COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

JOINT COMMITTEE ON CORPORATIONS AND SECURITIES

Reference: Aspects of the regulation of proprietary companies

WEDNESDAY, 28 JUNE 2000

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JOINT COMMITTEE ON CORPORATIONS AND SECURITIES

Wednesday, 28 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, Conroy, Cooney and Gibson and Mr Cameron, Mr Rudd and Mr Sercombe

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

DELANEY, Mr Michael, Executive Director, Motor Trades Association of Australia..........................21

ELLIOTT, Mr Rob, National Manager, Policy and Research, Australian Institute of Company Directors..........................1

FISHER, Mr Thomas, Assistant Secretary, Office of Small Business, Department of Employment, Workplace Relations and Small Business..........................27

GARDNER, Mr Geoff, Deputy Executive Director, Motor Trades Association of Australia..........................21

GRANT, Mr Stuart, Member of the Accounting and Financial Advisory Committee, Australian Institute of Company Directors..........................1

GREENWELL, Mr Anthony David, Director, Finance and Tax Policy, Office of Small Business, Department of Employment, Workplace Relations and Small Business..........................27

LANGFIELD-SMITH, Mr Ian Anthony (Private capacity)..........................8

LEE, Ms Margaret Adelaide, Assistant Director, Finance and Tax Policy, Office of Small Business, Department of Employment, Workplace Relations and Small Business..........................27

SERVICE, Mr James Glen, Member of the Accounting and Financial Advisory Committee, Australian Institute of Company Directors..........................1

Committee met at 5.04 p.m.

ELLIOTT, Mr Rob, National Manager, Policy and Research, Australian Institute of Company Directors

GRANT, Mr Stuart, Member of the Accounting and Financial Advisory Committee, Australian Institute of Company Directors

SERVICE, Mr James Glen, Member of the Accounting and Financial Advisory Committee, Australian Institute of Company Directors

CHAIR—I declare open this Joint Statutory Committee on Corporations and Securities hearing and welcome the witnesses who will be appearing before the committee this evening. The purpose of the hearing is to take evidence on the committee's inquiry into aspects of the regulation of proprietary companies. This is the first hearing on this particular inquiry and the committee will be holding a further public hearing in Melbourne on Friday, 30 June 2000. The committee has received and published 13 written submissions, which it will consider along with the evidence it receives during its public hearings in preparing its report.

The committee prefers to conduct its hearings in public. However, if there are any matters that a witness wishes to discuss with the committee in camera, we will consider such a request. I would also like to remind witnesses that the giving of false or misleading evidence may constitute a contempt of the parliament. This hearing will be held while the parliament is sitting, so some committee members may have to leave the hearing from time to time to attend divisions in either chamber. I hope this will not unduly disrupt the proceedings. Before we proceed with the hearing, I will just indicate that I have to attend another meeting for a brief period. Once we start I will hand over the chair to Senator Gibson. I welcome the representatives of the Australian Institute of Company Directors. Do you wish to make an opening presentation to the committee?

Mr Elliott—Yes, we do.

CHAIR—I will ask you to proceed with that and then there may be questions from the committee.

Mr Elliott—Before I start, let me say by way of background that Mr Grant is an experienced company director. He is also an ex-partner of KPMG, a long time commentator on financial reporting, currently executive director of the Australian Annual Report Awards, and probably most importantly, other than being a member of the AICD's accounting committee, is immediate past National Director of Accounting Policy for the Australian Securities Commission, as it then was.

Mr James Service Snr is well known to the committee, being an extremely well-known director of both large public and small proprietary companies, and also an extremely active member of the AICD in an honorary capacity, having been a former member of our national council.

For those who are not aware, the Institute of Company Directors is an organisation with over 15,000 directors as members and, I think most importantly for this committee, well over 13,000 of our members are directors of proprietary limited companies in all states, all industries and all sizes of proprietary companies. I will make a few very short points as an overview and then hand over to Stuart Grant who will make a slightly more technical presentation, and then we would be very pleased to take questions and enter into any discussion.

Generally, the institute wishes to see increased business efficiency, reduced costs and red tape, and appropriate levels of accountability through, and I stress, meaningful disclosure. The AICD has been a very long term contributor to the issues that are before this particular committee. I point not only to the submission that you have before you dated 17 April this year, but also to three prior submissions which, if you do not have, we can forward to you, they being August 1994, October 1994 and February 1995. I can give the secretary particular references to paragraphs within those submissions which are directly on point. The AICD welcomes this review having called for it in our October 1994 submission, and thanks to the PJC for the opportunity to appear here today. In addition, we have made a written submission.

Before I hand over to Stuart Grant for a more detailed presentation can I leave you with one particular overarching message that the AICD has, and that is that we really do not want to see small business in Australia, which is after all the engine room of the economy, impeded by unnecessary red tape from growing and thus employing more people. With that I will hand over to Stuart Grant.

Mr Grant—You have before you the submission from the Australian Institute of Company Directors. I am pleased to say it is probably one of the shortest submissions, which we try to achieve, and the key features of that are fairly simple as well in that. We say that with the present requirements which were enacted in 1995 there have been some favourable impacts but some adverse impacts as well, and obviously it is the adverse that we are focused on. The particular concerns arise from the impact upon large proprietary companies of the changed requirements that arose in 1995. In particular, if you are so-called ‘large,’ those companies now have to lodge and have audited their financial reports, and some small companies as well are caught under those requirements if they are foreign controlled.

It is probably that area that is the main issue of concern to the AICD because previously, typically, those companies, and there are about 2,000 of them, were classified under the old rules as exempt proprietary companies and did not have to lodge financial reports or have an audit. So for them the changes have been quite dramatic. Certainly, we have had representations, strongly, that it is an unreasonable invasion of privacy for those family companies.

To summarise, the key concerns regarding the present requirements for preparation, lodgement and audit for propriety companies are as follows: that the requirements are somewhat complex, and that they are arbitrary in that you can flip-flop in and out, being large or small depending on if you sell a property or whatever in one year—you pop over the $10 million revenue limit one year, but the next year you do not. It is uneven in impact in that there are a lot of organisations that do not have to file, even though they are large, because they are so-called grandfathered, and you have quite a cottage industry out there advising propriety companies on

how to structure their affairs so they sidestep the requirements through setting up trusts or limited partnerships.

It is considered that the present requirements are unfair on those large proprietary companies in that they require public lodgment of their affairs when it is not considered that there is really a public benefit in so doing. There are increased costs for those companies and, in summary, as I have mentioned, increased requirements at large for that 2,300-odd group. There is also an element of unfairness in that there is no mechanism, as ASIC have acknowledged, to identify those large proprietary companies that have kept quiet and not lodged. Through the application of the reporting entity concept there are concerns that the results are somewhat haphazard and ineffective in that the present wording of that definition means that it is largely a discretion as to whether or not a company deems itself to be a reporting entity. The definition is so subjective in that it says if you can identify so-called ‘users dependent’, then you are a reporting entity. But ‘users dependent’ is a highly judgmental description, and you can really argue it either way.

It is not in the interest of small or, particularly, medium sized businesses to have to lodge, because of the intrusion on privacy for no particular public benefit and because of the cost involved. We have suggested in our submission that the audit requirements flow from the lodgment requirements. Our submission has indicated that we would recommend a reversion to the exempt proprietary company definition, or something similar, which would enable particularly companies that are clearly family owned and controlled—with say, fewer than 20 shareholders—to be not required to lodge and not required to have an audit. Of course, the extent to which they prepare their financial statements is largely up to them—which is fair enough, because they are family companies. We are suggesting that there be the appropriate differentiation between the public disclosing entity type companies that have got comprehensive requirements and the family company, where we are suggesting there is not really a public interest requirement. In summary, those are the key messages that we would like to pass to you.

