Directors' Key Duties & Obligations

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Overview

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This package provides an overview of the key duties and obligations of directors, and in particular in relation to company directors' obligations under the *Corporations Act 2001* (Cth), taxation law, and their fiduciary responsibilities owed under common law, as at September 2020. It is intended to provide a working guide for all directors.

General Information Only

We trust that you appreciate that the law related to directors' responsibilities in any jurisdiction is complex.

There may be additional duties owed by the directors under a company's constitution, or incidentally under other legislation, that have not been covered.

This package does not purport to be comprehensive advice. Readers should seek professional advice as it pertains to individual circumstances and situations before acting in relation to these matters.

Structure of Package

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Who is a ‘Director’?

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‘Directors’ include:

> those who are appointed to the position of **executive or non-executive directors** (including temporarily as alternate directors);

> those who are acting as a **de facto director** (i.e.. someone not formally appointed but acting as if they are an appointed director); and

> **shadow directors** (i.e. someone not formally appointed but the board acts in accordance with that person’s directions).

Note: Some obligations of directors also apply to other ‘officers’ of the company. Company officers include those who participate in making decisions that affect the whole, or a substantial part of the entity, or who have the ability to significantly affect the entity’s financial standing (and may include senior management).

Directors' Financial Obligations

A director of a company must take all reasonable steps to comply with, or to secure compliance with, the below obligations. Non-compliance may result in penalties for the director including a declaration of contravention of the civil penalty provisions of the *Corporations Act 2001* (Cth), a disqualification order against the director, a pecuniary penalty order of over $1 million, or a compensation order made against the director in favour of the company (if there is actual loss).

Financial record keeping (all companies)

All companies (no matter the size or type) must keep written 'financial records' that:

> correctly record and explain its transactions and financial position and performance; and

> would enable true and fair financial statements to be prepared and audited.

Financial records overview

'Financial records' include:

> invoices, receipts orders for the payment of money, bills of exchange, cheques, promissory notes and vouchers; and

> documents of prime entry; and

> working papers and other documents needed to explain:

> > the methods by which financial statements are made up; and

> > adjustments to be made in preparing financial statements.

Specific requirements for financial records

All companies must have financial records so that financial statements can be conveniently and properly audited if necessary, and to obey tax laws.

Generally, financial records must be retained for seven years after the transactions covered by the records are completed.

Companies may keep financial records in any language. However, the company must be able to provide an English version of the records to an eligible person in a reasonable time upon request by such person.

Financial records may be kept electronically however if they are, they must be convertible into hard copy. A hard copy must be able to be made available within a reasonable time to a person who is entitled to inspect the records. If financial records are kept on a computer which is owned and operated by a third party (e.g. your company's accountant), the directors still have the responsibility to provide a hard copy upon request by ASIC.

If the company plans to keep any financial records outside Australia, sufficient written information relating to those records must be kept in Australia so that true and fair financial statements can be prepared. In such a situation, the company must give ASIC written notice (in the prescribed form) of the place where the information is kept. ASIC has the power to direct a company to produce specified financial records kept outside Australia.

The obligation to keep financial records of transactions extends to transactions undertaken as a trustee.

Best practice for financial records

Regardless of companies' record keeping obligations under the law, some of the basic financial records that a company should keep are:

1. a general ledger, recording the company's transactions and balances (e.g. revenue, expenses, assets, liabilities) or summarising transactions/balances detailed in other records;
2. cash records (e.g. bank statements, deposit books, cheque butts, petty cash records);
3. debtor and sales records (e.g. a list of debtors and their balances, delivery dockets, invoices and statements issued, a list of all sales transactions);
4. creditor and purchases records (e.g. purchase orders, invoices and statements received and paid, unpaid invoices, a list of all purchases, a list of all creditors and their balances);
5. wage and superannuation records;
6. a register of property, plant and equipment showing transactions and balances in relation to individual items;
7. inventory records;
8. investment records (e.g. contract notes, dividend or interest notices, certificates);
9. tax returns and calculations (e.g. income tax, group tax, fringe benefits tax and GST returns and statements); and
10. deeds, contracts and agreements.

