SUBMISSION BY MARK LEIBLER
TO THE JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT
REVIEW OF INDEPENDENT AUDITING BY REGISTERED COMPANY AUDITORS

EXECUTIVE SUMMARY

The focus is all wrong in the current debate over “the extent to which it may be necessary to enhance the accountability of public and private sector auditing”. The law is in no need of overhaul. It’s time to grasp the nettle and concentrate on the real issues.

The law requires that financial reports of Australian public companies both comply with accounting standards and give “a true and fair view” of the financial position and performance of the company.

Accounts which comply with accounting standards will not necessarily be accounts which give “a true and fair view”.

A company’s financial report will not give “a true and fair view” by providing an historical record of a company’s financial dealings as distinct from an up-to-date balance date assessment of the company’s “financial position and performance”.

Process driven adherence to accounting standards exists as common practice among auditors in Australia. This can, and does, produce gross distortions in financial reporting. Tragically, it is so easily avoidable. In the United States process driven rules apply. The law mandates otherwise in Australia.

In cases where compliance with accounting standards does not give “a true and fair view” Australian law requires that this must be corrected by way of an appropriate note to the financial statements.

Auditors of the financial reports of Australian public companies are either ignorant of, do not fully comprehend or choose to ignore this fundamental legal obligation, and a culture of complacency has become entrenched.

Although, occasionally, auditors pay lipservice to the “true and fair view” requirement, in practice that requirement is not treated as having any independent significance over and above compliance with accounting standards. This practice is contrary to law. In the result, there is a major disconnect between audit practice and what the law requires.

ASIC has an obligation to ensure that the law is enforced but has taken inadequate action to ensure that auditors comply with their legal obligations.

There is vast resource of accumulated accounting expertise and wisdom that auditors could harness to provide an up-to-date balance date value judgement of a company’s “financial position and performance”. But, as various illustrative cases demonstrate, unless ASIC acts against those who carry out audits in contravention of the law, the distortion between law and practice will remain. And so, the culture of complacency will inevitably continue to grow as will the rate of losses suffered by shareholders as a result of unexpected corporate downturns and collapses.

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1 INTRODUCTION

My name is Mark Matthew Leibler and I reside in the State of Victoria. I am a barrister and solicitor of the Supreme Court of Victoria, the senior partner of Arnold Bloch Leibler and I currently practice as a solicitor. I am also a director of a number of corporations including proprietary companies, public companies and a major listed public company.

This submission is made in a personal capacity and does not necessarily represent the views of any organisation with which I am associated.

For the information of the Joint Committee of Public Accounts and Audit ("the Committee"), a Curriculum Vitae is attached to the submission. (Annexure I)

Under its terms of reference, the Committee is to explore "the extent to which it may be necessary to enhance the accountability of public and private sector auditing".

No one who has witnessed the recent collapses of major Australian corporations and seen the terrible human and economic consequences could argue that we are not in urgent need of a new approach to auditing in Australia. It is an imperative that gives the terms of reference of the Committee the ring of classic understatement. Yes, we need to explore "the extent to which it may be necessary to enhance the accountability of public and private sector auditing", but we also need to look far deeper – to question the complacency that presently underpins an auditing culture that allows disasters to occur without warning.

As Professors Graeme Dean, Frank Clarke and Peter Wolnizer have said, we are too busy recycling old ideas to recognise that the core of the problem is not just how auditors deal with the information they are given, but the very nature of the information inherent in a standards based regime.

In many cases, the financial statements of apparently healthy but, in reality, doomed companies, have largely complied with the demands of accounting standards. But the common auditing practice of a process driven adherence to those standards can, and does, produce gross distortions in the financial reporting, as is demonstrated by the illustrative examples in this submission.

Equally important, those who audit our companies either don't understand, or, more alarmingly, choose to ignore their legal obligation to provide a "true and fair view" of financial positions and performances. This point is key and seems to have gone missing in the current debate. There is no need to radically overhaul the law. There already exists an absolute and unconditional legal imperative for the financial reports of Australia's public companies to give a "true and fair view". This legal mandate requires much more than mere compliance with accounting standards.

But there remains a fundamental disconnect between the law and auditing practice. And, as I argue in this submission, the ability to sidestep such crucial legislative requirements is made possible by the fact that ASIC either cannot, or will not, enforce the law.

II THE LEGAL FRAMEWORK

The legal framework is quite clear and not at all difficult to understand. According to subsection 295(1) of the Corporations Act 2001 ("the Act"), the "financial report" comprises the financial statements for the year, the notes to the financial statements and the directors' declarations about the statements and notes. The notes to the financial statements comprise, inter alia, the notes required by the accounting standards and any other information necessary to give a true and fair view (subsection 295(3) of the Act).

Subsection 296(1) of the Act states that the financial report for a financial year must comply with the accounting standards. Section 297 of the Act provides that the financial statements and notes for a financial year must give "a true and fair view of … the financial position and performance of the company" – but this "does not affect the obligation under section 296 for a financial report to comply with accounting standards".

The note to section 297 states that

> "If the financial statements and notes prepared in compliance with the accounting standards would not give a true and fair view, additional information must be included in the notes to the financial statements under paragraph 295(3)(c)".

To complete the picture, the directors' declaration must declare whether, in the directors' opinion, the financial statements and notes are in accordance with the Act, including (i) section 296 (compliance with accounting standards); and (ii) section 297 (true and fair view) (paragraph 295(4)(d) of the Act). Finally, the auditor is obliged to report to members "on whether the auditor is of the opinion that the financial report is in accordance with this Act, including: (a) section 296 (compliance with accounting standards); and (b) section 297 (true and fair view). If not of that opinion, the auditor's report must say why" (sub-section 308(1) of the Act).

In my view, the legal position is quite clear:

(a) The financial reports of Australian public companies must, as a matter of law, comply with accounting standards;

(b) The financial reports of Australian public companies must, as a matter of law, give a true and fair view of the financial position and performance ("a true and fair view");

(c) If there is a conflict between what is required by the accounting standards and what is required in order to give "a true and fair view", then this is to be reconciled by the inclusion in the notes to

> the financial statements of whatever additional information is necessary to ensure that the financial report gives "a true and fair view".

Nowhere in the Act is there a suggestion that accounting standards are to be treated as having primacy over "a true and fair view". The fact that differences between them are to be reconciled, in the case of "a true and fair view", by way of a note to the financial statements, does not in any way suggest that "a true and fair view" is to be treated as being in some way secondary to compliance with accounting standards. Furthermore, there is nothing in the Act which suggests that a conflict between accounting standards and "a true and fair view" is likely to be only a "rare occurrence".

There is no legal basis for the argument that compliance with accounting standards equates to "a true and fair view". On the contrary, the statutory framework specifically contemplates that accounting standards may not give "a true and fair view". Indeed, in one sense, looking at the financial report as a whole, it seems clear that the Act contemplates a "true and fair view" override, albeit that the override is by way of a note rather than being included in the body of the accounts.

On the assumption that, in a particular case, compliance with accounting standards does not give "a true and fair view", the directors are under an obligation to include in the notes an explanation as to why this is so. In order for that explanation to be meaningful, the note should be appropriately highlighted, should explain why the accounting standard does not give "a true and fair view" and should set out clearly how the profit and/or loss and/or relevant balance sheet items should be restated in order to present "a true and fair view".

