations and Capital Markets Division
Australian Treasury
Langton Crescent
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By email: corporatereportingreforms@treasury.gov.au (Word version & PDF version)

Dear Sir/Madam

Discussion Paper – Proposed Amendments to the Corporations Act

CPA Australia, the Institute of Chartered Accountants in Australia and the Institute of Public Accountants (the Joint Accounting Bodies) are pleased to respond to Treasury's discussion paper on Proposed Amendments to the Corporations Act.

The Joint Accounting Bodies represent over 190,000 professional accountants. Our members work in diverse roles across public practice, commerce, industry, government and academia throughout Australia and internationally.

The Joint Accounting Bodies are supportive of further amendments being made to the Corporations Act 2001 to address some of the issues arising as a result of the amendments made in 2010 and consider this discussion paper as being useful as a first step in achieving this.

Of the four dividend test options, our preference is for Option 2, which is based on a solvency test and a net asset test, without an explicit accounting standard requirement or a requirement for profits.

In the interim, we strongly urge the government to place a high priority on clarifying legislatively whether a payment to a shareholder is a dividend or a return of capital, so directors are clear about their legal obligations under the Corporations Act. Consideration should also be given to providing directors with a 'transitional no prejudice' rule in the event that they have paid dividends on the basis that the 2010 amendments authorised the payment of dividends out of capital.

The attached Appendix 1 includes our comments in response to the issues noted for consideration in the discussion paper. Appendix 2 includes our comments on other issues that were not addressed in the discussion paper which we consider also require Treasury's attention.

If you require further information on any of our views, please contact Mark Shying, CPA Australia by email mark.shying@cpaaustralia.com, Kerry Hicks, the Institute of Chartered Accountants by email kerry.hicks@charteredaccountants.com.au or Tom Ravlic, the Institute of Public Accountants by email tom.ravlic@publicaccountants.org.au.

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Yours sincerely

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Test for payment of dividends

Issues for consideration

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?

A fundamental concern with the current dividend model is the confusion created between the difference between a dividend and a capital return.

The legal opinion (Slater & Hmelnitsky) *Payment and Franking of Dividends* released by the Australian Taxation Office (ATO) with its Draft Taxation Ruling TR 2011/D8 on the taxation of dividends indicates that the previous Corporations Act changes and possibly any proposed changes will be ineffective if a distribution is not made 'from profits'. It also indicates that the wording of the dividends test, being such that it prohibits certain acts rather than authorising a certain act, has led to a provision which constrains situations where a dividend can be paid rather than expanding such circumstances (which was the original intention of moving to a solvency test).

We stress the urgency of resolving the legal issues, as directors may inadvertently breach the Corporations Act under the current provisions of the Corporations Act (or may already have done so). As stated above consideration should also be given to providing directors with a 'transitional no prejudice' rule in the event that they have paid dividends on the basis that the 2010 amendments authorised the payment of dividends out of capital.

Option 2 considered and supported

Consistent with our position in our submission dated 5 February 2010 on the original proposals in 2010, we are in favour of option 2 – adopting a solvency test and a net asset test without an explicit accounting standards requirement. This is because it minimises the impact on an entity's ability to pay dividends when there are changes in accounting standards, unlike the profits test which can be significantly impacted by such changes. We further expand on our support for the solvency test and the New Zealand model below.

The solvency test is more consistent with recent amendments to the Corporations Act relating to the return of capital and share buy-backs, and lessens the reliance on the outdated capital maintenance doctrine as applied to the distributions of dividends.

In our opinion the solvency test is a proper and modern replacement for the concept of capital maintenance operating under early corporate law models. The purpose of the solvency test is fully aligned with the historic purpose of the capital maintenance – namely that the enterprise has the funds it needs to operate and meet obligations. It is more aligned with that obligation than the profits test for dividends which would allow a company to pay dividends out of current year profits notwithstanding prior year losses.

Whilst the profits test could sit side by side with a solvency test, in our view:

- The historic common law tests are confused and complex, particularly where a company has made profits and losses serially over time or allocated sums to reserves or has revaluation profits that may be transient; and
- The solvency test is a single test better aligned to the commercial complexities companies are presently facing; and
- Is the basis used by a number of other countries that have previously used the profits test.

The solvency test is similar to the New Zealand requirements, which is consistent with the Trans-Tasman agreement between the two countries to harmonise corporate law requirements. New Zealand has had the solvency test in place for some time without any significant practical problems. The key to why a solvency test based on the New Zealand model would work well in Australia is because it avoids the strict link to accounting standards, which has two main benefits:

- non-lodging entities are not required to apply accounting standards; and
- fair values of entities can be taken into account.

