ISSUES PAPER

FOR-PROFIT ENTITIES AND THE REPORTING ENTITY CONCEPT – WHERE NOW FOR FINANCIAL REPORTING?

BACKGROUND

Australian law has long allowed individuals to organise and operate their business activities through a myriad of structures (e.g., partnerships, discretionary, unit and fixed trusts, small and large proprietary companies and public companies) with various advantages and disadvantages.

Historically, it was the law and/or practice of many jurisdictions, including Australia, to hold all companies to the same level of accountability, which extended to their financial reporting obligations. In recent decades, Australia has changed its approach for companies and financial privacy is now emphasised.

Currently, there are about 1,750,000 companies, registered schemes and disclosing entities in Australia and nearly all are for-profit. Of these, about 21,000 have financial reporting obligations under the current requirements of Chapter 2M of the *Corporations Act 2001* with the rest not required to reveal information to the world at large.

The purpose of this Issues Paper and its questions is to stimulate your thinking about new opportunities for deregulation of and/or improvements to the financial reporting currently required of for-profit entities under the *Corporations Act 2001*.

This Issues Paper deals with all public companies other than those limited by guarantee, registered schemes, disclosing entities and proprietary limited companies. The scope of this Issues Paper does not include not-for-profit entities such as public companies limited by guarantee or entities not within the scope of the *Corporations Act 2001*. The issues that apply to some of those entities are addressed in a separate Issues Paper.

An empirical research report (the Research Report) from the Australian Accounting Standards Board, published in June 2014, appears to confirm the opinions of some commentators that the financial reports[1] prepared by some entities are not consistent with the actions and outcomes that would be expected from applying the requirements of the *Corporations Act 2001.* These include the requirement that the financial report must comply with the accounting standards issued by the Australian Accounting Standards Board and regulations.

ACCOUNTABILITY AND THE REPORTING ENTITY CONCEPT

The *Corporations Act 2001* accountability requirement to prepare an annual financial report is contained in Part 2M.3 s 292 and requires that all public companies other than those limited by guarantee, registered schemes and disclosing entities prepare financial reports. However, the *Corporations Act 2001* does adopt a differential legislative reporting framework for proprietary limited companies whereby only large proprietary limited companies are required by s 292 to prepare financial reports and lodge them with ASIC.[2] If the company is a 'grandfathered' large proprietary company, it is required to prepare a financial report and have it audited but is exempt from lodging it with ASIC.

The *Corporations Act 2001* does not express an overarching principle for financial reporting such as the provision of financial information necessary to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs. Nor does the *Corporations Act 2001* s292 appear to have been developed using a single indicator that an entity should have financial reporting obligations. For example, the impact on the national or regional economy of entity failure appears to underpin the requirement for financial reporting by large proprietary companies whereas that requirement that all listed companies have financial reporting obligations could be explained as meeting the community's expectations of public accountability by entities that seek funding through equity instruments that are offered to the public. Unlisted public companies often have significant numbers of owners of the business who are not involved in its management or as employees. Therefore, the financial reporting obligation of unlisted public companies could be explained by the separation of management and ownership indicator. Some commentators believe that some financial reporting obligations might be explained by a combination of factors. For example, the reporting obligations of unlisted public companies might also be explained by the fact that as these companies have the ability to offer shares and raise capital from the general public, the public accountability indicator is also relevant.

As stated above, the *Corporations Act 2001* prescribes what constitutes a financial report and also requires that the financial report must comply with the accounting standards issued by the Australian Accounting Standards Board and regulations (*Corporations Act 2001* s 296). An overarching principle for financial reporting is not articulated.

Currently, the Australian Accounting Standards Board operates a differential accounting standards reporting framework consisting of two tiers of accounting standards (Tier 1: Australian Accounting

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[1] S 295 states that an annual financial report consists of the financial statements for the year, its notes and the directors' declaration about the statements and notes.

[2] Part 2M.3 does not apply to small proprietary limited companies except when the company is directed to do so under other provisions within Part 2M.3. Therefore as a general statement, the Corporations Act relieves these small companies from financial reporting. Small proprietary limited companies controlled by a foreign company must prepare and lodge financial statements with ASIC unless relieved from doing so by a Class Order or when part of a large group with an Australian parent which has lodged consolidated financial statements with ASIC. Small proprietary limited companies must prepare financial statements when given a direction by ASIC or as requested by at least 5 per cent of shareholders or members. The lodgment of financial statements with ASIC is required to satisfy the direction by ASIC.