In my view, the auditor's opinion must clearly relate to whether the financial report is in accordance with the law as I have just described it. The obligation of an auditor was correctly and clearly articulated in evidence given before the Committee by Mr Keith Reilly, Director-Technical Adviser, The Institute of Chartered Accountants in Australia:

> "The auditor is … required to give an opinion as to whether those financial statements comply with Australian accounting standards and give a true and fair view. The Corporations Act envisages that there may be an instance where compliance with an accounting standard would not, by itself, give a true and fair view; and so the Corporations Act is very clear. It states that, if compliance with an accounting standard would not give a true and fair view, the director is required to provide additional information so that a true and fair view is given … An example of that would be that a board of directors may determine that a particular accounting standard gives, for whatever reasons, a result which they do not believe is the correct or appropriate treatment. In that case there is a responsibility on the directors to say, 'Okay, we do not believe that that particular profit is the appropriate profit' – for whatever reasons – 'and we believe that the profit' – or the loss, as it may well be – 'should have been something else; and here are the reasons we believe that is the appropriate way to do it'." (Evidence, 21 June 2002, PA 32 and PA 33).

III AUDITORS' OBSERVATIONS ON THE ROLE OF "A TRUE AND FAIR VIEW"

Unfortunately, Mr Reilly's view, cited above, is idiosyncratic.

Consider, by way of illustration, the following statements, generally by senior auditors, many of which were made in evidence or submissions before the Committee.

- **Mr Richard Humphry – Managing Director and Chief Executive Officer, Australian Stock Exchange.**

  "I used to prefer the true and fair certification by auditors, but you might note that it has long since been taken away" (Emphasis mine). [Senator Watson – It comes back as a secondary consideration doesn't it?] "Yes" (Emphasis mine). (Evidence, 21 June 2002, PA46).

- **Mr Ian McPhee, Deputy Auditor General, Australian National Audit Office.**
- **Mr Michael Watson, Group Executive Office, Australian National Audit Office.**

  "Mr McPhee – I think the issue, Senator Watson, is that you cannot ignore the standard. You can provide additional information –

Mr Watson – And then disclose that. The standard has primacy over true and fair" (Emphasis mine). (Evidence, 21 June 2002, PA59).

- **Mr John Shanahan, Spencer & Co, Chartered Accountants.**

  "My point is that the auditor has to sign off that you comply with accounting standards in a very technical sense, rather than saying what the true and fair position is." (Evidence, 8 July 2002, PA165).

- **Mr Stuart Grant, Accounting and Financial Advisory Committee Member, Australian Institute of Company Directors**.

  "The predominant requirement is compliance with the rules which is embraced in accounting standards. There is a secondary requirement, which is a true and fair view, which we believe is somewhat neglected because of the focus on the specific requirements, because they are so extensive … The way the regime has moved … is that the true and fair view has tended to be only if you do not agree with the standard, so it is a one-sided assessment instead of an all-embracing assessment. As I say, we would like to see the more principles, the more all-embracing assessment. May I add that a true and fair view and substance over form are a more onerous test than any compliance with a set of rules. (Emphasis mine) (Evidence, 8 July 2002, PA169).

- **Mr Robert Wylie, Partner, Deloitte Touche Tohmatsu**

  "We collectively – the auditors and the preparers of accounts – are required to have those accounts prepared in accordance with Australian accounting standards, but should there be a view that that alone does not give a true and fair view, then additional information should be provided in the notes to the financial statements." (Evidence, 8 July 2002, PA183).

  Contrast the foregoing with Mr Wylie's views expressed less than three months earlier:

  "ROB WYLIE: The first point I'd make is that in Australia auditors are required to say that the accounts are fairly represented in accordance with accounting standards. Not that they're true and fair." (Roundtable, Melbourne "Age", 20 April 2002).

- **Mr Lindsay Maxsted, Chief Executive Officer, KPMG.**

  "We really think the item of 'truth and fairness in the accounts' is being understated as a secondary proposition behind 'compliance with accounting standards'." (Evidence, 8 July 2002, PA203).

- **<u>Mr Michael Coleman, National Managing Partner, Risk and Regulation, KPMG.</u>**

  "In Australia, the Corporations Law was changed in 1991 to require, firstly, compliance with accounting standards and, secondly, a true and fair opinion. I believe that if 'true and fair' was returned to the primacy position that it was previously in, an auditor has another very strong tool, because an auditor then has to say to the board of directors or to the management, 'I'm sorry but the actual accounts, even though they may comply with accounting standards, are still not right. I don't believe that they are right?' I would really like to see the true and fair override reintroduced". (Evidence, 8 July 2002, PA213).

- **<u>KPMG</u>**

  "Currently, the Corporations Act 2001 specifies that financial statements must give a true and fair view, but this is effectively given secondary importance due to the requirement to comply with accounting standards." (Submission to the Committee, 6 June 2002, page 2).

- **<u>Professor Frank Clark, University of Newcastle and Professor Graeme Dean, University of Sydney</u>**

  "… the current <u>technical</u> interpretation that accounts are "true and fair" <u>if</u> they comply with the Accounting Standards" (Collapse Incorporated, published by CCH, 2001, Part II, Chapter 3, "Corporate Collapses Analysed", page 91)

- **<u>Wayne Lonergan</u>**

  "… former Coopers & Lybrand partner Wayne Lonergan … advocates a radical three-pronged approach that would fundamentally change the audit process as we know it. [Secondly] there would be a fundamental change to the audit report, so that strict compliance with accounting standards would not be the only criterion for truth and fairness" (Richard Gluyas, The Weekend Australian, March 16-17, 2002, page 30).

In discussing the audit role, the CPA Australia submission to the Committee states as follows:

> "The auditor is required to follow auditing and professional standards in undertaking the audit, during which the auditor is required to assess whether the company has complied with accounting standards appropriately. The auditor's reliance on clear and relevant standards for auditing and accounting as well as for managing ethical challenges is significant and a critical consideration in assessing audit performance". (31 May 2002, page 5)

The CPA Australia submission comprises over 30 single spaced typed pages. Nowhere in that submission is any reference made to the relevance of “a true and fair view” other than a single mention in the Attachment which deals with “Australia’s Regulation Model Compared with International Alternatives”. By way of contrast, the submission discusses in detail the role of accounting standards.

Alarmingly, it is reasonable to conclude from the foregoing that many senior auditors are either ignorant of, do not fully comprehend or choose to ignore their legal obligations when auditing financial reports of Australian public companies.

IV THE MEANING OF “A TRUE AND FAIR VIEW”

The Act does not define the expression “a true and fair view” and there is no clear judicial determination of its meaning.

Those who argue that a balance sheet is a historical record, not necessarily bearing any relationship to current worth, point out that it has been standard practice for decades (subject to the steady intrusion of the accounting standards) to present accounts on this basis. The argument:

> “comes down to saying that it is legitimate to present accounts in this way because they have always been presented in this way. This is surely an extraordinary interpretation of a requirement that the accounts should present a ‘true and fair view’?” (Andrew McGee, Senior Lecturer in Law, Liverpool University, in “The ‘True and Fair View’ Debate: A study in the Legal Regulation of Accounting”, The Modern Law Review, Vol 54, No. 6, November 1991, page 882)

The practice of including property investments in audited accounts at book value continues, notwithstanding that market value may be demonstrably substantially in excess of book value. This practice is permitted by current accounting standards. It would appear that both the regulators and the accountants have overlooked the fact that the test of “true and fair view” is a

legal one and cannot be a matter purely for accountants, however much they might wish otherwise.