Financial reports (large proprietary and public companies)

Financial reports including (1) 'financial statements', (2) 'notes' to those financial statements, and (3) a 'directors declaration' must be prepared each year by:

1. disclosing entities;
2. public companies;
3. large proprietary companies; or
4. registered schemes;

and those reports must be lodged with ASIC.

Note: Small proprietary companies are ordinarily not required to prepare financial reports (unless, for example, the company's shareholders direct it to do so, or a foreign entity is involved in the company's ownership).

The financial statements for the year are:

- the financial statements in relation to the company required by the accounting standards; and
- if the accounting standards require the company to prepare financial statements in relation to a consolidated entity, those financial statements.

The **notes** to the financial statements are:

- disclosures required by the regulations;
- notes required by the accounting standards; and
- any other information necessary to give a 'true and fair view' of the financial statements.

The **directors' declaration** is a declaration by the directors:

- whether, in the directors' opinion, there are reasonable grounds to believe that the company will be able to pay its debts as and when they become due and payable;
- if the company has included in the notes to the financial statements, in compliance with the accounting standards, an explicit and unreserved statement of compliance with international financial reporting standards, that this statement has been included in the notes to the financial statements;
- whether, in the directors' opinion, the financial statement and notes are in accordance with:
  - accounting standards; and
  - true and fair view rules; and
- if the company is listed, that the directors have given the declarations required by s295A of the Corporations Act 2001 (Cth),

and the declaration must be made in accordance with a resolution of the directors, specify the date on which the declaration is made, and be signed by a director.

Auditing of financial reports

In most cases, a company must have the financial report for the financial year audited by an external auditor. Directors must allow auditors to access the books of the company, and give the auditor any information, explanation or assistance required for the purposes of an audit or review. The auditor must prepare a report of the audit.

The auditor must follow the Australian Accounting Standards Board (AASB) 'accounting standards'.

The AASB sets out accounting standards for the purposes of the Corporations Act 2001 (Cth), which are available at www.aasb.gov.au

While there is no legislative requirement for financial records to be kept in accordance with the accounting standards prescribed by the AASB, keeping records that meet the standard has practical merit. This is because it (in theory) should ensure that financial records present fairly the financial position, financial performance and cash flows of an organisation which in turn would satisfy the statutory requirements for directors to keep good records as are outlined above. In addition, there is merit in companies complying with a common accounting standard as their financial statements should be more comparable than they would otherwise be.

Annual directors' reports (large proprietary and public companies)

A directors report must be prepared each year by:

- disclosing entities;
- public companies;
- large proprietary companies; or
- registered schemes.

A directors report must contain general information such as:

- a review of operations during the year;
- details of significant changes in the entity's state of affairs;
- the principal activities during the year and changes;
- details of any matter that has arisen since the end of the last year; and
- likely developments in operations in future years.

and must contain specific information such as:

- dividends, distributions etc;
- names of directors and officers;
- information on the auditors etc; and
- if the entity's operations are subject to significant environmental regulation, details of the entity's performance in relation to environmental regulation;

and must contain a copy of the auditor's declaration in relation to the audit or review of the company's financial accounts.

A company must send its financial report, directors report, and an auditor's report to its members (shareholders) each year.

Directors’ Tax-Related Obligations

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Director liability for breach of obligations under taxation law

Directors can be held personally liable for company tax obligations where they are deemed to have failed to exercise their directors’ duties in ensuring that the company complies with its tax obligations, as “veil-lifting” provisions exist within the *Income Tax Assessment Act 1997* (Cth), and the *Taxation Administration Act 1953* (Cth).

In Australia, the director penalty regime as it extends to tax law mainly targets directors of companies that fail to meet their Pay as You Go **(PAYG)** withholding and super guarantee obligations.

The director penalty regime also requires a director of a company to promptly put the company into liquidation or voluntary administration in the instance that it is unable to fund its tax obligations.

Although a company is treated as a distinct legal person, failing a company being capable of being subjected to punitive measures, prosecution instead falls upon the natural persons controlling the company (the directors). As such, a director can be held personally liable by causing the company to commit an offence. If a tax offence is committed by a person, then the person is liable to prosecution and punishment, including possible jail time. Officers of a company (including directors and secretaries) are automatically presumed to have taken part in the company’s affairs, including the portion of affairs involving the tax offence. If prosecuted, the officer is treated exactly as if the officer had committed the offence personally.

