Chapter 2
Companies and corporate regulation

2.1 Discuss the characteristics of a company and the aspects that make the company an attractive structure for business enterprises.

These characteristics are discussed on pages 8 and 9 of the textbook:

- legal personality
- limited liability
- perpetual succession
- share based ownership interests
- ability to mobilise individual capital
- scope for professional management

These factors allow for an efficient and effective way for 'jointly' engaging in commercial activity. Legal personality and perpetual succession makes the company independent of individual owners, thereby facilitating transfer of ownership interest and not subjecting the business to other risks undertaken by individual owners (as is the case in partnerships). While for smaller enterprises limited liability may be defeated by lenders (and others) insisting on guarantees from owners, for larger companies the risk limitation makes the investment more attractive to potential investors, while the use of share capital as the basis of ownership and interest in profits creates potential for investments with higher marketability than is otherwise available. It allows undertakings that cannot be financed by individuals or small groups of individuals (via a partnership) to be established through mobilising relatively small investments by a large number of investors. Professional management provides the opportunity for more efficient and effective operation, thereby increasing returns to investors. (Of course, the risks arising from the separation of ownership and management must be remembered.)

2.2 Outline the factors that give rise to the different types of company allowable under the Corporations Act. By which permutations may the factors be combined?

Three general factors dictate the classes of companies that are available under the Corporations Act:

- **Factor 1:** maximum size of the ownership pool and scope for fund raising
  - ♦ proprietary companies
    - ⇒ maximum membership 50 (excluding employees and former employees)
    - ⇒ cannot raise funds from the general public (in chapter 4 we see that they can only make unregulated offers of securities)

- ♦ public companies
  - ⇒ no limit on number of members
  - ⇒ able to offer securities to general public (as we see in chapter 4 this requires a regulated offer of securities through a prospectus complying with the Corporations Act)

- **Factors 2 and 3:** limited liability and how it is implemented
  - ♦ companies without share capital
    - ⇒ limited by guarantee (pubic companies only)
  - ♦ companies with share capital
    - ⇒ limited by shares
    - ⇒ no liability companies (public companies only)
    - ⇒ unlimited companies

These factors affect the forms in which a company can be registered. The distinction between small proprietary and large (or not small) proprietary companies does not depend on formal characteristics; rather it depends on the indicators of economic significance. The implications of this distinction are limited to financial reporting requirements.

The possible combinations are depicted in figure 2.1 (page 12).

2.3 What is meant by the following terms: *limited liability*, *no liability* and *unlimited liability*?

- Limited liability
  - ♦ owner or member's (investor's) liability for the debts of the company is limited to the amount not yet paid on shares owned *or* the amount agreed by way of guarantee
  - ♦ if there is share capital
    - ⇒ the owner must pay amounts not yet paid when called on to do so (if they do not the shares can be forfeited)
    - ⇒ on liquidation owner can be called on to pay amounts not yet paid (but no more)
  - ♦ if there is no share capital
    - ⇒ usually an obligation to make an annual payment (can be varied from time to time)
    - ⇒ on liquidation, maximum amount member can be called on to pay is the amount of the guarantee
- No liability
  - ♦ a member or owner has no liability for amounts unpaid on shares owned, both arrears and uncalled amounts (only available if company engages in mining activities) – if a member fails to pay an amount when called on to do so, the company must forfeit the shares and sell them by public auction
  - ♦ there is no liability in event of liquidation
- Unlimited liability
  - ♦ the owner must pay amounts not yet paid when called on to do so (if they do not the shares can be forfeited)
  - ♦ on liquidation, the amount that members can be called on to contribute to meet the company's debts is unlimited

2.4 How may a share company be distinguished from a guarantee company?

- A share company can:
  - have limited liability; or
  - have unlimited liability; or
  - be a no liability company.