The words of Justice Wallace, then President of the New South Wales Court of Appeal, uttered almost forty years ago, still ring true:

> "It is a little difficult for a lawyer to detect why either expediency or the practice of the accountancy profession can authorize departure from ordinary principles of construction applicable to a statute. When we observe the wealth of detail required by the Ninth Schedule and the overriding requirement in S.162(11) that the accounts must give 'a true and fair view' of the state of affairs of the company and of its profit or loss … it seems legitimate to ask: where is there room for the 'historical record' doctrine as a fully satisfying compliance with the statute.? Of course one recognises the difficulties and perplexities involved in many cases in translating the 'true and fair' directive into action.
>
> "I, like Professor Gower, find much difficulty in reconciling the deliberate and calculated establishment of secret reserves with the provisions of the Ninth Schedule and of S.162(11), and I could never accept the views of accountants and directors on this matter. To me, the word 'true' (curiously enough) simply means what it says – it is for the legislature and not accountants and directors to alter the natural meaning of the statute… I am uneasy when I recognise the complacent if not eager way in which secret reserves are generally accepted by directors, auditors and the accountancy profession. Indeed secret reserves seem to be the goal of well-meaning directors" (Paper delivered to 3rd Commonwealth and Empire Law Conference, Sydney, 1965 – "Modern Problems In Company Law," Record of the 3rd Conference, Law Book Co, 1965, pages 334 and 335) (Emphasis mine).

Prior to the 1998 amendments to the Corporations Law, the requirement was that the profit and loss account must give "a true and fair view" of the profit or loss of the company for the financial year, and the balance sheet must give a true and fair view of the state of affairs of the company at the end of the financial year. In 1998 the law was amended to relate "a true and fair view" to the financial position and performance of the company. The Explanatory Memorandum to the Company Law Review Bill, dated 3 December 1997, stated as follows:

> "The Bill requires that the financial statements and notes for a financial year give a true and fair view of the financial position and performance of the company …This ensures that the financial statements and notes give a true and fair view of the company's whole operations including profit and loss and cash flows, and not just matters relating to the balance sheet. This approach is consistent with the *AASB's Statement of Accounting Concepts SAC2: Objectives of General Purpose Financial Reporting*, which requires that information that is relevant to the assessment of performance, financial position and financing and investing be included in general purpose financial reports".

It is nothing short of ludicrous to suggest that one can comply with the "true and fair view" requirement (a requirement which is said to be consistent with "information that is relevant to the assessment of performance, financial position and financing and investing") by providing an historical record of a company's financial dealings as distinct from an up-to-date market based assessment of the company's financial position and performance.

For example, if a figure of say $10,000 appears alongside plant in a company's balance sheet, this must mean something. If the figure represents the current value of the plant, ie, the amount for which it can be realised in cash, then this constitutes a useful piece of information which gives, at least in relation to that asset, a true and fair view of the financial position of the company. However, if that figure of $10,000 represents the initial cost of the plant acquired some years ago less amortisation to date, which has no correlation at all to current market value, then in what sense can this aspect of the balance sheet be said to be reflective of the financial position of the company except in a totally irrelevant historical context? The one thing it does not do is to give "a true and fair view of … the financial position" of the company as at the date of the balance sheet.

In my view, the depiction by the late Professor R J Chambers and Professor Wolnizer of the operation of the "true and fair view" requirement, remains absolutely compelling:

"The dominant feature of a balance sheet is that it relates to affairs at a stated date, to assets and obligations and their money amounts at that date. In principle, then, any money amount that relates to prior or subsequent dates is untrue as of the balance-sheet date; and any gain or loss based on any such amount will, in principle, be untrue of the period to which it is assigned. The inclusion of any such component statement in its appropriate aggregate statement will make the aggregate statement untrue to its date or period.

The most common feature of all balance sheets is the representation of cash, receivables and payables by their money amounts as they stand at the balance sheet date. These are amounts of general purchasing and debt-paying power. Other amounts of general purchasing and debt-paying power at that date may legitimately be added to or subtracted from such amounts, and the resultant may be related to any prospective course of action at that date. The resultant will have a commercial or financial referent; in that sense it will be true of the position of the company to which it refers. On the other hand, any component statement that does not represent an amount of balance-sheet dated general purchasing or debt-paying power will entail the addition in the balance sheet of sums that are and sums that are not amounts of dated purchasing and debt-paying power. To such heterogeneous aggregates there can be no commercial or financial referent; in that sense the balance sheet as a whole will be untrue of the financial position of the company at its balance date.

Now, recall that the conventional balance sheet may contain amounts that are up-to-date amounts (for monetary items) and other amounts that are, or are based on costs that may be, months, years or decades out of date; and recall the stipulation that statutory words and phrases may not be so interpreted that they lead to patent absurdity. Interpretation of "true and fair" as tolerating the use and the aggregation in dated balance sheets of amounts of money of diverse dates and diverse significances would, it seems, be an interpretation leading to patent absurdity. It would be absurd to suppose that the legislature could have had in mind the publication of a statement purporting to be a statement of dated financial position that was in fact a melange of variously dated amounts, of qualitatively different significances. Consequentially it seems that no competent tribunal, faced with a balance sheet of the conventional kind and with evidence of the logical and practical deficiencies of such a balance sheet, could hold that it satisfied the provisions of the Act."
("A True and Fair View of Financial Position", Companies and Securities Law Journal, December 1990, pages 360 – 361).

In 1983, when the National Companies and Securities Commission was engaged in a wide ranging review of the requirements for accounts and audit in the Companies Act and Codes, there was a proposal that the relevant legislation include the following definition of the requirement for financial statements to provide "a true and fair view":

> "Without affecting the generality of the meaning of the term 'true and fair view', a 'true and fair view', in relation to accounts or group accounts means a representation which affords those who might reasonably be expected to refer to those accounts (including holders or prospective purchasers of shares, debentures, notes or other interests, and creditors or prospective creditors) information which is relevant to the decisions which may be made by those persons in relation to the purchase, sale or other action in connection with their securities or interests".

Whilst the proposal was not adopted, I believe that, in broad terms, it reflects what would ordinarily be understood by the expression "a true and fair view" in the context currently under consideration. "Truth and fairness", according to Australian law, requires much more than mere satisfaction of accounting standards.

On the subject of "true and fair view", Alan Kohler recently highlighted the difference between the applicable law in Australia and in the United States:

> "Up to now, US accounting standards have been thought to lead the world. US authorities arrogantly demand that any company that wants access to US capital markets must meet US accounting standards, nothing less. Progress towards international harmonisation of standards has always been blocked by the refusal of the US to compromise on the mind-numbing volume of disclosure that it requires.
>
> But one thing that has been highlighted by WorldCom and Enron is that quantity of disclosure does not equal transparency.
>
> Specifically, the US's lack of the British 'true and fair' principle in judging the quality of company accounts is clearly a fatal flaw. Reliance on black-letter law, rather than allowing auditors to form a general opinion as to the truth and fairness of a set of accounts, simply encourages the use of technicalities to evade proper disclosure. This is what happened at both Enron and WorldCom." (The Weekend Australian Financial Review, June 29-30, 2002 page 72)

Alan Kohler's assessment is strongly reinforced by the testimony of Walter Schuetze, former Chief Accountant of the SEC, given before the United States Senate Committee on Banking, Housing and Urban Affairs on 26 February 2002 (Annexure II).

