COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

JOINT COMMITTEE ON CORPORATIONS AND SECURITIES

(SUBCOMMITTEE)

Reference: Aspects of the regulation of proprietary companies

FRIDAY, 30 JUNE 2000

MELBOURNE

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JOINT COMMITTEE ON CORPORATIONS AND SECURITIES

Friday, 30 June 2000

Members: Senator Chapman *(Chair)*, Senators Conroy, Cooney, Gibson and Murray and Ms Julie Bishop, Mr Cameron, Mr Rudd, Mr Sercombe and Dr Southcott

Senators and members in attendance: Senators Chapman and Cooney and Ms Julie Bishop

Terms of reference for the inquiry:

The committee has been requested by the Minister for Financial Services and Regulation, the Hon. Joe Hockey MP, to review aspects of the regulation of proprietary companies, including the operation of the ASIC class order under which proprietary companies may be relieved of the requirement to have their financial statements audited.

The provisions relating to the test for determining whether a proprietary company is large or small and the audit and lodgement of financial statements by proprietary companies were introduced by the *First Corporate Law Simplification Act 1995*. Following commencement of the Act, a number of reviews of the provisions and the operation of the ASIC class order were foreshadowed by the Committee and the Treasurer. The Minister has requested the Committee to undertake a single review that will also include the review envisaged by the Treasurer.

The Committee will examine:

- the small/large criteria in section 45A of the Corporations Law;
- the appropriateness of having requirements for audit and the lodgment of financial statements for some classes of proprietary companies;
- the appropriateness of the criteria for the exercise of ASIC's discretion to provide relief from the accounting provisions in subsections 342(2) and (3) of the Law;
- the manner in which ASIC has exercised that discretion; and
- the effectiveness and costs of the process of ASIC providing exemptions from the audit requirements in Chapter 2M of the Law through the exercise of an administrative power.

WITNESSES

Subcommittee met at 9.12 a.m.

MEADE, Mr Gerard, Chairman, Legislation Review Board, Australian Accounting Research Foundation

MIFSUD, Mr Richard, Senior Project Director, Australian Accounting Research Foundation

PARKER, Mr Colin, Director, Accounting and Audit, CPA Australia

REILLY, Mr Keith, Technical Consultant, Accounting Standards, The Institute of Chartered Accountants in Australia

WEST, Ms Jan, Deputy President, The Institute of Charted Accountants in Australia

CHAIR—I declare open this hearing and welcome the witnesses who will be appearing before the committee today. The purpose of the hearing is to take evidence for the committee's inquiry into aspects of the regulation of proprietary companies. This is the second hearing of this inquiry. We had our first hearing on Wednesday night in Canberra. To date, the committee has received and published 13 written submissions which it will consider, along with the evidence it received on Wednesday night and today, in preparing its report. The committee prefers to conduct its hearings in public. However, if there are any matters which a witness wishes to draw attention to or discuss with the committee in camera, then we will consider such a request. I also remind witnesses that the giving of false or misleading evidence may constitute a contempt of parliament.

I welcome the representatives of CPA Australia, the Institute of Chartered Accountants and the Australian Accounting Research Foundation. I apologise for the fact that on this side of the table we are few in number. This is as a consequence, as I mentioned informally earlier, of the fact that parliament did not adjourn until 2.30 this morning and some of our number were not quite sure what flights they would be able to get on this morning. Julie Bishop and I managed to make it. We had a meeting of the committee at 2.30 and formed a subcommittee comprising Julie and me to make sure that at least formally we could meet with you. We have before us your joint submission. Are there any alterations or corrections that you wish to make to the submission at this stage?

Mr Parker—No.

CHAIR—If not, then I invite you to make opening statements. Following that, we may proceed to questions.

Ms West—I will introduce our submission. The fact that I am here today representing the leadership of the accounting bodies just emphasises the importance with which we view this matter. To support the concepts underlying our submission, we should look at the purpose of financial reporting actually being placed on the public record and ask: why would it be there? If you think through the concept of information being accessible to those who are placing reliance on it, on the basis that they would not have access to that information if it was not on the public

record, and the use they would make that information, that then leads to whether the information that they have available is relevant and reliable, which leads into perhaps some of the detail of audit or non-audit, et cetera.

The question whether there is information that people are making decisions about, in terms of their economic resources, et cetera, is the point behind our submission. That leads to the reporting entity concept. Our proposition is that the reporting entity concept probably identifies whether there is an interest in the information that is on the public record and that is not available to those who need it or whether there is not. That is probably the crux of it, rather than necessarily the size, which is only one part of the criteria. That is the essence of our submission; and Gerard Meade, who is the Chairman of the Legislative Review Board of AARF, will expand on that particular concept.

Mr Meade—As Jan mentioned, the critical factor in our submission is the support for the reporting entity concept. I have just a few observations in terms of the small and large test. We would contend that the small and large test is not necessarily a complete and comprehensive test in terms of determining which companies should report under the Corporations Law. Whilst the test seems to have worked relatively well, there are a number of problems and limitations within the small and large test. A couple of examples are that there certainly have been cases where some companies, we would contend, have been incorrectly classified. They may well be companies that are not necessarily economically significant and, similarly, they may not necessarily have significant public interest.

I was actually coming down in a plane yesterday from Sydney and sitting next to me was a partner in a small chartered accounting firm. He glanced across and he saw I was reading the submissions on the proprietary company test and he said, 'What are you doing?' I said I was giving evidence before a parliamentary committee hearing. He said that it has actually caused small practitioners a large number of problems. He mentioned that he has a number of clients who are just above the thresholds, but certainly it would be argued that they are not really economically significant. They are basically run by a family enterprise. One that he mentioned was in the aviation industry. They might have a couple of aircraft, which obviously involves significant amounts of money, and that puts them over the asset test. The revenues generated would put them over the revenue test. There will be probably fewer than 10 people, but the argument is that that type of enterprise is really a family run business and it is really not of economic significance. He would argue that they should really not have to prepare financial reports pursuant to Corporations Law requirements. That was just one example and it was coincidental—

Ms JULIE BISHOP—It is an interesting concept, isn't it—a survey of business class passengers on your way to the hearing?

Mr Meade—It was certainly unexpected and, I must say, it detracted from my reading time, but I think it was a worthwhile exercise. Another example—and it is related to that same point—is that there probably are other factors that are relevant in determining whether a company should be required to report under the Corporations Law. One of those is the degree of separation between owners and managers. We would tend to argue that, for a lot of small businesses, the owners and managers are one and the same group of people and that in that situation they really do not require detailed financial reports. They might have access to

management information but they certainly do not have the need for the detailed financial reports that they would be required to prepare under the Corporations Law.

Another factor is that matters are complicated by the fact that we effectively now have two tests. We have the small and large test, which determines which proprietary companies are required to report, and we then have the reporting entity concept. The reporting entity concept basically is used to determine the content of the financial reports—that is, what information should be disclosed. Again, the gentleman I spoke to yesterday certainly felt that that does create confusion and added complexity in terms of financial reporting. We would contend that one test, being the reporting entity concept, is the preferable way to go.

In terms of grandfathering, a number of people who have put in submissions have contended that grandfathering creates an unlevel playing field. We would certainly support that contention in that we have two levels of disclosure by large proprietary companies. Those that were not grandfathered—that is, they were not previously exempt proprietary, they did not have audits conducted—are required to prepare financial reports under the Corporations Law, whereas grandfathered large proprietary companies are not. Having that differential level is seen as something which is really not in the public interest. In terms of companies restructuring, there certainly have been examples where companies and groups have restructured with the objective of avoiding classification as a large proprietary company. Once again, that is something that is not desirable, but it is one implication of the small and large test.

In terms of the reporting entity concept, as Jan mentioned, the accounting bodies believe that that concept should be the sole test which determines which entities are required to prepare financial reports under the Corporations Law. As indicated before, there is a number of submissions included within those before the committee which have focused on: who are the owners of the business; what is the correlation between owners and management of the business; and, similarly, is there a large or a small spread of shareholders? We would contend that the reporting entity concept does actually pick up this notion. One of the criteria within the reporting entity concept is the degree of separation between owners and managers, so we would argue that the reporting entity concept would basically pick up that problem with the small and large test that has been raised by a number of submissions.

The accounting bodies have supported the reporting entity concept for a long while. We know from previous discussions that there is a view that the concept is perhaps subjective. I have a couple of observations on that particular point. Firstly, the reporting entity concept has been operative as an applicable accounting standard since 1 July 1991, so it has operated for nine years. Keith and Colin can probably comment on this better, but the number of queries that the accounting bodies have had on the reporting entity concept and its application in practice has been quite small. So we would contend that it has been in operation for nine years and it has been working effectively, and that would support our contention that the reporting entity concept should be adopted as the test.

There is another, similar test which does involve subjectivity and that is the test of control embodied in AASB1024, which deals with the preparation of consolidated financial reports. When that test was brought in and included within the law, a number of people said it was a subjective test and it was going to cause problems in terms of practical application. Once again, that really has not been the case. It has been a test which has been widely recognised as being

relevant and one which has proved quite successful in determining relationships within groups of companies.

One of the key issues which is particularly relevant to stakeholders is the test of solvency. A number of the recent changes to the Corporations Law have focused on solvency as being a primary factor of relevance to users of financial reports and those who may have an interest in a company's affairs. Examples might be employees or creditors of a company. We would contend that the Corporations Law already provides very good safeguards in terms of solvency. Firstly, we have section 588—I cannot recall whether it is F or G—which places an obligation on directors of a company to make sure that the company does not trade when it is insolvent—that is, when the company cannot pay their debts as and when they become due and payable. So the law already contains a very important test in terms of solvency.

Another factor which is worth mentioning was contained in the Company Law Review Act 1998. One of the provisions in that act is that those companies that are not required to prepare a financial report under the Corporations Law—they could be small proprietary companies—are required to include within their annual report a solvency declaration made by the directors not more than one month before the date of lodgment of the company's annual return, pursuant to a declaration or a resolution of the directors that the company is solvent. Once again, that is something that indicates to the public and anyone viewing the ASIC database or conducting a company search that the directors have made a positive resolution that the company is solvent and able to pay its debts as and when they fall due. That should be something that is of particular relevance to people seeking information on companies. That would apply to those that do not have to lodge financial reports at all.

Mr Reilly—Gerry has already referred to the fact that we have had very few complaints raised about the application of the reporting entity concept. I think both Colin and I have received, in total, half a dozen complaints over that nine-year period. They have all been related to matrimonial disputes where there is a break-up in the marriage and a break-up in the family business. Usually it has been on legal advice which says, 'You're not getting reporting into the account, so let's get those and find out exactly what's happening in the company?' In each case I have gone back to the particular practitioner and said, 'What you really should be doing is asking just what information they are looking for.' Invariably it is far more detailed information than would be provided by accounting standards.