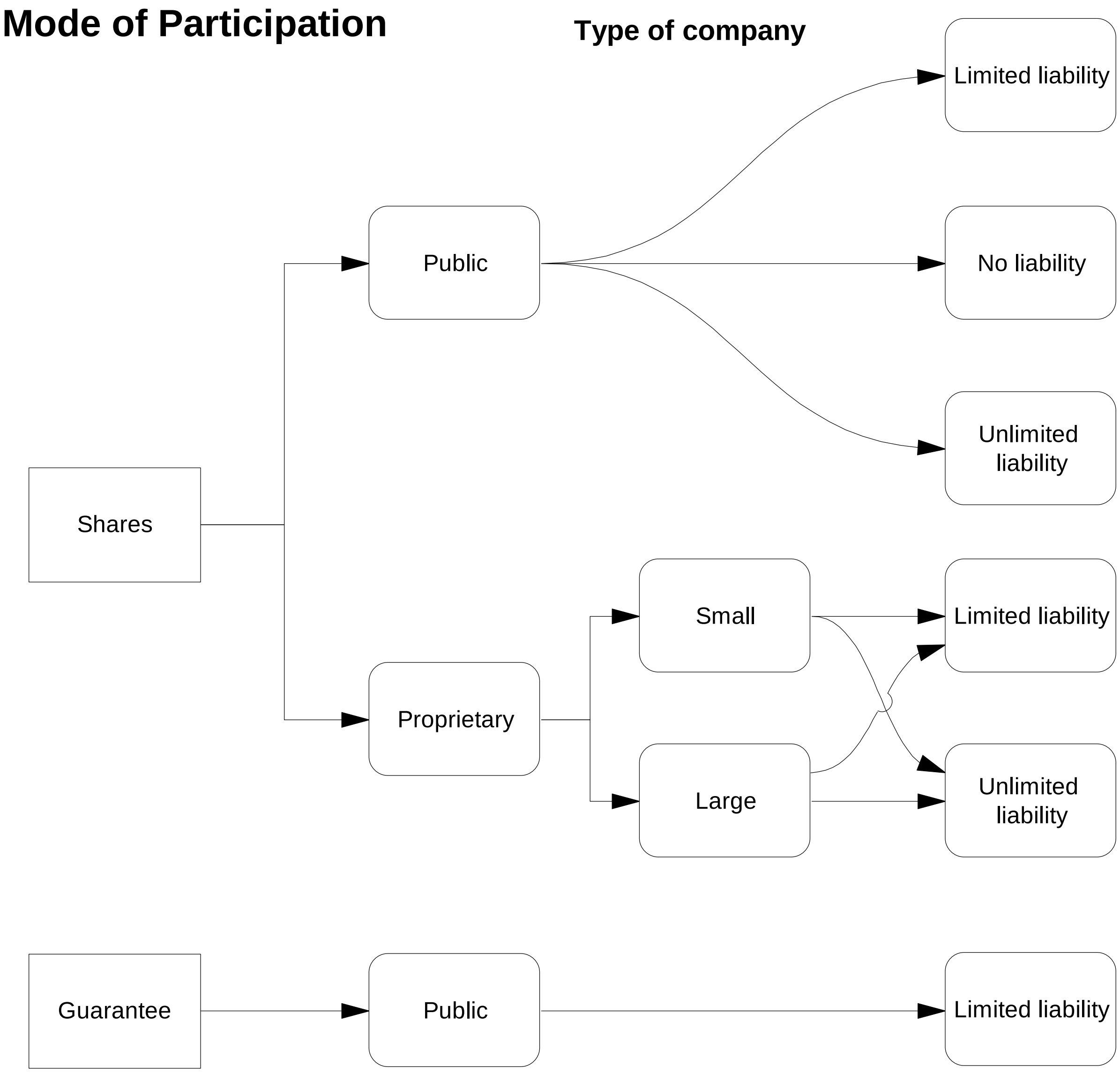
  A guarantee company must have limited liability.