In reality, prosecution of the officers behind an offending company is rare, and will usually only occur where the company assets are unlikely to cover the penalty, or where a single officer clearly controlled the company during its offence.

PAYG

One of the most common ways in which director liability arises is for unremitted amounts under the PAYG regime.

Where entities, including companies, employ individuals, the Australian tax system is heavily dependent on the PAYG regime, which effectively places the burden on enforcing remission of employees' income tax on the employer. In other words, a company is expected to remit amounts to the Australian Taxation Office (ATO), including PAYG remissions from salary and wages.

When a company fails to remit amounts to the ATO the directors are automatically liable for an amount equal to the unremitted amount.

Director liability does not arise during a period commencing where the company goes into voluntary administration or commences to be wound up. However, note that 'commencing to be wound up' requires something more than merely filing the application form for winding up or appointing a provisional liquidator.

It is also generally a defence, to a claim for breach of duty where the director could not reasonably be expected to take part in the management of the company at the time (e.g. due to illness), or that the director took all reasonable steps to ensure that compliance occurred.

Record keeping obligations relating to taxation

A person carrying on a business must keep records explaining all transactions. This includes, but is not limited to:

> income and sales records;

> expense or purchase records;

> bank records;

> asset purchase records;

> contracts and agreements;

> year-end records;

> minor deductible expenses;

> GST records;

> employee or contractor records (including records of wages, allowances, superannuation guarantee records, FBT calculations, worksheets, declarations, elections and supporting details, copies of TFN declarations or withholding declarations and copies of any contracts with contractors);

> Motor vehicle records;

> Stocktake records; and

> Documents relating to tax returns.

> Records must be kept in English. If electronic records are going to be kept, they must be in a form that can be easily accessed and converted into written English. Most records are required to be kept for seven years. Companies must keep any account books, records or documents related to preparing their tax return for at least five years after they are prepared, obtained or the transaction is completed, whichever occurs last.

The company can make payments and satisfy its reporting obligations under the tax system using an activity statement. The activity statement allows the company to report their obligations for a range of taxes, including:

> Goods and Services Tax (GST);

> Luxury Car Tax;

> Wine Equalisation Tax (WET);

> PAYG and instalments; and

> Fringe Benefits Tax (FBT) instalments.

The ATO sends companies an activity statement about two weeks before the end of its reporting period. The activity statement needs to be completed and the original returned by the due date, along with any payment due.

Duty to act in good faith and for proper purpose

Directors must act in good faith and in the best interests of the company (i.e. the shareholders collectively) and not act:

> in their own interest;

> in the interest of particular employees or shareholders; or

> in the interest of third parties.

For example, directors have a duty to not use a company's resources for reasons other than to benefit the company, and directors should not act dishonestly or recklessly in dealings with shareholders.

Nevertheless, it is important to remember that the interests of creditors must receive greater weight if a company is approaching insolvency.

Note: If a company is approaching insolvency, the duty to act in the best interests of the company includes an obligation to act in the interests of creditors, but does not make that duty paramount.

