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Financial Lines Alert

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“Blind Freddy” or a “Standard of Perfection”

ASIC succeeds in saying it is the former in its proceedings against Centro directors

On 27 June 2011 Middleton J handed down a detailed and considered judgment in the civil penalty proceedings commenced by ASIC against the directors and officers of the Centro Group. He held that in approving the accounts of Centro Properties Limited (**CPL**), Centro Property Trust (**CPT**) and Centro Retail Trust (**CRT**) for the year ending 30 June 2007, the Centro directors and officers contravened ss 180(1), 344(1) and 601FD(3) of the **Corporations Act 2001 (Cth) (the Act)**.

BACKGROUND

On 6 September 2007 the combined board of Centro directors approved and published the accounts to 30 June 2007 of CPL, CPT and CRT and related entities (which included Centro Properties Group (**CNP**) and Centro Retail Group (**CER**) (**the accounts**) which provided that:

- + CNP had current liabilities of \$1.1 billion and that the directors were not aware of any post balance date events; and
- + CER had no current liabilities and \$1.4 billion in non current liabilities.

However, CNP and CER had combined current liabilities of approximately \$2.6 billion. In addition, between 30 June 2007 and 6 September 2007, CNP had provided approximately \$1.75 billion worth of guarantees in respect of the obligations of a US subsidiary (**the guarantees**) that were not disclosed in the accounts.

Prior to approval by the Board the accounts had been approved by Centro’s accounting team, auditors and management and none had identified the errors in the accounts. That issue went to the heart of the directors’ defence. Centro ultimately discovered the errors in its accounts and in February 2008 published new accounts which referred to current liabilities of \$3.2 billion and the guarantees as post balance date events.

THE CLAIM

The Act provides that:

- + in approving the accounts the directors were required to provide a declaration that the accounts:
 - (a) complied with relevant accounting standards (s296); and
 - (b) gave a true and fair view of the company’s position (s297);
- + the directors’ declaration could only be made after receipt of a declaration from the CEO and CFO pursuant to s295A; and
- + directors have an obligation to take all reasonable steps to comply or secure compliance with relevant accounting standards (s344).

ASIC maintained that each director had been made fully aware of the extent of current liabilities (consistently over a period of time) and of the guarantees and in order to discharge their statutory duty (when armed with that knowledge) each director:

- + was required to have a sufficient knowledge of conventional accounting practice to enable them to carry out the responsibilities imposed on them by the Act. A failure to acquire such knowledge was itself a breach of duty; and
- + had to read and understand the accounts carefully (although they did not have to verify or scrutinise each line) and consider whether the accounts were consistent with their accumulated knowledge. Any discrepancies had to be brought to the attention of executive management and/or the other directors.

ASIC maintained that:

- + each director did not read the accounts with “the necessary degree of care and application of the mind to the task”;
- + the directors had irreducible duties to perform their statutory obligations; and
- + the errors in the accounts were so obvious that “Blind Freddy” would have spotted them.

The directors’ positions

It was not seriously disputed that the accounts did not correctly classify current liabilities. However, the directors disputed whether the guarantees were sufficiently material to require them to be disclosed (having regard to the commercial reality at that time that they were unlikely to be called upon).

The directors asserted that in discharging their obligations under the Act they had put in place best practice accounting and audit procedures and they were reasonably entitled to rely on Centro’s accounting team and auditors to ensure that the accounts were accurate, in accordance with the relevant accounting standards, and therefore complied with the Act. The directors submitted that a failure to detect both the management’s and auditors’ errors did not amount to a breach of their directors’ duties.

The directors submitted that if ASIC’s case succeeded it would require directors to have a detailed knowledge of accounting practices and standards and would impose an unrealistic standard of perfection on directors which would require directors to second guess the accounting experts by re-checking the accuracy of each item in the accounts.

THE DECISION

The Court did not accept that ASIC was seeking to impose an unrealistic “*standard of perfection*” as contended by the directors. A central theme of the judgment is that the Act imposes specific obligations on directors personally, with respect to the publication of financial reports and forming their own opinion about the accuracy of those reports. Notably that duty was irreducible.

His Honour stated that:

“...ASIC does not contend that the directors needed to be involved at “an operational level”. This is not a case concerning the need to verify information or scrutinise data of the type outside each directors’ own knowledge. The salient feature here is that each director armed with the information available to him was expected to focus on matters brought before him and to seriously consider such matters and take appropriate action. This task demands critical and detailed attention, and not just ‘going through the motions’ or sole reliance on others, no matter how competent or trustworthy they may appear to be.

Directors cannot substitute reliance upon advice of management for their own attention and examination of an important matter that falls specifically within the Board’s responsibilities as with reporting obligations. The Act places upon the Board and each director the specific task of approving the financial statements. Consequently each member of the Board was charged with the responsibility of attending to and focusing on these accounts and, under these circumstances, could not delegate or abdicate that responsibility to others...”

His Honour accepted that a detailed knowledge of accounting standards was not required, but that the director should be sufficiently aware and knowledgeable to understand what is being approved or adopted.

His Honour held that through various board papers and submissions provided during the course of 2007, the directors knew or should have known (i.e. an objective test) about:

- + CER’s and CNP’s short term debt (the fact that the information was provided to the directors in a different context (i.e. not in respect of the accounts) was irrelevant); and
- + the various guarantees entered into after 30 June 2007.