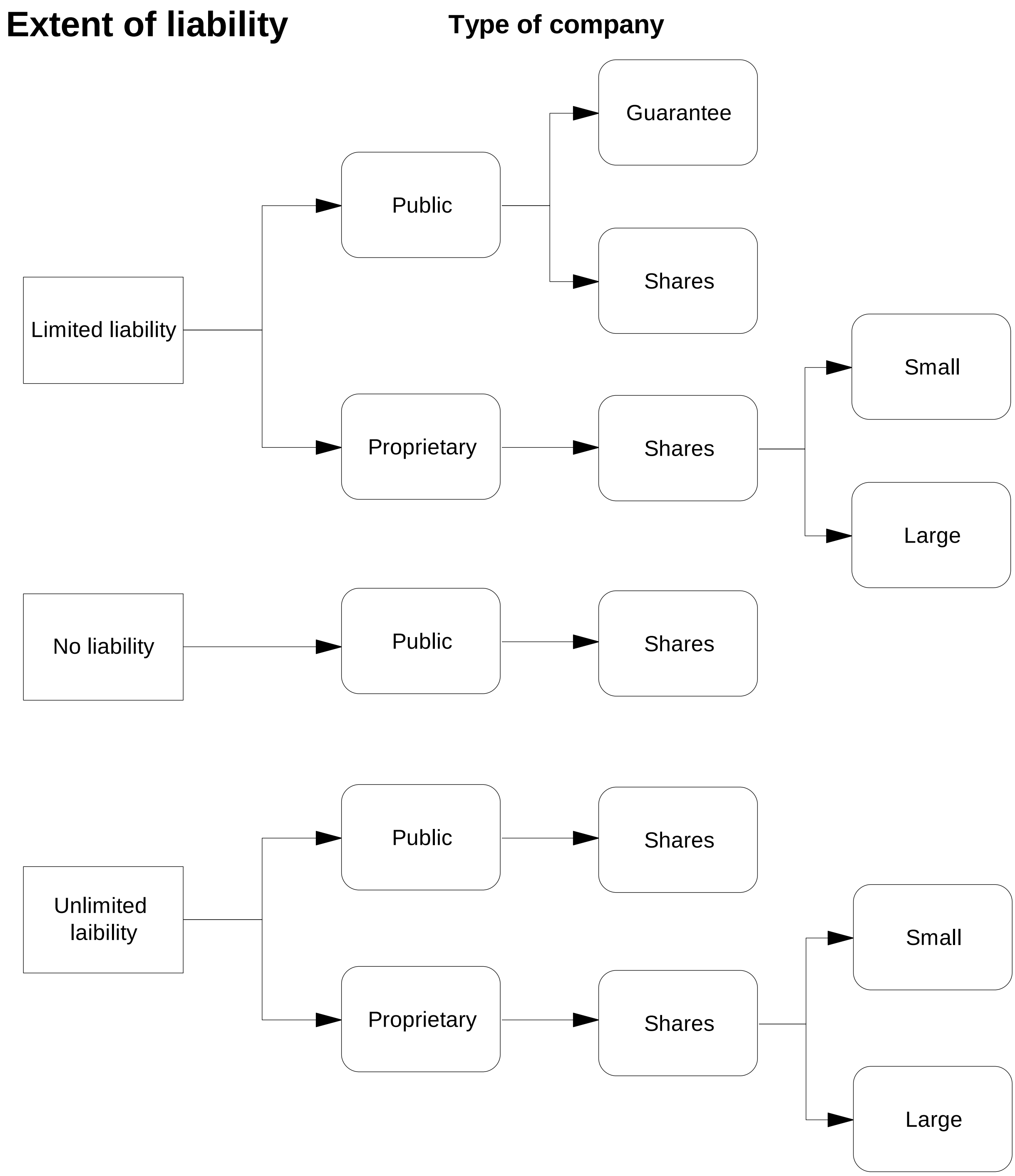
- A share company has share capital that is (notionally) divided into individual shares, and the interest of an owner of shares in the capital and profits of the company depends on the number of shares held, and the rights attaching to those shares.
  For a guarantee company, the members have no interest in the underlying assets of the company and cannot receive dividends or other distributions from the company.

- A share company can be ***either*** a public company or a proprietary company.
  A guarantee company must be a public company.

