BRI Ferrier

TECHNICAL INSIGHTS

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“Flying the company blind”: Consequences arising from a failure to keep adequate books and records

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Introduction

Section 286(1), Corporations Act states that a company must keep written financial records that:

- correctly record and explain its transactions and financial position ; and
- would enable true and fair financial statements to be prepared (and audited where required under the Corporations Act).

In addition to the obligation to keep adequate books and records section 286(2) requires that financial records must be retained for seven years after the transaction covered by the records are completed.

‘Financial records’ are further defined by section 9, Corporations Act. Moreover ASIC in Information Sheet 76 has provided useful guidance to directors in answering the question “What books and records should my company keep?” particularly with respect to directors of small proprietary companies.

It is common for insolvent companies to either have deficient books and records or to have failed to retain records for the prescribed period. Our discussion is primarily concerned with the consequences that may flow from an insolvent company’s failure to maintain adequate books and records.

Consequences of “flying the company blind”

The principal objective of section 286, Corporations Act is to ensure that a company can accurately ascertain its financial position at all times. In *Manning v Cory* [1974] WAR 60 the WA Supreme Court described the purpose of similar earlier legislation in the following terms:

“The evident policy of the requirement (to keep financial records) is that accounts should disclose or exhibit the financial position of the company at all times and at any time. They must be such as to enable one to say at any point of time where in a financial sense the company is… The whole policy of the section is… to prevent its officers from flying the company blind and upon its crash, and without having any information capable of sustaining the opinion, from then saying that they thought that they had more altitude.”

Failure to comply with section 286 has significant consequences for insolvency administrations. On a number of occasions it has been observed by the courts that in a company liquidation there are difficulties facing a liquidator to undertake a proper winding up process “without funds and having no co-operation from the liquidated company’s directors and virtually no company records”: see *Stratti Ocean and Earthworks Pty Ltd v Deputy Commissioner of Taxation*

[2003] NSWSC 509 at [8].

The adverse effect on, and additional costs of the process have been described by the NZ High Court in the following terms:

"It is manifestly clear, however, that the failure to keep proper records created uncertainty in relation to the company's assets and liabilities, and it impeded orderly liquidation. The liquidators should not have been put to the expense and inconvenience of having to reconstruct the company's affairs using documents obtained from third parties. The company's own records ought to have enabled the liquidators to ascertain and understand the transactions that the company had entered into…": see *Madsen-Ries v Petera* [2015] NZHC 538 at [107].

Director liability

An important part of directors' responsibilities is to ensure that their company maintains proper financial records. Directors who fail to take all reasonable steps to secure their company's compliance with section 286 contravene section 344(1), Corporations Act, which is a civil penalty provision: see section 1317E, Corporations Act.

As with all civil penalty provisions a court may impose on a director compensation orders for damage suffered by the company arising from contravention of the provision: see section 1317H, Corporations Act. For example, in *In the Matter of Lawrence Waterhouse Pty Ltd (in liq) – Shaw v Minsden Pty Ltd* [2011] NSWSC 964 the Supreme Court of NSW recognised that a director may be liable to compensate the company in liquidation for funds paid out of the company which could not be identified and recovered by the liquidator because of the failure to maintain adequate books and records.

The presumption of insolvency arising from a failure to maintain adequate books and records

Under section 588E(4), Corporations Act if it is proved that a company has failed to keep adequate books and records or to retain them for the prescribed seven years then the company is presumed to have been insolvent throughout the period of its failure to do so.

The presumption of insolvency is significant in those cases where the liquidator is seeking to institute recovery proceedings in which proof of the company's insolvency by the liquidator is an element of the proceedings. Understandably it can be difficult for a liquidator to prove that the company was actually insolvent for the purposes of the proceedings when the company has not kept proper financial records.

For the presumption to arise the liquidator will need to establish that no documents were kept or were deficient as to content in the sense that they did not correctly record the company's financial position at the time of the transactions under scrutiny: see *Fisher v Divine Homes Pty Ltd; Allen v Harb* [2011] NSWSC 8 where the court found that the liquidator had failed to provide sufficient proof to raise the presumption of insolvency.

The significance of the presumption of insolvency is apparent in recovery proceedings against directors in respect of insolvent trading by their company. See, for example, *In the matter of SSET Construction Pty Ltd (in liq) – Sims v Khattar* [2010] NSWSC 102 where the liquidator, in respect of insolvent trading proceedings against directors, was successful in proving insolvency in two ways: first by relying on the presumption of insolvency arising from the company's failure to keep and retain financial records, and second, by establishing actual insolvency made apparent from a reconstruction by the liquidator of the company's financial position.

Concluding comments

As observed above, the failure to maintain and retain financial records is encountered all too frequently in insolvency administrations. Too often company officers have been shocked to learn of the magnitude of their company's liabilities, largely attributable to the failure of their company's accounting records not keeping abreast of the true financial position at all times. The directors have been flying blind to the company's true

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financial position.

It follows that this failure will have contributed to the company's inability to pay its debts because the directors did not know with any certainty the magnitude of company debt, or whether the company had any reasonable prospect of meeting it. As a consequence, directors have been held accountable to contribute to the assets of their company by paying compensation that reflects the claims of creditors incurred at a time when their company traded without adequate financial records.

The message for directors, particularly of small companies, is to seek professional advice as to whether their company's books and records adequately "exhibit the financial position of their company at all times and at any time". Importantly, it is not appropriate to simply keep source materials whether in electronic or hard copy to be presented to an accountant to produce a set of accounts long after the happening of the events to which the materials relate.

About BRI Ferrier

BRI Ferrier is a unique affiliation of expert business recovery, insolvency, forensic accounting and advisory firms. We provide practical, innovative services that help financially distressed businesses to recover or at least minimise the negative impacts of insolvency.

With over 160 staff and eleven practices in Australia, New Zealand, Hong Kong and the United Kingdom, we work with clients of all types – from individuals, sole traders and small businesses to public corporations and government entities.

We also work with financiers, solicitors, accountants and creditors to address the needs of all stakeholders when businesses face financial challenges.

BRI Ferrier's team has the expertise and resources to meet any client challenge. By combining our skills and enthusiasm, we achieve the best possible outcomes in all cases where a business experiences financial distress.

How BRI Ferrier can help

BRI Ferrier can assess your current situation and advise on a path forward to minimise further risk.

Early intervention is often the key for a successful restructure of your business. If you or your client is experiencing financial challenges then don't delay, contact us today.

For positive solutions to financial difficulties please contact us.
The initial consultation to your client is free, strictly confidential and without obligation.

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