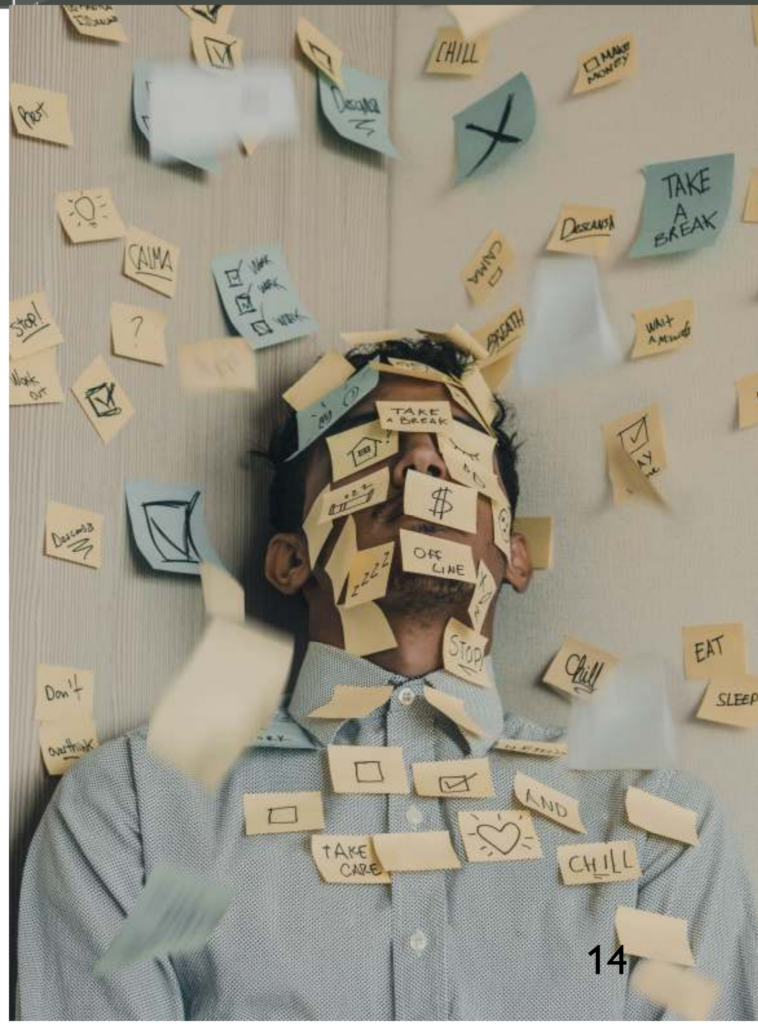
Directors must exercise their powers for a proper purpose, and not use assigned powers granted to them by law or by the company constitution outside of the scope with which they were conferred.

For example, if a company's constitution prescribes that a director is granted the power to issue shares for the purpose of raising capital, and the director issues shares for the main purpose of adjusting voting majorities, they are using their powers to advantage themselves or someone else, and not using their powers for the purpose intended, and may breach their duty to act with proper purpose.

Directors must not inappropriately use the Fair Entitlements Guarantee Scheme to pay outstanding employee entitlements. For example, a director cannot enter into a relevant agreement or transaction with the intention of (or being reckless in) avoiding, preventing, or significantly reducing employee entitlements that can be recovered.

Penalties

A breach of this duty may result in various penalties including a declaration of contravention of the *Corporations Act 2001* (Cth)'s civil penalty provisions, a disqualification order against the director, a pecuniary penalty order of over $1 million, or a compensation order made against the director in favour of the company (if there is actual loss). Further, if the breach is reckless, or dishonest by the standards of ordinary people, criminal sanctions including fines and imprisonment of up to 15 years may apply.



Duty to use care, due diligence and skill

Directors must exercise care in a way that a reasonable modern director would have in the circumstances (i.e. taking into account the type of company, the size and nature of its business, the composition of the board, and whether the particular director held themselves out as having particular skills and experience).

For example, if a director has special capacities, and the company takes those special capacities into account and were relying on the director because of the director's experience, the director can be subject to a higher standard based upon those skills and that experience.

Directors must (at an absolute minimum) adhere to the standards of a diligent director, including:

> becoming familiar with the fundamentals of the business;

> keeping informed about the company's activities (i.e. to not stop paying attention);

> monitoring, generally, the company's affairs and asking relevant questions; and

> maintaining familiarity with the financial status of the company (i.e. reviewing financial statements).

> having the minimum skills of a skilful director including a:
>   > base level of financial competence; and
>   > base level of knowledge of the business.

Defences

If a director is alleged to have breached this duty, directors may be able to assert certain defences such as:

> the decision was made in good faith as a matter of 'business judgment' having informed themselves of the subject matter and rationally believing it was in the best interests of the company;

> the decision was made in reasonable reliance of professional/expert advice; or

> the decision was made by the director's delegate and the director reasonably believed in good faith that the delegate was competent and reliable to make that decision.