ACTING CHAIR (Senator Gibson)—What specific criteria would you be recommending to us then for the exempt proprietary company to qualify?

Mr Grant—It is really picking up the definition that was previously in the law. Hopefully, it can be simplified, because in fact it was somewhat convoluted. But the substance of it would be that existing definition. Ironically, although the definition of exempt proprietary company is not in the Corporations Law today, it is still required. I do not want to get too technical, but if a large company is to continue to be grandfathered, as it is called, which means they do not have to lodge, then they have to continue to be an exempt proprietary company under the old definition. So it sort of lingers in the background still, even though it is not in the law. We might as a further refinement of that suggest, say, 20 people—family members or associated persons—as being a cut-off limit for that definition.

ACTING CHAIR—What about other entities?

Mr Grant—There is a tiered approach under the old definition and it gets very technical. I think you go about four layers and if you get to an individual person after four layers then you tick it off; you are right; but if you go to a fifth layer, you are not. That is very arbitrary. I would hope that it could be simplified. But from our point of view we would recommend that the

principle be adopted, and obviously there would be some work to be done on refining a precise definition. We do not have a precise definition at this stage.

Mr Service—We have been discussing this issue, because the institute is very committed to transparency in those organisations which have a general responsibility to the public; that is, those who raise capital, borrowings or deal with the public on a large scale where there is a wide interest in their solvency. One of the things we believe ought to happen, particularly if the committee is of a mind to get rid of the present large/small definition, is that every company should have to have all its directors sign and lodge with its annual return a declaration of solvency. We think that that, amongst other things that are of public importance, will actually make directors really think about this solvency issue. We are all seeing situations in the courts where directors simply have not addressed their minds to whether or not their companies are solvent. Whilst as shareholders they may suffer, very often a lot of other people suffer as well.

I think it is fair to say the institute would not even be uncomfortable if you were to recommend that proposal and that part of it ought to be that, when a company has signed its declaration of solvency, it should have an obligation to give a copy of that declaration to every one of its employees. They are one of the groups of people that need protection and, I have to say, are not adequately protected in fact by the law at the moment. The average employee does not go to ASIC and say, 'Can I look at this company's accounts?' Employees ought to know that their employer is solvent. We think, in terms of public policy, that would be quite effective in really making directors think about what their responsibilities are. They already have those responsibilities but, clearly, some of them do not address them.

Mr Grant—I would add the comment that one of the changes in the simplification law that came down in 1995 was that the so-called small companies no longer have to prepare a formal financial report. In fact, at the time the Institute of Company Directors queried that and really raised its eyebrows to say, 'Is that really desirable?' We would like to re-raise that and suggest that in fact we wonder why that was introduced, because we see it as a very important discipline that every company be required to present—to prepare for itself and for whoever else within the shareholding group needs it—a formal financial report.

The comprehensive requirements of accounting standards come in two parts, being the measurement requirements—how you measure your assets, how you measure your liabilities, if you recognise finance leases as borrowings, which the standards require; so there is that component—and the second component is disclosure, and typically you see 'note 43 to the accounts'; you see lots of notes. Instead of being required to follow them, the differentiation is that, instead of those, we are suggesting that many of those notes may not be required to add to the disclosure but that the basic computation measurement requirements should apply, we are advocating, to all companies. That is not the case at the moment. There is a proposal there from ASIC, as you have probably seen. It is a draft release by ASIC that would invoke that. But that is, more or less, a little bit of regulation, as we see it, by the regulator instead of the parliament. So we would get to the same result as they are suggesting but perhaps through a different mechanism.

ACTING CHAIR—If I remember correctly, the thrust of the previous changes in the law were to try to help small companies, to make life easier for them and to get rid of some red tape. Are you now of the view that, on reflection, it would be better if everybody had to report?

Mr Grant—To prepare, not to report.

ACTING CHAIR—Sorry, to prepare—okay.

Mr Grant—To prepare; there is a big difference. It would be not published, not lodged, but it would be prepared and be required to be submitted to all shareholders.

Mr Service—The purpose of that is not simply to keep the shareholders informed, it is to try to encourage good management of Australian companies. In my view, even the smallest company ought to have some kind of accounts; otherwise, how does it manage its business? If management is bad, in the end the national interest suffers.

Mr Grant—It is like a periodic score card.

ACTING CHAIR—Your suggestion about certifying the solvency complements that?

Mr Service—That helps to protect the public interest, including people like the employees. If I go to somebody and say, 'I want to open an account to buy my stationery,' at the moment most of those suppliers actually do nothing about credit. If they like the colour of my eyes they give me an account—which is not very wise, but that is what they do—or they ask for directors' guarantees—that is very common. In small companies, I personally do not object to that. If we go down this solvency declaration thing, all you have to say to somebody who wants to open an account with you for ordinary trading is, 'Give me a copy of your declaration of solvency.' A lot of consequences will flow from that in the sense that, if the declaration is fraudulent, the creditor is likely to have personal recourse to the directors, so directors are going to take this very seriously, and we think that is highly desirable.

Mr Elliott—This process will, in effect, focus the minds of the directors on their current obligations for solvency, but it will not—getting back to your point of the red tape—add to the burdens and the costs of unnecessary extra regulation and red tape. It will achieve the ends whilst leaving the small business people free to get on with doing the business and remaining relatively competitive.

ACTING CHAIR—Do you want to make any further comments?

Mr Elliott—I can provide the secretariat of the committee with the exact paragraph numbers within our previous submissions which address some of the points and flesh them out a little rather than verbatim read from previous submissions—that is a pointless exercise. A number of these issues relate to creditors making their own inquiries, red tape and other ways of achieving this. A final point is that the importance here is the difference between preparing the financial documents and the disclosure and therefore auditing of them in a public or wider sense. That is a substantial difference and we do that on the basis of what we believe is meaningful disclosure—disclosure where it is going to be meaningful to people who have no other way of ensuring the soundness financially of the organisation they are dealing with as employees or creditors.

Mr Service—In that case we are fully supportive of disclosure. That must be very much understood—we are not here just to say directors are wonderful people and should not have any laws to obey; that is not the position of the institute.

Senator COONEY—Though they are.

Mr Service—Senator, thank you for that; it is the nicest thing that has been said to me in at least a week.

Mr Grant—The principle in the definition of exempt proprietary company was in place for many years and seemed to work well. I am not aware, in my professional environment, of any grounds for concern with it, so it remains curious to us as to why it was changed.

Mr Service—It might almost have been one of those accidents that happen.

ACTING CHAIR—I was involved at the time but I cannot remember the reason behind it.

Mr Grant—The other comment I would make is probably self-evident, but I will put it in another way: clearly, all the commentators and people making submissions—I suspect you as a committee, too—agree with the principle that there should be some sort of differential reporting between the big end of town, the listed companies, and the small end. Differentiation of reporting requirements and content is almost unanimously accepted. The debate is where to draw the line, and that is really what we are discussing, I suppose.

ACTING CHAIR—Senator Cooney, we have virtually finished. Did you want to ask any questions?

Senator COONEY—I can understand what you are saying about what is reasonable but, in the old days, I did some industrial accident work and what have you to earn a few shillings for the table, and what is reasonable in any particular circumstance can be a problem. Have you thought of that? Can you really define what the break is? The various tests are really arbitrary in the sense that you could say, ‘It is going to be $2 million or $5 million.’ Can you think of any way that could be improved upon? I suppose it cannot be, unless you go to the court the whole time, but have you thought of any test other than simply having an arbitrary figure beyond which you report and below which you do not?

Mr Grant—As we were saying, we are suggesting that there not be an arithmetic cut-off but a family type cut-off. In other words, if it is clearly family controlled and owned, then that should be the distinction.

Senator COONEY—What the system is doing, in any case, is picking distinguishing marks which in a certain sense are arbitrary. Can you think of any way of doing it that would not be arbitrary? The family way of doing it is arbitrary; an amount of money is arbitrary.