(For some long-formed guarantee companies members can have an interest in the underlying assets, however, such companies are rare. Before the First Corporate Law Simplification Act 1995 it was possible to create public or proprietary companies with both share capital and liability limited by guarantee. Again, such companies are rare.)

2.5 Draw two separate tree diagrams, similar to the diagram in figure 2.1, showing the permutations of corporate structure possibilities. Start the left-hand side of the first diagram with 'Mode of participation' and the second diagram with 'Extent of liability'.





2.6 What is the applicability of the terms *member* and *shareholder*?

See page 10, paragraph under heading 'Mode of participation' where the distinction is explained as follows: 'A generic name for owners is *members*. Shareholders are described alternatively as members, but for companies with no shares, only the title '*members'*, is appropriate.'

2.7 Briefly outline the test applied in classifying an entity as a disclosing entity and describe the consequences of being classified as a disclosing entity.

The test for determining if an entity is a disclosing entity is quite complex, however, in summary an entity is a disclosing entity if:

- its securities are listed on a stock exchange (such as the one operated by the ASX);
- it has issued debentures for which the Corporations Act requires the appointment of a trustee for debenture holders; and
- for securities (other than debentures), the entity has issued securities – either under a disclosure document or under a takeover – for which there are at least 100 persons or entities holding those securities.

Securities that satisfy any of the above are called enhanced disclosure securities in the Act.

The main consequences of an entity being classified as a disclosing entity are:

- having to prepare both half year and full year financial reports;
- the ability to use abbreviated disclosure documents in fund-raising; and
- the obligation to keep both the ASX and ASIC informed of information that may affect the price of its securities (the continuous disclosure requirement).

2.8 Give a brief summary of the historical evolution of the company until 1961.

The answer to this question is found on pages 14–16 of the textbook.

2.9 Outline and briefly discuss the method of operation of the national company schemes that operated in Australia between 1961 and 2000.

Before 1991 regulation of companies was cooperative. In 1961 and 1962 uniform legislation was adopted in the States and Territories (although there were some differences between the states). These were known as the Uniform Companies Acts 1961–1962. There was no formal cooperation in the administration of the law. Starting in 1965 some states amended their legislation (often more than once); by 1980 there were substantial differences in legislation – there was little uniformity left. However, signatory jurisdictions to the Inter-State Corporate Affairs Agreement had substantially similar legislation and had developed limited administrative cooperation. In 1980 the National Co-operative Scheme was implemented under an agreement between the Commonwealth, the States and Territories. The scheme was based on the Commonwealth Act, which applied to the ACT, and was adopted as 'codes' in the States and Northern Territory (the codes were substantially the same as the Commonwealth legislation). Collectively, the legislation was known as the *Companies Act and Codes*. Amendments to the Act and Codes required Commonwealth legislation and legislation in each State and the Northern Territory. Administration was split between the national regulator (The National Companies and Securities Commission – NCSC) and the Corporate Affairs Commissions and Departments of the States and Territories. While the NCSC was responsible for coordination of policy, administration was primarily the responsibility of the States and Territories. This splitting of responsibility caused many problems.

The Commonwealth's Corporations Act 1989 was intended to address these problems. This legislation was originally intended to displace the States' involvement in company administration and to establish the Commonwealth as the only authority. However, the original legislation was substantially rejected by the High Court as being unconstitutional. The Commonwealth redrafted the legislation so that, rather than overriding the power of the States to legislate on company law, the Corporations Act would be used as a model that the States could adopt voluntarily. An amended version passed through the Federal Parliament in 1990, and all of the States and Territories subsequently adopted the scheme, which became operational on 1 January 1991.

The first part of the amended Act contained a lot of enabling legislation that provided the framework for the Commonwealth–States arrangements. The actual companies' legislation itself (the contents of the original Act) was relegated to a large schedule, which became known as the 'Corporations Law' to distinguish it from the rest of the Act. At first glance, the resulting scheme seems to be the same in concept as the 1981 National Cooperative Scheme. However, although the States still technically retained a 'reserve' power over their own companies' legislation, the scheme was much closer to being a truly national arrangement, especially because its administration was run by a single Commonwealth created and controlled body, the Australian Securities Commission. Despite all this remedial legislation there was still doubt that the changes would survive a constitutional challenge. This resulted in a new act in 2001, which forms the basis of the present scheme.