That has really been the only instance and I guess our colleagues at ASIC have also raised a number of instances in the past where they have seen companies of a significant economic size. The accounting bodies are very supportive of ASIC actually going back and asking the questions as the regulator, because the regulator has quite strong powers in that area to say, 'You've stated that you are a non-reporting entity. On what basis do you believe you are a non-reporting entity?' Again, that reporting entity test is that there is usefulness for that information.

We get quite a lot of concerns from our members on all sorts of legislation, not just Corporations Law, stating that the law is not terribly good if you are producing information at a cost, both to the organisation and also to the professional advisers, where that information is not being used in practice. Small business particularly is being run with cost constraints and we as a profession would prefer that small business actually put the effort into producing meaningful information to run the business. Therefore, in terms of the size test, the size test is focusing on

assets and revenues in particular, with employees as a third test which tends not to be used in practice. Just tripping over that size test suddenly imposes some significant cost on one group of business as against another that might be operating in the same field.

To reinforce, we really have not seen a problem in practice with the reporting entity. We believe—and my ASIC colleagues may well go into that in a bit more detail—that they do have the appropriate resources to ask the question. The accounting bodies, too, have the same resources, I guess, at the end of the day because our members are required to comply with accounting standards and the reporting entity is embodied in those accounting standards.

CHAIR—Have you had a look at the Institute of Company Directors submission and their propositions?

Ms West—I have not.

CHAIR—I understand that they proposed to us on Wednesday night that we revert to the exempt proprietary company situation, with the additional requirement that it is required of exempt proprietary companies that all directors sign a solvency statement and that a statement of accounts be prepared, but not be required to be lodged or be audited. Any member of the company can request a copy of those statements. Firstly, without being an accounting expert, how does the exempt proprietary company concept jell with the reporting entity concept and, secondly, what is your reaction to that proposal from the Institute of Company Directors?

Mr Parker—The exempt proprietary company focuses on an ownership test, and the ownership test closely aligns itself with the reporting entity. The reporting entity looks at the separation of management from ownership. The reporting entity is a more powerful test, there is no doubt about that, because you look at a number of factors, whereas this solely concentrates on ownership. It is another model that could be pursued. As a matter of fact, many years ago, when the legislation was being proposed for the size test, we indicated what were the problems with the size test. Three years later on we still stand by those initial statements we made regarding the problems. We believe the reporting entity test is superior. Then again, focusing the reporting requirements on the ownership structure, for example exempt proprietary companies, is a valid alternative. It is not our preferred model but it is better than the size test.

Mr Meade—One other point is that, yes, we would say that the reporting entity concept in effect embodies the exempt proprietary company test. The reporting entity concept would actually be a better test. One of the limitations of an exempt proprietary company test is that, if any shareholder in the company is a public company, then you fall outside the definition of an exempt proprietary company. If you had a mum and dad type company and they owned 90 per cent or 95 per cent of the company, and if you had just one public company shareholder who owned the five per cent or the 10 per cent, that would mean that the company would fall outside the relief that would be available. We would say that, provided the public company shareholder agreed that they could receive sufficient information to enable them to make their economic decisions, that public company ownership should not preclude the company from being a reporting entity. That is a limitation on the exempt proprietary company status test.

Mr Reilly—I have read the Institute of Company Directors submission. I was not sure whether they were actually saying that they would take out the small proprietary test as well.

There is some sort of implication that they might in which case, with regard to a lot of the benefits of the large and small tests, particularly those focused at the small proprietary companies, I would want to go back and look at just how many small proprietaries would be swept up again. If the AICD are suggesting—and I presume that is what they are implying—that the exempt proprietary test would apply to any of the large proprietary companies, I can see some benefit in that. I just want to go back and have a look at how many of the small proprietary companies, which are not economically significant at all, might well be caught by that. One of the benefits of the large and small proprietary legislation of 1995 was to reduce the reporting requirements on the vast number of proprietary companies that were small.

CHAIR—You either mentioned or it was in your submission that the reporting entity concept was defined on the basis of, and would have to comply with, accounting standards. Is a corollary of that, in relation to the inadequacy of the large/small tests, the fact that, in preparing their accounts, they do not have to comply with the established accounting standards?

Mr Parker—That is right. The large proprietary company that has to prepare accounts under the Corporations Law may not trigger the application of all accounting standards, so there is this area of uncertainty. Those large proprietary companies may prepare their financial statements in accordance with all the accounting standards, some of the accounting standards or the measurement aspects of accounting standards; the rules in that area are uncertain for those preparing accounts. This goes to one of the problems with the size test, that there is not simplicity between those who have to prepare accounts, those who have to lodge accounts and those who have to have their accounts audited with regard to the application of accounting standards. They are all triggered on a different set of principles, so explaining to people what are their responsibilities under the Corporations Law is a little tough. We would prefer just the one approach for those who have to prepare their accounts, lodge their accounts and have their accounts audited, and we recommend that that be the reporting entity test.

Ms West—It comes back to the point that Gerard made about restructuring. If you structure your operations in a way that gets you into the small category or out of the corporate reporting scene altogether, you are not reporting. However, if you are picking up in terms of, 'Is there a reporting entity in existence?' and that reporting entity is complying with accounting standards and preparing a set of financial reports that is relevant and reliable in terms of information conveying, it is far more useful within the business community and the community at large than stepping through, 'Am I small? Am I large? Yes, I am large. Am I a reporting entity? No, I am not. So I will just choose what I will disclose or not.' And the comprehensiveness of what is disclosed might be of no value to anybody.

Mr Parker—There is inconsistent reporting on the public record of why it is proprietary companies at the current time. That should be a concern to all parties. The reason for that is the lack of interface between the Corporations Law reporting requirements and the accounting standards reporting requirements. If the size test were appropriately fixed to be the reporting entity, you would not have this diversity in reporting on the public record at the current time.

Mr Meade—One particular example relates to the small and large test and that interface. In determining whether a company or a group of companies is small or large, the company or group is required to assess their total assets and total revenues on a consolidated basis. To determine whether you are small or large, you look at your consolidated numbers. The anomaly

that arises is that, if the particular holding company or the economic entity is not a reporting entity, the numbers that they will report will not necessarily include consolidated financial information. So, whilst we are saying that you are a large proprietary company, on a consolidated basis the numbers that the company will disclose in its financial report need not necessarily show the consolidated result. There is an inconsistency there at present.

Ms JULIE BISHOP—Obviously, one of the key issues is the incorrect classification. You concede that the reporting entity test is subjective. It just seems to me that it remains so because different people will obviously come to different conclusions in relation to the reporting entity tests, even though there are more hurdles than the large/small test. So isn't there still a risk that there will be incorrect classification by directors on the non-reporting side as there is no independent review of their classification?

Mr Reilly—A comment I made earlier on was that the number of complaints we have had about the application of the reporting entity concept over that nine-year period has been very small. If there are misclassifications we certainly have not had very many potential users who have come back to the accounting bodies—and ASIC may wish to comment later on—and to ASIC to say, 'This company has been misclassified. It's stating it is a non-reporting entity. We believe it's a reporting entity. We need information to make economic, rational decisions and we're not getting that information.' The half dozen have all been matrimonial disputes. They have been looking for information far in excess of what you would get in a set of financial statements.

Ms JULIE BISHOP—They may not necessarily go away whatever the test.

Mr Reilly—What has happened in practice is that I have gone back to the practitioner and said, 'You tell them exactly what they want within the bounds of what you believe is reasonable'. But they can trigger the reporting entity test. Any one shareholder could do that and invariably it has been much more detailed information, being a set of financial statements.

Ms West—But perhaps you are moving forward on that, rather than saying that the reporting entity concept is subjective.

Ms JULIE BISHOP—You said it. I was just picking it up.

Ms West—It is subjective, but in financial reporting there are many, many areas where professional skill and judgment are required. Gerard mentioned consolidated accounts, and whether something should or should not be consolidated is another point of judgment: is there control or not? Through the whole concept of financial reporting, the professional judgment skill of the directors, the financial people preparing the accounts and the auditors comes into play. Maybe the way forward is for the regulators, the accounting bodies, those involved with financial reporting to focus more on what those criteria might be. So rather than say it is too hard to apply, let us work out a better way of applying it.

Ms JULIE BISHOP—Are there obvious examples of incorrect classification? Has anyone done an analysis of how many companies would be classified under the reporting entity differently from the way they have been classified under the large/small test? Would we perhaps come up with the same group of companies in the same basket?

Mr Parker—I do not think so. Some of the research work that is being done by Keith's team and also some of the comments made by ASIC in their evidence lead me to believe that we are not talking about the same basket of entities. The reporting entity test, if applied, I think would exclude a lot of companies that are currently caught by the size test. In previous evidence before this committee, when asked what I thought about the size test numbers, I and the accounting bodies have always said that they are too low, they are arbitrary. If you like, their beauty is that everyone knows what $10 million revenue is, $5 million assets and 50 employees. But it has no logic other than it is a number picked.

Ms JULIE BISHOP—It is interesting, because ASIC have given evidence that the removal of reporting requirements equates to 99.3 per cent of all proprietary companies now being excluded from the reporting requirements.

Mr Parker—I believe so. All those small proprietary companies I would never have seen as reporting entities, nor those currently around those size thresholds. They are just being judged on what is a very crude test of economic significance. I do not believe that there would be all that many people interested in those types of companies.

Ms JULIE BISHOP—Ms West mentioned that perhaps it would more productive to focus on the tests, then, for the reporting entity concept. So we have got a legitimate public interest—

Mr Parker—Yes.

Ms JULIE BISHOP—size, economic influence and separation between owners and management? Coming back to my point: the assessment of those factors is done by the directors?

Ms West—It is their decision in the first place, yes.

Ms JULIE BISHOP—And then what process could there be to have that independently assessed, or how does one pick up that the directors have misclassified their company?

Mr Reilly—What happens is that it is the director's initial decision, but the directors also have to go back to the shareholders, so the shareholders have a say. The shareholders are saying, 'Do we want more detailed information, or is the information that you are required to prepare for Corporations Law sufficient?' In the absence of any shareholder objecting, that director's decision will follow through. Again remember that, under the size test, a set of financial statements may not even get on the public record if the company is grandfathered, or it may be audited in certain cases if it was not an exempt proprietary company prior to the legislation coming through, or it may be audited and be lodged if it was a company that has become a large proprietary since the legislation came through. So the shareholders will automatically have a say on whether they believe the directors have properly classified, as indeed they have a say on whether the directors are properly running the company. So that is the test that you have there.