Mr Grant—I believe you can come up with a definition. There was one under the exempt proprietary company definition that used to apply that was capable of rational and objective implementation.

Senator COONEY—Yes, but I suppose people could say, 'Well, who is going to make the judgment?'

Mr Service—I think there is an additional concept to that though, Senator, and that is that you cannot qualify what we are describing as an exempt proprietary company if you want to raise capital or borrowings from the public. If you want to do that you have got to be transparent and you have got to tell the world what your situation is because otherwise you do not protect the public. The sorts of companies that fitted under the old definition of exempt proprietary companies were not permitted to do that—unless they were badly managed, which is not in the national interest—but they were not destroying the public interest and therefore the public interest has no particular interest in whether they are very profitable or not very profitable or how they are performing.

The other thing we suggested—I think before you came in—is that the institute would be very supportive of every company, and I mean every company, having to lodge annually a declaration of solvency to make the directors really address their minds to the fact that their business is in good shape. We have also suggested that every employee of those companies should be required to be given a copy of the declaration of solvency on the basis that the average employee is not going to go to ASIC and look up the records. Of course, they are not but they ought to know that the boss is actually going to be able to pay their wages. The institute has a very strong view about that.

Senator COONEY—I am sorry I came in late. I had to be in the chamber.

Mr Service—We understand.

Senator COONEY—It seems to me that we have got to have some sort of test and that is going to be an arbitrary test. I suppose what you are saying is that—and I can understand this—any tests are going to be arbitrary to a certain extent, but the ones we suggest are less arbitrary than the others. That is closer to getting to the answer than the others.

Mr Service—And the old system, by and large I think, worked very well, whereas the new one is causing quite a lot of people a lot of pain. There has been no demonstrable public benefit from that. I think that is an issue. There has been nothing come out of it that has been of value to the public at large.

ACTING CHAIR—If there are no further questions, I thank you very much for going to the trouble of coming and meeting with us tonight. Thank you for your submission. It is very useful.

[5.33 p.m.]

LANGFIELD-SMITH, Mr Ian Anthony (Private capacity)

ACTING CHAIR—Welcome. I invite you to make a short opening statement, after which the committee will ask you questions.

Mr Langfield-Smith—By way of brief introduction, I am a lecturer in accounting at Monash University's Clayton campus and I have been involved in financial reporting matters in various capacities over the last 15 to 20 years. This includes two years with the National Companies and Securities Commission, in 1987 and 1988, when I was responsible for advising the commission on financial reporting matters and prospectus matters. Subsequently, for a period of 18 months, I was the senior adviser on accounting and auditing matters with the Australian Society of Certified Practising Accountants. That was followed by 4½ years with the Legislation Review Board of the Australian Accounting Research Foundation, after which I returned to Academe. In terms of the introductory comments I would like to make—

ACTING CHAIR—We have received your submission. If you want to highlight the points in that, please go ahead.

Mr Langfield-Smith—I am not sure which bits to highlight, but before I do that I wish to comment on some of the matters raised by the previous evidence, particularly Mr Service's views about the solvency declaration, which I very strongly support. It is a very good idea and I think many people would agree with that idea, particularly given his concerns about the position of shareholders. As you are aware, we have had a number of rather unfortunate circumstances in regard to insolvencies. While some legislative measures have been taken, they are not altogether satisfactory, I suspect, in solving those issues. Also, with regard to Mr Grant's comments about the need for businesses, regardless of their form, to prepare some sort of financial information for both the directors or managers and for the owners, I think that is very important

One of the reasons why, as I understand it, we stopped requiring such companies to lodge financial statements with the commission was because, first of all, from 1984, I think, they were not audited and basically they were more dangerous than informative in terms of their content—not to mention that some of the corporate affairs commissions, such as in Tasmania, ran out of space to store them—so it was a pragmatic decision in terms of the usefulness of the information as well as being seen as a very useful removal of burden.

In terms of my formal submission, I have my problems with the small/large proprietary company test. Given my background I also support, contrary to the views of the Institute of Company Directors, the reporting entity as being a more serviceable way of trying to distinguish. Unfortunately, in this area, whatever tests we take it is going to be difficult. We can have clear-cut tests that are completely meaningless or we can have possibly more meaningful tests that are subject to discretion. I can understand from the point of view of the institute why they are concerned about a requirement that is highly dependent upon discretion. It means that their members have to make these decisions and they do not wish to be seen as having made the wrong decision. I can fully understand that. From that point of view I believe that the reporting entity concept plus the small proprietary company approach were designed to try and get at some sort of test that minimises the possibility that those companies that should be reporting are

reporting and that those that should not have to report do not report. It is not a very good test, but it is as good as any.

Going back to the comments made by the previous presenters about the exempt proprietary tests, while it was in some ways easy, there were, despite the comments made, a large number of problems with those particular tests given that a number of companies became non-exempt because, for various reasons, they issued redeemable preference shares as part of their financing transactions. Those were held by a financial institution which wished to get access to the franking credits which the company did not need, and this meant they were no longer exempt proprietary companies and therefore they were forced out, so there were some problems.

I recall several instances, when I was at the National Companies and Securities Commission, when companies applied for relief from the auditing requirements on the basis that the particular transaction was solely on the basis of a financing transaction with somebody who was well able to take care of themselves. In this area it is very difficult to know who is the dependent user. In many cases I think they are unlikely to be dependent users, and merely saying that the company has creditors or employees does not mean we have dependent users because, as was previously indicated, many businesses when dealing with other businesses do not look at financial information to try and work out whether or not to grant credit; they rely on personal preferences or a credit agency. In terms of using financial information for that purpose, in many cases we are using extremely dated information and it is highly risky because, given the very swift economic changes, financial information which is 10 or 15 months old may not be all that much use. It also depends upon the ability of the user of those reports to interpret them because they may not have the skills.

Another area which is important is to try and understand what the policy underlying it is. We can either take it that there is a general proposition that all companies should report unless we can see no benefit for it, which is the view that I take, or we can take the view that is inherent in the position taken by several of the other submissions that this information is inherently private and we should only require it to be disclosed where there is a strong public interest.

Unfortunately, it is very difficult to measure when the public interest requires these things to be disclosed and when it does not, and again it is very difficult to gauge any cost-benefit analysis, which was indicated by the previous speakers, but there were some significant costs being incurred by that number of companies that previously did not have to report but are now reporting, yet we have no information in terms of whether or not there are any benefits. Their position is that there were no benefits but, as these benefits accrue to disparate groups of users, it is very difficult and we have no information that even helps us understand this issue. It would have been useful, I think, if, in the information provided by ASIC, they could be given some indication of the number of requests for financial information they have received, but I did not see that in their report and it may be if they are appearing before the committee that might be an issue you might wish to raise with them. It is a very difficult area in terms of what needs to be done.

If we are going to continue with the large/small requirement there are a number of areas where the mechanism adopted gives rise to some query. I have mentioned those in the report, in particular in terms of the shareholder requisition, which floats around that in terms of the small proprietary company, the test excludes shareholders who have non-voting shares. They cannot

request financial statements. One would have thought persons who have no ability to appoint directors would be in far greater need of that financial information than others. Unfortunately, the legislation refers only to voting shares. Therefore, presumably we have a situation where those companies wishing to avoid the risk are now issuing non-voting shares rather than voting shares.

There are other problems in terms of the number of shareholders and how we structure it. For instance, with employee share schemes, rather than issuing shares to the employees we have a situation where in many cases they are issued to a trustee. That reduces the number of shareholders and the trustees vote en bloc in terms of whether they wish to exercise that power. Depending on the trust deed, it may be that management appoints the trustees.