We strongly disagree with any proposed law having a strong link to accounting standards. Entities can be solvent with plenty of cash to pay dividends even though they may not appear to have significant net assets in accordance with the statutory balance sheet. This will be the case where entities have extensive intangible assets (that cannot be revalued under accounting standards) or where entities hold their property, plant and equipment at cost. The New Zealand test does have an indirect link to accounting standards, via the reference to financial statements. We strongly support an approach that is aligned with the New Zealand requirements.

A discussion paper titled *Payment of Dividends under the Corporations Act 2001* issued by the Australian Accounting Research Foundation (AARF) provides further support for Option 2. Although the AARF discussion paper was issued in 2002 (before the move to IFRS in 2005), it is still valid in terms of the reasons it provides as to why the profits test should be replaced, namely that it is incompatible with previous legislative changes and there is no statutory definition of profit. It also provides reasons as to why the appropriate test should be a solvency test, inter alia because it flows from a director's responsibility for a company's solvency. Although the AARF discussion paper recommends a strict solvency test which does have some benefits, our preference is to harmonise with New Zealand and have a solvency test combined with a net asset test.

When it comes to drafting the requirements of the solvency test for the Corporations Act, we recommend that Treasury uses the New Zealand requirements as a helpful and tested precedent. We instance for example sections 4 and 52 of the New Zealand Companies Act 1993, using wording such as:

"...in determining for the purposes of this Act...whether the value of a company's assets is greater than the value of its liabilities, including contingent liabilities, the directors-

(a) **Must have regard to-**

- (i) The most recent financial statements of the company that comply with [section 295 of the *Corporations Act*]; and
- (ii) All other circumstances that the directors know or ought to know affect, or may affect, the value of the company's assets and the value of the company's liabilities, including its contingent liabilities.

(b) **May rely on valuations of assets or estimates of liabilities** that are reasonable in the circumstances." [Emphasis added]

There are proposals to change the NZ Financial Reporting Act (FRA) to exempt most small and medium sized companies from preparing general purpose financial reports, and instead prepare special purpose financial statements using minimum standards set by Inland Revenue. The solvency test is proposed to be changed, in line with the above requirements, to have regard to financial statements that are 'relevant to the circumstances'. We feel that this changed wording could also be used in the drafting of the Australian requirements on this issue.

Option 1 considered

We do not support option 1. Whilst accounting standards provide a set of principles upon which financial statements can be prepared they are not constructed as a basis for determining solvency. And there are other and simpler methods of determining solvency that do not require the use of all the complexities of accounting standards. These other methods are more universally applicable. We note that over 90% of companies do not prepare statutory financial statements in accordance with the requirements of the accounting standards prescribed by the Corporations Law.

Further, we do not support the linkage of the net asset test with the accounting standards. This is discussed further in Option 2 above. The net assets of an organisation are representative of anticipated future cash flows. The accounting standards do not always recognise sources of future cash flows in areas such as internally generated goodwill, intangibles and increases in values of real property. As noted earlier, the New Zealand test overcomes this issue as it allows for valuations to be taken into consideration when performing the solvency test.

Option 3 considered

We do not support option 3 which involves proposing the reinstatement of the 'profits test' into the Corporations Law. We consider the 'profits test' is no longer appropriate for the reasons highlighted in the AARF discussion paper, being that it is incompatible with previous legislative changes, which have moved away from the capital maintenance concept towards the concept of solvency, there is no statutory definition of profit, and the fact that profits are not representative of the accretion in value of a company.

Option 4 considered

Option 4 also offers a solvency test as well as a 'profits test', allowing a choice between the two tests. Firstly, we do not consider the 'profits test' is appropriate, for the reasons noted above. Secondly, we consider that this proposal is likely to result in divergent practices in determining dividends, creating inconsistencies and lack of comparability. We therefore do not consider it in the public interest to offer a choice as proposed under Option 4 as to how a dividend is paid.

Other Corporations Act issues in respect of the dividends test

Use of 'declared'

Issue for consideration

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

Although we are in favour of option 2, we still consider that the terminology should be changed from 'declared' to 'determined' to ensure consistency in the terminology used within the Corporations Act.

Most company constitutions currently provide for the board 'to determine' that dividends are payable rather than declare a dividend. The issue with the use of the term 'declared' is because once the dividend is 'declared' by the directors of a company; it becomes a debt owing to shareholders by the company at the time it is declared rather than at payment date. Hence, confusion will arise as to when solvency is determined, at the time of declaration, at the time of payment or both. Hence we recommend that the wording in section 254T should be brought in line with that used in section 254U and most company constitutions.