Standards and Tier 2: Australian Accounting Standards – Reduced Disclosure Requirements), overlaid by its requirement that reporting entities prepare general purpose financial statements.

The AASB requirement that reporting entities prepare general purpose financial statements relies on the definitions of reporting entity and general purpose financial statement expressed in AASB 1053 *Application of Tiers of Australian Accounting Standards* and the application paragraph in Australian Accounting Standards.
AASB 1053 contains the following definitions:

- Reporting entity means an entity in respect of which it is reasonable to expect the existence of users who rely on the entity's general purpose financial statements for information that will be useful to them for making and evaluating decisions about the allocation of resources. A reporting entity can be a single entity or a group comprising a parent and all of its subsidiaries.
- General purpose financial statements are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

The application paragraph in all Australian Accounting Standards other than AASBs 101, 107, 108, 1031 and 1048 states that the standard applies to:

(a) each entity that is required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act and that is a reporting entity;
(b) general purpose financial statements of each other reporting entity; and
(c) financial statements that are, or are held out to be, general purpose financial statements.

The application paragraphs of AASBs 101, 107, 108, 1031 and 1048 apply to all entities required to prepare financial reports in accordance with Part 2M.3 of the *Corporations Act 2001*, whether or not they are reporting entities.

As stated above the AASB Research Report appears to confirm the opinions of some commentators about the quality of financial reports prepared by some large proprietary limited companies and unlisted public companies. The Research Report reveals widespread use of special purpose financial reporting by lodging entities of various types, a consequence of their self-determination as non-reporting entities.

The Research Report also notes a wide variation in the stated application of accounting standards by companies. Consequently, the researchers were not able to determine, directly, whether the special purpose financial statements of non-reporting entity companies comply with the ASIC Regulatory Guide 85 *Reporting requirements for non-reporting entities*. ASIC believes that non-reporting entities, which are required to prepare financial reports in accordance with Chapter 2M (and that would include Part 2M.3) of the *Corporations Act 2001* should comply with the recognition and measurement requirements of accounting standards.

The Research Report conclusions include a need to consider the relevance of the reporting entity concept, whether it should be changed perhaps with the creation of higher tests via the *Corporations Act 2001* and accounting standards to standardise the application of the reporting entity concept. Regarding special purpose financial statements, the Research Report notes an absence of explicit evidence of compliance, of itself, has the potential to reduce the reliance that users can place on the financial statements, especially in an environment in which special purpose financial statements are predominant. Accordingly, public-policy makers and the AASB may need to consider ways to enhance the transparency of accounting policies disclosure by these companies.

With the Australian Government focus on deregulation, amendments to the financial reporting provisions of the *Corporations Act 2001* might be possible. Those against further deregulation include those commentators who state that all companies should be required to prepare and lodge financial reports because companies, unlike other business entities, have the benefit of limited liability. Some commentators believe that the current requirements play an important role in the governance practices of subject entities. Another factor at play is the recent public attention to the percentage of tax paid by corporate entities and the view expressed by some journalists that the financial statements of foreign-owned proprietary limited companies and 'grandfathered large proprietary limited companies' are needed to make transparent company behaviour regarding tax.

QUESTIONS FOR DISCUSSION

1. Do you agree with the Research Report findings that the reporting entity concept is not being applied as intended? Why or why not? If it is being misapplied what is the mischief?

2. Do you believe that the accounting standards requirement that reporting entities prepare general purpose financial statements should be retained? Why or why not? If not, what is your view on amending the Corporations Act 2001 to mandate who should have to prepare general purpose financial statements? Are there other alternatives?

3. Currently, accepted practice appears to be that a for-profit entity with public accountability has financial reporting obligations that would require the entity to prepare general purpose financial statements. Do you agree that all entities with public accountability should prepare general purpose financial statements? Why or why not? How do you understand public accountability?

4. Economic significance is used in the *Corporations Act 2001* to indicate that a proprietary limited company has financial reporting obligations. Do you agree with this use of economic significance? Why or why not? If not, what alternative do you propose?

5. It appears that separation of management and ownership currently plays a role in requiring financial reporting by unlisted public companies. What continuing role, if any, do you see for the separation of management and ownership indicator?

6. What role, if any, do you see for special purpose financial statements? Is it something that the lawmakers and/or accounting standard setters should be involved in?

7. Do you have any other issues that you would like to raise? For example, the interaction of the reporting entity concept and the requirement to prepare general purpose financial statements for private and public not-for-profit entities.