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# ACCOUNTING NEWS

## THE 'BLIND FREDDY' PROPOSITION – WHAT DOES IT MEAN FOR AUSTRALIAN DIRECTORS?

**IN LAST MONTH'S ACCOUNTING NEWS, WE REPORTED ON JUSTICE MIDDLETON'S RULING AGAINST THE DIRECTORS IN THE CENTRO CASE.**

This month, we look further at the ruling and consider what other accounting issues **'Blind Freddy'** would be reasonably expected to recognise in a set of financial statements as a director of the entity issuing the financial statements, regardless of assurances from both management and auditors that the financial statements complied with Australian Accounting Standards.

As this is an accounting newsletter, this publication is usually read by accountants, but as Justice Middleton ruled against all of the Centro directors involved in the case, including non-executive directors and directors who were not on Centro's audit committee, for 'basic' errors in the Centro 2007 financial report, it may be advisable that readers of this article pass it onto their boards!

The judgement firmly places directors (if there was ever any doubt) as the key people responsible for an entity's financial statements. The judgement details that the approval of the financial report is a **key duty** of a director, and that this duty cannot be effectively delegated to management or auditors.

## IN THIS EDITION



In this month's newsletter, we look at lessons learned from the Centro case and questions directors should be asking as a result. We also look at the prospect of a new exposure draft on leasing proposals in Q4 2011 (leasing proposals to be re-exposed), extended relief to certain intermediate parent entities from preparing consolidated financial statements, as well as the answer to a frequently asked question about accounting for insurance proceeds received for natural disaster relief.

The judgement highlights that directors should be aware of the key transactions/events potentially impacting upon the truth and fairness of an entity's financial statements, in the Centro case, this being classification of current borrowings and material events after the year end. These material errors in the Centro case were frequently referred to as the 'Blind Freddy' proposition, being that they were so material, 'Blind Freddy' should have identified them.

### Background

The 2007 annual reports of Centro Properties Group ('CNP') and Centro Retail Group ('CER') failed to disclose significant matters. In the case of CNP, the report failed to disclose some $1.5 billion of short-term liabilities by classifying them as non-current liabilities, and failed to disclose guarantees of short-term liabilities of an associated company of about US $1.75 billion that had been given after the end of the reporting period. In the case of CER, the 2007 annual report failed to disclose some $500 million of short-term liabilities that had been classified as non-current.

### Responsibility of directors

Justice Middleton's judgement runs to some 186 pages and we urge directors to read this paper and to understand Justice Middleton's basis for arriving at his judgement.

In the following paragraphs, we have deliberately quoted directly and extensively from the judgement to hopefully relay the logic of the judgement, and to allow readers of the article who are directors to consider how this ruling impacts them.

**"The importance of the financial statements is one of the fundamental reasons why the directors are required to approve them".**

The major defence put forward by the directors was that they had fulfilled their duty as directors by making appropriate enquires of management and the auditors as to whether the accounts complied with accounting standards.

Justice Middleton concluded that the approval of the financial statements by directors was a key element of corporate governance and this role could not be simply delegated to management or auditors. He questioned how directors could vote to approve the financial statements if they did not understand what they were voting for, instead simply relying on the assurance of others.

Per Justice Middleton:
**"This proceeding is not about a mere technical oversight. The information not disclosed was a matter of significance to the assessment of the risks facing CNP and CER. Giving that information to shareholders and, for a listed company, the market, is one of the fundamental purposes of the requirements of the Act that financial statements and reports must be prepared and published. 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."**

### Will this cause the boardrooms of Australia to empty overnight?

Justice Middleton concluded that asking directors to take responsibility for documents they signed off/approved/adopted was not unreasonable and rebutted the idea that this would cause the boardrooms of Australia to empty overnight.

**"This proceeding involves taking responsibility for documents effectively signed-off by, approved, or adopted by the directors. What is required is that such documents, before they are adopted by the directors, be read, understood and focussed upon by each director with the knowledge each director has or should have by virtue of his or her position as a director. I do not consider this requirement overburdens a director, or as argued before me, would cause the boardrooms of Australia to empty overnight."**

### All directors must carefully read and understand financial statements

Against a background of ever more complicated and voluminous financial statements, Justice Middleton concluded that it was the directors' duty to carefully read and understand the financial statements they were approving.