It is of interest to note that, following the Enron and WorldCom debacles, the US Securities and Exchange Commission (SEC) has proposed a new Exchange Act Rule 13a-14 which:

> "would require the principal executive officer and principal financial officer of a company each to certify, with respect to the company's quarterly and annual reports, that :
>
> - he or she has read the report;
> - to his or her knowledge, the information in the report is true in all important respects as of the last day of the period covered by the report; and
> - the report contains all information about the company of which he or she is aware that he or she believes is important to a reasonable investor as of the last day of the period covered by the report.
>
> For purposes of the proposed certification, information is considered 'important to a reasonable investor' if:
>
> - there is a substantial likelihood that a reasonable investor would view the information as significantly altering the total mix of information in the report; and
> - the report would be misleading to a reasonable investor if the information was omitted from the report".
>
> (SEC Media Release 2002-88, 12 June 2002)

In effect, the SEC is proposing to introduce a belief based "true and fair view" override, the contents of which bears certain similarities to the 1983 proposed (but rejected) definition of that expression for the purposes of Australian law.

In my view, the role of an auditor in relation to the "true and fair view" requirement is clearly and accurately articulated in the evidence given to the Committee by the three eminent academics, Emeritus Professor Frank Clark,

University of Newcastle, Professor Graeme Dean, University of Sydney and Professor Peter Wolnizer, University of Sydney:

> Professor Clarke - "… generally speaking, as long as the true and fair override is in its present position, subservient to compliance with the accounting standards, it is quite likely that the current unsatisfactory situation will prevail. We would argue that the true and fair override ought to be there. If the true and fair override was there, no auditor could reasonably go along with the proposition that money spent – money that the firm no longer has – represents an asset." (Evidence, 28 June 2002, PA101).
>
> Professor Wolnizer - "The greatest impediment is the huge discretion that prevalent conventional accounting standards give to the reporting enterprise. People who prepare accounts have inordinate discretion about what they will report and how they will report it. Under a regime where you have statutory enforcement of accounting standards, there is a scenario where the auditor is necessarily bound to compliance with prevalent standards. Those standards give huge discretion to preparing accounts. It seems to me that the auditors, however ethical, however proper, however upright, however saint-like, can do nothing about that." (Evidence, 28 June 2002, PA102).
>
> Professor Wolnizer - "In the CLERP, there was a very profound reform recommendation to move to market value accounting or what we might call mark-to-market accounting, where assets would be reported at their current market selling prices and liabilities would be reported at their settlement prices – a proposition with which the three of us wholeheartedly agree.
>
> Were there to be such a system of accounting in place, I believe that that would transform the rigour of auditing. Auditors would then have the opportunity – indeed, they would have the responsibility – to test the assertions of the reporting enterprise and the values that are attached to assets and liabilities against evidence that would be adduced beyond the reporting enterprise – from the marketplace directly or through independent valuations in some cases. This would put auditing as a quality control function, if you like, on a very different footing, and it would enable auditors to form an opinion about the financial performance and positions of firms independently of the reporting enterprise. At the moment, they do not have that privilege." (Evidence, 28 June 2002, PA104).
>
> Professor Clarke - "I reached out and picked up the first balance sheet on my shelf yesterday, and it happened to be BHP's for 1998. To illustrate our point, in the notes under 'Property and plant and equipment' there is a list of 40-odd items – land and buildings, plant and machinery, mineral rights and all sorts of things like that – for which there are about, depending upon how you want to count them, 30 different valuation bases. But not one of the numbers is necessarily indicative of how much money any of those assets

> actually embodies at the date of the balance sheet and/or any amount of money the firm will necessarily have in the future. All that adds up to $40-odd billion of BHP's assets. I argue that that is absolutely in accord with the accounting standards. I have not checked but you will probably discover that BHP got an award in the annual report awards in that year – it gets one nearly every year. It is a paragon of compliance with accounting standards – good accounting, according to conventional wisdom. It is absolutely useless in trying to identify whether BHP is solvent or whatever." (Evidence, 28 June 2002, PA105)

In their joint submission to the Committee the three eminent Professors further elaborated:

> "Our submission notes that 'Over time the idea of authenticating the contents of periodical accounts by recourse to independent evidence has, with the exception of cash, receivables and payables, been submerged. Recourse to external evidence has been replaced by professional prescription of the manner in which financial statements are to be prepared without considering whether the data are generally serviceable for the purposes made of them – determining the wealth and progress of the companies to which they relate and deriving indicators of their salient financial characteristics'.
>
> In the absence of full mark-to-market accounting that has external commercial referents, auditors shall continue to be at the behest of their clients' financial calculations – a situation in which 'independence of mind' can neither exist nor be shown to exist. There is little likelihood that the recycled ideas being proposed will mitigate unexpected corporate collapses and their associated fallout.
>
> Accounting is, and always has been, the core focus of the audit of published financial statements. Reliable financial statements are the very objects of the independence rules! Compulsory compliance with the present crop of account standards poses the greatest threat to auditors' *independence*. That constraint ensures that 'surprise' continues to be a prevailing characteristic of corporate failures, and that auditors attract the flak".
> (Submission, 23 May 2002, page 3)

Further detail is provided by Professor Frank Clark and Professor Graeme Dean in "Collapse Incorporated" published by CCH, 2001, Part II, Chapter 3, "Corporate Collapses Analysed":

> "None of the Accounting Standards declares the essential characteristics that the data must have to be serviceable in, ie fit for, the uses habitually made of them – informing on the wealth and progress of companies and for deriving their salient financial

characteristics, solvency, debt to equity, rate of return, asset backing, earnings per share, and the like". (Page 90).

"Unquestionably, compulsory compliance by accountants and auditors with prescribed Accounting and Auditing Standards provides them with a safe harbour. Yet, compulsory compliance threatens to create a moral hazard. Removal of the *true and fair* override has relieved auditors of the obligation to draw upon their accumulated wisdom in forming their audit opinion. But the current *technical* interpretation that accounts are "true and fair" *if* they comply with the Accounting Standards robs auditors of an essential professional edge. The technical interpretation relies on the automatic veracity and reliability of compliant data. Nonetheless, that is rare". (Page 91)

"Thus the typical company balance sheet comprises a combination of:

- actual amounts of money (for liquid assets and sometimes for some physical assets);
- amounts of money spent at myriad past times – money gone;
- amounts amortised in various ways – indicative neither of money possessed nor money gone;
- amounts estimated to be *recoverable* (anticipated future sales revenue and scrap values into a far distant future), sometimes discounted, sometimes not – not indicative of any present amount of money or money's worth;
- amounts of money expenses in the past, *capitalised* (as with HIH's *acquisition costs and deferred expenses)* delaying its inclusion in the calculation of profits and losses – money frequently long gone; and
- (for example) amounts for so-called *goodwill* – bookkeeping discrepancies between what was paid for assets and their fair values at the time of acquisition, such as HIH's booked *goodwill.*

To that agglomeration is to be added the artefacts of the accounting system; the data not indicative of anything other than the defects in the processes by which they are created. Top of the list are the future income tax benefits and the provisions for deferred income tax items, mentioned above. The difference between income tax charged in the calculation of income in accord with the Standard practice and the amount assessable for the year in accord with the tax legislation is plugged into the balance sheet as an asset or a liability as the sign of the balance dictates. When the data for a parent (holding) company and its subsidiaries (or controlled entities) are consolidated, an excess of the acquisition cost of the controlling interest and the proportionate fair value of the net assets acquired is reported as