There are all sorts of problems there in terms of protecting employee shareholders. In some cases they have a good idea what is going on and in other cases they are more surprised than anybody when a company fails. It depends upon how close they are. It is very difficult. It varies from company to company in terms of the extent to which those who are running it know the financial condition. It depends on their access to the sorts of information signals in terms of whether they are in the accounting area where they know there are all these accounts that are not being paid, or whether the accounts are done by accountants and therefore they do not know whether there is any problem paying accounts.

It is very difficult to know what forms of alternative information are available. We have to remember that financial statements are only part of the information available to all people who have relationships with companies. They may be important but they have a limit.

ACTING CHAIR—You made the point that you are in favour of all companies having to prepare financial statements.

Mr Langfield-Smith—For their own uses, yes.

ACTING CHAIR—You also thought that these proposals from the company directors about signing a solvency declaration by each director for shareholders, and possibly for employees, would be a good thing. There may be a couple of thousand involved or caught by that small/large test now. What is the public benefit in staying by that? Looking at the wider scheme of all companies, a million odd, is that worth while, given if we moved in the other direction as they suggested?

Mr Langfield-Smith—It is worth while because whilst some of these companies are very small others have assets of several hundred million dollars.

ACTING CHAIR—Yes, and some are in the billions.

Mr Langfield-Smith—It therefore may be appropriate that they be accountable for their economic power in the way in which they use it. There is also the suggestion that they should also be held accountable to the extent to which they might be earning monopoly profits, although when you start looking at the very large companies in this class, such as the Smorgon Group, although given its diversified nature you can really not get very much information at all in terms of monopoly profits.

ACTING CHAIR—Is it not also true that the main companies have got the grandfather clause in front of them anyway.

Mr Langfield-Smith—I am not at all in favour of the grandfather provision. That was a decision made by the government at the time on the basis of political and other factors. This is to a degree a mixture of political and economic considerations in terms of what is appropriate. We can take the argument that the number of companies involved is so small that the costs are relatively small. The cost in terms of what is suffered by others could be extremely large in terms of the cost-benefit analysis. Trying to work out the cost-benefit analysis is extremely difficult when you are trying to determine what costs might be suffered by people if this information was not potentially available to them. We could argue that putting this burden on 1,500 companies, which I think is the number in question, in the way of the world is not very much.

ACTING CHAIR—On the other hand, if in fact the directors of those 1,500—which averages four or five of them, or whatever it is—signed a declaration of solvency, which is on the public record, it may affect the progress.

Mr Langfield-Smith—We have made progress, yes. I agree.

ACTING CHAIR—I just want to tease out from you what additional benefit we get.

Mr Langfield-Smith—We could argue that the general availability of this sort of information, given that the companies are economically significant, increases market efficiency, because we have a situation where there is a symmetry in the market for resources because of the information gathering costs and the barriers to information being gathered. If we believe that we should have efficient and effective markets, this means that there should be the maximum amount of transparency and information available. Once we get to a certain size then, arguably, by not requiring that information to be provided we are decreasing market efficiency.

Mr ROSS CAMERON—In terms of public benefit of disclosure, the Incat submission says that they were knocked back by ASIC, they appealed and got knocked back on appeal. It says:

> ... Incat’s rationale was that such lodgement would lead to a situation of competitive disadvantage to the companies in that their customers would be provided with accurate price sensitive information sufficient to allow an educated participant in the fast ferry market to establish Incat’s profit margins.

What is your assessment of the validity of that rationale?

Mr Langfield-Smith—There are two issues here: there is the competitive issue, and then there is another issue which I might get on to later. Indeed, they were further knocked back by the Federal Court on appeal. That is what subsequently happened. I was reading through the analysis done by the Administrative Appeals Tribunal and the analysis by the judge in the Federal Court. The nature and structure of their operations was basically that they were speculative building; they had a continuous production line and, while they were in production they tried to sell. They claimed that, given the nature of the disclosures required by the construction standard plus the fact that they were basically a one product company, but with a number of variants in terms of size, they are at a disadvantage, given the fact that there are only two other competitors, one which was a subsidiary of a multinational company in Europe and

the other which was in Western Australia and had several other product areas, which meant that by looking at their financial statements you could not get the same degree of information about the operations.

The extent to which a competitor could get price sensitive information in terms of determining, firstly, the cost of production and, secondly, the price that they are actually selling at is somewhat limited by the nature of the disclosures being required. Also, those disclosures in a fiercely competitive industry are likely to become dated very quickly. So, even if the information could be used by competitors, by the time it became publicly available—and given the degree of aggregation—it may be of relatively little use.

One of my former colleagues Mr Stan Droder, who was at one stage an executive of CSR Coal and chairman of the Accounting Standards Review Board, said that basically if one of his competitors needed to rely on the financial information in the financial statements to get information about his cost structure, then it was not a competitor he needed to worry about. If it is that competitive, they will have other more effective ways of getting information. It would be mostly confirmatory information, rather than key information, for those decisions. So it is useful in terms of confirming other sources of information.

Another question becomes whether as a matter of public policy we wish to isolate individual companies from competition, assuming we are in favour of competition and provided that the competition laws are respected in terms of not breaching the Trade Practices Act. I do not think we should give people an additional advantage in terms of non-disclosure.

Mr ROSS CAMERON—We are talking about annual reporting here, are we not?

Mr Langfield-Smith—Yes, we are.

Mr ROSS CAMERON—That is pretty recent—in the last 12 months—is it not?

Mr Langfield-Smith—It covers the last 12-month period. It must be lodged with ASIC within four months of the end of the reporting period, so at any point it can be a minimum of four months old and up to 16 months old. This means that there is some difficulty in terms of the dating of that information plus there is also, particularly given the nature of the products being built, a large number of relatively arbitrary cost allocations involved as well as revenue allocations involved, given the nature of construction contracts. I gather that there was expert evidence given before the AAT which went into all these details and that the AAT and the judge took the view that those arbitrary items and the nature of disposal were such that it would be relatively difficult to get very accurate information; it would give you a general idea but probably no more than somebody who was in the industry would know anyway in terms of cost structures.

Mr ROSS CAMERON—If they were sufficiently motivated to seek the relief in the first place and then to appeal the original decision, obviously they would have a pretty firm view that the data would be commercially sensitive?

Mr Langfield-Smith—Yes.

Mr ROSS CAMERON—But your view is that they are mistaken about that.

Mr Langfield-Smith—Yes. My view is that they understate it. I have come across it in my time in the National Companies and Securities Commission, where subsequently I have been employed as an expert consultant, with the companies who were trying to put the case for non-disclosure. They had this feeling that competitors will use this information if it is available. I think this is unfounded in that, if you are a really efficient and well organised company, you have relatively little to worry about. The contrary suggestion that is suggested is this: if you are only relying, in terms of your intelligence, on trying to glean information from your competitor's financial statements in a highly competitive industry, you are not doing too well.

Given Incat's market, they are also subject to extreme difficulties in terms of foreign currency fluctuations and how to manage those sorts of issues. That will have an important impact on the way in which it flows through their financial statements in terms of their hedging strategies and their financing strategies. It is interesting to note, in terms of the earlier comments about an exempt proprietary company, that Incat has been around since before the current legislative provisions, so they were never an exempt proprietary company. I am not sure why—whether they had too many companies in this stream—but more likely, I suspect, is that they have a public company which came in as part of the finances side of it, which may indicate that they had problems under the old system. It is intriguing that they only decided to start to carry on with their concerns about this about four years ago; other companies have tried.

Mr ROSS CAMERON—So your implication is that a serious competitor should be expected to aggressively seek the means to discover the commercially confidential data of a competitor not otherwise publicly available?

Mr Langfield-Smith—They will; yes. Some of it will be legal and some of it will be not so legal, I suspect, unfortunately. Some companies are extremely ethical in the way they behave and other companies are less ethical.

