The 2003 AASB Discussion Paper (written by Julie Cotter), 'Relevance of Parent Entity Financial Reports'.

Submission prepared by Professor Graeme Dean, Professor of Accounting, The University of Sydney and Emeritus Professor Frank Clarke, Emeritus Professor of Accounting, The University of Newcastle, and Honorary Professor of Accounting, The University of Sydney.

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Draft ideas

Analysing the AASB Discussion Paper (DP) 'Relevance of Parent Entity Financial Reports' reveals a lack of evidence to support its main suggested reform, namely to no longer require parent companies to prepare and file their separate financial reports. Were a parent company’s accounts to be excluded from a group's financial reporting obligations, but those of its subsidiaries, albeit in a group form were to remain, the Annual Report would then not include the accounts of any legal entity. A further confounding factor would arise for any corporate closed group that has executed an ASIC-approved corporate deed of cross guarantee. In such cases the consolidated reports would be all that would be filed with regulatory bodies as the separate subsidiary accounts (within a closed group) are not required to be prepared and filed.

There are several problems in the DP. The main reasoning underpinning the proposed reform is based on purported cost savings and limited benefits arising from data contained in parent company's financial reports. However, there is little analytical or empirical support contained in the DP for either the ‘cost savings’ or 'limited benefits' arguments. Discussion in the DP also is possibly misleading— in particular footnote 7 in para 1.1.2 could give the impression that all deeds of Cross Guarantee entailing closed groups always comprise the parent and its 100% owned subsidiaries. Our research as part of an ARC Large Grant research project examining various aspects of the Deed usage over a ten -year period (1992-2002) reveals that it is not infrequent that several closed groups within an economic entity exist, and that the ultimate parent entity is not always included.

Arguably there is little need for research into the matters canvassed by the DP. Elsewhere (Clarke, Dean and Houghton, 2002, and Clarke, Dean and Oliver, 2003) demonstrated that there are critical aspects related to corporate group financial reporting however, that do require attention by regulators. We discuss aspects of the ARC funded project below.

It is curious that the prominence of group structures in corporate shenanigans that spawned the new millenial bouts of governance fever has not motivated closer attention to management’s seemingly selective use of the group notion. When it suits management adopt the 'group' notion and a 'lifting of the corporate veil'. There have been alleged shifting of assets around related companies, thereby legally isolating creditors from assets. And also, alleged asset shifting from publicly held interests into promoters’ private companies. Whilst at other times when legal refuge is deemed appropriate, management take refuge in the legal separateness of each of the business entities comprising the ‘group’ - the so-called century-old Salomon v. Salomon separate legal entity rule.
Bond Corp’s alleged milking of Bell Resource’s 'cash box' in the late 1980s, early 1990s is an apt example of this alleged selective recourse to the group notion. More recently judicious use of the group structure was a primary modus operandi in alleged attempts to separate creditors, often dismissed employees, from the assets necessary to meet their claims. Initially that was the effect in the 1998 waterside dispute between members of the MUA and the Lang Corp. group. And currently, the James Hardie saga involves the alleged 'ring fencing' of asbestos related claims pertaining to subsidiaries of the James Hardie group from the assets of the James Hardie's parent company. The corporate group is again under the spotlight as regulators ponder proposed reforms specific to the James Hardie particulars or their implications more generally to corporate commercial affairs.

In this context consider the uniquely Australian financing arrangements using a regulatory-approved Deed of Cross Guarantee. In 1985 Australia's national corporate regulator, the NCSC introduced a voluntary 'Deed of Indemnity'; the ASC adopted a more inclusive 'Deed of Cross Guarantee' in December, 1991 (altered slightly by ASIC in 1998) as creditor protection and group cost saving devices that would spread debt cover across related companies and reduce group's accounting, auditing and financing. Cost savings are definitely evident. But for numerous reasons the Deed offers little creditor protection. ‘Closed groups’ within the ‘ultimate group’ allow companies to benefit from the Deed’s quid pro quo reporting cost savings and still legally quarantine assets.