Penalties

A breach of the duty to use care, due diligence and skill may result in various penalties, including a declaration of contravention of the Corporations Act's civil penalty provisions, a disqualification order against the director, a pecuniary penalty order of over $1 million, or a compensation order made against the director in favour of the company (if there is actual loss). There are no criminal penalties for breaching this duty.

There are also grounds under the common law (outside of the Corporations Act) to allege that directors acted negligently with their role (in tort).

Duty to avoid conflicts of interests and private profits

A director has a duty to:

> disclose direct or indirect interests in a company contracting with the company;

> not take bribes;

> not misuse company funds for personal use;

> avoid personally utilising a corporate opportunity that should have been taken on by the company (without disclosure or approval); and

> not misuse confidential information for their own benefit i.e. trade secrets, client lists etc.

A director may have breached this duty if they:

a. have used their position to gain an advantage for themselves, for someone else, or to cause detriment to the company; or

b. have used the information they acquired in their role to gain a benefit for themselves, for someone else, or to cause detriment to the company.

Importantly, directors must give notice (to other directors) of matters with which they have a material personal interest. If the company is a proprietary company and the other directors have approved the conflict, then it is unlikely to cause a breach of this directors' duty. Higher standards apply to directors of public companies.

There are no prescribed defences a director may assert for a breach of this duty.

Penalties

A breach may result in various penalties, including a declaration of contravention of the Corporations Act's civil penalty provisions, a disqualification order against the director, a pecuniary penalty order of over $1 million, or a compensation order made against the director in favour of the company (if there is actual loss). Further, if the breach is reckless, or dishonest by the standards of ordinary people, criminal sanctions including fines and imprisonment of up to 15 years may apply.

There are also grounds under the common law (outside of the Corporations Act 2001 (Cth)) to allege that directors breached their fiduciary duty to the company, for example, if they entered into an engagement where they had a direct or indirect personal interest, and profited personally from that interest. Seeking approval from other board members, or resigning from the board may prevent the director breaching this common law duty.

Duty to prevent the company trading while insolvent

When is a company insolvent?

A company becomes insolvent at the point in which it cannot pay its debts when they become due and payable.

Determining whether a company is insolvent predominantly involves applying the 'cash flow' test (i.e. making a real assessment as to whether the company's anticipated current and future cash flows will be sufficient to enable current and future liabilities to be paid as and when they fall due for payment).

The nature of a company's assets, and its ability to convert those assets into cash within a relatively short time, at least to the extent of meeting all of its debts as and when they fall due, must be considered in determining insolvency.

In some cases, it may also be relevant to look at the company's financial position as a whole and consider other commercial factors (referred to as the 'balance sheet test'). For example, it may be relevant to consider whether the company could collect debts owed to it within agreed terms, whether additional money can be realistically raised in a timely manner from the issue of share capital, or from future borrowings, etc.

Duty to prevent insolvent trading

Directors have a duty to prevent a company from trading insolvent.

A director may be personally liable to the company for an amount equal to the loss or damage suffered by unsecured creditors if:

- they were a director (or alternate, de facto, or shadow director) when a debt was incurred;
- the company was insolvent (or became insolvent) by incurring that debt;
- there were reasonable grounds to suspect the director knew of the insolvency, or a reasonable person in the director's position would have known; and
- the director did not stop the company from trading.

If a director is alleged to have traded while insolvent, directors are able to assert certain defences such as:

- the director had reasonable grounds (more than mere hope) to suspect the company was solvent;
- the director had relied on a competent and reliable person providing adequate information to the director about the company's solvency;
- the director was absent from the company's management (i.e. through sickness or other good reason (but not merely because they were not interested in monitoring the affairs of the company)); or
- all reasonable steps were taken to prevent the company from incurring a debt i.e. the directors put the company into voluntary administration.

Penalties

A breach may result in various penalties, including a declaration of contravention of the Corporations Act's civil penalty provisions, a disqualification order against the director, a pecuniary penalty order of over $1 million, or a compensation order made against the director in favour of the company (if there is actual loss). Further, if the breach is reckless, or dishonest by the standards of ordinary people, criminal sanctions including fines and imprisonment of up to 15 years may apply.