Mr ROSS CAMERON—We should not be regulating on the basis that we assume—and, in effect, give implicit encouragement to—competitors will have to seek the non-publicly disclosed data.

Mr Langfield-Smith—If I take your argument through, that therefore is an argument in favour of disclosure because we discourage them from engaging in otherwise unsavoury activities.

Mr ROSS CAMERON—Yes, but the question is: what should the level of disclosure be?

Mr Langfield-Smith—The level of disclosure becomes quite important. There have been a number of cases where, in fact, over the years ASIC and its predecessors have limited disclosure for a number of companies in terms of the particular disclosure of revenue. This was before the 1991 amendments to the legislation. Up to that date, companies could decide not to comply with the accounting standards provided they disclosed that fact and quantified the effect. When the legislation changed in 1991, when it basically became that you had to comply with the accounting standards, their choice was that they applied to the commission for a variation under the corresponding provision which was also covered by this reference. Up until

that date there was a number of instances where companies applied for and were granted exemption from disclosure of revenue and, in some cases, from cash flow information.

I do not know if I should say any more because I am still bound by the secrecy provisions of the NCSC Act. Unless you wish to direct me to answer questions on that, which I am quite happy to do if you make that direction, I will not answer.

Mr ROSS CAMERON—I note you are arguing for consistency of treatment of entities, whether they are proprietary or public companies whereas, perhaps, the view has been that the dividend for managing your affairs in such a way that you rely upon private provision of capital is that you have greater control over the commercially sensitive information in your business, but going to the public for subscription involves an additional set of obligations. Should there not be some advantage? You are suggesting that there should not be any commercial benefit to a company that raises its capital privately.

Mr Langfield-Smith—Not exactly. I agree with your initial proposition that, if a company goes to the public and issues a disclosure document, then quite clearly they have to follow all the requirements that then follow. For instance, most of those will be disclosing entries and have very significant obligations placed upon the directors in terms of keeping the market informed and the regulator informed. I agree that where a small company or even a relatively large company secures its finance through private means from people who are well trained and well capable of looking after themselves—or so we should hope, although in the 1980s there were a number who were not quite as well trained and as capable of looking after themselves as perhaps they should have been—and who are professionals who know what they are doing and have the mechanisms to get the information they want, then, provided there is nobody else who needs information, there is no good reason for that information being made available.

However, look at Incat in terms of the issues being considered. Incat, in their submission, stated that they employ 900 in Hobart. That is very significant employment in Tasmania—about 0.5 per cent of the total population of greater Hobart. The amount of money that it puts through the economy of south-east Tasmania would have a very significant effect and would be central to ongoing commercial confidence, I suspect. If Incat went down it would have a big impact upon commercial dealings in Tasmania. They are very significant—small pond, big company.

Senator GIBSON—I return to an earlier question from the previous witnesses: if the directors of a particular company sign the statement of solvency, what additional comfort should employees or suppliers require?

Mr Langfield-Smith—This is a good question. The vast majority of directors, and indeed I suspect nearly all the members of the AICD, are ethical, honest people. There are, unfortunately, directors who are not ethical and honest. We have had the Mr Bonds of this world and various others who have managed to sign all sorts of statements which are untrue and who have managed, unfortunately, to persuade auditors to agree to them. The mere fact that financial information is available and audited is not a guarantee that there is nothing wrong because the audit process itself is a statistical process—it depends upon interpretation of evidence. In many cases the question of whether irregularity is discovered is more good luck than the result of good systems because where you have collusion it becomes extremely difficult. While 99 per cent of people are honest, there is the one per cent who are not.

We also have problems where we have people who are not dishonest, but who, because of financial stress—as recently when we had a problem with the builders trying to get everything finished by 30 June—find themselves in a corner and think they will get away with it for three months and it will be okay, but it is not okay. These are not dishonest people; they are ones acting in an extremely stressful situation and do things that are unlawful but not really intending to defraud anyone. It is a very difficult situation.

CHAIR—In your submission you argue that the criteria for the Australian Securities and Investment Commission drought relief are too wide, but you also argue that ASIC's exercise of its discretionary powers in relation to granting relief has worked effectively. There is an element of conflict in those two statements. Can I just ask you how you resolve that?

Mr Langfield-Smith—As far as I am aware, the evidence is extremely limited in terms of the way in which ASIC exercises its power. There is always, whenever there is any administrative function involving discretion, somebody who is unhappy with the outcome. But if somebody goes and says, 'I want X', and it is not given to them, they are going to be unhappy. We see Incat in particular were extremely unhappy when they got the 'No'. The question is whether or not ASIC, when reviewing these applications, does so in a systematic way, does not engage in bias and does not engage in erratic behaviour. It is my understanding that ASIC has put in place procedures designed to, first of all, ensure that there is quality in terms of the way in which they deal with things, that there are procedures in terms of making sure that applications are handled speedily in that there are performance reports going to senior management listing the number of days each application has been in hand. It the efficiency of the system that I was concerned with.

There are other problems in terms of the extent to which the powers given to the commission are being appropriately conveyed. I have always had some uncertainty about the extent to which parliament intended to grant powers to ASIC in terms of the burdens resulting from compliance. The words used are capable of two interpretations: one is the burden of complying with the legislation which is purely administrative costs, and there is the alternative definition which looks at the costs of having complied, which is the sort of situation Incat finds themselves in.

During the late 1980s when the remuneration disclosures first came in there were a number of companies that applied for relief on the basis that they were afraid the directors were going to be kidnapped, which was quite a legitimate fear, I suspect, for some of them. But that is a separate issue. If we go back to the genesis of that provision, originally it was concerned with problems when the schedule requirements were introduced. The Eggleston committee in their report said, 'There may be some problems here so we should give a discretionary power to the regulator to allow people not to comply with the provisions.' However, we might also note that the Board of Trade of the United Kingdom has had the power since I think 1946 to regulate disclosures on the basis of international competitiveness. I think it is more a question of whether the legislature should expressly state in the grant of powers to the commission that it shall take into account the competitive impact rather than relying on differential interpretations of what is meant by the burden in complying with the requirements.

Mr ROSS CAMERON—I thought your earlier argument was that we should not shield anyone from competition.

Mr Langfield-Smith—I do not believe we should, but I am just pointing out that in some jurisdictions I think they still do so. The last time I checked up in, I think, Canada and the United Kingdom there were provisions where international competitiveness is at risk to allow non-disclosure.

Mr ROSS CAMERON—It would be interesting to know if Incat's one external competitor is required to make the same level of disclosure.

Mr Langfield-Smith—That is a very difficult question. I am just trying to work out where they said they are incorporated. My knowledge of European accounting requirements is very limited. It depends whether they are a listed company. If they are listed, then at least in the medium to long term they will be required to comply with international accounting standards in terms of the disclosures. But what Incat is worried about is basically identical. In their case it is a large company and it would be more difficult, if not impossible, to get the information in terms of just that one small operation in terms of manufacturing because, even to have segment reporting, it would probably have shipbuilding as a segment. Part would be catamaran-type Incat stuff and the other stuff would be supertankers. It would not help from that point of view because it depends on how you define the segment.

Mr ROSS CAMERON—So we could be putting Incat at a competitive disadvantage with their international—

Mr Langfield-Smith—That could be, and it may be appropriate for the committee to consider whether or not the legislation should be changed to expressly allow ASIC to grant relief where international competitiveness is an issue. That is one thing that I would like. We will clear up, first of all, the question of what we mean by burden. I think ASIC has assumed and regulators like to assume they have the widest power possible, that they have had this power; and it is not in their own interests to argue they do not have the power—regulators just do not like that. That is the point that is very important—we need to make it clear, both to the regulator and to those who want the help of the regulator, what is expected.

CHAIR—Do you think that ASIC have been deliberately interpreting their power on a narrower basis than the actual criteria that are laid down give them?

