

The Boardroom Report

A call for appropriate NFP regulation

**“WE NEED A
REGULATOR
APPROPRIATE TO THE
NFP SECTOR”**

Directors attending the recent launch of the *Directors Social Impact Study 2011* called on those involved in creating a new not-for-profit (NFP) regulator to avoid formulating “one-size-fits-all” rules that did not recognise the wide variety of the 600,000 organisations within the sector.

Steven Cole, chairman of Emerson Stewart Group and Brightwater Care Group, and the Australian Institute of Company Directors’ Western Australia division president, noted that any regulation should lead to improved performance, greater accountability, better management of risks, enhanced succession planning and should ensure the going concern basis for organisations so that they could continue to deliver their valuable services and operate effectively and efficiently.

“This has to come culturally and from within,” he said. “If it doesn’t, we will start to get ‘one-size-fits-all’ common denominator approaches. One of the concerns that I have is that if we don’t segment our NFP pool adequately, we will come up with regulation that cripples some of the smaller organisations that provide such valuable services to the community.”

Gabrielle Trainor, a director of Breast Cancer Network Australia and Victorian Urban Development Authority (VicUrban), also called for a calibrated and proportional regulatory response. “The

idea of a national regulator is a very good one, but its effectiveness will depend on the extent to which it can lay down principles and provide support, encouragement and cultural change rather than being prescriptive and impose an impossible burden on very small organisations, which already struggle to exist.”

John H C Colvin, CEO of Australian Institute of Company Directors and chairman of Can Assist, said any new regulation should be principled-based and suitable for the whole sector. He also called for an appropriate regulator for the sector. “I would not like to see the sector regulated out of the Australian Taxation Office or by the Tax Commissioner... The Australian Securities and Investments Commission could be an interim regulator, if there is to be an interim one. And after that, we’d need to have a regulator appropriate to the NFP sector.”

Colvin noted that at present, there were more than 700 laws imposing liability on directors in general for the actions of their organisations. “We don’t want directors being put off going onto NFP boards because of issues relating to insolvency, occupational health and safety (OH&S), strict liability and the reverse onus of proof. The same issues that apply to for-profit directors apply to NFP directors. It’s hard enough to get directors to sit on either types of boards and we don’t want regulations that will deter them from giving back for their own and society’s purpose.”

Directors participating on a panel discussion at the launch also tended to agree with an important finding of the *study*. Respondents with experience in both NFP and for-profit organisations were evenly split in their views when comparing NFP sector governance practices. Half the respondents felt that the quality of governance in NFP organisations was equal to, or greater than, for-profit organisations.

Cole found the current state of governance in the NFP sector “remarkably high”, noting that the same disparity that existed in the commercial sector, which ranged from large listed companies to small “mum and dad” operations, existed in the NFP sector. “Obviously, the level of governance that they require needs to be appropriate to their organisation, size and scale, and I have witnessed some great learnings from NFP boards across to the for-profit sector and vice versa.”

Anne Robinson, chairman of World Vision Australia and deputy chairman of the Not-For-Profit Sector Reform Council, said the study’s findings “confirmed what a lot of us think from our own experience” and anecdotal evidence.

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She noted that operating an NFP was a bit like a three dimensional chess game. "Not only are there multiple stakeholders but the work itself is very complicated," she said, adding that many for-profit directors have been surprised at the complexity when joining a NFP board.

Martin Watkins, vice president of Mission Australia, said his was a national organisation with more than \$300 million in turnover and the same OH&S concerns as for-profits. "The skills we need and the number of stakeholders we have are big issues, so in my view there is no difference in what is required from us."

To view the results of the *Directors Social Impact Study 2011*, click [here](#).

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New liabilities for directors?

All eyes will be on the appeal of a legal case in Queensland that threatens to open up a new set of liabilities for company directors.

The case involves former rugby league star and company director Jarrod McCracken who is appealing against a \$1.5 million damages (plus interest) award.

Geoff Hoffman, a partner in Clayton Utz's Sydney corporate advisory/M&A practice, says that what takes this case out of the ordinary is that the damages were awarded to someone to whom McCracken owed no legal duties.

The Queensland Supreme Court made the award under a little-noticed section of the *Corporations Act* 2001. Section 1324 says that a court can, on the application of the Australian Securities and Investments Commission or a person affected by the conduct, grant an injunction to prevent a person from contravening the *Corporations Act*. It also says that the court can "order that person to pay damages to any other person".

"Although it has been a part of company law for many years, section 1324 has rarely been used in litigation," says Hoffman.

In McCracken's case, the court used section 1324 to order him to pay damages to a creditor of his company for an alleged breach of duties owed by McCracken to the company as a director.