The next stage, I would argue, would be whether there are other users who are relying upon those accounts and who have said, 'Hang on, this is not sufficient information for me to make decisions.' The tests that you referred to in our submission are qualitative tests. The basic test is: are there users of those financial statements that need detailed financial information? So in our

reporting entity guidance, in the Statement of Accounting Concepts 1, we have given a number of examples of entities that we would expect to be reporting entities. Not surprisingly, listed companies are one.

On the other hand, we have also said that smaller family owned companies would probably not be reporting entities. Again, ASIC then has, as the regulator, a role to play there, so if there are concerns that companies have been misplaced, then it is ASIC's responsibility to go back to those companies and ask, 'How can you demonstrate that you are preparing accounts that are not being used?' That then takes you to the next question, I guess—which is why this parliamentary inquiry is useful—and that is: why should the law require information to be prepared, at some cost, when it is not actually being used in practice? If the law does do that, then we would contend the law should change.

Ms JULIE BISHOP—Could I just put to you something that ASIC had indicated in commenting upon the reporting entity test. There was a concern raised, basically on directors' accountability, that there is a greater possibility for incorrect classification and that, as no accounts will be available, the directors may be less accountable to potential users of the accounts for their classification because those potential users will have limited information available to them to question the decision. Could you comment on that evidence that was given by ASIC?

Mr Reilly—I am happy to start on that by saying that, if it is a grandfathered large proprietary company, the only people that are seeing the accounts are the shareholders and the legislation is quite clear, so it is effectively excluding any users by legislative definition, whereas we would argue the reporting entity test is a far better test to use there. If it is a company that is lodging financial information, then any potential user has the right to go back to the regulator and say, 'This financial information does not comply with the law.' Maybe there should be some sort of warning on accounts that are lodged on the ASIC database for large proprietary companies that are using the non-reporting entity concept to say, 'Beware, these are non-reporting entity accounts. They do not necessarily provide you with the same level of assurance that they would if you were looking at National Australia Bank's accounts.'

Again, we would argue the same with audit, because you are getting financial information lodged on the ASIC database that is not subject to audit and, therefore, the assurance that is provided by a third party, by a professional group of auditors, is not available. Having said that, the financial information is being prepared and lodged on the ASIC database with the directors saying, 'We do not believe these accounts will be useful to people.' That is what they are essentially saying. So if you require an auditor to go through and assess that, you are just putting on additional costs. I would turn it back and say that I would like to see some evidence as to why people are unhappy with the information that is provided on the ASIC database for non-reporting entities, because there has been no real evidence that I can see. There may be some misclassification, but we have not seen much evidence of people coming back and saying that is causing problems; and if it is a problem, then there are appropriate remedies today to fix that.

Ms West—If you are asking why the reporting entity test would pick up those that are not lodging when they should any less well than the large test is now, it comes down to, I suppose, the points that Keith has been raising, but also the directors' responsibility in respect of making

those judgments in accordance with the law as it is laid down. If a company chose to measure the three tests on the large proprietary company test in a way that meant that it was not lodging, it is easier to say, 'Yes, you have added it up, and you have got revenue and you have got assets and, therefore, you should be lodging,' but if they are not measuring those particular financial parameters in a way that is producing the right answers anyway, that is, if they are not actually applying correct accounting standards, they might be coming up with the wrong answer anyway. So, yes, one is easier to apply, but the fundamental is the same—that the directors should be applying the test according to the law in the right way.

Mr Meade—The other thing is that even under the current tests there may well be companies that directors may well know that they actually classify as a large proprietary company and therefore they should be preparing and lodging, and those directors may well have made a conscious decision contrary to the requirements of the law that they are not going to lodge. At present we have no way of knowing the number of companies involved. My guess is that there are companies out there that under the current small and large test would be classified as large proprietaries and therefore should have to lodge, but they are not. We have no way of detecting those companies at present.

Mr Reilly—The other issue that we have raised in our submission is the unlevel playing field. We have actually put a bit of a task before your subcommittee in saying that there is a whole area of business that is totally unregulated, and that is in the use of trusts. We would argue that in that area that is a significant gap in our financial reporting scheme. I am not going to suggest there is an easy answer to that but essentially business does have some option as to whether it is going to be caught potentially by the Corporations Law, large and small, or it is not by organising its activities outside a company structure. Our reporting entity concept applies to all business enterprises and our members are required to enforce those requirements. So if they are providing financial advice to directors of companies or to trustees or whatever, then the reporting entity requirements are being applied in terms of financial information.

CHAIR—Given the requirement for interpretation of a reporting entity in terms of accounting standards and reasonableness, would you concede there is obviously an element of arbitrariness there? Does that raise the same problem that the current arbitrariness does in relation to the small/large test in terms of how ASIC exercises its discretion? Whichever system you use, is the same problem going to be there?

Ms West—The comment that I would make—perhaps without the deep technical background that you will get from my three colleagues here, more from a practitioner's perspective—is that, just on the face of it, there is a deeper base of logic behind the reporting entity concept than one that just says if you meet three particular numeric hurdles you are in one category and if you do not you are in another category. It has a little bit more of what is the reality.

Ms JULIE BISHOP—Because currently there is no way of identifying what is a large company that has managed for one reason or another to describe itself as a small company, there is no way of—

Ms West—No, short of the regulator identifying them, doing the review of all companies and testing that proposition.

CHAIR—Is your proposal for a financial reporting act likely to add a further layer of regulation, given the government's intent to try and simplify and minimise regulations through the CLERP process? Would a financial reporting act be consistent with the CLERP intent?

Ms West—For simplicity going through it, it would be simpler if it sat over and got rid of a whole lot of the detail underneath. But, if it sat on top of still complex detail, probably not, but I will pass that through to whoever wants to speak on that topic.

Mr Parker—Essentially, if we had one piece of legislation in Australia that regulated financial reporting, life would be easier for all parties involved where consistent reporting requirements were set for businesses, government and the not-for-profit sector. So in the submission and in previous submissions we were championing the cause of a generic financial reporting act that would apply to, if you like, all reporting entities. Because we deal with financial reporting issues under the Corporations Law, you pick up all the constitutional limitations of the Corporations Law. That is evident in the role of the new AASB where it makes accounting standards for the purposes of the Corporations Law but formulates them for other purposes. When it formulates them for other purposes, it is basically using other legislation in existence throughout Australia and the support of the accounting bodies to have those standards enforced. So a longer term view would be a financial reporting act that applied to all reporting entities throughout Australia would be in everyone's best interests. But that is a long-term issue.

CHAIR—Thank you very much for appearing before the committee this morning and for the evidence you have given and the answers to questions. Certainly they have been very helpful in terms of our consideration of the relevant issues.

Ms West—Thank you for the opportunity.

[9.56 a.m.]

AGLAND, Mr Reece Graham, General Counsel, National Institute of Accountants

MARSHALL, Mr Neil Leslie, Chief Executive Officer, National Institute of Accountants

ORD, Mr Gavan Russell, Technical Policy Manager, National Institute of Accountants

CHAIR—I welcome the representatives of the National Institute of Accountants. Do you wish to make an opening statement? We have your submission before us and it has been published. You might like to make an opening statement in relation to that. We would welcome that and then proceed to questions.

Mr Marshall—Thank you, Chairman. The National Institute of Accountants is one of the three professional accounting associations in Australia. It was established in 1926 and now has over 12,000 members across a wide range of disciplines and industries. We take a keen interest in the development of law in areas that directly impact upon small business and the accounting profession, and hence our submission to this committee. The vast majority of our members either work for or provide accounting services to small business. We have therefore approached the submission from the small business angle. Chairman, we seek your permission to speak to our submission.

CHAIR—Yes.

Mr Marshall—The focus of this submission is whether our recommendations benefit small business by reducing compliance costs, reducing the regulatory burden and adding flexibility to the remaining regulatory burden. While the NIA remains committed to pushing for a reduction in the administrative burden of small business, the keeping of good, accurate financial records by small business is essential to the long-term viability of small business. The NIA supports the use of accounting standards and other accounting concepts, although we must always be aware of the information needs of the end user. It is no use to a small business owner to be required to meet the financial reporting standards of a Coles Myer or a large national company.

The broad thrust of our submission is to support small business. The regulatory regime governing its corporate and financial governance must be flexible and unhindered to small business doing small business. Because of its flexibility both to assist the small business owner and to protect minority shareholders, the NIA probably supports, firstly, the retention of the section 45A criteria, and, secondly, that the requirements to audit relief be maintained but be made more flexible. The NIA would also like to see a standard definition of small business employed in all legislation, both state and Commonwealth, and standard audit requirements in both Commonwealth and state legislation.

Reece Agland, our general counsel, will now speak to the NIA submission on section 45A and the granting of audit relief. Gavan Ord, who is the manager, technical policy, will follow with a discussion on accounting standards and a more consistent approach to legislation regarding small businesses.

Mr Agland—The NIA believes that the current criteria set out in section 45A of the Corporations Law should be maintained. While it is an arbitrary definition, any definition is going to be either arbitrary or seen to be too subjective. The current definition, we believe, is workable and it meets the desired goals. The main alternative raised is the reporting entity concept which has been favoured by the other accounting bodies. While we support that concept as far as accounting standards go, we are not too sure whether it is applicable in this area. We see it as being too subjective and there will be problems for directors making the decision.

Definition 45A has the advantage of having three criteria and these criteria are easy to understand and easy to apply. Furthermore, sections 293, 294 and 340 of the Corporations Law add to the flexibility by allowing either for five per cent or more of the shareholders of a company to demand financial reports or for ASIC to be able to demand financial reports. Section 340 can be used to alleviate inflexibility for large proprietary companies. The reporting entity concept, on the other hand, relies too heavily on subjective decision making of the directors who may, for one reason or another, not wish to report, even though they should. It is a difficult test to police and one that is dependent on expert knowledge to make an accurate decision.

How do you determine whether it is reasonable to expect the existence of users dependent on general purpose reports for information which would be useful to them in making and evaluating decisions about allocation of scarce resources when the people making those decisions are generally accountants? In reality, just about any proprietary company would come under this if a strict approach were taken—or, if a very loose approach were taken, none would. Furthermore, what is required for accounting standards purposes is not always the same as what is required for regulatory purposes, and the two concepts should be kept separate. Therefore, the NIA supports retention of the section 45A test as the most appropriate test in the present circumstances.

Financial statements are an important business tool. They help businesses to set out the position that they are in and it is important for shareholders to know the information that they contain. However, for some companies, mostly small proprietary companies, there is not the same need as there is in large companies for the same amount of disclosure; generally because of the close relationship between the shareholders and their easy access to information. For large proprietary companies it is a little different, because the larger the company, generally the shareholders are more distanced from the actual running of the business. They tend to have one or two people who make the main decisions and the other shareholders stand back a little bit. Therefore, for large proprietary companies, we think there does need to be greater scrutiny and greater reporting requirements for them. However, to make it flexible, we support the current ability of large proprietary companies to seek exemption because of the cost or other problems that would be raised by these financial reports.