As part of the ARC-funded research we surveyed a sample of corporate officers of Australia's 'Top 200' listed companies. It revealed that there is little to be gleaned from the information contained in the 'closed-group' reporting entity group accounts contained in the Notes to the Accounts of the parent companies' reports. Further, corporate officers were of the view that there was limited, if any, creditor protection benefits contained in the Deed. The findings suggest regulators need to review the closed group reporting requirements as well as the serviceability of data produced from following existing group reporting accounting standards and Corporations Law requirements. (since the submission in 2004 – the results of the survey have been published in two articles: “Corporate officers’ Views on Cross Guarantees and other Proposals to Lift the Corporate Veil” (Graeme Dean and Frank Clarke), Company & Securities Law Journal, August, 2005, pp, 299-321. and G. Dean, F. Clarke and J. Margret, ‘Solvency solecisms: corporate officers’ problematic perceptions’, Australian Accounting Review, April, 2008; pp. 71-80.

In sum, corporate groups and their accounting have proved for many decades to be a regulatory nightmare. The group structure cuts across the long-established separate legal entity principle underpinning British company law. It is a device that, perhaps unintentionally, facilitates injustices, and has been a boon for corporate manipulators keen to diffuse and limit liability even further without surrendering control over assets. Arguably continued use of a corporate group and the current form of group accounting should survive only if there is a demonstrable net benefit to society. Surprisingly, these aspects were not examined as apart of the AASB Discussion Paper.

Graeme Dean is Professor of Accounting at The University of Sydney; Frank Clarke is Emeritus Professor of Accounting at the University of Newcastle and Honorary Professor of Accounting at the University of Sydney.
General Comments:

We are curious how the question that is the focus of this Discussion Paper has greater priority over the more important questions of whether consolidated financial statements serve any useful purpose, (whether they provide meaningful information), and whether they clarify or otherwise extend the insights to be gained from the bland disclosure in the parent company’s financials regarding its investment in the various other entities that comprise the “group”.

We have detailed elsewhere (Clarke and Dean, 1993; Clarke, Dean and Oliver, 1997, 2003; Clarke, Dean and Houghton, 2002) how corporate groups in general, and consolidated financial statements in particular, have played an important role in notable corporate failures, exacerbated the misleading data available to stakeholders, and been otherwise the medium for quarantining assets from the claims of creditors. Apart from the general complaints and criticisms of accounting prepared in accord with the Accounting standards, we have not detected any particular specific complaint and criticism of parent company’s financials.

Addressing the focus of the Discussion Paper we note:

Re: Potential cost savings

Potential cost savings from not including the parent companies' financials in the Annual Reports appear to underpin the push for their non inclusion. If so, we are surprised why no cost-benefit analysis was undertaken in preparing the DP? We wonder how much saving there would be. It seems that apart from printing costs, only minimal savings would likely accrue:

- Presumably, the parent company’s Statement of Financial Performance and Statement of Financial Position would still be prepared for ordinary compliance purposes, management use, for the tax reconciliation process, and for the preparation of the Consolidated Statement of Financial Performance and the Consolidated Statement of Financial Position; and

- 42 of the 70 respondents to the survey appear to require parent company data – ranging from the full financials to selected items therein;

In respect of the latter dot point we find it difficult to make any firm assessment regarding some of the reports of answers to the survey, without access to the actual questions. It is curious that whereas the detail of the questions put in respect of the survey of international practices, similar detail was not provided regarding the questions put to the sample regarding their use of parent company data. It would have been useful to see the wording of the questions that elicited answers to questions addressing the possibility of partial inclusions in the annual report of parent company data, the possibility of merely being able to access parent company data through the ASIC, minimum amount of disclosure items.
Taking the results as reported, we have to presume that to the extent that the small sample is indicative, more want parent company disclosure than do not want it. On that score it may well be that “gutting” the group financials for the desired disclosures might be more troublesome, perhaps more costly, than publishing the parent’s financials as at present.

