ThomsonsLawyers

Corporate Alert
July 2011

A director's duty to review accounts – the *Centro* decision

'Directors cannot substitute reliance on the advice of management for their own attention and examination of an important matter that falls specifically within the Board's responsibilities.'

With the end of the financial year and the reporting season around the corner, the *Centro* decision[1] is a timely reminder of the obligations of directors when reviewing financial statements.

Centro's 2007 financial statements understated liabilities

Centro directors approved its 2007 financial statements which understated the group's short-term liabilities by around $2 billion and failed to disclose that Centro had guaranteed about $1.75 billion of US dollar liabilities for an associated US company. These accounts were the first full year accounts required to be prepared by the Centro group after the introduction in Australia of the International Financial Reporting Standards.

It was not until early 2008 that Centro revealed the errors. Each director was aware of the short-term liabilities and the guarantee at the time that they approved the accounts.

ASIC's allegations

ASIC argued that the degree of care and diligence required of a director in approving accounts consists of two parts:

- **(financial literacy)** A director must have sufficient financial literacy to have a general awareness of the financial reporting obligations of the Corporations Act
- **(adequate scrutiny)** Each director must read the financial statements carefully and consider whether what is disclosed in the accounts is consistent with that director's own knowledge of the company's affairs.

In what became known during the trial as the *'Blind Freddy'* proposition, ASIC said that *'the obviousness of the error to any reader of the accounts who had the requisite financial literacy and the knowledge that these directors had of the affairs of the companies'* meant that the only conclusion that could be drawn was that there had been a breach of the standard of care and diligence in relation to approval of the accounts.

Directors' submissions

The directors claimed they did all that could reasonably be expected. They argued:

Unreachable standard of care – the Court should not impose a *'counsel of perfection'* on directors and that ASIC's contentions lacked any sense of reality and required a standard of care so high that it was unreachable.

[1] *ASIC v Healey and Ors [2011] FCA 717.*

ThomsonsLawyers

Volume and complexity of information – the information provided to the directors consisted of over 3,000 pages in total and the non-executive directors could not reasonably be required to scrutinise and cross check all of the material provided to the board in the detail required by ASIC.

Reasonable reliance – they were entitled to fulfil their responsibilities by adopting procedures and relying on proper advice. In particular the directors should have been able to rely on:

- (**proper processes**) the processes that were in place to ensure that they took all reasonable steps to ensure that the financial statements were accurate and complied with the accounting statements
- (**advice**) the advice of others (ie management and the auditors) in approving the reports and complying with the requirements of the Corporations Act.

The Court's decision

The Court rejected the Directors' arguments.

Court accepted normal procedures followed and no dishonesty

The Court accepted that the Centro board were *'intelligent, experienced and conscientious'* and had:

- (**followed usual procedures**) followed their usual practice in approving these accounts, which involved the preparation of the accounts by management under the supervision of the CFO and after consultation by management with the auditors; and
- (**obtained sign offs**) only resolved to approve the accounts after receiving assurances from management that the accounts gave a true and fair view and complied with the accounting standards and an assurance from the auditors that they had expected to sign the audit opinion without qualification.

It also accepted that *'there is no suggestion that the directors were dishonest'*.

Directors had failed standard of care

Nonetheless, the Court found that the Centro board had breached their duties under the Act by:

- failing to take all reasonable steps to ensure compliance with the financial reporting provisions of the Corporations Act;
- failing to take all steps that a reasonable person would take in that director's position to ensure compliance with the each of the provisions of the Corporations Act; and
- failing to exercise the degree of care and diligence required.

Required standard of care in reviewing financial statements

It was held that:

- (**Standard of financial literacy**) Each director was required to be able to understand basic accounting conventions and to use proper diligence in reading the financial statements. Each director was or should have been aware of the accounting principles relating to the classification of the loans and the guarantee.
- (**Directors cannot rely entirely on others**) Each director relied completely on management and Centro's advisors and the internal and external review processes. This was not reasonable or sufficient to ensure that the accounts were accurate.

  The task of approving financial statements *'demands critical and detailed attention'* and not just *'going through the motions'* or *'[placing] sole reliance on others, no matter how competent or trustworthy they may appear to be'*.

  Each director in reviewing financial statements was required to *'take upon themselves the responsibility of reading and understanding the financial statements'* and *'enquire further into the matters revealed by those statements'*.
- (**Failure to scrutinise**) Each director failed to make enquiries of management or the other directors in relation to the proposed classification of the short term debt and guarantees and failed to have apparent errors corrected.

  All the directors failed to see the *'obvious errors'* because they all took the same approach in relying exclusively on those processes and advisors. No director *'stood back, armed with his own knowledge and looked at and considered for himself the financial statements'*.

  It was held that *'if they had understood and applied their minds to the financial statements and recognised the importance of their task, each director would have questioned each of the matters not disclosed'*.

- (**Complexity and volume of material no excuse**) The volume of paperwork was no excuse for failing to properly read and understand the financial statements. A board can control the information it receives.

Implications for company directors

When reviewing draft financial statements the *Centro* decision means Directors must:

- (**Review level of financial literacy**) Every director must understand the terminology used in the preparation of a company's accounts, have the *'financial literacy to understand basic accounting conventions'* and understand the content of the financial statements.

  This is the principal challenge for Directors following the *Centro* decision. There, it was considered that the misclassification of short term debt and the failure to disclose a material guarantee were errors of such *'obviousness'* that the Court could not reach any other conclusion, despite all the other factors raised by the Centro directors.

  So what is the extent of the technical accounting knowledge that is expected of directors? What is a *'basic accounting convention'* and what other technical accounting standards or issues are *'obvious'*? Reasonableness suggests that will be a fluid benchmark.

  Following *Centro* all directors should:

  - Review their level of financial literacy and, no matter what their skills set, ensure they understand *'basic accounting conventions'* and how they apply to their company.
  - Familiarise themselves with accounting issues and new standards which impact materially on their companies.

- (**Apply their mind**) Every director must personally ensure that the financial statements are consistent with their knowledge of the company's affairs. It is not sufficient to rely solely on the company's internal processes and internal or external sign-offs.

- (**Make enquiries**) Make all relevant enquiries to ensure that matters that they are aware of are accurately disclosed or treated in the accounts. This could well require directors to seek external professional advice on the accounting treatment of specific matters separate from internal management advice and also auditor feedback.

Example – bringing leases onto the balance sheet

A topical example is the current accounting proposal to bring leases on to the balance sheet. If these proposals are adopted, the directors of those companies that are likely to be impacted materially should be taking special care:

- To understand the new rules.
- To consider how they impact on the company.
- To consider whether the draft financial statements presented to them reflects the financial picture of the company under the new rules.
- To ask questions to test whether the new rules have been applied properly.
- Potentially, to seek separate external accounting advice in addition to whatever input they may receive from the company's auditor.

Written by:

Jamie Kerr
Associate
+61 7 3338 7508
jkerr@thomsonslawyers.com.au

Eugene Fung
Partner
+61 7 3338 7524
efung@thomsonslawyers.com.au

For further information, please contact:

David Zwi
Partner
+61 2 8248 3414
dzwi@thomsonslawyers.com.au

Michael Warren
Partner
+61 3 8080 3562
mwarren@thomsonslawyers.com.au

Eugene Fung
Partner
+61 7 3338 7524
efung@thomsonslawyers.com.au

Loretta Reynolds
Partner
+61 8 8236 1406
lreynolds@thomsonslawyers.com.au