AUSTRALIAN INSTITUTE *of* COMPANY DIRECTORS

DIRECTOR TOOLS

What to consider before approving financial statements

Board performance

Companies have a legal responsibility to keep written financial records and to regularly report to members their financial performance and position.

This duty is placed on companies,not directors. Directors, however, in effect represent the company and have a duty of care to ensure that these statements are an accurate representation of the company's financial affairs. In confirmation, a director is required to sign a declaration to this effect.

Responsibility for monitoring financial affairs is often delegated to the board's audit committee. The audit committee reviews the financial integrity of the company via effective internal control processes and accounting policies that reduce the risk of irregularities or fraud. Although authority is delegated, the board retains collective responsibility for financial matters. This was emphasised in the Centro case (discussed below) which made it clear that approving financial statements is a core duty for all directors and one which requires them to apply their overall knowledge of the company's affairs in forming an opinion as to approving financial statements.

Directors must make a declaration in the Directors' Report that the financial statements comply with accounting standards, are true and fair and that the company is solvent. When signing financial statements, directors should keep in mind that they can face civil and criminal penalties for failing in their duties. These penalties may take the form of fines, disqualification or a compensation order (Austin, R and Ramsay, I, *Ford, Austin & Ramsay's Principles of Corporations Law,* 16e, LexisNexis Australia, 2014, p 485).

Directors can become aware of potential financial issues through:

- their own analysis of financial reports;
- reports of the audit committee and external auditors;
- regular management reports to the board;
- investigations conducted by internal auditors.

ASIC Information Sheet 183 *Directors and financial reporting* (p 2), states that:

> *"You must read, understand and focus on the contents of the financial report. You must apply your own mind to, and carry out a careful review of, the financial report and directors' report, determine that the information they contain is consistent with your knowledge of the company's financial position and affairs, and ensure that material matters known to you, or that should be known to you, are not omitted.*
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> *In reading the financial report, you should:*
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> - *ensure, as far as reasonable and possible, that the information included is accurate*
> - *question the accounting treatments applied, and*
> - *examine the adequacy of disclosures and whether any matters have not been disclosed that should be disclosed."*

What are the specific questions to ask?

The following is a summary of the checklist provided by James Lonie ('Approving the financial report', *Company Director*, February 2013) for approving and adopting the financial report of a public company:

1. Do you have the necessary minimum financial literacy and basic knowledge of key accounting standards?
2. Ensure you have and maintain a basic knowledge about the company, its financial position and affairs sufficient to reach a reasonably informed opinion of the financial capacity of the company.
3. Are the company's risk and audit structures and processes appropriate for the company?
4. Review the nature and quantum of financial advice provided to you.
5. Ensure you have adequate time to review information.
6. Review the legal requirements for the financial statements and reports.
7. Do you have reasonable grounds to believe the company will be able to pay its debts as and when they fall due and payable?
8. Do not totally rely on management and the auditors (or other directors).
9. Regularly refresh your memory on your personal obligations as a director, especially relating to the accounts.
10. What significant accounting practices and standards apply? Have they changed?
11. Consider asset values.
12. Meet management and obtain all necessary sign offs (including s 295A declarations where necessary).
13. Non-executive directors to meet auditors and obtain preliminary audit sign off.
14. Obtain a copy of the final financial statements.
15. Read and carry out a careful review of the financial statements.
16. Consider if the financial statements are consistent with your knowledge of the company's financial position.
17. Bring an open and enquiring mind, even in respect of matters outside your area of expertise.
18. Consider areas of high risk and subjectivity.
19. Do the financial statements present a true and fair view?
20. Consider changes to the financial statements and reports before passing the directors' resolutions. If changes are so significant they cannot be readily absorbed, arrange a later time for approval to allow review.

Many questions can be asked for each section of the financial statements and some alternative or additional questions to consider may include:

- Do the financial statements make sense? Do they present a realistic view of the results, cash flows and state of affairs?
- Have the external auditors raised any issues?
- Are there any disputes with the ATO, ASIC or the ACCC for which provisioning may be needed?
- Does management ensure compliance with relevant government regulations and accounting standards?
- Is there sufficient cash to pay dividends?
- Do any matters need to be disclosed in the Notes?
- Are significant items clearly explained?
- Are related party transactions fully documented?
- Are subsequent events effectively flagged?
- Have all the assets (including goodwill) been tested for impairment and what assumptions have been made?
- If changes in accounting policies, who has approved those changes?
- What are the critical accounting estimates and judgments and who has approved them?
- Are there any off-balance sheet financial arrangements and if so, why are they not recognised in the financial statements?
- Have the liabilities been correctly classified in terms of maturity?
- Are the disclosures relating to financial risk management consistent with the board's understanding of how financial risk is managed?