The directors maintained that the information about current liabilities was lost in the mountain of board papers provided to them (450+ pages) and that the directors could not feasibly be aware of all that was put to them. Middleton J rejected that submission outright and said that *“the complexity and volume of information cannot be an excuse for failing to read and understand the financial statements”*. It was incumbent on directors to ensure that they were provided with a manageable amount of information by obtaining more succinct briefings of management or reducing the volume of papers provided.

His Honour considered that the question of disclosure of the guarantees was *“relatively straightforward”*. He accepted expert evidence that the guarantees were material events occurring after the balance date that may significantly affect CNP’s operations in future financial years and should therefore have been disclosed. This was because *“there is always a risk that a guarantee will be called upon. In the case of very large amounts guaranteed as here, unless the risk was remote or seriously unlikely, the existence of the guarantee should be disclosed”*.

Consistent with his earlier reasoning His Honour considered that the directors failed to turn their mind to the omission of the guarantees from the accounts and instead relied solely upon advice from management and the auditors. What was required of the directors (and no more) was that, being aware of the need to disclose post balance date events, and the magnitude of the

guarantees that had been provided, they make appropriate enquiries with management. The directors failed to do so and therefore failed to exercise the required degree of care and diligence and failed to take all reasonable steps required of them under the Act.

His Honour also briefly considered the purported CEO/CFO declarations pursuant to s295A of the Act which are required to state their opinion that the matters referred to in s295A(2) are correct. The provision of a s295A declaration is a prerequisite for the subsequent directors' declaration pursuant to s295(4).

His Honour held that the purported s295A declaration did not comply with the requirements of the Act as it did not contain any declared opinion of the CEO and CFO. His Honour found that while the non-executive directors were entitled to place trust in their external advisers who had reviewed and approved the purported s295A notification, nevertheless the directors had a responsibility to receive appropriate declarations under s295A. As such they had an obligation to ensure strict compliance with s295A before they each approved the accounts. He considered that the directors ought to have read s295A to ensure compliance, and while he accepted that this could equate to potential strict liability to ensure compliance with the Act, he did not consider that obligation to be onerous.

Middleton J succinctly summarised his findings as follows:

“What each director is expected to do is to take 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 enquires if matters revealed in these financial statements call for such enquiries ...

The reading of the financial statements by the directors is not merely undertaken for the purpose 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 in them is accurate. The scrutiny by the directors of the financial statements involves understanding their content. The director should then bring information known or available to him or her in the normal discharge of the directors' responsibilities to the task of focusing upon the financial statements. These are the minimal steps a person in the position of any director would or should take before participating in the approval or adopting of the financial statements and their own directors' reports...”

COMMENTS

Arguably the decision does raise the bar with respect to directors' duties, rather than merely restate the extent of directors' statutory obligations in respect of financial accounts. The Act has always provided an irreducible duty to provide a director's personal declaration which requires an enquiring mind in respect of each aspect of the accounts to which their declaration relates. What may have not been appreciated was the required extent of directors' accounting knowledge and the extent to which outside accounting expertise could be relied upon. However, had the directors been entitled to rely on management and auditors to the extent

maintained, the legislative requirements would arguably have been made redundant as effectively a sign off by auditors would have been sufficient.

The decision clearly increases the need for directors to be financially literate and thereby potentially broadens the scope of potential claims that may be made against them.

Arguably the disclosure of the guarantees was less apparent than the current liabilities issue, in that it required an assessment of materiality in circumstances where there was purportedly \$1 billion of “*head room*” and where the external auditors (PWC) had clearly considered the guarantees and did not require their disclosure in the accounts. In such circumstances, would a basic understanding of the relevant accounting principles really have been sufficient for the directors to have determined whether there may have been a problem with disclosure? No doubt the size of the guarantees was a key factor in the Judge’s finding. Further, if the directors had turned their mind to the issue and questioned management and auditors, given the fact that management and auditors were aware of the guarantees, would any enquiries have caused the guarantees to have been disclosed in any event?

In addition his Honour’s finding of effective strict liability for ensuring compliance with s295A arguably requires the directors to second guess not only their auditors but also their own legal Counsel.

The decision has enormous importance to the forthcoming financial reporting season for the financial year ending 30 June 2011. From a practical perspective, directors need to ensure compliance with their statutory obligations in the manner set out by Middleton J. To ensure this occurs directors ought:

- + ensure that they have a basic understanding of relevant accounting principles and of relevant requirements of the Act (such as s295A);
- + obtain a check list of the significant financial information (particularly about liabilities and profit and loss) provided to them throughout the prior 12 months;
- + create a check list of essential issues and potential questions about the financial accounts which at a bare minimum should be put to auditors;
- + review accounts line by line, with an enquiring mind and raise all issues (including those in the check list) with management and auditors; and
- + ensure that they have sufficient time to fulfil their duties. If board packs are too voluminous, they should be reduced and more succinct information provided.

D&O insurers will also be worried by the implications of this judgment. Profit forecasts and financial accounts are probably the predominant cause of D&O liability in Australia. D&O insurers need to work with their insureds with a view to minimising the risk by the adoption of practices of the kind referred to above, so as to avoid or minimise liability and to the extent possible seek to transfer the risks associated with the accuracy of financial accounts to the auditors, rather than the directors. Notably His Honour found that his findings were not onerous on the directors who were well educated, well experienced and said to be well remunerated. In the case of the non-executive directors, that remuneration is only a fraction of that provided to a company’s auditors.