Mr Langfield-Smith—I think that, if anything, they have been interpreting their power more widely than perhaps it is, but in terms of when they exercise the power they have been extremely reluctant to exercise it. Before the 1991 amendments to the Corporations Law, the policy statement dealing with financial reporting matters expressly dealt with some of the more complex issues, such as disclosure of revenues and those sorts of issues, in the commission's stated policy. When the true and fair view override was removed, ASIC took that as a signal from the parliament that accounting standards were to be complied with basically at all costs and therefore they removed that section of the policy statement, so they have got one with general requirements not referring to accounting standards.

I suspect they also became more reluctant to grant approvals for requests for non-disclosure. Mind you, before that date, I suspect they were not terribly keen on giving relief. I notice the ASIC submission gives no indication of the number of requests for relief, but that the major number of those requests have been granted. So, in terms of working out how effective the

system is and which particular side is winning or losing, it is extremely difficult for us to judge. Basically, we just have to go through the gazette and look at the orders under the legislation. It is impossible to know the success rate because, by definition, only two or three companies in the last 10 years have actually questioned the refusal to grant. Therefore, we have no idea how many other unsuccessful applicants there have been.

CHAIR—Excuse me if you dealt with this issue while I was out of the room. As I understand your proposal, you favour a reporting entity concept—

Mr Langfield-Smith—Yes.

CHAIR—If that is not to be adopted you favour the current system, but with no change in the dollar limits for small proprietary companies?

Mr Langfield-Smith—Yes.

CHAIR—Does that mean that effectively you are reducing the threshold by not allowing that, because of the effects of inflation? Or are you in fact saying that you want to put in other criteria, rather than focusing on dollar limits, and get rid of the dollar limits?

Mr Langfield-Smith—Dollar limits impose all sorts of difficulties, as was pointed out by the Institute of Company Directors. If you are near the margin, you have to work out everything on the basis that you have to prepare the financial statements anyway because you have to use the measurement rules required by the accounting standards and the allocation rules. If you are at the margin the only difference is whether you get audited or not. It is a relatively expensive exercise—I do not know in terms of total revenues, after tax cost, et cetera. Indeed, given the other benefits that flow from audit which are not solely concerned with the financial statements, in terms of risk analysis and the like, it can be very useful to have an external expert go through your systems and point out the problems of your internal controls, so there are benefits that may flow.

If there is a dollar limit it should be indexed to make any sense. The approach is based on that in the United Kingdom, where they have three tiers—small, medium and large—and the dollar tests here were a conversion of the medium tier in the UK, so they had a more restrictive one further down and a much larger one. I notice that the government in the United Kingdom has just finished a review of the pound limits and decided not to change them, so I am not convinced that it is a good idea to increase them. I think there are relatively few companies in that group that should not be reporting. I think it is easier for them to go along to ASIC and apply for relief on the basis that they are not a reporting entity and I think ASIC needs in that case to be somewhat more lenient than they have been in the past in interpreting the provisions.

The legislation itself does not actually say that you can grant relief if you are not a reporting entity. The circumstances in which relief has been granted are illustrated in the case in Western Australia which is referred to in one of the submissions, the Liquid Air WA case. In that case the applicant went to a great deal of work, went to all its customers, all its employees, and got statements from them saying they did not want the financial information. The then delegate, the Western Australian corporate affairs department, said, ‘No, we are still not going to give you

relief,' but that was overturned by the Master. That company demonstrated it was not a reporting entity.

Also, while company directors seem to have some difficulty with whether or not a company is a reporting entity, I note that neither the Administrative Appeals Tribunal nor the Federal Court seem to have great difficulty with that issue. But lawyers, particularly judges, are used to dealing with areas of grey that require an exercise of judgment, whereas company directors, in what they see largely as the peripheral area, prefer a great deal of certainty. Of course, their main concern is running the company. Issuing the financial reports is just incidental to that, except when they are in fundraising mode. You can understand the difference in that approach.

CHAIR—If the current regime is to be retained, what are the minor changes to it that you recommend? Can you clarify that?

Mr Langfield-Smith—There needs to be some tinkering around the edges. For instance, I think where we have small proprietary companies there are circumstances where shareholders are disenfranchised. I mentioned, while you were out of the room, that non-voting shareholders cannot request financial statements because it is limited to those who have voting shares. This may be an area that needs to be addressed.

It may also be of concern in terms of addressing some of the legitimate worries about the margin. I have thought about these issues very hard. Of course, basically, companies at the margin do not know whether they are going to be big or large, perhaps until two weeks before the end of the financial period. In fact, they may not know until afterwards in terms of some of the measures they are required to use. It may therefore be not unreasonable to base it on the position at the end of the previous financial year, or six months before, in terms of trying to make life a little bit easier in terms of removing some of the uncertainty.

We have to remember that the commission has a residual power to require accounts to be lodged if it thinks it is appropriate. There are no guidelines given for what basis they need to do it on. It seems an unrestricted power to require lodgment of audited financial reports. That is always available for people who are worried about a particular company. They can go to the commission and suggest that they should exercise this power. But I note that there is no formal mechanism where somebody can apply to the commission for a company to be required to lodge information. That may be something that might be appropriate. I do not know.

CHAIR—Thanks very much.

Senator COONEY—In your submission—it interested me a lot—you talk about a retreat from high ethical and professional standards and you say that is a cause for considerable concern. You talked about the 1980s and then there was the other argument at the end of the 1980s and start of the 1990s about fuzzy law and black print and all that. That was done in the context of how regulated companies needed to be, given their culture at that time. Is that a factor you would take into account now?

Mr Langfield-Smith—To a degree. These things go in waves. We have periods when the temptations become great and people transgress and then we have periods when there is great concern. There is a great deal of effort being made by those who are deeply concerned with

improving corporate governance. There is Henry Bosch and his group in particular, plus the Institute of Company Directors, and various other organisations such as the ASX. They are very concerned about these issues. They are moving slowly towards redressing some of those problems. Unfortunately, whatever they do, the real crooks will try still to get away with it.

Senator COONEY—Yes, I would like to pay tribute to Henry Bosch on the record. What you have told us here today you would stick by, whether or not we were in times of high ethical standards or low ethical standards. Would that be right?

Mr Langfield-Smith—Yes. We tend to go through waves of deregulation and re-regulation. Every time a change is made there is a genuine desire to try to make more effective regulation. In terms of the current regimes, if I recall correctly—my memory is as rusty as Senator Gibson's—it came out of the report on the Close Corporations Act. That was considered to be a completely unsatisfactory way of dealing with small business and the corporations simplification task force in A-G's brought in that this is the way of melding the existing system to try to help the smaller business within the existing structure. It was not as successful as it may have been but I suspect the problem is intractable.

Senator COONEY—As I take it, what you are saying is that if everybody had to report there would be no real problems as to whether the particular criteria are reached or not.

Mr Langfield-Smith—Yes, you have to have a report but then, again, we would then have a million companies reporting and those reports would never be looked at. If we have electronic lodgment that is not such a storage problem as it used to be, but it is requiring a great deal of cost in terms of the sort of information needed for internal management which differs from the sort of information you would presumably have if it is going on the public record.

Senator COONEY—Balancing all those matters, I understand what you say is that the present situation is how you would go, but with an indexation.

Mr Langfield-Smith—Yes, I would prefer that to merely depending upon whether the company was a public company or a proprietary company.

CHAIR—There being no further questions, I thank you very much for your presentation to the committee and particularly for your answers to our extensive questions.

Mr Langfield-Smith—I would like to thank the committee for the assistance they have provided in allowing me to come to be of assistance.

[6.19 p.m.]

DELANEY, Mr Michael, Executive Director, Motor Trades Association of Australia

GARDNER, Mr Geoff, Deputy Executive Director, Motor Trades Association of Australia

CHAIR—Welcome. Do you wish to make an opening statement before we proceed to questions?