We also think that ASIC should be more biased towards granting relief than it currently is. Generally, if the companies concerned have not had any problems with ASIC as there are not any known concerns, we do not see why ASIC should hold back on granting the exemptions. Generally, they will only be asking for the exemptions in circumstances where they truly believe that they would be required. Therefore, we think that ASIC should be a little more lenient in its application and should read the requirements more broadly.

Mr Ord—I will now speak about the number of issues which may not be directly related to the terms of reference of this committee but that we believe do fit into the terms of reference. With regard to accounting standards, section 334 of the Corporations Law gives the AASB—the Accounting Standards Board—the power to make accounting standards. But these accounting standards, unlike other statutory instruments, are not freely available online—currently, there is restricted access to them. We believe that if you are going to require someone to meet a particular standard you cannot restrict access to that information. One of our recommendations is that accounting standards be made freely available online. We encourage this because it has greater transparency and will encourage compliance with the accounting standards.

As an accounting body we do encourage and support our members taking up and using accounting standards. It is not necessary to use accounting standards for the small proprietary companies, but we do encourage it. But if you want people to use accounting standards they should be made available freely online, just like a taxation ruling or an ASIC policy. As they are produced by the AASB, there is a contention that the copyright rests with the crown. Just as with any other act of parliament, if it rests with the crown then they should be making it available online, consistent with other government approaches. We are aware that the Accounting Standards Board is currently reviewing its publication policy. This may include making the accounting standards freely available online. May I suggest that the committee recommend to the AASB that the accounting standards be made freely available online and, in return, that the standards board be compensated for the loss of revenue which it might otherwise have got since it now a self-funding body.

Another area of particular concern to small business is that there are vast inconsistencies in the definition of what is a small business, both within the same legislation and between Commonwealth and state legislation. We believe that the definition of what would be a small proprietary company under section 45A is the most appropriate definition of a small business. To give an example of where there is inconsistency, in the tax act, under the new simplified taxation system you are considered a small business if your turnover is $1 million or less; but if you look under the capital gains tax area, if your net assets are $5 million or less then you are a small business. In our submission we have a number of definitions. One is under the Land and Business (Sale and Conveyancing) Act, where a small business is a business with $200,000 or less in turnover. This inconsistency means there is a lot of trouble for small business. They may be a small business under one definition and a large business under another definition, and each has different compliance costs. For transparency and consistency, one standard definition of small business is needed across all legislation. I know that a number of small business associations have been pushing this for a number of years and we support that push. We believe the section 45A definition—$10 million in turnover, $5 million in net assets, or 50 employees—is the most appropriate definition.

The registered company auditor regime is currently being reviewed by Treasury. Hopefully, we should receive legislation in the second half of the year. We support that process and what is coming out of that process. It is opening up the field as to who can become a registered company auditor. Previously it was quite restricted. As you know, as soon as you start to restrict who can do something you add to the cost. Once you add to the cost of who can do an audit for a large proprietary company it becomes prohibitive. Again, it is an additional regulatory burden on business. In the context of tax reform and with a lack of accountants, we really need to move away from imposing unnecessary regulation.

We do agree that there is a need for the registered company auditor qualification because it does provide a degree of comfort to the community and it meets the public interest test. We are concerned that the registered company auditor qualification is used in a lot of legislation where it is not necessary. In the recent registered industrial organisations bill, if an industrial organisation had a turnover of $200,000 or more, the audit was required to be done by a registered company auditor. There are a number of other state legislations which require a registered company auditor at the same level. Under the Corporations Law, you have a $10 million turnover threshold in which you need a registered company auditor. So you can see that a small proprietary company may not need a registered company auditor under one piece of legislation, but it might need it under another piece of legislation.

This is a particular concern to country businesses because the vast majority of registered company auditors are in metropolitan areas. I will quote a figure, if I may: between 1993 and 1996 there were 87 registered company auditors in Victoria; only four of those were registered in non-metropolitan Melbourne. The same goes for Western Australia where there were 41 registered company auditors and only three were registered in metropolitan Perth. So you can see that the registered company auditor criteria, although beneficial in some sense, is unnecessary for a lot of situations, and we do recommend that the definition used in the Corporations Law be applied across all Commonwealth and state legislation.

Mr Marshall—I would like to very quickly give a summary. As a whole, we do not believe that there is any need to radically change the present regulatory environment for proprietary companies. We do recognise the need, though, to periodically review such regulations to ensure that the purpose they were developed for is actually being met, and we believe there are a number of areas that could be improved and there could be some finetuning to the current arrangements. However, in general, the regulation of proprietary companies is working effectively and efficiently. We are concerned, as Mr Agland and Mr Ord have said, about the provision of the accounting and auditing standards and the definition of small business in the various regulations and legislation. We are open for questions, Mr Chairman.

CHAIR—Thanks very much, Mr Marshall. The evidence you have given to us in a sense generally supports the current process in the large/small test. It is at odds with some evidence which you might have heard this morning from the CPA and the Institute of Chartered Accountants. It is also at odds with evidence from the Institute of Company Directors and also at odds with the Office of Small Business within the Department of Employment, Workplace Relations and Small Business. I was wondering: would you like to account for why you have a different perspective from those other three significant groups?

Mr Ord—As with the other groups, we have regular contact with our members and this area is of little concern to our members. There are other areas of concern and also we believe that the more regulatory burdens you put on business the more you are discouraging business, and this is particularly so for small business. Business already has a lot of financial reporting obligations. Their lenders require financial reporting information. Their members, or their shareholders, require this information. So we do believe that, in the large, the needs of small business are being met. I have never heard small business actually raise this area as a particular area of concern.

CHAIR—What would be your concerns about a return to the exempt proprietary company concept or the adoption of the reporting entity concept?

Mr Agland—We would oppose this option of the reporting entity concept because, as far as we can see, it is a very subjective test and it is a test based on accounting standards, which is good for accountants but it is not necessarily what directors want or what directors understand. The present test has its problems. It is very easy for a company to decide whether it is a small or a large proprietary company and therefore which rules it had to apply. If it had to apply the reporting entity concept, then they are going to have to go through accountants or they are going to make a decision even though they are probably not the best people to make it. For regulatory purposes, as far as we can see, it would be easier to apply the 45A definition than the reporting entity definition.

As far as the other concept goes, we are not so opposed to that. It worked in the past. It had its problems, but it is the same with any test that you apply. You have to find one that works both in the marketplace and for the people who have to do it. There is no point setting a standard for people who are removed from the actual day-to-day running of the business.

Mr Ord—There is enough flexibility built into the current test. If ASIC has a concern about a company it can require them to be fully audited and to comply with the accounting standards. Minority shareholders are already protected in the legislation, as well. We believe that the current test is flexible enough. Regarding the alternative, there could be a situation where a farmer owns some property that may, for one year, go above $5 million and that would push them into being classified as a large proprietary company which would require them to be fully audited by a registered company auditor. There is also the possibility to gain relief from that, so we believe there is enough flexibility built into the current system.

CHAIR—In terms of flexibility, the motor vehicle dealers certainly would not agree with you in their experience with the large/small test. Would you care to comment on their experience?

Mr Ord—We are not really knowledgeable on what has happened to motor dealers. We gain information from other sources.

Ms JULIE BISHOP—Mr Ord, picking up that point about the section 45A criteria where you cited the example of a farmer, two of the tests contained in 45A are applied at the end of the financial year—the consolidated gross assets and employees—so that a farmer whose activities are of a seasonal nature or somebody else who negotiates significant business, which cannot be deferred, at the end of a financial year can move outside the test. You have suggested a fourth criterion—a return on capital. Would that deal with the concerns I have raised?

Mr Ord—I will pass that to Mr Agland.

Mr Agland—We believe it will add extra flexibility to the test. It is something they can look at and say, 'For this reason we have gone above.' But if you apply that test it will make it easier for them to still be a small proprietary company and it adds extra flexibility.

Ms JULIE BISHOP—What would you say to the suggestion that a criterion be applied, say, on the basis of an average of consolidated gross operating revenue, consolidated gross assets and employees over a set period of, say, two or three years?

Mr Agland—That would be even better. In one year you may suddenly expand—for the Olympics, for example. You might bring on extra employees and make extra money, but it may be only for a very short time. Averaging it over three years will keep those sorts of businesses still small proprietary companies. We would support that.

CHAIR—At our hearing on Wednesday night we were told that the cost of compliance with the current regulations is of the order of $20,000 to $25,000 per business and possibly $63 million industry-wide. Does that sort of estimate jell with your experience? Do you think that is a reasonable or affordable cost for small to medium businesses to have to bear?

Mr Ord—Does that refer to large proprietary companies?

CHAIR—Those that are caught and are required to have the audit and lodge their records.

Mr Ord—From our experience, that is about right, on an average basis, because of the cost of bringing in an auditor and having an accountant with significant knowledge of accounting standards and the computer system. This is where we suggest further criteria to add a bit more flexibility. We believe that you have to look back at the public interest test. With these larger companies, it is in the public interest that they remain audited by registered company auditors. If we look at ways of reducing that cost, we may actually lessen the result and we may lose public confidence.

CHAIR—You referred to the public interest requirement. I quote to you what the Office of Small Business said in their submission:

> If the Committee prefers to retain the existing audit requirements, it should be justified on strong public policy grounds which at present are not notably apparent.

Would you care to comment on that?

Mr Ord—That is a fair statement. The $10 million test is quite arbitrary. That figure was chosen initially because once you get above $10 million in turnover you deal quite significantly with the public. The original argument was that over that figure you are dealing largely with the public; therefore, it is in the public interest that they have some safety and they have some knowledge that the company is viable and liquid. That is where the original concept came from. We do not see any particular need to depart from that at the moment. We think the current threshold is quite adequate and the vast majority of businesses will never fall into this large proprietary area. If they do, we believe it is in the public interest that they remain audited to some extent, but there is that flexibility for them still to be granted audit relief.

CHAIR—Is there any evidence that the public make use of the information provided?

Mr Ord—You would assume that most members of the public will not, but you would assume that some creditors may make use of that information. That is probably where the public interest test really lies—with the creditors, not so much with the customers.

CHAIR—Can you outline for me the areas where you think the definition of small business in section 45A should apply? You say that it should be used as a benchmark throughout all Commonwealth and state laws to remove unnecessary compliance costs and regulatory inconsistencies. What sort of areas are you looking at? Are you looking at, for instance, retail trading areas and retail trading hours as they are applied by state legislation—those sorts of issues?