Other Miscellaneous Obligations

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Annual Statements

Each year, within two weeks after the company's 'review date' (usually the anniversary of the company's registration), ASIC will provide an annual statement (otherwise known as an 'extract of particulars') to the registered agent of the company.

The annual statement sets out the company's details recorded in ASIC's register, such as the names and addresses of its directors and secretary, registered office, principal place of business, ultimate holding company (if any), share details and members' details.

If any details on the statement are no longer correct, the details must be updated using a Form 484, known as a 'Change to Company Details' form. The company has 28 days from the statement's issue date to lodge this form.

If these details on the annual statement are correct and no other changes have occurred that are required to be notified to ASIC, then within two months after the review date:

a) the company must pay the annual review fee shown in the invoice that accompanies the annual statement; and

b) the director(s) must pass a solvency resolution i.e. a resolution of the directors that states the company will be able to pay its debts when they become due and payable (unless the company has made a similar statement in its financial report as outlined on page 8).

Solvency Resolution

The company is not required to lodge the solvency resolution with ASIC however payment of the annual review fee is taken to be a representation by the directors that the company is solvent.

If the directors pass a negative solvency resolution, ASIC must be notified using a Form 485, known as a 'Statement in Relation to Company Solvency' form, within seven days of the resolution being passed.

If the directors do not pass a solvency resolution within two months after the company's review date, ASIC must be notified using a Form 485 within seven days after the end of the two-month period following the review date.

Company name use

The Company **<u>must:</u>**

a) prominently display the company name at every place at which it carries on business and that is open to the public; and

b) display the company name, the words 'Australian Company Number' (or 'ACN') or 'Australian Business Number (or 'ABN') and the relevant number on:

    a) the common seal;

    b) every public document of the company;

    c) every negotiable instrument (e.g. cheque, promissory note) of the company; and

    d) all documents lodged with ASIC.

Maintaining other records

The company must keep at its registered office or principal place of business:

a) registers of members (shareholders);

b) registers of option holders (if you have them);

c) proceedings and resolutions of meetings of the company's members;

d) proceedings and resolutions of directors' meetings; and

e) resolutions passed by members or directors without a meeting.

Director Identification Numbers (DIN)

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The Australian Government has passed the *Treasury Laws Amendment (Registries Modernisation and Other Measures)* Act 2019 (Cth). This Act introduces a new requirement under the Corporations Act 2001 that all Australian directors obtain and hold a unique Director Identification Number (**DIN**) issued and administered by ASIC.

The DINs will be kept permanently and provide traceability of a director's profile and relationship across companies over their career. If a director of a company ceases to be a director, the DIN will remain with that person and not be re-issued to another person or incoming director.

When

The new regime is expected to be rolled-out in the first half of 2021, with key details yet to be finalised, such as what director information will be made publicly available.

Requirements

The specific procedures and requirements needed to obtain a DIN will be provided for in the "data standards", which is a separate legislative instrument expected to be made subject to public consultation in late-2020 and early-2021.

Directors making an application are required to provide specific personal information, as well as undergo a 100-point identity verification with ASIC.

Directors will be required to apply for a DIN prior to being appointed as a director. For the first 12 months of the operation of the new requirement, all new company directors will have a grace period of 28 days following their appointment as a director to apply for a DIN.

For existing directors, transitional provisions will apply, providing for a 15 month window to apply once the new requirement is mandated.

Penalties

Not having a DIN is a strict liability offence. There are several civil and criminal penalties for:

> failing to apply for a DIN within the required timeframe;

> deliberately providing false identity information to the registrar;

> intentionally providing a false DIN to a government body or relevant body corporate; and

> intentionally applying for multiple DINs.

Further information can be found here.

Note: Once released, this Handbook will be updated and recirculated to provide for the specific DIN requirements and procedures for Directors.

COVID-19 & Annual Report Disclosures

COVID-19 has created unique challenges in the operation and oversight of Australian entities. These challenges are particularly acute when it comes to financial reporting and disclosure.