A consequential amendment will also be required to column 3 in the first row of the table in section 588G to replace the terms 'declared' and 'declaration' with 'determined' and 'determination'.

Capital maintenance requirements

Issue for consideration

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.

The Joint Accounting Bodies consider that a legislative amendment is needed to clarify that satisfying the test for paying a dividend in section 254T is a circumstance where a reduction in capital is 'otherwise authorised' by the law. In making this change consideration will need to be given to the issues raised in the ATO legal opinion referred to above.

Taxation issues in relation to the test for the payment of dividends

The view of the Joint Accounting Bodies is that, as a consequence of the views expressed in the legal opinion and Draft Taxation Ruling TR 2011/D8, unless the former profits test is reinstated (which we do not support), there will be a need to revisit the character of Corporations Law dividends for tax purposes and the extent to which they can be franked. This will necessarily entail a review of the various integrity provisions to determine the extent to which they should continue to apply.

We would welcome an opportunity to discuss with Treasury ways in which any revised Corporations Law rules which increase a company's flexibility to make distributions should integrate with the tax provisions. In our view, any tax rules should not inhibit companies from taking advantage of the more expansive test, provide certainty (so that directors know exactly when a distribution is a frankable or unfrankable dividend or a return of capital) and have regard to any revenue concerns of Treasury.

As previously indicated, in order to provide certainty to directors regarding the dividend provisions of the Corporations Act as a result of the 2010 amendments, we recommend that the government clarify legislatively that a distribution that satisfies the Corporations Law rules for paying a dividend is not subject to any other provisions of the Corporations Law that govern share capital reductions. This is particularly the case as we understand that this was the intention of those amendments.

We also recommend that the government consider whether it is appropriate to provide a 'taxation transitional no prejudice rule' to complement our proposed 'Corporations Law transitional no prejudice' rule for directors who may have paid a dividend in reliance on the Corporations Law as it was intended to apply.

The Joint Accounting Bodies, together with a number of other professional bodies, will be commenting on Taxation Ruling TR 2011/D8 in due course. If as part of that process other issues come to light which should be addressed by legislative amendment they will be brought to the attention of Treasury.

Other amendments

Parent entity reporting requirements

Issues for consideration

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?**

We believe the intention of these amendments was to ensure that all companies preparing consolidated financial statements can take advantage of the parent entity relief requirements; as long as this was not inconsistent with any other legislation they were required to comply with.

Whilst an amendment to the Law as proposed is preferable, we consider the technical nature of such amendments may be difficult without the risk of introducing any further unintended consequences. Therefore we support continuing the Class Order issued by ASIC in 2010. There should be no restrictions placed on circumstances in which an entity may decide to prepare parent entity financial statements.

We do consider that there exists another parent entity financial statement-related issue that must be considered, either through drafting of legislation or by an ASIC class order. This relates to the ability for companies lodging consolidated special purpose financial statements (i.e. non-reporting entities), to also obtain the parent entity relief under the Law. Divergent practice has emerged in this area, due

to the lack of clarity, with some entities applying relief and other entities continuing to include parent entity financial statements. So in practice, most companies preparing general purpose financial reports (i.e. reporting entities) get the exemption, while those non-reporting entities do not always get the exemption (often dependant on the views of their advisor or auditor). It would seem anomalous that an unlisted non-reporting entity would have a greater burden on disclosure of parent entity information than a listed reporting entity.

The reason this issue has arisen is firstly because the amendment to s295(2)(b) of the Corporations Act as a result of the Corporations Amendments (Corporate Reporting Reform) Bill 2010 which states that the exemption applied if the company was 'required by accounting standards' to prepare consolidated financial statements. The relevant accounting standard is AASB 127 *Consolidated and Separate Financial Statements*, which states that consolidated financial statements are only required by reporting entities. This causes an issue for non-reporting entities who choose to prepare consolidated financial statements and would like to rely on the relief provided to reporting entities in respect of producing parent entity financial statements.

The Joint Accounting Bodies recommend that non-reporting entities be allowed to rely on the relief provided for parent entity financial statements and be required to disclose the additional parent entity information in the notes. This can be addressed by an ASIC Class Order, similar to the way in which Class Order 98/1418 *Wholly-owned entities* allows for the preparation of consolidated financial statements by non-reporting entities.

Changing the financial year of a company

Issue for consideration

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?