2.10 Give an overview of the present company law scheme that operates in Australia.

The current company law is found in the Corporations Act 2001, which re-enacted the prior Corporations Law (a schedule to section 82 of the Companies Act 1989). The Act applies to all states and territories – the States having referred the necessary legislative powers to the Commonwealth (thereby avoiding constitutional problems that had plagued the Corporations Law). Administration of the Corporations Act is the responsibility of the Australian Securities and Investments Commission (formed under the Australian Securities and Investments Commission Act 1989). ASIC's powers in relation to companies arise from the Corporations Act 2001 and the Australian Securities and Investments Commission Act 2001.

2.11 Outline the structure of the Corporations Act 2001.

This structure of the Corporations Act 2001 is depicted in Table 2.1 (page 17 of the textbook). The most important chapters, for our purposes, are 2A–2C, 2F–2J, 2L–2N, 2M (deals with financial reports and audit), 5, 5A and 6D.

2.12 Briefly outline the powers and functions of the AASB.

Under the Corporations Act 2001, the AASB has the power to make accounting standards which, under Chapter 2M of the Corporations Act, must be applied by entities that are required to prepare financial reports under Part 2M.3 of the Act. The AASB has the power, under the ASIC Act 2001 to make accounting standards for the purposes of the Corporations Act and for other purposes. Other legislative and administrative schemes can require entities to apply AASB accounting standards.

The AASB is formed under the Australian Securities and Investments Commission Act 1989, and under section 227 of the Australian Securities and Investments Commission Act 2001 its powers include the power to:

- develop a conceptual framework not having force of law for the purposes of evaluating accounting standards;
- make accounting standards under s 334 of the Corporations Act for the purposes of the Corporations Act and formulate accounting standards for other purposes; and
- participate in, and contribute to, the development of a single set of accounting standards for worldwide use.

2.13 Describe the role of ASIC in the regulation of financial reporting in Australia.

ASIC's role in the regulation of financial reporting in Australia is primarily in enforcement of the Corporations Act's financial reporting requirements. In doing so it can assist enforcement through Practice Notes (outlining the ASIC's interpretation of particular requirements of the Act – including accounting standards) and policy statements (outlining how the ASIC will exercise its powers under the Act relating to accounting requirements – primarily the power to modify the application of accounting standards). [From July 2007 these were included in a new category 'Regulatory guides', together with policy statements, guides and frequently asked questions.] From time to time the ASIC establishes enforcement programs, which include the review of financial reports lodged with it. If a report is deficient in any way, the ASIC can require lodging of reports amended to overcome that deficiency or take other enforcement action. It can also refer matters to other administrative organisations such as the Company Auditors and Liquidators Disciplinary Board.

2.14 Describe the objectives of the international harmonisation of accounting standards.

Reductions in international differences of standards or the adoption of one set of accounting standards world-wide could improve efficiency and comparability in world capital markets, and reduce costs. There are a number of ways in which this could occur. Three distinct approaches, globalisation, international harmonisation and internationalisation, are summarised by Godfrey and Langfield-Smith (2005) as follows:

(a) **globalisation,** which involves adopting a single set of accounting standards throughout the world;

(b) **international harmonisation,** which involves Australia using all, or a subset, of accounting standards developed in another jurisdiction to develop its standards; under this approach compliance with Australian standards would ensure compliance with the standards of that other jurisdiction but not, necessarily, vice versa; and

(c) **internationalisation,** which involves Australia developing local accounting standards on the basis of a detailed examination of accounting standards and practices in other jurisdictions.

Globalisation is the ultimate goal of the IASB (International Accounting Standards Board) but international harmonisation is a means of helping to attain this goal, while at the same time offering some of its ultimate benefits. Harmonisation needs to occur with the agreement of governments who can adopt, in part or full, the accounting standards made by the IASB. Other interested parties include domestic standard setters and stock exchanges.