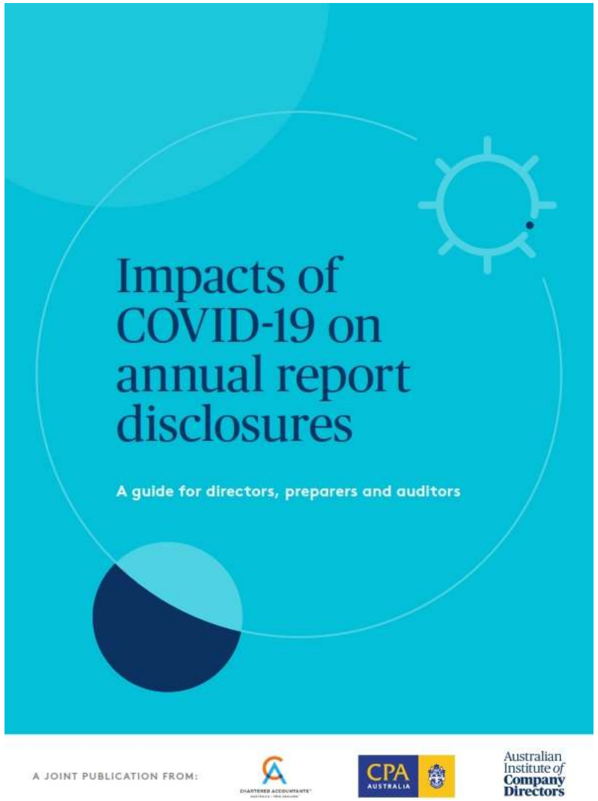
This guidance is a joint publication of the Australian Institute of Company Directors (AICD), Chartered Accountants Australia and New Zealand (CA ANZ) and CPA Australia and can be downloaded, free of charge, here.

This guide provides a summary of the key considerations that are important when assessing how best to disclose the effects of the COVID-19 pandemic when preparing annual reports for both the 30 June 2020 reporting season and in future periods impacted by COVID-19.

The Guide's aim is to help directors, managers, preparers of financial reports and auditors navigate these considerations and determine how best to disclose necessary information in both the financial report and directors' reports. It seeks to be applicable for listed and unlisted entities, public sector entities, not-for-profits, charities and small and medium sized entities (SMEs). Like all such guides, the information contained within it is general in nature.

It should be supplemented by guidance provided by government regulators and standard setters, as well as tailored advice from professional advisers. This guide provides references to relevant publications issued by the Australian Securities and Investments Commission (ASIC), the Australian Accounting Standards Board (AASB) and the Auditing and Assurance Standards Board (AUASB).

We strongly urge readers of this guide to study these publications, which in many cases provide more detailed information.



Director Resignation

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The *Treasury Laws Amendment (Combating Illegal Phoenixing) Act 2020* was enacted in February 2020. This Act had a specific purpose – to combat illegal phoenix activity.

Illegal phoenix activity refers to creating a new company to continue the business of an existing company that has been deliberately liquidated, in order to avoid paying outstanding debts, including taxes, creditors and employee entitlements

When

Due to a 12 month roll-out period, the new regime came into effect on 18 February 2021, despite the Act commencing last year.

What

Key amendments to be aware of include sections 203AA, 203AB, and 203CA of the *Corporations Act.*

The purpose of these provisions is to prohibit company directors from improperly backdating their resignation or leaving a company with no directors.

Requirements

Section 203AA – resigning directors or the company itself will need to notify ASIC of the resignation within 28 days. Otherwise, the effective resignation date will be the document lodgement date. To fix an earlier date, the director or company must apply to ASIC or the court.

Section 203AB – a director may not resign if doing so would leave the company without a director at the end of the day that the resignation is to take effect, unless the company is being wound up. This requirement stands regardless how many directors resign – that is, if all directors resign on the same day, their resignations will be ineffective unless at least one director remains.

Section 203CA – a company now may not remove a director by resolution of members, if doing so would leave the company without a director, unless the company is being wound up.

The Team

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We hope that this has provided you with a broad understanding of key directors' duties and obligations under Australian law.

Please let us know if there is any particular topic that you would like us to expand on.

If you have any queries regarding this package, or if we can provide any specific advice to assist you, please contact a member of our Corporate and Commercial team.

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