> goodwill (as it appears in respect of HIH's acquisition of FAI's insurance business) and compulsorily amortised in subsequent years. This amount 'falls' out of the procedures. That excess of the fair value of the net assets attributable to the interest is pro-rated against the fair values of the assets. Such amounts refer neither to money any entity in the group has nor is necessarily likely to have. Absolute fictions! Clearly data in that mix are rarely fit for the uses made of them.
>
> Yet, ensuring the reporting of data of those kinds, reliance on the practice of the compulsory procedures by which they are created, are the duties imposed upon auditors and audit committees."
> (Pages 94 and 95)

In an article published in the Weekend Australian, financial journalist Richard Gluyas refers to the views of former Coopers & Lybrand partner, Wayne Lonergan:

> "Lonergan urges a three-pronged approach to minimise the chances of any future Enron-like implosion.
>
> The first move would be to require market valuations for all financial assets and liabilities.
>
> Next there would be a fundamental change to the audit report, so that strict compliance with accounting standards would not be the only criterion for truth and fairness.
>
> Lonergan suggests something like auditors attesting to the client not having entered into arrangements of a material nature which could be considered 'aggressive accounting'.
>
> Or, indeed, any arrangements which only comply with the letter of accounting standards rather than their true intent.
>
> The final leg would [be] a huge emphasis on acquiring objective, verifiable evidence to support material book entries.
>
> In a move to finally close the audit expectation gap, this could mean approaching counter-parties in key contracts rather than relying on a piece of paper issued by the client firm's management.
>
> Lonergan agrees this could substantially increase the cost of an audit. His response? Hang the cost.
>
> 'The benefit to the community would vastly exceed the incremental cost,' he says."
> (The Weekend Australian, March 16-17, 2002, page 30)

It is interesting to note that Lonergan appears to assume that his proposed three-pronged approach is not something which is mandated by the law as it presently stands. This obviously flows from his view that, currently, strict compliance with accounting standards is the only criterion for truth and fairness. Were it to be otherwise, and if, as I contend, the current law does not define "truth and fairness" simply by reference to the accounting standards, then there is a strong argument that Lonergan's three-pronged approach is indeed mandated by the current law.

V THE APPLICATION IN PRACTICE OF THE "TRUE AND FAIR VIEW" REQUIREMENT

In my view, there is a fundamental disconnect between the practice of auditors in relation to "true and fair view" on the one hand, and what the law requires, on the other. In practice, audits are conducted as though the opinion to be given by the auditor is on the basis of "a true and fair view" in accordance with the applicable accounting standards. In other words, accounting standards are treated as the sole criterion for what constitutes "a true and fair view". This practice is clearly contrary to law.

In giving evidence before the Committee, Mr Robert Wylie, Partner, Deloitte Touche Tohmatsu, described the processes which had been instituted by his accounting firm to ensure that a company is compliant with the Australian accounting standards:

> "The processes that we go through to satisfy ourselves that the company is complying with its stated accounting standards, policies and practices – and let us assume that its stated practices are in accordance with Australian accounting standards – and complying with the Australian accounting standards are very rigorous. They include several levels of review, and within that process you can often find differences of opinion at various levels within the organisation, even at partner level. Our processes require us, at the end of the day, to refer all of these grey or questionable areas to our national technical group. The group has the final say, not the partner signing the accounts. That is part of our quality assurance procedures". (Evidence, 8 July 2002, PA 185).

I regret that the Committee did not put to Mr Wylie the question of what processes Deloitte Touche Tohmatsu has instituted to ensure that, over and above compliance with accounting standards, the financial report gives "a true and fair view" of the company's financial position and performance. My guess, without knowing the answer, is that the Committee would have been told that the processes in place in relation to compliance with accounting standards would be sufficient to satisfy the true and fair view requirement.

Directors of major public companies who have had differences with auditors would maintain that those differences have involved, for the most part, issues relating to whether or not particular accounting standards had been complied with.

How many auditors, having satisfied themselves that the financial statements complied with the accounting standards, really sit back and carefully consider whether the financial report, taken as a whole, gives "a true and fair view"?

On how many occasions have auditors been able to rationalise away a failure to qualify misleading financial statements simply on the basis that the accounting standards have been complied with?

How frequently have the notes to the financial statements of a publicly listed company contained an explanation and reconciliation based on the fact that the accounting standards did not give "a true and fair view"? Very rarely, I would venture.

VI ENFORCEMENT OF THE LAW

In my view, ASIC has taken inadequate action to ensure that auditors comply with their legal obligations.

As the New South Wales Supreme Court pointed out in Pacific Acceptance Corp. Ltd v Forsyth and Ors (1970) 92 W.N. (N.S.W.) 29 AT 75:

> "if the auditing profession or most of them fail to adopt some step which despite their practice was reasonably required of them, such failure does not cease to be a breach of duty because all or most of them did the same."

While the SEC is now belatedly moving to introduce a modified form of "true and fair view" override (SEC Media Release 2002-88, 12 June 2002), ASIC's principal focus is on non compliance with accounting standards. In its Media Release of 12 July 2002 (02-249) the Chairman of ASIC invites the Chairmen of all listed companies "to directly involve their Boards in ensuring compliance with the relevant accounting standards". He points out that a special task force has been assembled, the primary focus of which "will be compliance with accounting standards".

I have no problem about ASIC calling for compliance with accounting standards. No doubt, some of the problems being encountered are due to non compliance with accounting standards. However, there is a more fundamental problem which ASIC completely overlooks. That problem arises from an entrenched practice on the part of auditors which is contrary to law. There is a major disconnect between how auditors, in practice, discharge their obligations in relation to the "true and fair view" requirement and the manner in which the law mandates that those obligations be discharged.

In my view, ASIC has an obligation to ensure that the law is enforced and that auditors carry out their obligations as required by law.

VII SOME ILLUSTRATIVE CASES

I am a lawyer and company director. Although I have no accounting qualifications, I do believe that I can read and understand financial

statements. However, I do not have any detailed knowledge of the intricacies of the Australian accounting standards.

I therefore sought expert advice to assist me in demonstrating to the Committee the distortions which can arise from applying current accounting standards.

Jan McCahey, a Partner at PricewaterhouseCoopers, Melbourne, and formerly Chief Accountant, ASIC (Curriculum Vitae attached as Annexure III), has provided the following illustrations:

> "**Comments on asset carrying amounts**
>
> Companies can elect to measure property, plant and equipment (PPE) at cost or fair value. Where PPE is measured at cost, the carrying amount of the asset must not exceed its recoverable amount: that is, the amount that could be recovered from the use or sale of the asset. This is known as the 'recoverable amount' test.
>
> The objective of this test is to ensure that carrying values of impaired assets are not overstated in company balance sheets. However, the Australian test (contained in AASB 1010 *Recoverable Amount of Non-Current Assets*) does not achieve this objective because it does not require the time value of money to be taken into account when calculating an asset's recoverable amount. This means that impaired assets may be recorded in companies' balance sheets at amounts which exceed either or both of:
>
> - their market value
> - the present value of the future cash flows expected to arise from their use.
>
> Take the example of an investment property purchased during a property boom at a cost of $20 million. The market value for such properties then falls to $10 million. The company may elect to continue to record the value of that property at $20 million if the sum of the net cash flows expected to be received from renting the property over its useful life and from selling it at the end of that life exceeds $20 million. The fact that the calculation of recoverable amount has not involved discounting cash flows to determine a present value must be disclosed in the notes, but the present value itself does not need to be disclosed. In the example given, the $10 million market value is clearly the most relevant indicator of recoverable amount because it will represent the market's assessment of the value today of the expected rental stream from the property.