**Part 1.**

**Re: Paragraphs 1.1.2 – 1.1.3**

**Deeds of cross guarantee**

The discussion in this part is possibly misleading. Footnote 7 in 1.1.2 could give the impression that all deeds of Cross Guarantee entailing closed groups always comprise the parent and its 100% owned subsidiaries. This impression is possibly reinforced by paragraph 1.1.3. The deeds can be undertaken by any of the subsidiaries and the closed groups do not have to include the ultimate parent company. Our research as part of a 2001-2003 ARC Large Grant reveals that it is not infrequent that several closed groups within an economic entity exist, and that the ultimate parent entity is not always included. Hence, the allusion there to the lifting of the corporate veil such that “...a parent and its wholly-owned subsidiaries [can] operate as if they were a legal entity” is misleading. See also re: 3.3.

It also now (since 1998) possible for less than wholly-owned subsidiaries to be part of a closed group - and (also since 1998), for foreign subsidiaries to be included in a closed group. Aspects about Deeds of Cross guarantees have been discussed in detail in: Dean, Luckett and Houghton, 1993a, Dean, Luckett and Houghton, 1993b, Clarke, Dean and E. Houghton, 1995, Dean and Clarke and Houghton (1999), Clarke, Dean and Houghton (1999).

We wonder whether it is widely known that, if the main DP Recommendations were to be accepted, then for a substantial number of company groups (i.e. where ‘closed groups’ apply and all subsidiaries are included in the closed group) there would be no separate company (either the parent entity or separate subsidiaries) accounting data publicly available – only the consolidated data.

**Lifting the corporate veil**

Footnote 8 in the same paragraph likewise could mislead. Lifting the corporate veil through the provisions of the Corporations Act arises in the case of liquidation to allow access in particular circumstance to assets not ordinarily available. The differing court approaches are noted in the cases: Adams v Cape Industries plc [1991] Re Polly Peck International plc [1996], Industrial Equity v Blackburn [1977], and Salomon v. Salomon & Co Ltd [1897]. They are well summarised in CASAC (2000). The AASB Discussion Paper is addressing circumstances arising in the ordinary course of events, not those to which the liquidation provisions apply. Likewise, the focus is on reporting data indicative of the wealth and progress of the group, not the provisions of the income tax regime to which they are subjected. It is misleading to imply (or to invite the inference) that those situations in any way negate the *Salomon*
and Salomon separate legal entity status of separate entities included in the group (see CASAC, 2000). The notion of a corporate group crops up in various settings, indeed in the accounting and audit provisions of the Corporations Act. That recognition in a legal context does not convey legal status to the group, per se.

Part 2.

Paragraph 2.1.2

Re: Information needs

It should be noted that Paragraphs 21-25 of SAC2 relate to general purposes for which users are presumed to want financial information. It is couched in terms of information to be provided by reporting entities, of which a corporate group is deemed to be. The Discussion Paper does not discuss whether the information those users might seek is to be sourced from the parent’s or the consolidated financials. Such an analysis and discussion would have been interesting. Resource providers, the Recipients of goods and services, and the Parties performing a review or oversight function, for the most part deal with individual entities – or at least their legal contractual relations with them – rarely the group. That has been the recent commercial experience in say the 1998/1999 Patrick /MUA dispute, the many subsequent employee disputes with corporate groups (as was evident at Ansett); as well as the latest James Hardie imbroglio.

It would be interesting to know how the data in the consolidated financials could assist in the kind of evaluations, assessments and decisions to which SAC 2 alludes. It may well be that those consolidated data are used for those purposes, but those who do so, in the commercial world that we are aware, would be deluding themselves.

Part 3

Re: Paragraph 3.1

Inadequacy of parent entity financial reports

Taking the points drawn from Jubb, Haswell and Langfield-Smith (1999 - details in the DP) the conclusion that consolidated financials are superior for the enumerated information (points 1, 2 and 3) is contestable. Their conclusion is presented somewhat as supportive of the theme that the parent entity’s financial statements are inferior to the consolidated statements for those purposes. But, arguably, none of the information sought by those points is any more available from the consolidated statements. Preference for consolidated statements only on those grounds, draws upon false reasoning.