"What makes this decision very unusual – if not unique – is that directors have long been held to owe no duty to creditors," says Hoffman. "Although directors may be held personally liable for insolvent trading, such proceedings are brought by a company liquidator (or by a creditor only with the liquidator's consent). Unsecured creditors have otherwise been held to have no interest in the company's assets and no standing to bring proceedings directly against directors regarding their management of the company. The court's interpretation of section 1324 in McCracken's case could considerably dilute the effect of that principle.

"Another potential group of 'beneficiaries' is shareholders. Like creditors, shareholders have traditionally been owed no duty by directors and so have been unable to recover damages directly from directors for breach of duty."

But Hoffman stresses that this is a single instance judgment with a particular set of unique circumstances. "So we would not say it's a big change in the law unless the Court of Appeal agrees with the judgment."

Without anticipating what the Court of Appeal will say, he says it is likely that the court will be asked to decide between two competing theories about section 1324.

"On the one hand, there is a school of thought that the decision against McCracken merely demonstrates the hitherto unrealised potential of section 1324. Opposing this is the view (which enjoys some judicial support) that Parliament never intended the section to override longstanding limitations on the persons to whom directors owe duties."

He adds: "If the Court of Appeal were to uphold the first instance judgment, you could end up with something akin to *Sons of Gwalia* in the sense that a provision in the *Corporations Act* has been applied in a particular way by the court, which is perhaps contrary to the way the business community expects and wants it to apply, and that would probably lead to a significant lobbying effort to get the law changed."

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Likely questions for this AGM season

Boards are no doubt anticipating many questions about their company's executive remuneration practices this annual general meeting (AGM) season. However, a report by Ernst & Young lists a host of other questions they should be preparing for, including whether they have learnt any lessons from the Centro case and what they are doing ahead of looming new legislation.

"The economic environment is changing on a day to day basis with extraordinary volatility observed in global stock markets and exchange rates, much as was the case during the first global financial crisis," observes Tony Johnson, Ernst & Young's Oceania managing partner, assurance, in the report entitled *Connected leadership: Equipping the board for the AGM*.

"Against this background, it is clear that shareholders will look for evidence that the company fully understands and can clearly articulate both its financial performance over the last year and current financial position,"

He adds that questions can also be expected on the drivers of future shareholder returns, including growth prospects, cost guidance and the future financial position of the company, with particular emphasis on debt and capital management and the link to assessments of impairment.

The report notes that shareholders may use the AGM to question directors on how they are responding to the findings of the Centro case and whether they have revised their approach and activities. It lists the following as likely questions for directors to consider when preparing for the AGM:

- What is the view of the directors on the findings and what it means for them?
- Has the company changed its corporate governance processes in light of this judgment, and if so, how?
- Are the directors considering additional training or education on any aspect of the company's processes?

The report notes that shareholders will also look for clarity in the disclosures in the annual report around significant judgement and estimates. This can lead to questions to the board as to how these have been challenged by the directors, how they compare against industry or peer examples and where changes have taken place during the year, why?

The report adds that the spotlight on climate change issues will be a concern to shareholders – especially if the company is highly affected or if the shareholders perceive there to be a lack of action or response. Questions to anticipate include:

- Will you be affected by the carbon price?
- Are you a liable entity under the draft legislation?
- Do you report on climate change and sustainability performance and information in your annual report or sustainability/corporate responsibility report?

The report also observes that companies are increasingly being asked by shareholders about how they are managing their broader sustainability risks. It notes that occupational health and safety (OH&S) is one such risk that needs to be revisited by companies, particularly given that the Model Work Health and Safety Act is to be enacted and implemented by each state and territory by 1 January 2012.

The report recommends directors consider the following questions ahead of the AGM season:

- Is there a process in place to acquire and keep up to date knowledge of OH&S laws and regulations?
- Do you understand the nature of operations and the OH&S hazards and risks generally associated with these operations?
- How do you ensure appropriate resources are allocated and processes are established to eliminate or minimise OH&S risks?
- Are there appropriate processes in place for receiving and considering information regarding incidents, hazards and risks?

Johnson adds: "The AGM continues to experience declining attendance figures and the increasing power of institutional and proxy votes, however, the AGM remains a significant opportunity to explain the company's story. It is still the case that a well-run AGM reflects positively on governance, builds confidence in the board and contributes to shareholder value."

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The ripple effects of Centro

The ripple effects of the Centro judgment are starting to be felt, with some boards fine-tuning the way they review financial statements and asking many more questions of management and their auditors.

Andrew Archer, national head of audit and assurance at Grant Thornton Australia, says the Centro decision has prompted a great deal of discussion by boards and audit committees, particularly around the potential implications on their duties.

“Undoubtedly, astute directors are asking more questions around areas such as the judgements being made in the preparation of financial reports, changes in accounting standards and areas of regulatory focus. The Centro case highlighted the importance of debt classification, so this issue is also getting greater attention by directors and more questions are being asked of auditors.”