> In the case of plant and equipment, its selling price is generally not the most appropriate indicator of its recoverable amount. Instead we need to look to the amount of cash that will be generated from using the equipment. However, under current Australian rules, equipment purchased at a cost of $5 million can continue to be recorded as this amount (less accumulated depreciation) where at least this amount of cash inflows (net of cash out flows necessarily incurred to generate the inflows) is expected to be derived from using the equipment. This is the case even if the inflows are expected to arise over such a long period that their present value would be considerably less than $5 million".

These examples clearly demonstrate the distortions which a process driven adherence to accounting standards can produce in the absence of appropriate and independent consideration being given to the "true and fair view" requirement.

If one takes the first example of an investment property purchased at a cost of $20 million and having a current market value of $10 million, is there any real question that the $10 million represents the true economic financial condition and the $20 million does not? Yet, it is quite clear that the accounting standards permit the directors to include the investment property in the accounts at $20 million. Of course, the accounting standards also would allow for the alternative of valuing the investment property at fair value and therefore including it in the accounts at a stated value of $10 million.

In this case, the accounting standards permit two alternative forms of treatment of the investment property for accounting purposes, both of which comply with accounting standards. If the Board of Directors of a company were to decide to adopt the more aggressive alternative, then the auditor would be obliged to accept this without qualification to the extent that his or her opinion is determined solely by reference to compliance with the accounting standards.

I return now to ASIC's Media Release of 12 July 2002 (02-249), where the Chairman of ASIC invites the Chairmen of all listed companies "to directly

involve their Boards in ensuring compliance with the relevant accounting standards". Surely, if accounting standards are to be the principal focus, then ASIC cannot complain if, in the above example, the Board of Directors adopts, and the auditor accepts, the more aggressive approach to the treatment of the investment property, notwithstanding that it conveys a totally misleading picture of the financial condition of the company.

I suggest that what ASIC should be doing is not focusing on compliance with accounting standards but instead reminding directors of public companies and their auditors that, in addition to complying with accounting standards, they have an obligation to ensure that the company's financial reports give "a true and fair view" of the company's financial position and performance. Clearly, the more aggressive alternative in relation to the accounting treatment of the investment property does not meet that requirement of giving "a true and fair view".

If ASIC were to make plain its intention to enforce the law, then it is most unlikely that a Board of Directors would opt for, or that an auditor would accept, the more aggressive accounting treatment of the investment property. However, in the current climate, given the way auditors understand their legal responsibilities, and given the lack of enforcement activity on the part of ASIC, accounts will continue to be prepared, and auditors will continue to accept those accounts without qualification, on the basis of compliance with accounting standards and irrespective of whether, independently of those standards, the accounts give "a true and fair view".

VIII CONCLUSIONS

1. The law requires that financial reports of Australian public companies both comply with accounting standards and also give "a true and fair view" of the financial position and performance of the company. In cases where compliance with accounting standards does not give "a true and fair view" the law requires that this must be corrected by way of an appropriate note to the financial statements.

2 Many auditors of the financial reports of Australian public companies are either ignorant of, do not fully comprehend or choose to ignore their legal obligations.

3 Although, occasionally, auditors pay lipservice to the "true and fair view" requirement, in practice that requirement is not treated as having any independent significance over and above compliance with accounting standards. This practice is contrary to law. Indeed, there is a major disconnect between audit practice and what the law requires.

4 Accounts which comply with accounting standards will not necessarily be accounts which give "a true and fair view". As was affirmed in the United States case of Herzfeld v. Laventhol, Krekstein, Horwath and Horwath:

> "The policy underlying the securities laws of providing investors with all the facts needed to make intelligent investment decisions can only be accomplished if financial statements fully and fairly portray the actual financial condition of the company … compliance with generally accepted accounting principles will not insulate an accountant from criminal culpability for fraud." ((1974) 378 F. Supp. 112 at 122)

5 A company's financial report will not give "a true and fair view" by providing an historical record of a company's financial dealings as distinct from an up-to-date balance date assessment of the company's "financial position and performance".

6 A process driven adherence to accounting standards can, and does, produce gross distortions in financial reporting.

7 ASIC has taken inadequate action to ensure that auditors comply with their legal obligations. ASIC has an obligation to ensure that the law is enforced.

8 There is a vast resource of accumulated accounting expertise and wisdom that auditors could harness to provide an up-to-date balance date value judgement of a "company's financial position and performance". But unless ASIC acts against those who carry out audits in contravention of the law, the culture of complacency will inevitably continue to grow. Tragically, so will the easily avoidable rate of unexpected corporate collapses.

ANNEXURE I

CURRICULUM VITAE
MARK LEIBLER A.O.

* Mark Leibler has been a partner in the legal firm Arnold Bloch Leibler since 1969 and senior partner since 1981. Mr Leibler was an adviser to the Commissioner of Taxation from 1986 to 1992, as member for various periods of the Commissioner's Advisory panel, the National Tax Liaison Group and the Self Assessment Steering Committee.

* His other advisory appointments include membership of the Law Council of Australia's Taxation Committee since 1984, and Committee Chairman from 1988 to 1991.

* Mr Leibler joined the Board of Coles Myer Ltd in April 1995.

* He is currently Chairman of Alpha Investment Management Pty Ltd, a specialist in active equities management, and was a Director of the Board of Jetset Tours Pty Ltd from 1985 to 1997.

* Mr Leibler has contributed to numerous publications and has been a frequent lecturer on taxation and related subjects at various institutions including Monash University, the Taxation Institute of Australia, the Law Institute of Victoria, the Securities Institute of Australia and the Committee for the Economic Development of Australia, of which he is a trustee. He is a frequent media commentator on taxation issues, and is much sought by industry groups as a Keynote Speaker on issues of taxation and revenue law reform.

* Since December 2000, Mr Leibler has been a Director of Reconciliation Australia Limited, a non profit entity established to continue the leadership role of the Council for Aboriginal Reconciliation after the Council's statutory term ended on 31 December 2000.

* Mr Leibler's community activities also include Chairman of the Fundraising Council of the Mental Health Foundation of Australia (1992 – 1997) and Director of Monash University Syme Faculty Foundation (1992 – 1996).

* Mr Leibler is a prominent leader of the Australian Jewish community and in 1987 was appointed an Officer in the Order of Australia in recognition of service to the community, in particular to the Jewish community. He currently has key leadership roles in a number of Australian and international peak Jewish organisations.

* He was educated at Mount Scopus College, Melbourne University (LL.B Hons.) and Yale University Law School, where he was awarded an LL.M. (Hons.).

* Aged 58, Mr Leibler's favourite pastime is reading. He is married with four children and six grandchildren, and lives in Melbourne.

ANNEXURE II

Testimony of
Walter P. Schuetze

before the
United States Senate
Committee on Banking, Housing, and Urban Affairs
Paul S. Sarbanes, Chairman

Tuesday, February 26, 2002

(Wanted: Accounting that Investors, Members of Congress, and My Sister Can Understand)

Thank you, Mr. Chairman. Senator Gramm. Members of the Committee. My name is Walter P. Schuetze. My brief resume is attached hereto.