Mr Ord—Anywhere in legislation where it actually tries to distinguish between what is a small business and what is not a small business, we believe there should be some consistent definition. We do recognise that there are revenue considerations, say, in income tax, as to why that would not be so. When we have a business which is not a small business in one act and which is a small business in another act, it creates a lot of confusion for small business.

CHAIR—Do you want to include that in the new tax system rather than the $1 million turnover?

Ms JULIE BISHOP—I cannot believe you mentioned that on 30 June.

Mr Ord—That was one of our submissions—that the section 45A test should be applied in the new tax system. We do not believe $1 million in turnover is adequate. It is quite easy for a retail shop to get more than $1 million in turnover in a year, but I digress.

Ms JULIE BISHOP—It seems that you are coming from the notion of a standard small business criterion, whereas the other accounting bodies are coming from a consistent basis for financial reporting requirements. So it is apples and oranges, isn't it?

Mr Ord—We have to look at what the capability is of the end user and what information the end user needs. There is definitely a need for better financial reporting for the end user in the small business area. Hopefully, the new tax system will do that. We have to look at the capability of the end user. The end user, for a normal small business, does not understand what a balance sheet does, does not understand what a profit or loss does and does not understand what a cash flow does. They understand what their bank statement says—that is about all.

CHAIR—In that context, whom are you defining as the end user?

Mr Ord—The end user in that situation would be the owner. Their lenders already require this information, so in some respects it has already been required. We have to look at who the end user is and base everything around that. As for starting to impose a regime which is the same for every business, it is like comparing apples and oranges: you cannot compare what a Coles Myer might need to report with that of a small business down the street. We think what they do now is quite adequate. The extra compliance regime from the new tax system, dare I say it, would be a benefit as well. The only real person who benefits from this type of information is the accountant. The normal small business owner does not understand what the return on capital is, does not understand the rate of return on investment and does not understand the quick asset

ratio. That does not mean anything to the person at all. They want to know how much money is coming in. What reports their accountant produces should be based on what they can get out of it and what the small business owner can get out of it.

Ms JULIE BISHOP—Wouldn't the reporting entity concept cover your concerns as well in relation to small business? As I understand it, the reporting entity test takes into account size, economic significance et cetera.

Mr Agland—Yes, it would take into account all those issues. But who has to make the decision as to whether you are a reporting entity or not? In the end, it is the directors. I am not sure that directors in many circumstances in small businesses are going to be able to properly make that determination. With the small/large test under 45A, they are able to know whether they fall in or out of that test in most circumstances. Some will be on the borderline and it will be more difficult for them to make that determination, but a lot of companies will know beforehand within a certain range whether they are likely to fall in or out. I think that for them that test is easier than the reporting entity test.

Ms JULIE BISHOP—So if we were concerned with the problem of incorrect classification, you would say—and do not let me put words in your mouth—that the risk of incorrect classification would be greater under the reporting entity test because it is up to the directors?

Mr Agland—Yes, because it is up to the directors. In many circumstances they are not experts in it. There may be reasons why the directors choose whether they apply it or not, and they might have their own reasons for deciding that they should not be a reporting entity when in reality they should be.

Ms JULIE BISHOP—Could I put to you the same question as I put to the previous witnesses about whether anyone has done an analysis, even a rough analysis, of how many companies would be differently classified under the different tests?

Mr Agland—I have not done any large analysis. I do not think there would be a large difference in the amount of companies that would be reporting entities that would be large under section 45A. There would not be many different companies caught out. The outcome would be very much the same. It is just that to me the end user would understand better the section 45A definition than the reporting entity definition.

CHAIR—That concludes our questions. Thank you very much for appearing before the committee, presenting your evidence and answering our questions.

Mr Marshall—Thank you, Mr Chairman. The National Institute of Accountants appreciates the opportunity to be able to present information today.

Proceedings suspended from 10.29 a.m. to 10.40 a.m.

[10.40 a.m.]

KNOTT, Mr David William, Deputy Chairman, Australian Securities and Investments Commission

McCAHEY, Ms Jan, Chief Accountant, Australian Securities and Investments Commission

NIVEN, Mr Douglas David, Deputy Chief Accountant, Australian Securities and Investments Commission

TREGILLIS, Mr Shane, National Director, Regulation, Australian Securities and Investments Commission

CHAIR—Welcome. We have before us your submission which has been published. I assume there are no alterations or corrections you wish to make to that.

Mr Knott—That is right.

CHAIR—I offer you the opportunity to make an opening statement and then we can proceed to questions.

Mr Knott—As you say, we have delivered a reasonably comprehensive submission on each of the five terms of reference and I will, therefore, confine my opening comments to some of the key contents of the submission and optimise the time then available for discussion. The first point to reinforce is that ASIC supports the statutory differentiation between large and small proprietary companies as installed in the Corporations Law by the 1995 simplification act.

We believe that the large/small test is a relatively simple, yet relevant and objective means of distinguishing the small minority of economically significant proprietary companies for financial reporting purposes. In this respect, it is important to note that the prime objective of the First Corporate Law Simplification Act 1995, namely that the overwhelming majority of proprietary companies should be free of financial reporting requirements, has been achieved. This relief continues to encompass more than 99 per cent of the relevant proprietary company population and relieves more than 1.15 million proprietary companies from previously prevailing regulatory requirements.

The statistics which we have included in our submission also indicate that a majority of the balance of the proprietary company population—that is, the large proprietary companies—exceeds the minimum tests prescribed by section 45A(3), often by a substantial measure, thereby reinforcing their economic significance. We believe that the statutory obligation of those companies to prepare financial reports is appropriate and our submission indicates a reasonably active level of public access through ASIC's database to the accounts of such companies.

While our submission supports the overall effectiveness of the large/small differentiation, we have commented on certain aspects which we believe have resulted in an unlevel playing field. Principally, this concerns the treatment of the two classes of exempt proprietary companies under the old law. Under that law, those companies had the option of either auditing their

accounts, in which case they were excused from lodgment, or of lodging unaudited key financial data.

When the shift to the large/small test was introduced, it was decided to overlay that test by grandfathering from lodgment those large proprietary companies which had been in the practice of auditing their accounts. This overlay has resulted in the accounts of some 2,101 large proprietary companies being unavailable for public scrutiny. Our submission discusses several aspects of this anomaly and suggests various methods by which it might be addressed. The comments we have made in the submission reflect the experience we have gained in administering the new law.

The second key issue which I wish to highlight from our submission goes to the quality of accounts lodged by large proprietary companies. The law requires that such accounts be prepared in accordance with accounting standards, but the full requirements of many accounting standards are expressed to apply only to reporting entities and there is no explicit relationship between that expression and the statutory definition of large proprietary companies. ASIC believes that all financial information provided on the public record should be of consistent quality and is concerned that some companies which are required to lodge accounts nevertheless claim that they are not reporting entities and, therefore, escape the full rigour of accounting disclosure.

Again we are reflecting our on-the-ground experience, which has included deficiencies in disclosure, which we have described in our submission and can expand upon this morning. That experience suggests to us that the disconnect between the definitions of ‘large proprietary company’ and ‘reporting entity’ undermines the public policy objectives which led parliament to draw a line in the sand at the large proprietary company level and which assumed that above that line the public would have access to reporting entity level disclosure.

ASIC is not able fully to resolve this problem. However, we believe that to be compliant with the Corporations Law all large proprietary companies must observe the recognition and measurement provisions of accounting standards. It is apparent that some companies have concluded that such observance is optional, giving rise to accounts which may not comply with the overarching true and fair view requirements of the law and which do not report profits on a consistent and comparable basis. We have briefed your committee, Chairman, with a draft information release which we propose to issue and which will address this matter and, we hope, improve the quality of reporting from this sector.

We understand that some stakeholders prefer to seek out a different solution, and we remain responsive to any concrete proposals which may be formulated over time. In the interim, our information release should act to clarify the standards which we expect to be met under the law.

In conclusion, our submission addresses the final three terms of reference dealing with ASIC policy and the administration of the current law, particularly in relation to the exemptions and modifications powers under part 2M.6. We believe that we are implementing the law in a manner which is both practical and reasonable, but will be pleased to discuss those matters more fully with you this morning. I hope that those introductory comments are of some assistance and my colleagues and I are now available to answer any questions you may have.

CHAIR—Thanks very much, Mr Knott. Can I first refer you to the evidence—and you may have heard my reference to it earlier—from the Office of Small Business, which was in effect that there has been no real public benefit test, they believe, met to justify the new provisions and, therefore, they believe that the provisions should be either removed or modified to a significant extent because of the cost impact on small business.

Mr Knott—And you would like us to comment on that submission? Perhaps Ms McCahey might answer that question.

Ms McCahey—I think that what we would say is that the number of accesses to information that have been made on the public database indicate to us that there is a level of public interest in the information that is provided in the financial reports of large proprietary companies and being made available on the database. Of course, it is not our role to develop public policy—ours is to administer the provisions of the law as they are—but it does seem to us in our role of administering the law that there is a reasonably active use of the information that is being made available by companies. So we would judge there to be sound benefits resulting from the provision of the financial information, against which, of course, must be weighed costs incurred by individual companies in preparing the information. But it does seem to us that there is certainly a public benefit.

CHAIR—The other evidence we have heard, which was again confirmed this morning, is that the cost to an individual medium sized enterprise is about $25,000 per audit and an overall cost of $63 million. Would that be consistent with your assessment of cost, and again do you believe it is a cost that businesses of that size can reasonably bear?

Ms McCahey—Costs will vary from one company to another, of course. Depending on the complexity of business, that will bear on the cost of audit. We would not be in a position to make a positive or a negative comment in relation to the totals that you present. One thing that needs to be said is that it is much easier to identify the costs of compliance by individual companies and much more difficult to identify in a broader aggregate sense the benefits to the community from those companies providing the report. So, in all of those sorts of cost-benefit analyses that we seek to talk about in the financial reporting area, there is inevitably the problem that the benefits are enjoyed by the public at large; with respect to the community in general and the standards that it expects from information that is made available on the public record, it goes to the integrity of information that is being provided; and there is the role that integrity plays in the way the markets work. There is not a lot that we can say about the detail of the cost-benefit equation.

CHAIR—On page 11 of your submission, there is a table that indicates the number of companies that have obtained relief. Do you publish the number of companies that apply for relief under section 341?

Mr Niven—This was in relation to the applications for audit relief. Most of the companies that have obtained audit relief have fallen into the relief provided by a class order, so there has been no need for them to make an application. We have not actually quantified the number that made individual applications who had not fallen within the terms of our class order. I could probably give you only a rough number based on my feeling from talking to people in our regional offices. A lot of the companies that have applied for audit relief on an individual basis

are also the ones that have applied for lodgment relief, and we have mentioned those applications in our document. I would have thought it would be something in the order, including the lodgment relief applications, of 40 or 50. But we probably need to take that on notice to give you more precise details of the applications on an individual basis.

