Case note

7 July 2011

Directors and financial statements - what you should be doing

ASIC v Healey & Ors [2011] FCA 717

Take heed intelligent, experienced and conscientious company directors when approving financial statements. The Federal Court has expressed the view that the actions of a director may have a profound effect on the community, and not just shareholders, employees and creditors (at [14]). As such directors are subject to a duty greater than that of simply representing a particular field of expertise (at [18]), whatever a director's background. Justice Middleton found that directors are required to have sufficient knowledge of conventional accounting principles and practice in order to satisfy the obligations imposed on them by the *Corporations Act* 2001 (Cth).

The central question raised in the proceedings brought by ASIC against the directors of the Centro group of companies (Centro) was:

> "whether directors of publicly listed entities are required to apply their own minds to, and carry out a careful review of, the proposed financial statements and the proposed director's report, to determine that the information they contain is consistent with the director's knowledge of the company's affairs, and that they do not omit material matters known to them or material matters that should be known to them" (at [13]).

In finding that the Centro directors, who relied on management and their advisors in approving financial statements, had "failed to take all reasonable steps required of them, and acted in the performance of their duties as directors without exercising the degree of care and diligence the law requires of them" (at [8]), Justice Middleton noted that the "importance of the financial statements is one of the fundamental reasons why the directors are required to approve them and resolve that they give a true and fair view" (at [10]).

What happened?

Centro directors approved financial statements that contained errors. Specifically:

- The 2007 annual reports for Centro Properties Group:
  - classified some US$1.5B in short term liabilities as non-current liabilities, and
  - failed to disclose guarantees of short-term liabilities of an associated company of approximately US$1.75B given after the balance date
- The 2007 annual report for Centro Retail Group incorrectly classified US$500M in short term liabilities as non-current liabilities.

Relevant accounting standards required the classification of liabilities as current when they were due to be settled within twelve months after the reporting date. All other liabilities were required to be classified as non-current. The financial statements were incorrect in that the non-current liabilities should have been classified as current liabilities, and the guarantees should have been disclosed on the basis of their significance on the entity's operations in future financial years and because their non-disclosure could influence economic decisions that users make on the basis of the financial statements.

ASIC's position was that the directors should have had a routine knowledge of and understood the basic application of the test for the classification of liabilities as current and non-current, and so should have noticed the error in the accounts (at [288]). ASIC's Counsel relied on the "Blind Freddy" proposition, that the error was such that it would have been obvious to any reader with the requisite financial literacy and the knowledge that the Centro directors had of the affairs of the companies, specifically their debts (at [251]).

Justice Middleton characterised the errors as ones relating to information that was important in assessing risks facing the companies. This was important knowledge for the market and shareholders that was known or should have been known to the directors.

What the directors did

In essence, Centro's directors either assumed that Centro's management or advisors would bring necessary information to their attention or they relied solely on management and advisors to be properly informed of information relevant to the financial statements (at [579]-[580]).

His Honour found that:

- none of the directors took all reasonable steps to focus on and consider the content of the financial statements, and in particular, what those statements said about short-term debts and whether the guarantees should be disclosed (at [576])
- none of the directors had demonstrated a questioning mind or made enquiries of management, the Board Audit and Risk Management Committee or of other directors (at [577])
- the directors had not taken steps to ensure that the directors were given section 295A declarations that accorded with the requirements of the *Corporations Act* 2001 (at [578]).

What you should do

Justice Middleton expressly rejected the argument that requiring directors to understand and focus on the content of financial statements, to make enquiries where necessary and to ensure that information contained in the statements is accurate (at [20]) would overburden directors and "cause the boardrooms of Australia to empty overnight".

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To satisfy the duties and obligations imposed on directors by the *Corporations Act* 2001, specifically section 180 and section 344, his Honour suggests directors:

- have at least a rudimentary understanding of the business of the corporation
- become familiar with the fundamentals of the business in which the corporation is engaged
- keep informed about the activities of the corporation
- monitor corporate affairs and policies
- maintain familiarity with the financial status of the corporation by regularly reviewing and understanding financial statements
- have a questioning mind (at [17]), and
- read, understand and focus on the financial reports before those reports are approved or adopted (as required by section 295(4)).

This decision serves to reinforce the requirement on directors to form their **own** opinion and to discourage, as a sole basis of decision making, reliance upon declarations by the CEO, CFO and other qualified, competent advisors. Directors cannot substitute reliance upon the advice of management for their own attention and examination of a matter that falls specifically within the Board's responsibilities (at [175]).

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