The IASB (originally called the International Accounting Standards Committee (IASC)), was formed in 1973 through the cooperation of the professional accounting bodies in numerous countries. Its purpose was to 'formulate and publish … accounting standards to be observed in the preparation of financial statements and to promote their world wide acceptance and observance.'

The standards issued by the IASC were called International Accounting Standards (IAS) and those issued by the new Board are called International Financial Reporting Standards (IFRS), which is now also the generic name for IAS. These standards have been adopted by many countries for specific purposes, for example, for reporting to stock exchanges by listed companies. Countries such as Pakistan, without a history of their own standard making, have adopted IFRS in the 1980s or 90s for general purposes. In 2005 Australia became the first country with a history of its own standard setting to adopt IFRS for general financial reporting purposes. The European Union has also adopted IFRS from this date but in a more limited way, for group reporting of listed companies. While many countries have, or have annouced an intention to adopt IFRSs for listed entities, other Western countries are yet to adopt IFRS as compulsory for general purposes so the long term prospects for harmonisation by this means are still unclear.

Reference: Godfrey, J.M. and I. A. Langfield-Smith, I.A., 2005, ‘Regulatory Capture in the Globalization of Accounting Standards’, *Environment and Planning*, 37, 11: 1975–1993.

2.15 Describe the process by which AASB interpretations are produced and their authority in the regulation of financial reporting.

The role of interpretations is to provide timely guidance on urgent financial reporting issues, and to avoid the development of ‘divergent or unsatisfactory’ financial reporting practices in areas not dealt with in the accounting standards.

The time frame for production of an interpretation is very short. It does not involve the lengthy due process used in the development of accounting standards; this process is needed to consult widely with interest groups. Members of CPA Australia and ICAA must comply with them under APES 205: Conformity with Accounting Standards, a standard developed by the Accounting Professional & Ethical Standards Board Limited, which was established in 2005 as an independent body to develop ethical standards for the profession. Members of CPA Australia, The Institute of Chartered Accountants in Australia, and the National Institute of Accountants are required to apply its standards. The content of an interpretation must be consistent with existing accounting standards.

2.16 ‘The type of entity used to conduct economic activity affects the nature of the financial information presented in an entity’s financial reports.’ Do you agree with this statement? Give reasons to support your view.

The critical question (as we see in Chapter 3 when discussing the reporting entity concept) is: what information would it be reasonable to expect that users will need? The answer may depend only partially on the form in which the entity’s operations are carried out, for example, whether the entity is a company and if so whether a proprietary company, large or small. Other important factors include the degree of separation of management and owners, the number of owners, the size of the entity and amount of resources deployed.

2.17 Provide a brief history of the role of the Australian professional accounting bodies in the development of accounting standards.

Compliance with the profession’s own technical statements became mandatory for members of ICAA and ASA in 1973. Primary responsibility for enforcement rested with the professional bodies, although neither ASA nor ICAA had a formal monitoring process. Auditors could issue qualified audit opinions for non-compliance but could do little else. A qualified audit report signals that all might not be well within the company and can have a powerful communicative effect on investors. In 1984 the Accounting Standards Review Board (ASRB) was founded under the legislation of the National Cooperative Scheme. The ASRB was the first quasi-government body to have the power to approve standards that had force of law. The ASRB was the forerunner of the AASB. Initially the ASRB's role was primarily one of reviewing accounting standards submitted to it by others, generally the accounting profession represented through The Australian Accounting Research Foundation (AARF) a body jointly funded by the professional associations. In 1988 an expanded ASRB took over the standard setting functions of the Accounting Standards Board of AARF. This included AARF taking over the role of ASRB technical support. Responsibility for public sector standard setting remained with the Public Sector Accounting Standards Board (PSASB) of AARF, established in 1983. Accounting standards, other than public sector specific ones, were developed jointly by the ASRB and PSASB. The ASRB was replaced by the AASB, with similar powers, to coincide with the new scheme under the 1989 Corporations Act. These arrangements prevailed until January 2000 when the FRC was created, with the revamped AASB assuming all accounting standard setting responsibilities, including those formerly the responsibility of the PSASB. This left AARF and the professional bodies with no formal accounting standard making responsibilities, and a corresponding reduction in power and influence. It was disbanded in 2005 following the establishment, under the ASIC Act, of a statutory body, similar to the AASB, to set auditing standards.