CHAIR—Do you think that something that perhaps ought to be published in your annual report is the number of companies that seek relief and the number that are actually granted relief?

Mr Niven—I think that is a difficult one because there are so many areas of the law that we administer, and this is only one of them. I guess it is a question of how much emphasis should be given to each area of the law that we administer. One of my colleagues may wish to comment further on that.

Mr Tregillis—I think that is right. We have wide-ranging discretions. We keep statistics for that, and for the number of applications that we would get across our range of functions, but it is quite extensive. A large part of the commission's activities is the granting of relief. Individual applications will often contain numerous requests for relief as well. So there is an accounting issue. Each application may in fact request a series relief, both audit lodgment or combined with other forms of relief. We do keep internal statistics on that information.

CHAIR—As you are probably aware, we have had two propositions put to us as to alternative regimes that in each case the witnesses believed would be a better regime than the current regime. The first was put by the Institute of Company Directors, which was a return to the exempt proprietary company but with a requirement that all directors of the company sign a statement of solvency, combined with the preparation of financial statements but not a requirement that they be lodged or audited. Then we heard the proposition this morning for the use of the reporting entity concept as a better measure of the requirement to lodge information. I am wondering what your view is of those alternatives compared with the small/large regime we currently have in place in terms of comparative benefits and comparative shortcomings of each regime.

Ms McCahey—The first point we make is this: the merits of reverting to the exempt proprietary test rest on the objective of the requirement to report. We understand that the objective embodied in the law at the moment is that economically significant entities, deemed in this case by the large/small test, would be required to report. We would not see that the exempt proprietary company test would meet the objective of economically significant entities reporting because the measure of whether a company is economically significant to us is not determined by its ownership characteristics alone. That is the first point.

In relation to the proposal regarding reporting entities, the test that is currently embodied in the law appears to be directed towards meeting the reporting entity test in the sense that the reporting entity test is trying to say—if it were applied in this context—that the entities that ought to be reporting are those where it is reasonable to expect there are users who rely on the financial information of that company to meet whatever information needs they had for their decision making. That jells quite well with the objective of economic significance. The concern we have with the reporting entity test is that it is very subjective to apply in practice and the great advantage of the tests that are currently embodied in the law is their simplicity. That is not

to say they do not have their own problems, but objective tests are much easier for people to apply in the first instance, for directors and others to make their judgments on, and for us as a law enforcement agency to enforce.

CHAIR—I would like you to comment on an issue that was raised this morning that businesses under the reporting entity concept are required to meet the formal accounting standards and businesses under the small/large test are not necessarily required to do that for the financial statements they lodge.

Ms McCahey—It is indeed unfortunate that the same test does not apply to both lodgment and content of financial statements because it is certainly the case that the quality of the financial information appearing on the public ASIC database is lacking in comparability. The quality of the information being prepared is variable because some of the large proprietary companies have identified themselves to be reporting entities and therefore are complying with all the detailed requirements set out in accounting standards, while other large proprietary companies are identifying themselves to be non-reporting entities and, as a result of that, making an interpretation that the suite of accounting standards does not necessarily apply to them. Application clauses of standards generally say, 'This standard must be applied by reporting entities' and they feel they can say, 'I'm not a reporting entity so I don't need to comply with all of this.'

From our perspective there are some inconsistencies between taking that interpretation of the quality of the information that needs to be prepared and the requirements of other areas of the law. Mr Knott referred you to our concern that there are other provisions in the law—for example, the need to prepare true and fair accounts, the need to be paying dividends only out of profits, and the requirement that financial reports, or any information, not be false or misleading. We would be of the view that there is an onus on all large proprietary companies, in order to meet the provisions of the law, to comply with what we would call the recognition and measurement rules of accounting standards. Those would be the rules that would ensure that a company included in its financial reports all its assets, all its liabilities and all its revenues and expenses for the financial year and, what is more, did not include revenues relating to a different year or put expenses somewhere else to be included in a different year.

So it does seem to us that there is that implication already in the law. Mr Knott referred you to the information release we are proposing to issue which will try to address the interpretation that is being made by some companies at the moment. I think the release can go a long way to setting out clearly for people what is, in our view, the valid interpretation of the law; although it certainly would not be as neat a solution as bringing together formally the nexus between the requirements on companies in terms of what they must do to prepare appropriate accounts for the database and identifying which companies it is that need to lodge accounts on the database.

Ms JULIE BISHOP—So if we were moving toward a single set of criteria, would that need to apply to public companies as well?

Ms McCahey—Yes, that is right. I think an appropriate approach to take would be that all companies whose accounts are being lodged on the database would be deemed as reporting entities, if you like, for the purposes of the requirements of accounting standards that would apply to them. That would be, if you like, the simplest solution: all companies that are

reporting, putting their information on the public record because parliament has identified that as being appropriate because they are of economic significance, would be deemed to be reporting entities for the purposes of the provisions of the financial reporting requirements in terms of the content of financial statements.

Ms JULIE BISHOP—And you would get your comparability.

Ms McCahey—That is right. We would get comparability and high-quality financial reporting.

CHAIR—If the current regime is to be maintained, do you believe it should be amended to give ASIC the capacity to provide relief on the grounds of international competitiveness—and I am referring here to the Incat example, obviously? Lodging documents might be detrimental to the international competitiveness of the particular company, ought that be grounds by which ASIC is given the power to give audit relief?

Mr Knott—I am a bit reluctant to answer that in a definitive way because I think it is a question of policy that extends well beyond that particular example you have just mentioned. One might, in a general policy sense, apply that same logic to disclosure generally. There may well be cases, including cases of public companies, where one might argue that, because of differential disclosure or reporting standards in different jurisdictions, the requirements of the Australian law puts them at a disadvantage. So as a broad proposition it is not one that appeals, and I think it is subject to the same sort of difficulty if one applies it to the specific type of example you have given.

Ms JULIE BISHOP—Just on another tack, I was rather interested in your comments about ASIC's understanding of the level of access to the public database as being an indication of public interest. I was going through your table on page 15 and I was reminded of my own web page, where I boast how many hits there are and then do not reveal that most of them are by me. We have here something like an average number of accesses—around one, two or three per company per year—but that does not take into account the number of, say, company secretaries who are accessing the ASIC database to check up on their own company. Is this really a useful guide? Is this really a gauge of public interest in terms of the benefits of lodgment requirements?

Ms McCahey—It certainly could not be regarded as being complete in the sense that it identifies here only accesses that have not, in our case, been undertaken by ourselves.

Ms JULIE BISHOP—But by the company, that is my concern, not by ASIC.

Ms McCahey—No, not by the company, but then we would expect many companies would have that information themselves, so using our database would not be the mechanism for them obtaining their own financial information. I would also point out to you that it is not possible for us to identify whether, say, a rating agency or similar company interested in providing financial information about other companies to others has made an access because in that case, for example, one access might be being made effectively on behalf of hundreds of others.

Ms JULIE BISHOP—The multiplier effect?

Ms McCahey—That is right.

Ms JULIE BISHOP—This is how the *West Australian* newspaper describes its circulation figures: 400,000, but there would be hundreds of thousands who read it in hospital waiting rooms and the like.

Ms McCahey—That is the difficulty that we have in trying to elaborate in detail or provide a comprehensive summary. But what this table does say is, clearly, the information is being used.

Ms JULIE BISHOP—The question is: by whom?

Ms McCahey—That is right.

CHAIR—The other major concern that has been raised with us is that of the motor vehicle dealers who sought relief under a class order and that was denied. I wonder whether you would like to comment on that, particularly on the reasons for that particular class order and its effectiveness in operation.

Mr Knott—It seems fair that Mr Tregillis answer that question as he has a long history with this sector.

Mr Tregillis—I will give you a bit of background. We have given this in evidence on a number of occasions before this particular committee before, during and after the development of that relief. We have always indicated that there were quite divergent views and that the difficulty for ASIC—and it is still represented in these submissions—is that we would be accused of being either too liberal and subverting the fundamental intentions of the requirements, or too narrow. That debate still seems to continue.

In terms of the relief, as we have put in our submission, that was an extensive period—12 months—of consultation. In the end we reviewed that. In coming to the final class order relief, the considerations that led us to its current form were that we did release a draft in about May that contained a package of requirements, including cash flow and some of the things that the MTAA mention, and we received about 45 submissions which pointed out some of the difficulties and complexities with that.

The final form of the class order relief is an attempt for it to be as objective and as simple to administer as we could make it. Some of the major issues raised, for example, about trade creditors were that that was highly uncertain and therefore subjective and in a class order it was quite difficult for people to know whether or not they fell within it. Secondly, we had concerns about whether we had actually provided real protections to creditors, because that is fine until something goes wrong.

In terms of the gearing ratio, there had always been a requirement that we had proposed that assets exceed liabilities. This was an attempt to make that clear and provide a buffer for creditors—again, it was an attempt to clarify. Right up to the last moment there were very strong and divergent views. It was still being put to us that any exercise of class order relief was in fact outside power. On the other hand, we were getting views that any cost of audit should be taken into account whatsoever. In the end, we sought to apply the policy of parliament that large

proprietary companies should be audited. The unreasonable burden test, as set out in the policy statement, goes beyond the mere cost of audit and it is about the minimal benefits. That is the balance that class order seeks to make.

In terms of the specific issues, again we had information at the time that there are large single creditors for the Motor Trades Association under the floor plan deal, with a reasonable percentage of unsecured creditors. It is interesting to note in their submission that the figure they quote is still about 20 to 40 per cent, although I think that probably includes purchasers and it is not clear which percentage represents trade creditors as opposed to purchasers. But we would still regard 20 to 40 per cent as a large percentage of unsecured creditors at risk, and the protections proposed do not quite provide the level of comfort required to remove the audit relief. They were considerations rehearsed at that stage. I do not think there are additional considerations raised in the most recent submission. They were issues canvassed at the time.

CHAIR—Do you acknowledge that it is virtually impossible for all motor dealers to reach this asset-liability ratio that is required, given the nature of their floor plan financing and so on?

Mr Tregillis—I think we would accept that it is difficult, although in the calculation of liabilities we do talk about approved subordinated debt. So that provides an avenue, and we have issued a pro forma that enables them to effectively subordinate liabilities to ensure that the unsecured creditors are not at risk. That does provide one mechanism that I understand has actually been utilised on a number of occasions by some, but I am not quite sure how many.

CHAIR—Do you think there is an anomaly whereby businesses operating through family trusts are exempt from the audit requirement?