Whilst we agree with the proposed amendment, regarding the unintended consequence of companies being prevented from changing their financial year to a shorter period if they have used the +/- 7 days provisions, similar relief is also required under other sections of the Law.

Sections 323D(3) and 323D(4) allow an entity to synchronise its year end to that of a parent. We would expect an additional exemption to be given in this circumstance for a subsidiary company if the entire group wished to change its year end within a five year period of the subsidiary being acquired by the group.

Other issues requiring Treasury's attention relate to the timing of such an exemption. This has been detailed fully in Appendix 2 of our submission.

Solicitors' representation letters

The original reform proposals contained an amendment in relation to solicitors' representation letters which we supported in our submission dated 5 February 2010. This amendment was not in the final Bill and in a media release dated 26 May 2010 by Chris Bowen, it was noted that "While most stakeholders supported the measure, several requested further consultation be undertaken on the details of the amendment. The Government will consult further on the proposal and include reforms in a later Bill once appropriate wording has been settled."

Whilst we understand that work is currently being done with the Attorney General's office to progress this issue, we continue to urge Treasury to resolve the issue and make the necessary amendment as soon as possible.

Changing the financial year of a company

As noted in Appendix 1, we would like to bring to Treasury's attention the fact that in our letter dated 5 February 2010 we supported the original proposal which allowed for a financial year of up to 18 months when changing the financial year of a company. This original proposal to allow a period of up to 18 months was widely supported by submissions at the time. However, we understand that the regulator had concerns regarding such a period, especially in relation to listed entities. We understand this concern for listed entities, although it is not relevant for non-disclosing entities. Therefore the Joint Accounting Bodies request that Treasury consider amending this to allow non-disclosing entities to have a financial year of up to 18 months when changing the financial year. Only allowing 12 months does not reduce the burden on these companies to change its financial year as it must prepare two full annual reports to do so, one for the interim period and one for the new financial year end.

Companies limited by guarantee

Who can perform an audit

As noted in our submission dated 5 February 2010, some of our members have highlighted concerns regarding the shortage of Registered Company Auditors (RCAs) in rural areas, and the impact this shortage has on the ability for many companies to comply with this legislation; especially the audit requirements for Tier 3 and Tier 2 companies. Feedback from these members has included suggestions for an additional tier of company for which an audit can be done by either an RCA or a member of one of the three professional accounting bodies holding a public practising certificate (PPC). The Joint Accounting Bodies commissioned research in 2006 that demonstrated the effect the declining numbers of RCAs is having on entities' access to auditors. We also note that there is a continuing trend of declining numbers of RCAs reflected in recent annual reports of the Australian Securities and Investments Commission. Furthermore, we understand the proportion of RCAs in non-metropolitan locations to total RCAs has also continued to decline. We therefore ask Treasury to consider allowing members of the three professional accounting bodies who hold a certificate of public practice to be permitted to do audits of Tier 3 and Tier 2 companies limited by guarantee. The Joint Accounting Bodies propose a similar competency standard to that for reviews of companies limited by guarantee be prepared for members with a PPC who wish to perform such audits.

Concise reports

The 2010 reforms included an amendment to s314 with the addition of s314(1AAA) so that s314 (which refers to providing concise reports to members) no longer applies to companies limited by guarantee. We question whether it was deliberate to prohibit companies limited by guarantee from preparing concise financial reports or whether this was an oversight or an unintentional consequence. We have had member queries on this which suggest that many companies limited by guarantee were preparing concise financial reports as the most effective and efficient way to keep their members informed. The Joint Accounting Bodies ask that Treasury review this and if possible make an amendment to allow concise financial reports to be prepared by companies limited by guarantee.

Requirement to appoint an auditor

Although Tier 1 companies limited by guarantee are no longer required to prepare a financial report, section 327B was not amended by the original amendments and therefore still requires a public company to appoint an auditor. Further, the same issue also exists in respect of Tier 2 companies limited by guarantee that choose to have a review and not an audit. The Joint Accounting Bodies request that Treasury make an amendment to address this inconsistency.

Small/large proprietary company threshold

It has been five years since the thresholds for determining what is a large and small proprietary company were amended as a result of the Corporations Legislation Amendment (Simpler Regulatory System) Act 2007. In Chapter 2 of the Draft Regulation Impact Statement for the Corporate and Financial Services Regulation Review Proposals Paper 2006, it notes that the operation of the Corporations Act will continue to be monitored to ensure it operates as intended. We therefore ask that Treasury review these thresholds to determine whether they are still appropriate.

Parent entity exemption and non-reporting entities

This issue, which was not addressed in the discussion paper, has been explained in Appendix 1.