DIRECTORS AND FINANCIAL STATEMENTS

Australian Securities and Investments Commission v Healey [2011] FCA 717

On 27 June 2011 Justice Middleton of the Federal Court of Australia handed down his decision in *Australian Securities and Investments Commission v Healey* [2011] FCA 717.

This decision, which has been well publicised, makes important findings about the role and responsibility of directors.

ASIC brought the proceedings seeking declarations of contravention against the defendants, directors of Centro, in relation to sections 180(1), 601FD(3) and 344(1) of the *Corporations Act*. These sections of the *Corporations Act* relevantly prescribe the degree of care and diligence with which directors must exercise their powers and discharge their duties. The allegations concerned the directors' approval of the consolidated financial statements of certain Centro entities for the 2007 financial year.

Middleton J found that the 2007 Annual Reports of the Centro Properties Group and the Centro Retail Group (collectively **Centro**) failed to disclose significant matters which were well known or should have been known to the directors. He found that each director did not take all reasonable steps to focus and consider for himself the contents of the financial statements, and that by approving the financial statements the directors breached sections of the *Corporations Act*.

The significant matters not disclosed were some billions of dollars in short term debt. Middleton J found that the directors 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 disclosure of that debt. If they had understood and applied their minds to the financial statements and recognised the importance of their task, each director would have questioned why the debt was not disclosed.

The central question at issue was whether directors of substantial publicly listed companies are required to 'apply their own minds to', and carry out a careful review of financial statements and directors' reports to ensure that the information they contain is complete and consistent with the director's own knowledge of the company's affairs.

The directors submitted that the court must proceed on the footing that the directors were reasonably entitled to place reliance on the processes which Centro had put in place for the purposes of ensuring that the financial statements were accurate and in accordance with the accounting standards, keeping in mind that accounting and auditing are specialised fields. For example, the directors submitted that they were entitled to place trust and confidence in the fact that Centro's external auditors, PWC, and Centro's management had not identified any errors with the financial statements.

Middleton J accepted that the directors were entitled to have that trust and confidence but found that their obligations went further. Documents such as financial reports must be read, understood and focused on by each director with the knowledge that that director has, or should have, by virtue of their position as director before they are adopted by the director. He said:

> '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. No less is required by the objective duty of skill, competence and diligence in the understanding of the financial statements that are to be disclosed to the public as adopted and approved by the directors.'

Middleton J noted that the directors are intelligent, experienced and conscientious people, and that there was no suggestion that they did not honestly carry out their responsibilities as directors. However he found that the directors did not take all reasonable steps to focus and consider for themselves the content of the financial statements. His Honour noted that the failure to notice certain omissions may well be explicable, but here the directors, in some cases of their own admission, clearly looked to the management and external advisors. The judge said that the directors were not required to be familiar with every accounting standard but were required to be sufficiently aware and knowledgeable to understand what is being approved or adopted. If they had acted as the final filter, taking care to read and understand the financial accounts, the errors may have been discovered earlier than they were. Each director knew or should have known of the short term debt position, knew or should have known that those liabilities were not disclosed in the accounts and should have, but failed to, make appropriate enquiries with management. He stated:

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

ASIC has welcomed the decision, its Chairman Greg Medcraft saying:

> 'Each member of the board must bring and apply their own skills and knowledge when declaring financial statements are true and fair. This is not a responsibility company boards can delegate or merely rubber stamp. It's not good enough for directors to just be present.'

Mr Medcraft commented on the community's expectations of directors, noting:

> 'Directors are an important gatekeeper for our markets. The community expects them to take their responsibilities seriously, and discharge their duties seriously.'

Middleton J also commented on the importance of the role played by directors, stating:

> 'A director is an essential component of corporate governance. Each director is placed at the apex of the structure of direction and management of a company. The higher the office that is held by a person, the greater the responsibility that falls upon him or her. The role of a director is significant as their actions may have a profound effect on the community, and not just shareholders, employees and creditors.'

This decision provides important guidance to directors concerning how the Court interprets their duties and responsibilities as directors, when it comes to approving the company's financial statements. Directors are required to read, understand and focus upon financial reports before they approve them. They are not required to have a detailed knowledge of accounting standards but are required to ensure that the information in the financial reports is consistent with their own knowledge of the company's affairs and, if it is not, to draw the apparent error to the attention of the other directors or the executive management.

The proceedings have been adjourned until 1 August 2011 when there will be a hearing on relief from liability and penalties.

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This article was prepared by Kathryn Rigney, Director and Isla Chisholm, Solicitor. Kathryn Rigney can be contacted on 9231 7027 or at krigney@ypol.com.au and Isla Chisholm can be contacted on 9231 7028 or at ichisholm@ypol.com.au

LEVEL 2, 39 MARTIN PLACE
SYDNEY NSW 2000

DX 162 SYDNEY

T: +61 2 9231 7000
F: +61 2 9231 7005
WWW.YPOL.COM.AU

YPOL PTY LTD TRADING AS
YELDHAM PRICE O'BRIEN LUSK
ACN 109 710 698