2.18 How are professional accounting standards enforced?

ICAA, CPA Australia and NIA enforce financial reporting-related requirements through their rules of professional conduct. These standards are determined by an independent standard setter established by the profession – the Accounting Professional and Ethical Standards Board, and are formalised in the rules within APES 205 Conformity with Accounting Standards. Compliance is required of individual professional practitioners rather than reporting entities; for the latter compliance is enforced by ASIC. Penalties for practitioner's non-compliance with the standards may include censure, fines or temporary or permanent exclusion from membership. Members who are in breach of AASB standards may also be prosecuted by ASIC.

2.19 Describe the relationship between the AASB, the former UIG and the FRC.

The FRC is responsible for the oversight and funding of the AASB. It also appoints all members of the AASB, other than the chair who is appointed by the Minister (currently the Treasurer). The AASB is responsible for the making of accounting standards both for the purposes of the Corporations Act and otherwise. The FRC has no power of veto over AASB standards; however those standards may be disallowed by either House of the Commonwealth Parliament. The UIG was a subcommittee of the AASB. Following the change to IFRS protocol in 2005 the UIG committee has been disbanded and its functions have been returned to the AASB.

2.20 Are AASB standards exactly the same as IASB standards? Explain.

No. All of the IAS/IFRS standards issued at 1 January 2005 have an Australian equivalent, but the new standards are not exactly the same as their IFRS counterparts due to slight modifications for Australian use. Additional requirements were also necessary for not-for-profit and government entities, since Australia has sector neutral accounting standards. The new set of AASB standards in 2005 comprised 35 of the 36 IFRS-based standards plus some additional standards. The remaining

IFRS (IAS 26) is replaced by AAS 25: Financial Reporting by Superannuation Plans. Five other of the previously existing Australian AAS standards were retained – most in a revised form – because there is no IFRS equivalent. There is also a new AASB standard with no IFRS equivalent, this is AASB 1048: Interpretation and Application of Standards. All the new standards have a re-numbered and re-titled AASB-prefix that distinguishes them from the IFRS equivalent. This resulted in three groups of AASB standards, those with three digit numbers (corresponding to IAS-series), those with one digit numbers (corresponding to IFRS-series), and those with four digit numbers (existing Australian standards for which there is no corresponding IFRS).

Except for AAS 25, all of the AAS series standards were subsequently replaced with AASB standards (with four digit numbers). The AASB has continued the use of four-digit Australia specific standards, with new standards primarily dealing with public sector reporting issues. There is also a series of standards that amend existing AASB standards, mainly to reflect changes made to IFRSs, they are identified by the year and a sequence number, for example AASB 2007-8.

2.21 Describe the role of the ASX in the development of financial reporting requirements in Australia.

The ASX (and its predecessors) has played an important role in the development of Australian financial reporting requirements. Although today the ASX's financial reporting requirements substantially mirror those in the Corporations Act and AASB accounting standards, in the past many financial reporting requirements started as requirements of the ASX Listing Rules, for example the provision of consolidated financial statements, the provision of funds statements (and later, the statement of cash flows), and the preparation of half-year financial reports. The ASX also played a key role in the AASB's international harmonisation program, by promoting the use of IAS accounting standards and provided substantial financial support for the AASB's harmonisation activities.