We agree with the sentiment in the final paragraph of 3.1 to the extent that some information is only available from the separate accounts of a particular subsidiary. That only amounts to a re-affirmation of the consequences of the separate legal status of the separate companies. But is also true of the parent entity. And, contrary to the
conclusion drawn in the final sentence of that paragraph, we would draw the opposite conclusion, for such a situation does not change anything. It seems to be implied that the Deed of Cross Guarantee eliminates the need (and hence cost) to prepare consolidated statements. Of course it does not, the consolidation of the closed groups is included in the consolidation process. In such a case, if there is a closed group that does not comprise all of the group entities, the consolidation process entails several different levels of aggregation and several different applications of the consolidation elimination rule. The consolidated data are thus potentially more misleading and even less useful than is usually the case.

Re: Paragraph 3.3

Information needs of financial report users

We have noted some potentially misleading comments on Deeds of Cross Guarantee above (re: 1.1.2 -1.1.3). Our research does not confirm the claim that “... the closed groups to which these deeds pertain generally comprise a (implied ultimate) parent and its wholly owned subsidiaries” we have found that the use of the Deeds of Cross Guarantee vary in both structure and motivation. We do not understand the connection between closed groups and partly owned subsidiaries made in the final sentence. The consolidated statements are no less meaningful in those circumstances when the subsidiaries are partly owned. Again, this comment seems to ignore that the presence of the Deeds does not remove the need to prepare consolidated statements. Note that closed groups may (and do) comprise less than wholly-owned subsidiaries.

The financial paragraph is confusing. The second sentence seems to contradict the first. In any event there can be explanations for the ASX listing requirements other than that “parent company information is not demanded by users”. The explanation suggested proceeds on the assumption that the market would demand parent company data were it needed. But satisfying listing requirements is not for the purposes of providing corporate stakeholders to financial information. The only conclusion to be drawn is that those dealing with listing do not want the parent company data. And, of course, that may well be a mistake on their part. Investors can (and no doubt do) draw their information from other sources. There is limited mention of other stakeholders, such as employees or other creditors, like James Hardies' asbestos claimants.

Part 4.

Research methodology

It should be noted that the research questions in 2.2 refer to “needs”, but the survey appears to have addressed “wants”. Needs and wants are not necessarily consonant.

It is problematic whether what users say they want is much to the point. Arguably, it is not so much the information they say they want, as much as the information they need to be able to assess in an informed manner the wealth and progress of companies and from which to draw the data necessary for calculating the usual financial
indicators concerning financial characteristics such as solvency, rate of return, liquidity and financial flexibility.

We noted above the difficulty in interpreting results arising by not having the exact wording of the survey questions. Obviously the sample is small and is biased towards bankers. It again needs to be noted that no employees or trade unionists, creditors generally (and more specifically of the James Hardie type) were sampled. Why was not explained fully - a timing factor was mentioned.

Part 7

Re: Recommendations

1. Recommendation 1 appears somewhat in conflict with the preference for some parent company data revealed in the responses set out in Table 2 (5.1.2).

2. Recommendation 2 would follow were Recommendation 1 to remain, but the conditions set out for it seem to be too restrictive. Those conditions suggest that ultimate parent entities serve no purpose except those listed in the recommendation. It appears to ignore the function of the ultimate parent as the primary investment medium. Consolidated financial statements are structured in such a fashion to reflect an implicit distributive flow assumption - that the group resources will (in the ultimate) collapse into the parent. As such, the consolidated statements have no existence independent of the parent company.

3. The suggested inclusions of parent company data in the Annual Report includes directly or indirectly the data that parent companies' financial reports would usually include. Most parent companies would be caught under Recommendation 3.

Arguably, if (a) is answered in the affirmative, the little purpose is served by not publishing in the Annual report. Item (b) is almost certainly going to arise. Item (d) could not be determined from the consolidated financials alone. Thus it is a case of either (c) or (d), or not at all. And (e) will be disclosed irrespective of whether the parent company’s financials are included in the Annual report, and thus is not a discriminating criterion pertinent to the research questions. It is our view that the required information discussed in Recommendation 3 is better provided in our alternative Group accounting proposal described in Clarke, Dean and Houghton (2002) and in Clarke et al., 2003 (especially the Appendix to Chapter 17).
References:


CASES

*Adams v Cape Industries plc* [1991] 1 All ER 929.
*Industrial Equity v. Blackburn* [1977] 137 CLR.