Just a few comments about my experience and background. I was on the staff and a partner with the public accounting firm KPMG and its predecessor firms for more than thirty years. I was one of the charter members of the Financial Accounting Standards Board from April 1973 through June 1976. I was a member and chair of the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants in the 1980s. I was Chief Accountant to the Securities and Exchange Commission from January 1992 through March 1995 and Chief Accountant of the SEC's Division of Enforcement from November 1997 through mid-February 2000.

I need to mention that although I am retired, I am a consultant to the Securities and Exchange Commission and several other entities under consulting contracts. In addition, I have one remaining tie with my former firm KPMG in that I am an insured under a group life insurance contract obtained and administered by that firm; I pay the premium attributable to me. The views I express here today are my personal views.

I appreciate very much the opportunity to testify here today. Your letter of January 16, 2002 inviting me to testify at this hearing says, "A number of high-profile business failures in recent years, including, most recently, the collapse of Enron Corp., have involved significant accounting irregularities, and the February 26 hearing will examine the issues raised by those failures for financial reporting by public companies, accounting standards, and oversight of the accounting profession. You should feel free to address those issues as you see fit. The committee would also appreciate any recommendations you may have about ways to deal with the issues you discuss." I indeed have a major recommendation, which I will get to at the conclusion of my remarks.

The public's confidence in financial reports of and by Corporate America, and in the audits of those financial reports by the public accounting profession, has been shaken badly by the recent surprise collapse of Enron, by recent

restatements of financial statements by the likes of Enron, Waste Management, Sunbeam, Cendant, Livent, and MicroStrategy, and by the SEC's assertion of fraud by Arthur Andersen in connection with its audits of Waste Management's financial statements in the 1990s, which Andersen did not admit or deny in a settled SEC action last summer. The public's confidence needs to be regained and restored. If that confidence is not regained and restored, the result will be that investors will bid down the price of stocks and bonds issued by both US and foreign corporations; we have seen evidence of that phenomenon in recent weeks. That is an investor's natural response to increased risk or the perception of increased risk. This will reduce the market capitalization of corporations, which in turn will negatively affect capital formation, job creation and job maintenance, and ultimately our standard of living. So, we are concerned today with a very important matter.

You will hear or have heard many suggestions for improvement to our system of financial reporting and audits of those financial reports. Some will say that auditor independence rules need to be strengthened. That external auditors should not be allowed to do consulting work and other non-audit work for their audit clients. That external audit firms should be rotated every five years or so. That external auditors should be prohibited from taking executive positions with their corporate clients for a number of years after they have been associated with the audit firm doing the audit unless the firm resigns as auditor. That peer reviews of auditors' work need to be improved and done more frequently if not continuously. That auditors should be engaged by the stock exchanges and paid from fees paid to the exchanges by listed companies. That the oversight of auditors needs to be strengthened. That punishment of wayward auditors needs to be more certain and swift. In that regard, Chairman Pitt of the SEC has proposed that there be a new Public Accountability Board overseeing the external audit function; this Board would, as I understand it, have investigative and disciplinary powers. And so on and on. In my opinion, those suggestions, even if legislated by Congress and signed by the President, will not fix the underlying problem.

The underlying problem is a technical accounting problem. The problem is rooted in our rules for financial reporting. Those financial reporting rules need deep and fundamental reform. Unless we change those rules, nothing will change. The problems will persist. Today's crisis as portrayed by the surprise collapse of Enron is the same kind of crisis that arose in the 1970s when Penn Central surprisingly collapsed and in the 1980s when hundreds of savings and loan associations collapsed, which precipitated the S&L bailout by the Federal government. Similar crises have arisen in Australia, Canada, Great Britain, and South Africa. There will be more of these crises unless the underlying rules are changed.

Under our current financial reporting rules promulgated by the Financial Accounting Standards Board, management of the reporting corporation controls and determines the amounts reported in the financial statements for most assets. For example, if management concludes, based on its own subjective estimates, that the cost of an asset—say equipment--will be recovered from future cash flows from operations without regard to the time value of money or risk, no write down is required even when it is known that the current market price of the asset is less than the cost of the asset. The

external auditor cannot require that the reported amount of an asset be written down to its estimated selling price; the external auditor cannot even require the corporation to determine the estimated selling price of the asset and disclose that price in its financial statements. So, when it comes time to sell assets to pay debts, there often are surprise losses that investors then see for the first time. Management also makes similar assessments in determining the amount of inventory obsolescence, the allowance for bad debts, and whether declines in the values of investments below cost are "other than temporary."

Under our current accounting rules, corporate management often records sales and trade receivables at 100 cents on the dollar even though a bank or a factor would pay only pennies on the dollar for those trade receivables. We saw that phenomenon in the past few years in the telecom rage where sales and receivables were recorded followed several months later by write offs of the receivables. On another front, we currently are seeing swaps of assets and the recognition of gains in what is effectively a barter transaction, even though the fair value of what was exchanged is apparently negligible.

Except for inventories and marketable securities, none of these asset amounts in the financial statements—trade receivables, commercial and consumer loans receivable, real estate loans, oil and gas reserves, mineral deposits, pipelines, plant, equipment, investments--is subjected to the test of what the cash market price of the asset is. Yet, we know that most individual investors, and, in my experience, even many sophisticated institutional investors, believe that the reported amounts of assets in corporate balance sheets represent the current market prices of those assets; nothing could be farther from the truth.

And under the FASB's definition of an asset, corporations report as assets things that have no market price whatsoever; examples are goodwill, direct response advertising costs, deferred income taxes, future tax benefits of operating loss carry forwards, costs of raising debt capital, and interest costs for debt said to relate to acquisition of fixed assets. I call these non-real assets. Today's corporate balance sheets are laden with these non-real assets; this is the kind of stuff that allows stock prices to soar when in fact the corporate balance sheet is bloated with hot air. Of course, when it comes time to pay bills or make contributions to employees' pension plans, this stuff is worthless.

The same goes for liabilities. Corporate management determines the reported amount of liabilities for such things as warranties, guarantees, commitments, environmental remediation, and restructurings. Again, this is as per the FASB's accounting rules.

The upshot is that earnings management abounds. Earnings management is like dirt; it is everywhere. SEC commissioners have made speeches decrying earnings management. Business Week, Forbes, Barron's, the New York Times, the Wall Street Journal, and the Harvard Business Review carry hand-wringing articles about earnings management. Earnings management is talked about matter-of-factly on Wall Street Week and on Bloomberg TV, CNBC, CNNfn, and MSNBC. Earnings management is a scourge in this country. Earnings management is common in other countries as well

because their accounting rules, and the accounting rules promulgated by the International Accounting Standards Board, are much the same as ours.

We need to put a stop to earnings management. But, until we take control of the reported numbers out of the hands of corporate management, we will not stop earnings management and there will be more Enrons, Waste Managements, Livents, Cendants, MicroStrategys, and Sunbeams. How do we take control of the reported numbers out of the hands of corporate management? We do it by requiring that the reported numbers for assets and liabilities, including guarantees and commitments, be based on estimated current market prices--current cash selling prices for assets and current cash settlement prices for liabilities. And by requiring that those prices come from, or be corroborated by, competent, qualified, expert persons or entities that are not affiliated with, and do not have economic ties to, the reporting corporate entity. And by requiring that the names of the persons or entities furnishing those prices, and the consents to use their names, be included in the annual reports and quarterly reports of the reporting corporate entity so that investors can see who furnished the prices.