However, Greg Couttas, a senior partner at Deloitte, says: “Many of the boards that I have dealt with have always made the appropriate types of inquiries regarding the matters that are disclosed in the financial statements and the adherence of these to the accounting standards. But for other boards, there has been some fine-tuning in the type of information they are asking for and the questions they are asking. A number have applied their minds as to the types of analysis of the financial statements they are receiving from management and the quality of those analyses.

“There is no doubt that some companies are beginning to focus on getting more comprehensive analyses prepared for them at the time they consider the financial statements. Some boards are also starting to look at whether they will have audit committee meetings well before financial year-end to consider all the significant transactions and matters that have arisen during the year, rather than have all that come to them after year-end.

“Some audit committees may have been through the accounts in detail, but are now sitting back and taking time to reflect or take a helicopter view on what has happened during the year to ensure they are comfortable these things have been properly reflected in the financial statements.”

Tim Kendall, BDO’s national audit leader, says: “We have received numerous calls from directors asking how they can possibly comply with the obligations Justice Middleton appears to have placed on them. There has been a desire from boards to understand what the Centro case means for them. We have had a number of requests for BDO to present short updates to boards on the issues and

consequences of these issues so that the board members can ensure they are not falling into the traps that Centro highlighted. To date the general response from boards has been that they need to know what they should do to ensure they meet all their obligations.”

Kendall says BDO has identified a number of areas that boards can generally improve. These are:

Reviewing the auditor’s representation letter: As a matter of course, as required by Australian Auditing Standards, the entity’s auditors will request from management a “management representation letter”, setting out key areas of judgement and items where they have specifically relied on management’s representations in order to form their opinion. This letter will typically include “key judgements” in the financial report or potential contentious areas. It is also a useful “checklist” for disclosure of contingent liabilities, subsequent events and so on.

Checking accounts against the prior year: It is sometimes worthwhile checking the current year’s financial report against the prior year report, the purpose being:

1. To identify deleted disclosure, which may still be appropriate.
2. If the accounts are exactly the same, but the business has changed significantly, perhaps the disclosures should change.

Checking against competitors’ financial reports: It is good practice to familiarise yourself with the facts and disclosures of other entities operating in the same sector that have been audited by different audit firms to identify potential omitted disclosures or better presentation.

The “Blind Freddy” proposition, questions to be raised: The key principle behind the “Blind Freddy” proposition is that when the board is fully aware of a transaction, or is fully aware of disclosable situations facing the entity for which it approves the accounts, it should be able to spot if this is not properly disclosed or accounted for in the financial report. Having knowledge of these issues, directors should reasonably be expected to make enquiries about going concern, impairment, provisions/accruals, litigation, contingencies, subsequent events, related party transactions and other key judgements or estimates.

“The above areas are by no means exhaustive, but hopefully they show that directors do not have to be chartered accountants to raise common sense questions, based upon their knowledge of the business, which will present the potential for ‘Blind Freddy’ errors,” says Kendall.

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A win for directors

The successful defence of Timbercorp's directors against a class action by its investors is encouraging news for directors disclosing information to the market, says Sue Phillips, a director at Brian Ward & Partners, which acted on behalf of three Timbercorp directors in the case.

She believes that investors contemplating similar proceedings may struggle to succeed with an argument that investment decisions are fundamentally based on an organisation's disclosures.

Phillips adds: "The verdict should restore confidence in directors, especially those of liquidated companies. The courts will look at the environment in which decisions were made and determine whether directors have breached their duties under the *Corporations Act* 2001. If directors have acted properly and taken reasonable advice from their management team, were diligent about disclosing information and had measures in place to determine risks, then there are actually good and successful defences that can be used."

Timbercorp was an investment company offering tax-efficient forestry and horticulture management investment schemes and provided finance to investors to make investments in these businesses. In April 2009, when Timbercorp collapsed, it had outstanding loans to more than 14,500 investors totalling \$477.8 million. Investors in the class action argued that they were not obliged to repay these loans in circumstances where Timbercorp had failed to disclose information about risks which put Timbercorp at a heightened risk of failure.

However, Justice James Judd dismissed the class action on 1 September 2011, finding that Timbercorp's directors had competently managed the company and had put sufficient information into the product disclosure statements to ensure they complied with the *Corporations Act*.

Phillips says the decision highlights the obligation of plaintiff investors to prove their reliance on alleged misrepresentation or non-disclosures.

"The case will be useful to defendants as it goes some way to defining what materials may be considered 'generally available', the requisite contents of a disclosure document and at which point risks that may be seen as normal business risks become risks that need to be disclosed to investors," she says. "The case highlighted that each claimant must prove that they relied on material provided by the company when making the decision to invest. His Honour observed that, where reliance is in issue, evidence-in-chief by way of witness statement is an 'unsatisfactory' way of proceeding."

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