**"All directors must carefully read and understand financial statements before they form the opinions which are to be expressed in the declaration required by s 295(4). Such a reading and understanding would require the director to consider whether the financial statements were consistent with his or her own knowledge of the company's financial position. This accumulated knowledge arises from a number of responsibilities a director has in carrying out the role and function of a director. These include the following: a director should acquire at least a rudimentary understanding of the business of the corporation and become familiar with the fundamentals of the business in which the corporation is engaged; a director should keep informed about the activities of the corporation; whilst not required to have a detailed awareness of day-to-day activities, a director should monitor the corporate affairs and policies; a director should maintain familiarity with the financial status of the corporation by a regular review and understanding of financial statements; a director, whilst not an auditor, should still have a questioning mind."**

### The responsibility for the financial statements does not rest solely on the accountants on the board

**"A board should be established which enjoys the varied wisdom, experience and expertise of persons drawn from different commercial backgrounds. Even so, a director, whatever his or her background, has a duty greater than that of simply representing a particular field of experience or expertise. A director is not relieved of the duty to pay attention to the company's affairs which might reasonably be expected to attract inquiry, even outside the area of the director's expertise."**

### The role of a director is more than a mere 'going through the paces…. a director is not an ornament, but an essential component of corporate governance.'

**"Nothing I decide in this case should indicate that directors are required to have infinite knowledge or ability. Directors are entitled to delegate to others the preparation of books and accounts and the carrying on of the day-to-day affairs of the company. What each director is expected to do is to take a diligent and intelligent interest in the information available to him or her, to understand that information, and apply an enquiring mind to the responsibilities placed upon him or her. Such a responsibility arises in this proceeding in adopting and approving the financial statements. Because of their nature and importance, the directors must understand and focus upon the content of financial statements, and if necessary, make further enquiries if matters revealed in these financial statements call for such enquiries."**

"A reading of the financial statements by the directors is not merely undertaken for the purposes of correcting typographical or grammatical errors or even immaterial errors of arithmetic."

**"No one suggests that a director should not personally read and consider the financial statements before that director approves or adopts such financial statements. A reading of the financial statements by the directors is not merely undertaken for the purposes of correcting typographical or grammatical errors or even immaterial errors of arithmetic. The reading of financial statements by a director is for a higher and more important purpose: to ensure, as far as possible and reasonable, that the information included therein is accurate. The scrutiny by the directors of the financial statements involves understanding their content. The director should then bring the information known or available to him or her in the normal discharge of the director's responsibilities to the task of**

**focussing upon the financial statements. These are the minimal steps a person in the position of any director would and should take before participating in the approval or adoption of the financial statements and their own directors' reports."**

## The 'Blind Freddy' proposition

From reading the above, many directors, particularly those with no accounting background, may well be either looking to enrol in an accounting degree, or perhaps looking for another career. However, perhaps the ruling should not be viewed in such a light.

The Centro case and its ruling very much centres around the nature of the errors in the CNP and CER 2007 financial reports. These became known as the 'Blind Freddy' proposition.

**"The significant matters not disclosed were well known to the directors, or if not well known to them, were matters that should have been well known to them."**

**"In the light of the significance of the matters that they knew, they could not have, nor should they have, certified the truth and fairness of the financial statements, and published the annual reports in the absence of the disclosure of those significant matters. 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. Each director, in reviewing financial statements, needed to enquire further into the matters revealed by those statements."**

**"In what in this proceeding became to be known as the 'Blind Freddy' proposition, ASIC's submission in opening was that the errors in the financial statements were so obvious that breach of the standard of due care and diligence is the inescapable conclusion that this Court must draw. The position is probably best summarised by what ASIC said in opening:**

> **We will submit that the court can draw the conclusion [as to breach of the standards of care and diligence] from 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, specifically their debts."**

## So what could reasonably be considered 'Blind Freddy' items?

The Centro case obviously placed the spotlight on;

- Classification of current vs non-current debt
- Disclosure of material subsequent events.

## Classification of current vs non-current debt

AASB 101 *Presentation of Financial Statements*, paragraph 69 requires that an entity classifies a liability as current when:

(a) It expects to settle the liability in its normal operating cycle

(b) It holds the liability primarily for the purpose of trading

(c) The liability is due to be settled within twelve months after the reporting period, or

(d) It does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period (see paragraph 73).

Paragraph 73 deals with roll over features by saying that if an entity expects, and has the discretion, to refinance or roll over an obligation for at least twelve months after the reporting period under an existing loan facility, it classifies the obligation as non-current, even if it would otherwise be due within a shorter period. However, when refinancing or rolling over the obligation is not at the discretion of the entity (for example, there is no arrangement for refinancing), the entity does not consider the potential to refinance the obligation and classifies the obligation as current.