Let me give you an example of what I am talking about. Pre-September 11, 2001, the major airlines, to the extent that they own aircraft instead of leasing them, had on their balance sheets aircraft at the cost of acquiring those aircraft from Airbus and Boeing. Let's say that cost was 100 million dollars per aircraft. The market prices of those aircraft fell into the basement post-September 11 to about 50 million dollars per aircraft and remain there today although prices have recovered somewhat. Yet, under the FASB's rules, those airlines continue to report those aircraft on their balance sheets at 100 million dollars and are not even required to disclose that the aircraft are worth only 50 million dollars. Under mark to market accounting, the aircraft would be reported at 50 million dollars on the airlines' balance sheets, not 100 million dollars.

I could give you many more examples, but I will add just one more. In the late 1970s, this country was experiencing great inflation. The Federal Reserve Board raised short-term interest rates dramatically. Long-term rates shot up. As a consequence, the market value of previously acquired residential mortgage loans and government bonds held by savings and loan associations declined drastically. But, the regulations of the Federal Home Loan Bank Board and the FASB's accounting rules said that it was OK for the mortgage loans and bonds to be reported at their historical cost. Consequently, the S&Ls appeared solvent but really were not. This mirage allowed the S&Ls to keep their doors open and in so doing they incurred huge operating losses because their cost of funds far exceeded their interest income on loans and bonds in their portfolios. Some of the S&Ls decided to double down by investing in risky real estate projects, also accounted for at historical cost, and proceeded to lose still greater amounts, which losses were also hidden on the balance sheet under the historical cost label. (The Federal Home Loan Bank Board even went so far as to allow S&Ls to capitalize and report as assets losses on sales of assets, but the FASB said no to that procedure.) Of course, when the Federal government had to bail out the insolvent S&Ls in the 1980s, the Federal government paid for the losses that were hidden in the balance sheet under the historical cost label and the operating losses that had been

incurred while the S&Ls kept their doors open because of faulty accounting. Had mark to market accounting been in place and had the Federal Home Loan Bank Board computed regulatory capital based on the market value of the S&Ls' mortgage loans, government bonds, and real estate projects, the S&L hole would not have gotten nearly as deep as it ultimately did.

Various members of Congress have said in recent hearings about Enron that a corporation's balance sheet must present the corporation's true economic financial condition. A corporation's true economic financial condition cannot be seen when assets are reported at their historical cost amounts. The only objective way that the true economic financial condition of a corporation can be portrayed is to mark to market all of the corporation's assets and liabilities. Recall my earlier example about the cost of aircraft being 100 million dollars and the current market value being 50 million dollars. Mr. Chairman and Members of the Committee: Is there any question that the 50 million dollars presents the true economic financial condition and the 100 million dollars does not? Moreover, following today's FASB's accounting rules produces financial statements that are understandable only to the very few accountants who have memorized the FASB's mountain of rules. Indecipherable is the word Chairman's Pitt has used in recent speeches. On the other hand, marking to market will produce financial statements that investors, members of Congress, and my sister, who also happens to be an investor, can understand.

The various proposals that have been made to cure Enronitis will not cure the problem. I liken our current accounting system to bridges built from timber, which bridges keep collapsing under the weight of eighteen-wheelers. The public demands that expert consulting engineers be called in to oversee the building of replacement bridges. But the replacement timber bridges keep collapsing under the weight of eighteen-wheelers. More expert consulting engineers will not make the timber bridges any stronger. What needs to be done to fix the problem is build bridges with concrete and steel. The same goes with accounting. In the 1970s, after the surprise collapse of Penn Central, the auditing profession instituted peer reviews—where one auditing firm reviews the work and quality controls of another auditing firm. In the 1970s, auditing firms also instituted concurring partner reviews where a second audit partner within the public accounting firm looks over the shoulder of the engagement audit partner responsible for the audit. These procedures have been ineffectual as shown by the dozens of Enrons, Waste Managements, Sunbeams, MicroStrategys, Cendants, and Livents that have occurred since then. Coincidentally, the Financial Accounting Standards Board also came on the scene in 1970s; it was going to write accounting standards that would bring forth financial statements based on concepts. What happened was that the FASB wrote a mountain of rules that produce financial statements that nobody understands and that can be and are gamed by corporate management. What all of that amounted to was continuing to build timber bridges that keep collapsing under the weight of eighteen-wheelers. We need to stop building timber bridges. We need to build concrete and steel bridges. We need to mark to market all assets and liabilities.

Now, you may ask—how much will concrete and steel bridges cost? Can we afford to build concrete and steel bridges? My response is that we cannot

afford not to build concrete and steel bridges. How much of the cost of the S&L bailout was attributable to faulty accounting; the amount is unknowable but no doubt was huge. How much does an Enron or Cendant or Waste Management or MicroStrategy or Sunbeam cost? The answer for investors is billions, and that does not count the human anguish when working employees lose their jobs, their 401-k assets, and their medical insurance, and retired employees lose their cash retirement benefits and medical insurance. By some estimates, Enron alone cost 60--70 billion dollars in terms of market capitalization that disappeared in just a few months. Waste Management, Sunbeam, Cendant, Livent, MicroStrategy, and the others also cost billions in terms of market capitalization that disappeared when their earnings management games were exposed. And, these costs do not include the immeasurable cost of lost confidence by investors in financial reports and the consequent negative effect on the cost of capital and market efficiency.

By my estimate, annual external audit fees in the United States for our 16,000 public companies, 7,000 mutual funds, and 7,000 broker/dealers total about 12 billion dollars. Let's say that 4 billion dollars is attributable to mutual funds and broker/dealers. (Incidentally, mutual funds and broker/dealers already mark to market their assets every day at the close of business, and we have very few problems with fraudulent financial statements being issued by those entities. Mark to market works and is effective.) That leaves 8 billion dollars attributable to the 16,000 public companies. Assume that the 8 billion dollars would be doubled or even tripled if the 16,000 public companies had to get competent, outside valuation experts (and not the public accountants because they are not competent valuation experts) to determine the estimated cash market prices of their assets and liabilities. We are then looking at an additional annual cost of 16--24 billion dollars. If we prevented just one Enron per year by requiring mark to market accounting, we easily would pay for that additional cost. And, when considered in relation to the total market capitalization of the US corporate stock and bond markets of more than 20 trillion dollars, 16—24 billion dollars is indeed a small price to pay.

The question arises: Who should mandate mark to market accounting? I recommend that there be a sense of the Congress resolution that corporate balance sheets must present the reporting corporation's true economic financial condition through mark to market accounting for the corporation's assets and liabilities. I recommend that Congress leave implementation to the SEC, much the way it is done today by the SEC for broker/dealers and mutual funds. There will be many implementation issues, so the SEC will need more staff and money.

My testimony today is a summary of a lengthy article that I wrote about the definition of assets and liabilities, earnings management, and mark to market accounting that was published last year in <u>Abacus,</u> a University of Sydney publication, and which was the basis for the RJ Chambers Research Lecture that I presented last year at the University of Sydney. That article and lecture are attached hereto.

I will be pleased to answer the Committee's questions.

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