Mr Delaney—Thank you for our interests being referred to the committee once again and thus for the opportunity for us to appear. Our particular interest is the same one that it has been on previous occasions and that is the application of the audit test as between small/large companies—

CHAIR—The audit requirement?

Mr Delaney—Yes, and the burden that our car dealer members, in particular, report to us that it was at the outset and remains. We have said to you in our submission that we did not believe that the discretion that you provided after hearing us and others propose that you should was perhaps taken up or acted upon by the commission in quite the way we thought the committee and the parliament had intended. We, indeed, engaged in negotiations with ASIC over that discretion in pursuit of a fast audit for quite a long period of time but, in the end, it came to nothing and the efforts were abandoned.

We say in our submission that it still remains the case that the internal-external cost of the audit is over $20,000 and that there are peculiar circumstances operating for dealership businesses. They look large on one test of turnover but they are, in fact, small in reality. But in any case, rather than try to appear before you and propose a silly contest over the facts, we thought it might be best to propose to the committee that there did seem to be some questions that the committee might ask ASIC to answer by which the truth of the matters could be established. So we have really just said at page 16 of our submission what we think those questions are and then at page 17 we have recommended to you that you might perhaps address whether it is able to be reported as to the four things that we set out there.

CHAIR—Thank you, Michael.

Mr Gardner—Mr Chairman, when talking to some of the accountants that deal most closely with franchise dealers they make the point that the people who are most affected are those who operate family companies and who have normally one or two major creditors, their finance company or their supplier—often literally the same person. For that reason it is their supplier who essentially keeps them honest. They have very close access to their accounts and they have reporting practices installed on the dealership network that are literally far in excess of what is going to be shown up by the snapshot of the annual accounts. For this reason they feel that the burden of the audit requirement that they face is just simply unwarranted. We have just had a quick look at the ASIC submission and, although we have not been able to digest very much of it and we would probably like to come back on that, it does mention there that ASIC does not have any information concerning costs. Our view is, as Michael said, that it does cost well over $20,000 to jump through the hoop. That is a $20,000 cost to an individual or to a family

business. Those people believe that that is a personal cost to them for this requirement to be met.

CHAIR—That is your estimated cost of compliance to each individual?

Mr Delaney—It was $25,000 when we first appeared before you but it turns out now to be more like $20,000. The market has moved on a bit since then, as well. Whereas back in 1995-96 there might have been four or five—I am speaking of a multi-site franchise—financial reporting systems going to the supplier, it is typically now an obligation imposed by the principal supplier to report the whole of the business, not just one franchise. Indeed, most of that is online, as Geoff says, and is able to be interrogated by the principal supplier which can actually be the principal supplier of the bailment money—because they are all bailment businesses—or the principal supplier of the goods who may well be providing the bailment finance, as well.

CHAIR—Are there any consequential costs of compliance, as described here, applying to Incat in their situation that apply to motor vehicles in terms of competitive issues?

Mr Delaney—We saw the two cases that had been admitted and the two appeals to the AAT, one of which succeeded. I do not know the details of the Incat one or that we would want to argue on that basis. What has happened since your report on these measures is that most of the motor vehicle dealers—and we represent 99 per cent if not 100 per cent—say that having an audit is very prudent and desirable and they can understand why these measures have been put place. They say that if they were in another part of the economy they would say that that is fine but in their case these are very peculiar businesses. They may turn over $50 million; they might have only $500,000 capital in them; they may produce only a $200,000 profit; and they probably have 25 employees. The principal creditor will be just one party which has a charge over everything including the private assets and directors’ guarantees. All they are saying is that in a circumstance where the best you can do is, on industry standards, two per cent retained gross on your sales and a net, if you are lucky, of maybe 50 basis points, $20,000 is a lot of money. Essentially, such a business might have $500,000 or $600,000 gross retained and so it is a small business and it is a very substantial part of the outgoings which, they would argue, are avoidable and probably, in that case, would get passed on through competition.

CHAIR—How many dealers do you estimate are caught inappropriately by the large/small test?

Mr Delaney—The present population is 1,430 franchised, holding about 5,000 franchises at about 4,300 sites. There would be a couple of individuals whose sales would be as high as $2 billion. There are a number who would be at $500 million through to $900 million. There are two that are listed—Adtrans, well known to you—and then there is the Queensland group, whose name escapes me for the moment, but there are only two listed. It is a bit hard to say, but I would think probably about two-thirds would be more like that description I have given you of maybe $50 million or less turnover. But we could certainly get Horwaths, who are the principal auditors—they have 500 clients nationwide amongst the dealers—to give us a profile for you.

Mr Gardner—I did ask Horwaths that question and they thought, based on the numbers that they represent, that those who would be caught up would be 400 or more dealerships.

CHAIR—At $20,000 per dealer, you are talking $8 million. To what extent are you able to estimate how that translates in cost to consumers? Is it being passed on to consumers as an additional cost per vehicle?

Mr Delaney—I think it is. There is a level below which dealers cannot cut the prices of cars—and that is the fixed cost—because to go below that, given that they are fully controlled by their supplier or their financier—and it may be one and the same—would suggest that this cost, as it is not being able to be competed away, is probably a cost to consumers in that fashion.

Because all the businesses are franchised—and that is unavoidable—you never see the businesses go broke. That does not happen. What happens is that suddenly the person who had it is not there any more. It is true that often a site will go out of the market because it is no longer market appropriate. But basically all that has happened is that the bailor or the supplier has moved in and it does not go into liquidation or something like that; you just get a work-out, if you like, and that arises because they know on a daily basis what is happening in the business. We are really only suggesting that for those suppliers and financiers this is a cost that they allow, which they would probably prefer—as we would—not need to be there and that, given that it is so madly competitive, it is probably a cost that will competed away.

Senator GIBSON—Did you hear the proposals from the company directors about retreating to exempt companies but, in addition, making it a requirement on all companies, first of all, to prepare financial reports but not have to lodge them and and—probably more importantly—secondly, that all directors sign a declaration of solvency for distribution to shareholders and to employees?

Mr Gardner—Without knowing the actual details, I think most of the accountants who do the work on behalf of the dealers would believe that sort of arrangement would be quite appropriate. In fact, I am not sure that we have not suggested that in the past.

Senator COONEY—By way of clarification, not of the principle but just of how it works, are the bailees—it, he or she—also bailees of the used cars?

Mr Delaney—Both.

Senator COONEY—And what about the services that are carried out?

Mr Delaney—On the new cars, the bailee would typically go to 85 per cent. The cars are then bar-coded in conspicuous places and the bailee's agent comes round every couple of days and puts a reader over them to make sure they are still there. In the case of the used cars, it is probably more like 65 per cent or 60 per cent of the value in a valuation guide. That is loaned against those cars. Then this transaction occurs where, while the title goes to the bailee, we carry the cost of doing the repairs and bringing them up to the new value. Then when they are sold on with the warranty and the like attached, the money comes back less the cost of the finance and we carry the cost of that change in character.

Senator COONEY—I have probably given you the wrong idea about the repairs. You usually have a workshop where the dealer would sometimes make quite a substantial part of the

money that the business brings in. I was just wondering how you treat that in the bailor or bailee situation, how that fits in there.

Mr Delaney—But for some people who are cyclically very lucky, most of the dealers do not actually make much on the car itself. By cyclically lucky I mean if you have a Subaru dealership at the moment you are doing pretty well.

Mr Gardner—Or Honda.

Mr Delaney—Yes, Honda. Yes, the money is made from the other elements of the transaction such as finance, insurance, extended warranty, accessories, other fitments—the whole of ownership relationship over servicing and anything else that arises. That is how the business actually works.