## Disclosure of material subsequent events

The requirements to make disclosure in respect of material subsequent events is contained in AASB 110 *Events after the Reporting Period*, paragraph 21 which states that if non-adjusting events after the reporting period are material, non-disclosure could influence the economic decisions that users make on the basis of the financial statements. Therefore entities must disclose for each material category of non-adjusting event after the reporting period:

- The nature of the event
- An estimate of its financial effect, or a statement that such an estimate cannot be made.

Paragraph 22 includes examples of non-adjusting events after the reporting period that would generally be required to be disclosed:

- A major business combination after the reporting period (AASB 3 *Business Combinations* requires specific disclosures in such cases) or disposing of a major subsidiary
- Announcing a plan to discontinue an operation
- Major purchases of assets, classification of assets as held for sale in accordance with AASB 5 *Non-current Assets Held for Sale and Discontinued Operations*, other disposals of assets, or expropriation of major assets by government
- The destruction of a major production plant by a fire after the reporting period
- Announcing, or commencing the implementation of, a major restructuring (see AASB 137)
- Major ordinary share transactions and potential ordinary share transactions after the reporting period (AASB 133 *Earnings per Share* requires an entity to disclose a description of such transactions, other than when such transactions involve capitalisation or bonus issues, share splits or reverse share splits (all of which are required to be adjusted under AASB 133))
- Abnormally large changes after the reporting period in asset prices or foreign exchange rates
- Changes in tax rates or tax laws enacted or announced after the reporting period that have a significant effect on current and deferred tax assets and liabilities (see AASB 112 *Income Taxes*)
- Entering into significant commitments or contingent liabilities, for example, by issuing significant guarantees
- Commencing major litigation arising solely out of events that occurred after the reporting period.

## What other 'Blind Freddy' errors can a board miss?

A very interesting aspect of the Centro case, in respect of the errors contained in the 'Blind Freddy' proposition, is that the errors were **disclosure** rather than **measurement.**

It is therefore very important that board members get to grips with the nuances of IFRS disclosure and classification, as well as the complexity of measurement.

Below we highlight key disclosure requirements that boards should focus their attention on in light of J Middleton's ruling:

- Going concern
- Key estimates and judgements
- Impairment
  - Goodwill
  - Capitalised development costs
  - Other intangibles
- Related party transactions
- Share-based payments
- Control of a subsidiary
- Significant influence over an associate
- Impairment of inventory.

Perhaps the most likely extensions of the 'Blind Freddy' proposition are both contained within AASB 101 *Presentation of Financial Statements*, namely, the disclosures around uncertainties that **may** cast doubt on an entities ability to continue as a going concern, and key judgements and estimates used in applying AIFRS.

### Going Concern

It would follow that directors will (or should) have full knowledge of key uncertainties impacting an entity's ability to continue as a going concern. They therefore should take particular responsibility for ensuring AASB 101.25 requirements are met.

"When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties."

### Sources of estimation uncertainty and judgements

Again, directors will (or should) be in the best position to determine the key estimates and judgements made in preparing financial statements under AIFRS and they should therefore take particular responsibility for ensuring AASB 101.122 and 125 requirements are met.

Paragraph 122 requires that entities disclose, in the summary of significant accounting policies or other notes, the judgements, that management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements.

Paragraph 125 requires that entities disclose information about the assumptions they make about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes must include details of their:

- Nature
- Carrying amount at the end of the reporting period.

Examples of the types of disclosures required include:

- The nature of the assumption or other estimation uncertainty
- The sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity
- The expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected
- An explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.

### How does a board become aware of these issues?

In determining that the directors should have known about the current vs non-current classification, ASIC demonstrated that each of them had received Funding and Financial Risk management papers. This allowed the board to monitor compliance with the funding and financial risk management policies on a monthly basis.

To this end it may well be worth board members considering the following sources of information, that may contain information which should be considered for disclosure within a financial report:

- Board packs
- Board minutes
- Budgets/forecasts
- Plans to close business divisions
- Specific items included in auditor's representation letter.

An interesting observation of Justice Middleton was that boards were in a position to control the volume of information they were supplied with, and that it was not a reasonable defence to say they were overwhelmed with data.

### How does a board properly review financial statements?

The judgement specifically refers to the AICD publication 'How to Review a Company's Financial Reports – A Guide for Boards' (the 'AICD Guide'). Contained within the overview is:

**'Do the financial statements make sense and present realistically the results, cash flows, and state of affairs of the company? Consider the adequacy of disclosures in order to present a 'true and fair view.'**

Included in the AICD Guide under 'Compliance with accounting standards', it recommends that boards ask the following questions:

- How has it been confirmed that the requirements of AIFRS have been properly applied? For example, independent opinion
- What are the key accounting standards that affect the company and how does management ascertain compliance with these standards?
- Have there been any other major amendments to existing accounting standards or issues of new accounting standards in the last year that affect the financial statements? If so, how?
- Could the company's adoption of any accounting policies be reasonably challenged?