Ms McCahey—Maybe I should address that. There is no doubt that businesses which are pursued through trust arrangements are not dealt with in these financial reporting provisions. That is just a fact. It is a question of what this law deals with. This law deals with corporations.

CHAIR—In relation to the specific class order relating to the motor vehicle dealers, have you made any assessment of the public benefit consequential on that class order?

Mr Tregillis—Again, in terms of the debates at the time, it depends which side you are on. But I suppose we would take some comfort that, in terms of the actual outcome, 16 per cent had been able to use the class order. That, in some senses, gives us comfort that it was not significantly large enough to undermine the intention of parliament about large proprietary companies. At the same time, it is not such a small number as to show that class order was so tight or unreasonable that nobody could take advantage. Again, reactions to that figure would probably depend on your starting position in the debate about what you thought the result should be. But that is about the only indication that, in some senses, at least on a percentage figure, that did not look too out of line with using relief to be facilitative without actually undermining the requirements for large proprietary companies. But I do not think we have done any more assessment than that.

Mr Niven—Perhaps the only other thing that it is worth while to relate is that the Motor Trades Association, in their submission, point out that their assessment is that the unsecured creditors are of the order of 20 per cent to 40 per cent. So there would be some benefit in

relation to the audit there but, as Jan pointed out earlier, there is a difficulty in quantifying benefits and comparing those with the more quantifiable costs associated with the audit itself.

Ms JULIE BISHOP—Mr Knott, you have said that overall the large/small test seems to have met the original objectives. It has been suggested that perhaps a further test be added to it for clarification. One suggestion was a return on capital test, and another suggestion—not this morning—was that there be a criterion applied on the basis of an average of consolidated gross operating revenue, consolidated gross assets and employees over a set period of, say, two or three years. Do you have a comment on either of those proposals?

Mr Knott—The overriding comment from our point of view is that the formulation of those tests is not a matter for the regulator, but, whatever those tests may be, they ought to be objective and they need to be capable of easy determination for the directors of the companies involved, for the regulators and for the marketplace generally.

Now, to the extent that some of the proposals I heard this morning might take into account more than one financial year, average periods and the like, I think they create some difficulties in terms of the objectivity one might be looking at for any reporting period. In terms of other economic tests—returns on capital and the like—I have no comment to make one way or the other as to whether it is desirable but, no doubt, additional tests could be imposed, if that were the will of parliament, to clarify in a policy sense what this line in the sand is to be above which, as a matter of public policy, parliament wishes companies to lodge financial reports.

Ms JULIE BISHOP—The examples that people were considering related to seasonal adjustments or where a financial transaction was entered into at the end of the financial year, which would have affected whether or not the entity came within large or small. Would you see the way the law currently stands as being able to deal with those situations anyway in terms of seeking relief?

Mr Knott—Ms McCahey will add to my answer, but I think that the emphasis in this area has been for simplicity, a test that is simple to apply and simple for the management involved to calculate. Taking the end of the year as a cut-off date and looking at the situation then achieves that objective. Of course, as Ms McCahey has already indicated, there are difficulties with these things at the margin. We would say that these difficulties are at the margin. I just emphasise again that the objective of the simplification reform has been achieved overwhelmingly: more than 99 per cent of companies which would have been under regulatory burden are no longer so. We are talking very much about a small group of companies and we are talking about a narrow range of issues. Do you want to add to that, Ms McCahey?

Ms McCahey—The only thing that I would add is that the test is designed to ask: at the end of the year is the company economically significant—yes or no? I do not think the test was designed to say maybe it was not economically significant last year and so should we be taking that into account? Maybe it should not be a large proprietary company treated that way for this year? We would say that it is just easier to say, 'Is it now?'

Ms JULIE BISHOP—I refer to your analysis of 99.4 per cent of proprietary companies that are not required to report now. How different would that analysis be if we were to adopt the reporting entity concept? You have heard me question previous witnesses on this. Are we

talking about a vast number of companies that would be reclassified or are we just talking about the edges here?

Mr Knott—The real difficulty is that we cannot know the answer to that question, partly because of the subjectivity of the concept of reporting entity. One would hope that the definition of large proprietary company has used tests of economic significance that would create a quite strong parallel with the reporting entity definition. Indeed our argument is that it does and it should. But if you have a company with a thousand employees, $100 million worth of turnover and more than $50 million worth of assets that says it is not a reporting entity—and that is what we have in the instance referred to previously by the chairman—who is to say how many companies would argue that they were not reporting entities?

Mr Niven—One thing we could add to that is that in the report that we did to the Senate in 1988 we did a sample of roughly 400 large proprietary companies—

CHAIR—It was in 1998.

Mr Niven—Yes, 1998, sorry. In looking at that particular sample, we found that 56 per cent of those large proprietary companies classified themselves as not being reporting entities. That is not to say that the classification was necessarily appropriate, but that is an interesting indication of the situation.

Ms JULIE BISHOP—As a regulator, are there difficulties in your view with consolidated financial statements?

Ms McCahey—Are you referring to the comments that were raised this morning about the difficulty of classification?

Ms JULIE BISHOP—It is in terms of, say, the parent entity not considering itself a reporting entity and any difficulties that that might create.

Ms McCahey—I guess we would go back to the comments that I made in my remarks earlier. They are that there are going to be difficulties in terms of the lack of comparability and the quality of financial information that is prepared if an entity can identify that it is a non-reporting entity and then go on to make the interpretation or the claim that because of that it does not need to comply with all of the measurement and recognition requirements of accounting standards.

Ms JULIE BISHOP—Including not preparing consolidated accounts.

Ms McCahey—Consolidated accounts. So that is just one of the outcomes, I think.

CHAIR—You are familiar with the MTAA submission. You might have noted on page 16 they set out a series of questions. It is on page 154 in terms of the bound volume of submissions, but page 16 of their submission. I think it would be useful for the committee to have answers to those questions. You might care to take them on notice. Would you prefer to take them on notice or answer them today?

Mr Tregillis—We can take them on notice but I suppose when we did work through them we actually thought most of them or nearly all of them were actually addressed quite explicitly in our submission. So, if there is something you do not think is actually addressed, we could respond to that. But when we worked through them we looked at the usage of reports and tried to provide whatever information we had. I think we tried to answer what we expect but we cannot actually confirm the usage in response to your question. We talked about the test criteria and our attitudes to that. With costs, we do not have direct knowledge of the costs of audit, but we responded to that. When we worked through these when we received it, we thought we actually addressed them in slightly different terms and probably not directly in response to those questions, but there was nothing that we felt we had left unaddressed.

Mr Knott—I think I should add that when we read these questions and looked at the date and noted that it was quite soon after our own submission, our assumption was that the association had probably not seen our written submission when these questions were formulated.

CHAIR—No, they would not have. The submissions were released all together.

Mr Knott—I see.

CHAIR—Thanks for your response on that. I do not have any further questions. On that basis, thanks very much for your evidence to the committee this morning and your answers to our questions.

[11.24 a.m.]

BALCOMBE, Mr Lance Bradley, Company Secretary and Chief Financial Officer, Incat Tasmania Pty Ltd

CHAIR—I now welcome the representative of Incat. We have before us your submission which has been published by the committee. Are there any alterations or corrections you wish to make to the submission?

Mr Balcombe—No, there are not.

CHAIR—In that case, I invite you to make an opening statement, at the conclusion of which we will proceed to questions.

Mr Balcombe—Thank you very much for the opportunity to appear before the committee today. I suppose I really have not done too much about following the guidelines. What I have done is speak about Incat's particular case which, as you can see, went over about a four-year period.

From Incat's point of view, we regard ourselves as a good corporate citizen and we chose to apply for relief as opposed to restructuring the group, which I note from the content of some of the submissions was a course of action that several companies had chosen to adopt. I suppose we went down the route of applying for relief because we thought we were a fairly good candidate to be successful in any such application.

I suppose that throughout the course of our application and subsequent objection to the AAT and our appeal we felt that the position taken by ASIC was one where they really wanted to concentrate on Incat's economic significance rather than really what presented the facts. I suppose ultimately we had to accept the umpire's verdict, but unfortunately, in our view, it will be to the detriment and harm of our business.

Unfortunately, ASIC are choosing to continue to investigate our business. Sometime in March—I cannot remember the exact date—we were obliged to lodge our accounts in accordance with the orders of the Federal Court. At that time we lodged non-reporting entity accounts. Since then we have been subject to an investigation by officers from ASIC where they are attempting to prove that Incat directors did not adequately consider the reporting entity proposition. This is despite receiving expert advice and despite the matter being addressed throughout that four-year period where we sought relief. We are still somewhat concerned about that and really we would like to see this committee come up with some recommendations that perhaps clarify that situation for all parties.

I suppose one of the big issues we have is the current inconsistency in relation to grandfathered entities and, again, it sort of flies in the face of the position that has been adopted by ASIC where they are saying that Incat is an economically significant entity and therefore is a reporting entity. However, there must be several companies within those grandfathering provisions that must be economically significant. ASIC has not chosen to pursue those companies to require lodging accounts. So we see that as being a substantial inconsistency.

There has been a new accounting standard released, AASB 1018, which is a statement of financial performance and which becomes effective for all companies required to prepare financial accounts in accordance with chapter 2N of Corporations Law for the year ending 30 June 2001. So basically it applies to all companies which are required to lodge accounts with ASIC.

This new standard prescribes the basic format of the statement of financial performance or, for want of a better term, profit and loss account. This standard actually requires significant additional disclosure, including cost of sales where applicable. The introduction of this standard essentially hands the margin per ship to Incat customers and competitors and basically is even more accurate than the information we are currently required to produce.

Unless this committee makes a recommendation that reporting entities are only required to lodge accounts, the imposition of this standard has the power to impact significantly on Incat margins. The ultimate loser in this is Australia with potentially lower revenue from tax collection, lower employment levels and lower exports. It is our view that this standard is really only relevant for entities which are not closely held and should be required for reporting entities only.

I suppose we should perhaps flag that we may have to consider restructuring or somehow tailoring some of our transactions to try and change the information we are presenting, and certainly that is not what we want; that is not our objective. Certainly on a consolidated basis it would not make any difference, but so far as an individual company by company reporting is concerned, it may alter.

I have read a few of the submissions and I would like the opportunity to comment on a few of those. I have read the submission of Mr Ravlic. He appears to have adopted the view that large corporates which are not reporting entities choose not to comply with accounting rules and produce lower than reported results or somehow change results. This should not be the case as reporting entities are still required to comply with some accounting standards and, ultimately, directors must produce accounts that are true and fair. The paper that Mr Ravlic produced appears to take the view that accounts are prepared on the basis of what suits accountants and directors at the time. The majority of companies certainly do not fall within that.