What is the overall responsibility outlined in the Centro case?

All directors should be aware of the Centro case (*ASIC v Healey* (2011) FCA 717) in which directors who approved a company's financial statements failed to notice that $2 billion in current liabilities had been classified as non-current. The court held that the directors should have known that these liabilities were payable within 12 months. The directors relied on the fact that the mistake had not been found by management or external auditors and the directors had relied on those other checks that the accounts were correct. The court rejected the directors' arguments and found they had breached their duty, saying:

> *"It may be that in the course of this trial the directors have been able to show others had difficulties with the issues confronting the directors in 2007.*
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> *The first point to observe is that the directors themselves were not distracted by the various so called complicated issues raised now in this proceeding. Each director relied completely on the processes in place and their advisors. All the directors failed to see the 'obvious errors' because they all took the same approach in relying exclusively upon those processes and advisors. No director stood back, armed with his own knowledge, and looked at and considered for himself the financial statements.*
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> *The second point to make is that as far as the other persons who fell into error are concerned, the Court in this proceeding cannot adequately determine the reason for this occurring. Every person referred to by the directors as having fallen into error, had different roles to play, and had various levels of information available to them. Some may well have had limited knowledge of the facts, or themselves failed to take sufficient care. Mr Nenna has acknowledged that he failed to take sufficient care. The mere fact that others (perhaps many others) fell into error does not assist in determining the key issue in this proceeding relating to the conduct of the directors.*
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> *The final point to observe, is that ASIC does not allege, as I have previously indicated, that the directors needed to get it right or that they needed to realise that the information available to them was 'necessarily' indicative of error (as the directors would frame the issue). All that is being alleged is that they should have detected the apparent error, and acted accordingly, by for instance, asking the appropriate question of management Therefore, I do consider that all that was required of the directors in this proceeding was the financial literacy to understand basic accounting conventions and proper diligence in reading the financial statements. The directors had the required accumulated knowledge of the affairs of Centro, based upon the documents placed before them and discussion at board meetings. Each director then needed to formulate his own opinion, and apply that opinion to the task of approving the financial statements."*

ASIC's Deputy Chairman, Belinda Gibson, has set out what ASIC expects in this area following the Centro case ('What ASIC expects of NEDs', *Company Director*, November 2011):

> *"In the Centro case, ASIC did not argue directors needed to check the accuracy of figures or the accounting treatment in the company's financial statements. Nor did the Centro judgment decide directors must have knowledge of every accounting practice and accounting standard. However, some common accounting concepts must be grappled with. One is solvency and another is classification of debt as current or otherwise.*
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> *Directors must consider relevant information provided to them. They must ensure they have access to board papers and use the information gained in considering all matters put to the board. The Centro decision highlights that directors must review matters against their knowledge of the company, including knowledge obtained from different or earlier board papers.*
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> *Directors must be sceptical. ASIC expects board members to ask management questions and to challenge recommendations put to them. They must apply their minds to critically review the information given to them against their knowledge of the company. If the information is not consistent with that knowledge, they must probe management until they are satisfied. It is vital that directors do not uncritically adopt the work of management and advisers on issues of fundamental importance to the company.*
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> *Directors are expected to bring their expertise and experience to the board's deliberations on all matters. They cannot abdicate responsibility in areas where they have less expertise than others on the board. However, ASIC accepts that much of a company's activities must necessarily be delegated from the board to management and from management to employees.*

> *Nevertheless, there will be some matters that cannot be delegated. One is where the director's opinion is required. Where an opinion is required by law – as in approving financial reports – directors must apply their own knowledge to the information provided and form their own opinion. This does not exclude relying on others to inform that opinion, but directors must provide the "final filter"."*

The final word should go to the Chairman of ASIC, Greg Medcraft, who summarised the effect of the Centro case as follows ('Q&A with Greg Medcraft', *Company Director*, September 2012):

> *"There are four simple principles here. Directors need to be sceptical. They must be able to read a set of financial statements, understand the business and understand that delegation does not remove their accountability.*

"What are the warning signs for insolvency?

Insolvent trading is a serious breach of the *Corporations Act 2001*. Directors can be held liable and face civil and criminal penalties. Indicators of potential problems include:

- Weak operating cash flows (as opposed to investing or financial cash flows);
- Payments to suppliers and employees are higher than receipts from customers;
- Evidence of a breakdown in internal controls; Financial reports not provided to the board or provided late;
- Lenders withdrawing support;
- Delaying payments to creditors, including salaries to staff;
- Regularly requesting extensions to due dates for payments;
- Evidence of negligent or incompetent management;
- Lack of risk management planning;
- Internal housekeeping not up to date e.g. bank reconciliations;
- Incomplete financial records;
- Absence of a business plan;
- Lack of cash flow forecasts of other budgets.

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