Given that the Centro directors did use a reputable audit firm and appeared to have skilled qualified management, it would appear that simply enquiring of the auditors and management 'are the accounts ok to sign?' is insufficient.

It would appear that directors should enquire specifically as to how specific major transactions/events have been accounted for/disclosed.

They should in particular focus their attention on the disclosures made in respect of an entity's going concern and key judgements.

Given the complexity of AIFRS, and the far reaching nature of Justice Middleton's judgement, it may be that boards will engage accounting experts to allow them to fulfil their duties as directors.

# LEASING PROPOSALS TO BE RE-EXPOSED

**THE INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB) AND THE US-BASED FINANCIAL ACCOUNTING STANDARDS BOARD (FASB) RECENTLY ANNOUNCED THAT THEY WILL RE-EXPOSE THEIR REVISED PROPOSALS FOR A COMMON LEASING STANDARD. DECISIONS TAKEN BY THE BOARDS TO DATE ARE SUFFICIENTLY DIFFERENT TO THE ORIGINAL PROPOSALS EXPOSED IN AUGUST 2010 TO WARRANT RE-EXPOSURE.**

The boards intend to complete their deliberations by the end of September 2011 and to publish a revised exposure draft shortly thereafter. Although we do not anticipate that all principles contained in the new exposure draft will differ significantly from those already proposed, the re-exposure will delay by at least six months the issuance of a final standard, with no standard likely before June 2012. We would strongly advise readers to keep a watching brief on this ED and not take any immediate action to restructure their leases or business model.

# CONSOLIDATION RELIEF EXTENDED TO NOT-FOR-PROFIT ENTITIES AND ENTITIES APPLYING RDR

### Not-for-profit entities

In July 2011, the Australian Accounting Standards Board (AASB) issued amendments to AASB 127 *Consolidated and Separate Financial Statements*, AASB 128 *Investments in Associates* and AASB 131 *Interests in Joint Ventures* which extends consolidation (or equity accounting or proportionate consolidation) relief to not-for-profit entity groups whose ultimate parent entity is also a not-for-profit entity that prepares consolidated financial statements. Currently, such not-for-profit entities can only obtain relief from consolidation, equity accounting or proportionate consolidation if they prepare consolidated financial statements under IFRS (which is often not the case for not-for-profit entities that can apply various alternative measurements that do not comply with IFRS).

If you wish to take advantage of this relief, you can early adopt these amendments for 30 June 2011 year ends.

### Reduced disclosure requirements

AASB 2011-6 *Amendments to Australian Accounting Standards – Extending Relief from Consolidation, the Equity Method and Proportionate Consolidation – Reduced Disclosure Requirements* [AASB 127, AASB 128 & AASB 131], provides similar consolidation relief for intermediate parent companies applying the Reduced Disclosure Requirements, whose ultimate Australian parent entity prepares consolidated financial statements for public use applying the Reduced Disclosure Requirements.

# ACCOUNTING FOR INSURANCE PROCEEDS FOR NATURAL DISASTER RELIEF

**Question one -Timing of insurance proceeds:**
During the recent floods, our land and buildings were extensively damaged and most of our inventories were destroyed. We are currently preparing financial statements for our year ended 30 June 2011. We have written off all damaged inventory and buildings, which were insured. Due to the large number of claims being received by our insurer, they have not yet processed our claim and therefore have not yet determined the effect of the averaging clause and are unable to provide a final estimate of proceeds. Can we recognise a receivable for insurance proceeds to be recovered in our 30 June 2011 financial statements?

**Answer one:**
The accounting standards do not include any specific guidance about the timing for recognition of insurance proceeds related to asset losses. However, AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* requires that in the absence of an Australian Accounting Standard that applies specifically to a transaction, management must use judgement to develop and apply accounting policies that are relevant to the economic decision-making needs of users and that are reliable. To do this, management must first consider the requirements of Australian Accounting Standards dealing with similar or related issues and then look to guidance in the Framework.

The following references could be argued to deal with similar or related issues in Australian Accounting Standards:

- AASB 116.66(c) says that compensation claims from third parties for impairment or losses of property, plant and equipment are recognised in profit or loss when the compensation becomes 'receivable'. However, the term 'receivable' is not defined in AASB 116.
- AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* includes guidance for accounting for reimbursements of expenditure incurred to settle provisions and requires that such reimbursements are only recognised when they are **virtually certain** of being recovered.
- The future recovery of insurance proceeds could meet the definition of a **contingent asset** under AASB 137 P*rovisions, Contingent Liabilities and Contingent Assets*, i.e. "….a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity". AASB 137 requires that contingent assets not be recognised in the financial statements.
- AASB 139 *Financial Instruments: Recognition and Measurement* defines 'receivables' as having fixed or determinable payments.