The majority of the submissions support the proposition that only reporting entities should be required to lodge financial statements. As you can see from my submission, we certainly comply with that. However, I cannot agree with the recommendation from Bentleys MRI that we need ASIC to act as umpire, whether or not his argument as to whether the reporting entity/non-reporting entity definition is applicable. In my view, and from personal experience, ASIC adopts a far too biased approach in this regard. This is also reflected in the submission from the Institute of Chartered Accountants, which, although not recommending the reporting entity approach, does recommend that ASIC, when reviewing a request for relief, adopt a stronger bias towards granting relief.

Further, ASIC, in the draft information it released on the reporting requirements for non-reporting entities, states that, because a company has a significant number of creditors and employees, these companies should be classified as reporting entities because it would be reasonable to expect the existence of users dependent on general purpose financial reports. My

personal view is that the words 'reasonable to expect' are far too subjective and broad to apply in making such an important distinction. In reality, it is only the directors of a company who can determine where there exist users who are dependent on the receipt of general purpose accounts.

I do not have too much else to say to the committee. Frankly, I would like to get back to the good old days when there was this lovely distinction between exempt and non-exempt proprietary companies. It was pretty easy to determine. We have come from that. I do not have too much to say on audit. Our accounts are audited and we are audited really by a function of our financing facilities, through our banks and financiers. We are happy to be audited. However, the lodgment of accounts is going to be detrimental to our business and our margins.

CHAIR—Thanks, Mr Balcombe. I do not know whether you were here when I asked ASIC questions in relation to your particular circumstances. Part of their response was that a number of companies could claim that their international competitiveness would be disadvantaged by their financial details being lodged and, therefore, publicly available, even including listed companies. I am just wondering what your response is to that.

Mr Balcombe—I do not know whether you can have a broad generalisation about international competitiveness. The issue for our company is that we build four homogenous units a year. They are identical products. Hopefully we sell those each year that we build them and, therefore, it is a pretty easy exercise, particularly with the release of this new standard under which we can identify margins. I cannot speak on behalf of all exporting companies but, from our point of view, release of the financial information does provide the opportunity for customers, and obviously competitors as well, to easily establish margins. That is what affects our international competitiveness—nothing else.

CHAIR—Is that really the only issue of concern that you have about the current regime?

Mr Balcombe—That is where I come from. I have done 4½ to five years work on this now and I have a pretty good feel for it from our point of view. It is interesting to note that we are the only individual corporation that is represented here today, so I suppose our case stands out from that of the majority of other companies. The issue for us is that we do not want to lodge accounts because it will harm our business.

CHAIR—Have you estimated the cost to you of complying with the requirements?

Mr Balcombe—The cost of compliance has not been a great deal because, as I say, we are obliged to audit. The cost is $30,000 to $40,000 per annum. With regard to the cost of lodging accounts, we prepare those anyway, although admittedly we did redraft our accounts from the ones that we normally present to our financiers. We actually tailored our accounts, which we lodged, so the costs were not an issue.

CHAIR—And the cost of seeking relief?

Mr Balcombe—It was fairly significant. That was four years of work on my part, with lawyers and accountants—probably towards $150,000.

Ms JULIE BISHOP—Could I just seek a clarification. Perhaps you could assist me with my understanding of that issue. In relation to your application pursuant to policy statement 43, you have stated in your submission to the committee:

> Incat … provided expert evidence that indicated that due to Incat's purchasing power and production line method it was impossible to make an accurate estimate of Incat's production costs and, accordingly, its profit margins.

In your observations to us you acknowledge that you have had to accept the umpire's verdict and have lodged annual statements for the years going back to 1996, and you note there has been no impact on profitability. Then you say:

> However Incat is firmly of the view that margins will be impacted by the release of the financial statements due to customers' (or potential customers') ability to establish profit margins per unit sold.

Am I reading a conflict there?

Mr Balcombe—No, you are not. Basically, on the information that was available prior to lodgment, which was nothing, people could not estimate how much money we were making. All they knew was the sale value of a ship. Incat operates on a production line method. For example, we are the largest purchasers of aluminium in Australia, we are the largest purchaser of Ruston diesel engines on the globe and the way we produce ships is different from any other producer in the world, so people cannot estimate how much our ships cost to produce.

Ms JULIE BISHOP—Not even approximately?

Mr Balcombe—This is an argument that ASIC used. They used the words 'rough but valid'. But 'rough but valid' was some millions of dollars out—I say $5 million to $10 million out. The issue is whether you think an estimate is going to harm us or whether an accurate figure is going to harm us when we are negotiating with a customer. He pulls out your accounts and says, 'I know you are making X million dollars per ship. I am going to halve that.' He could quite adequately say that is too much. Whereas, if you were across the desk and saying, 'I think you make that much,' we would have to say, 'You prove it to us.' Your negotiating power is reduced if you are relying on estimates. ASIC were pulling figures out of BRW. We have never provided figures to BRW, other than an estimate of what our annual bounty receipts are or something like that.

Ms JULIE BISHOP—Other than to refute them, perhaps.

Mr Balcombe—Yes, perhaps so. But you would have to admit that, if you are relying on estimates, your bargaining or negotiating position is greatly reduced, whereas if you are relying on accurate figures it has to be enhanced. It is very hard for us to disprove when someone actually tables documentary evidence across the table about our margins but, if you are sitting across a desk trying to estimate how much money we make, it is not very good negotiating and it is stuff we can easily refute.

Ms JULIE BISHOP—Your company would obviously be deemed to be a sophisticated company. You have competitors. Would you not be able to estimate quite closely your competitor's position?

Mr Balcombe—I am quite happy to talk about our competitors. Incat is a case in point. Our biggest competitor is Astral, in Western Australia. Astral is a company that builds a range of ships. They are just about to start building a 101-metre ship. They build 95-metre ships and they build 82-metre ships. They also build tugboats and they build luxury yachts. They have a range of ships thrown into a pool, for which there are revenue and costs. Incat builds four identical ships every year. They are homogeneous. The only change is that they may be somewhat larger between production runs and normally we build four to six of any one model. We are currently building 98-metre models, we have just built four 96-metre models, prior to that we built four 91-metre models. So they are a homogeneous unit and all they are is stretched. They are identical: same machinery package, same electronics package, same number of seats. All their ships offer is increased deadweight, which is carrying capacity. The selling prices are easily recognised because we publish selling prices. We do not publish costs. Astral, on the other hand—I do not mean to focus on Astral, but it is typical of a lot of shipbuilders—

Ms JULIE BISHOP—You are just doing it because I am from Western Australia; I appreciate that.

Mr Balcombe—Not at all. You would know them very well; you should be proud of them. They have a product range. They do not build four homogenous units every year; they build a range of products. So it is not easy to identify. You can probably identify an overall margin for Astral but, if you go to Astral and buy a 101-metre ship or a 50-metre ship, you do not know whether they are making that margin on the larger ships and losing on the smaller ships. From an Incat point of view, all you have to do is divide the figures by four and you have an accurate reflection of how much money we make per unit.

Ms JULIE BISHOP—Aren't you competing in an international market? Isn't your competition far broader than just the national competition?

Mr Balcombe—Yes. We are the only shipyard in the world that operates as we do. All other shipyards build cruise boats. The people we compete with are companies like Alstrom Le-Roux in France, which builds cruise ships and fast ferries. Rodriguez in Italy is doing the same thing, and Astral in Western Australia. They all have a mix of products. We are internationally competitive. Our products are the best in the world; no doubt about it—you might argue that point. We build four identical units. We do not go outside those guidelines.

Ms JULIE BISHOP—I should not be revisiting the case, but perhaps I could take you back to the legislation. You have made a number of recommendations. I will ask you about some of those. You suggest that, should the large/small test continue to apply, ASIC guidelines should be modified to ensure there exists a workable system. What have you got in mind?

Mr Balcombe—They have to review the words, 'unreasonable burden'. Arguments are presented in some of these papers that determine what 'unreasonable burden' is in respect of cost. The cost of compliance is insignificant.

CHAIR—In your case.

Mr Balcombe—Yes, in our case. The unreasonable burden for us is the detriment to our margins and our international competitiveness.

Ms JULIE BISHOP—You also suggest that the threshold for large/small companies be reviewed. You say that net assets in excess of, say, $100 million constitute a large company. Is that backed by any independent analysis?

Mr Balcombe—Purely a stab in the dark.

Senator COONEY—I apologise to Mr Balcombe for not being here earlier. What you seem to be saying is that you should not have to lodge the accounts, et cetera, and you have given a lot of very good reasons. If we have to run a regulatory system, which we do, what sort of message does it send if we say, 'We have to accept this company because it's exceptional.' Another company could simply say, 'I'm exceptional.' Why shouldn't Mr Cameron here say, 'There shouldn't be any restraints on me because I'm a really good regulator so just let me regulate according to the way I feel.' That is the problem, isn't it? We are always asked to give ministers discretions and what have you, and we go through this formula of saying, 'Of course, this minister is absolutely terrific but we don't know who's going to be replacing him down the line, therefore we have to have these sorts of regulations.'

Mr Balcombe—I could raise the same question today—why do we have grandfathered entities? It is a straight inconsistency. We have been asked to come here today to speak on the issues that affect us. This lodgment of accounts issue is going to harm our business. Prior to that, we were classified as an exempt proprietary company where we lodged key financial data. Frankly, I think we might be able to live with that, but we have got to make huge disclosures such as those we are going to be obliged to make under standard 1018—from memory. That is going to cost us huge amounts of money. The issue is: where do you draw the line in the sand?

Senator COONEY—The other thing is that, where you say Mr Balcombe has made a convincing argument, bang, we are going to exempt him. Why shouldn't other people?

Mr Balcombe—All I am saying is that at the moment you have a line in the sand. We do have a policy statement and a regulator that has to abide by that policy statement. I just think the bar is way too high right now.

CHAIR—You think there is a way in which you can distinguish between a company in your situation and other companies that, as I mentioned earlier, have been mentioned in ASIC's response going right up to listed companies?

Mr Balcombe—I personally think there is, but I do not think it is the preferred view that we go down that track. As I said, I abide with most of what those applications say with regard to reporting and non-reporting entities but, at the moment, the bar is way too high in relation to the way that ASIC can exercise its discretion.

Ms JULIE BISHOP—Under policy statement 43?

Mr Balcombe—Yes.

Senator COONEY—And you say that it is too high for everybody, not just for Incat?

Mr Balcombe—Correct.

CHAIR—As there are no further questions, I thank you, Mr Balcombe, very much for your evidence before us and your answers to our questions. We certainly appreciate that. I think all the witnesses have been very good this morning. That is reflected in the fact that we have managed to stay awake, despite having had only two hours sleep last night. You have all arrested our attention very well for the three hours of the hearing. Thank you again to everyone.

Subcommittee adjourned at 11.47 a.m.