2.22 What was the purpose of professional (AAS) accounting standards and what now is their relevance?

AAS standards are remnants of the professional bodies' standard making, designated 'Australian Accounting Standards' (AAS), all but one of which have now been replaced following the assumption of full standard-setting responsibility by the AASB in 2000. Several of the AAS standards remained in force in 2005 to cover topics outside the scope of IFRSs or where the IFRS was not considered acceptable for Australian use; AAS 25: Financial Reporting by Superannuation Plans is an example of the latter and is also the only one left. This standard applies mainly within the superannuation industry, although AAS 25 may affect the accounting obligations of a company, for example, if it is the trustee of a superannuation plan. The other AAS series standards, primarily concerned with public sector reporting issues, were subsequently replaced by Australia specific AASB standards. Enforcement of AAS standards is primarily made by the professional bodies. The origins and role of AASs are explained in the section on enforcement of financial reporting requirements.

2.23 Describe the means by which compliance with financial reporting requirements can be achieved.

Essentially, achieving compliance is predicated by some form of enforcement mechanism. Such mechanisms can be formal or informal. Formal mechanisms include the professional obligations (under APES 205 Conformity with Accounting Standards) of members of the accountancy bodies to comply with (a) AASB/AAS accounting standards and with (b) AASB/UIG Interpretations. In doing so, members must use their best endeavours to ensure that if an entity is a reporting entity that the entity prepares a financial report that is a general-purpose financial report that complies with accounting standards. Another formal mechanism arises when compliance is required by law. For example, AASB accounting standards must be complied with when reporting under Part 2M of the Corporations Act. Further requirements and obligations to comply can be imposed by the listing rules of a stock market on which a company's securities are traded (for example by the ASX). The accountancy bodies, the ASX and ASIC, have compliance programs designed to pick up instances of non-compliance.

2.24 Describe the reasons for, and the political process that led to, the introduction of IFRS for Australian use in 2005.

The Australian economy, with its high degree of share ownership, has an investor-information orientation like the US and UK. The EU decision to adopt IFRS in 2005 has been used by the Government and FRC to justify its move to IFRSs; even the same date was chosen. The key difference is that in Australia, IFRSs have been adopted for all types of entities rather than partial adoption. The decision process is shrouded in mystery. The announcement took the accounting community in Australia and elsewhere by surprise. There was no pubic consultation, which for a statutory authority is extremely unusual. The FRC may have seen it as an opportunity to steal a march on other regulators; however being the first one to do so is not without risk. The decision may have increased the AASB's political visibility and its influence on the IASB, in the short-term at any rate. The incentives to move from harmonisation – the process previously adopted in Australia – to adoption were significant. Doing so may be in the interests of big business, especially the stock exchange. Smaller companies that are not listed and do not raise finance offshore, the overwhelming majority of companies, will not benefit directly, but they have the massive changeover costs, nevertheless.

2.25 Which of the following broad regulatory reporting requirements

- **statutory provisions;**
- **ASX listing rules;**
- **AASB/UIG interpretations;**
- **AASB accounting standards;**
- **AAS accounting standards;**

apply to each of the following:

- **public companies limited by shares;**
- **listed public companies limited by shares;**
- **proprietary companies;**
- **small proprietary companies;**
- **companies with unlimited liability?**

Explain your answer.

	Public companies limited by shares	**Listed public companies limited by shares**	**Proprietary companies**	**Small proprietary companies**	**Companies with unlimited liability**
Statutory provisions (Corporations Act)	Yes	Yes	Yes	Yes	Yes
ASX listing rules	Only if listed	Yes	No	No	Only if listed
AASB/UIG Interpretations	Yes	Yes	Yes	Only if reporting entity	Yes
AASB accounting standards	Yes (provided it is a reporting entity; if not, only AASB 101, 107, 108, 1031 and 1048 apply)	Yes	Only if a large proprietary company (provided it is a reporting entity; if not, only AASB 101, 107, 108, 1031 and 1048)	No (limited exceptions explained in chapter 11)	Yes (provided it is a reporting entity; if not, only AASB 101, 107, 108, 1031 and 1048 apply)
AAS accounting standards	No (AAS 25 may apply)	No	No (AAS 25 may apply)	No (AAS 25 may apply)	No (AAS 25 may apply)