Given the insurer is yet to process your claim, and although you may think (or hope) that you are adequately insured, you should not recognise a receivable at 30 June 2011. In part, this is because insurance contracts often include legal exclusions (such as for a river flood) and averaging clauses, such that it would be hard to argue that insurance proceeds are probable of recovery or fixed or determinable (quantifiable) at 30 June 2011. It would be very difficult to argue that recovery is virtually certain. Therefore, insurance proceeds should not be recognised in your financial statements until the insurer:

- Has acknowledged that they will pay your claim, and
- Has quantified the payment.

The above should be documented in writing.

Note: AASB 137.35 requires that contingent assets be continually assessed to ensure that developments are appropriately reflected in the financial statements. If it becomes virtually certain that an inflow of economic benefits will arise, the asset and related income are recognised in the financial statements in the period that the change occurs. This means that we are likely to see a mismatch in profit or loss of entities subject to natural disasters where impairment losses are expensed in the period when damage occurred, with delayed insurance proceeds being recognised in profit or loss in later periods.

**Question two – Offsetting disaster expenses and insurance proceeds:**
Same facts as for Question one above, except that insurance proceeds have been confirmed by the insurer prior to 30 June 2011 (i.e. virtually certain). Can we offset insurance proceeds income against relevant losses and expenses in profit or loss in our 30 June 2011 financial statements?

**Answer two:**
Accounting Standard AASB 101, paragraph 32, requires that an entity cannot offset income and expenses unless required or permitted by an Australian Accounting Standard. As such, unless another standard allows the insurance proceeds to be offset, AASB 101 prohibits such offsetting.

AASB 137.54 does allow an expense relating to a provision to be presented net of the amount recognised for a reimbursement (insurance proceeds could be one type of reimbursement). However, because your expenses do not relate to provisions recognised under AASB 137 (because you have already incurred the expenses and they are known), we do not believe that you will be able to offset because AASB 137 does not apply to your reimbursement.

Also, AASB 116.66 says that compensation claims from third parties for impairment or losses of property, plant and equipment and any subsequent purchase or construction of replacement assets are separate economic events and must be accounted for separately as two events, not one.

Although the inventories standard (AASB 102) is silent on this issue, recent articles in the accounting literature support this view, not only for property, plant and equipment, but also for other asset losses.

It is also worth noting that various accounting standards require disclosure of asset losses and impairments. As these are separate events from any insurance recovery, the relevant losses and impairments disclosures must exclude the insurance proceeds. Such proceeds should be disclosed as other income.

# COMMENTS SOUGHT ON EXPOSURE DRAFTS

At BDO, we provide comments locally to the AASB and internationally to the IASB. We welcome any client comments. If you like to provide any comments please contact Wayne Basford.

| DOCUMENT | PROPOSALS | COMMENTS DUE TO AASB BY | COMMENTS DUE TO IASB BY |
|---|---|---|---|
| ED 213 *Improvements to IFRSs* | Proposes various amendments to standards as a result of the IASB's annual improvements project. | 6 September 2011 | 21 October 2011 |
| Tier 2 Supplement to ED 201 Insurance Contracts | The AASB considers there to be no need for Tier 2 disclosure relief for entities with material insurance contracts as such entities are expected to be publicly accountable. | 30 September 2011 | NA |
| ED 215 *Mandatory Effective Date of IFRS 9* [proposed amendment to AASB 9 (December 2009) and AASB 9 (December 2010)] | Proposes deferral of date when IFRS 9 would be mandatory from 1 January 2013 to 1 January 2015. | 7 October 2011 | 21 October 2011 |
| ED 212 *Not-for-Profit Entities within the General Government Sector* (proposed AASB 10XX, including proposals relating to Tier 2 disclosure requirements) | Proposes to change the financial reporting requirements for not-for-profit entities, including government departments and statutory authorities, within the General Government Sector of the State, Territory and Federal Governments. | 31 October 2011 | NA |
| ED 214 *Extending Related Party Disclosures to the Not-for Profit Public Sector* | Proposes to extend application of AASB 124 to not-for-profit public sector entities and to permit Tier 2 not-for-profit public sector entities to apply the reduced disclosure requirements of AASB 124. | 31 January 2012 | NA |

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