Senator COONEY—But that does not make any difference to the propositions you put forward.

Mr Delaney—No, because the bailee's charge is over the whole of the business. Its expectation of solvency is very much related to those parts of the business you just referred to.

Mr ROSS CAMERON—In your submission you said that ASIC switched at the 11th hour from an audit relief criteria which originally related to the proportion of debt owed to unsecured creditors and then went to a measure of assets over debts. Why was that such a significant adverse decision for the industry?

Mr Gardner—Because the balance sheets of most dealerships have the cars that are bailed to the finance company as a liability on their balance sheet so almost none of them can ever leap the hurdle of their liabilities exceeding their assets. The point the dealers always make is that the liability on their balance sheet is covered to 100 per cent or more by the assets that the finance company has in the cars themselves. But because it is on there as a liability, that hurdle never gets jumped.

Mr Delaney—The liability does not change much. The servicing costs for the liability is calculated on a daily basis, it moves up and down, but it is met through the selling of finance and insurance, which is usually supplied by the bailee. What actually transpires is that, suppose the bailee cost for the stock is eight per cent nominal, if you sell their retail finance at 10 per cent you then get rebated so much of the eight per cent. So you have a running account all the way through, which means that you are not actually in the end writing a cheque to them. What Esanda and AGC, the two biggest, try to do is say that that is how they want it to work, and always there will be this liability of so much nominal, because that is the stock of cars you need to keep selling their finance. That is the second part of what Geoff has just said.

Mr ROSS CAMERON—From the tone of your submission it sounds like your dealings or relationship with ASIC as an industry group have not been very constructive.

Mr Delaney—It was to begin with. The strength of your committee's report got us off to a terrific start and we negotiated through long phone conferences, meetings and a large amount of documentation for about eight months. We thought that we had reached a point where they

understood the industry absolutely and that we would have the benefit of the discretion you proposed. But at the last minute we were told informally that, while those we had been dealing with were entirely sympathetic, it was thought by others, perhaps more senior, that this would create a precedent that would cause terrible problems. Discussions stopped and we were given a firm declination, about which the chairman was badgered by his car dealer constituents for about a year afterwards.

Mr Gardner—We did get the impression that the accounting profession also let off a lot of alarm bells and said, ‘You can’t let this happen,’ and so on. We thought, as in our case, there was a measure of self-interest in their sounding that alarm.

CHAIR—It really just came to a dead halt.

Mr Delaney—Yes. You may recall we wrote to you at the time and said that we were not sure what had happened.

Mr ROSS CAMERON—I understand that the Ford parent company has been pretty aggressively buying back the Australian dealerships. Is that right?

Mr Delaney—Ford has trialed at three places in the world for reasons Jac Nasser says are unavoidable in an attempt to capture a large part of the wholesale or resale margin. In the US, its attempts at buying back the businesses and going into minority partnerships with aggregations of the dealers has been quite unsuccessful.

CHAIR—It is like a car version of multisite franchise.

Mr Delaney—Yes. It has done it in New Zealand, where it has been successful so far, and it has introduced it in Perth. It is currently making offers in Sydney. Ford Australia is a bit unusual for having four or five of its outlets owned by Sumitomo Finance of Japan. In the case of Perth, all but two dealers joined the Ford retail joint venture. In the case of Sydney, perhaps half of the dealers will. It is essentially a judgment by Ford that they are unable to support so many retail outlets any longer. In Sydney, for example, there are 24 and it is thought that there should be only about 10 or 12.

They have been pretty fair in how they do it, which is why you have not heard any complaints from us. Essentially, you are invited to join in or stay out, it is up to you. You are invited in if your real estate is particularly attractive and you are paid at valuation. You might otherwise not be able to get in the market. You are paid in shares in the joint venture. If you stay out, that is fine. They say you will not be discriminated against and you will set your own terms and manage your own market. We are watching with interest to see what will happen. The two sites in Perth, the owner of which is Colin Horton, who did not join in seem to be creaming the market against the Ford factory by being quicker, cleverer and all sorts of things. It will be interesting to see what happens elsewhere.

It is not just Ford that is doing that; there is a worldwide realignment of ownership and the like. At the moment we have a particularly nasty fight going on with Subaru, which is attempting to do the same thing in Melbourne but not elsewhere because its master franchisee

for Australia, which is not factory related, has decided that Subaru dealers in Melbourne are doing far too well.

Mr ROSS CAMERON—Is there any evidence that those changes in direction are being driven by inefficiencies in the current commercial structure imposed by this kind of regulation, or do you think it is a separate set of factors?

Mr Delaney—It is entirely separate. Worldwide it is asserted that there is about 30 per cent of the sticker price of the car attributable to the marketing process and distribution of marketing. No-one can afford that any longer and you have to cut it back somehow. In fact, the four aggregated sites would probably be subject to—and necessarily so—a lot more regulation but, of course, what Ford is saying is that you will not be going through a multiplicity of times of responding to it.

Mr Gardner—Every now and then one of the major manufacturers does a huge number about how the Internet is going to change everything and people are going to buy their cars off the Internet and that there is a need to rush to rationalise the networks. I think Jacques Nasser actually thinks that, although in our view there is not a lot of evidence that it is either happening or likely to happen. It is just that the way people buy cars is to touch and sit, and not click—

Mr ROSS CAMERON—Under the former test of debt held by unsecured creditors what would the profile of your franchises have looked like?

Mr Gardner—Do you mean would we have qualified?

Mr ROSS CAMERON—For relief, yes.

Mr Gardner—Most of them believe that the former test which was originally in the first class order, or the draft class order, would have meant that they qualified, yes.

Mr ROSS CAMERON—What was the figure?

Mr Gardner—I am not sure now.

Mr Delaney—It has gone on for so many years that it is hard to keep track of.

Mr Gardner—I am sorry, I cannot tell you that.

CHAIR—Are there any further questions? If not, thank you very much for appearing before the committee and answering our questions.

[6.43 p.m.]

FISHER, Mr Thomas, Assistant Secretary, Office of Small Business, Department of Employment, Workplace Relations and Small Business

GREENWELL, Mr Anthony David, Director, Finance and Tax Policy, Office of Small Business, Department of Employment, Workplace Relations and Small Business

LEE, Ms Margaret Adelaide, Assistant Director, Finance and Tax Policy, Office of Small Business, Department of Employment, Workplace Relations and Small Business

CHAIR—Welcome and thank you for appearing before the committee. Do you wish to make an opening statement before we proceed to questions?

Mr Fisher—Just a very brief one. By way of background I should explain that the Office of Small Business provides policy advice and support to the government on small business issues. As part of this role we seek improvements in the commercial environment for small business to promote efficiency and employment growth. Importantly, one of our major roles is to encourage and facilitate the reduction of paperwork and compliance burden of small business. That is really the main focus in having made this submission.

While the existing legislation does provide relief from reporting and audit requirements, a significant number of small to medium companies are not able to access this relief and a number of representations have been received on this matter. Our concern is that the benefits of the requirements for external parties, for example, ASIC and creditors, have not been demonstrated sufficiently to warrant the cost to affected businesses. We do not have anything further to add to our submission but obviously we are happy to answer any questions that you might have.

CHAIR—I note you provide some alternatives. Were you here when the Institute of Company Directors presented their alternatives?

Mr Fisher—No, we were only here for the MTAA.

CHAIR—Perhaps Senator Gibson might outline them because he heard them more directly. I have had them second-hand. See how you perhaps judge them against the alternatives that you present.

Senator GIBSON—They made a strong case basically to retreat to the exempt definition: in other words, all proprietary companies, if they are privately owned, do not have to report publicly. But in addition, they made two suggestions. The first was that all companies ought to be required to prepare financial statements but not have to report. In other words, the requirement as it was at present exempted companies from doing that. More importantly, directors of all companies should be required, in conjunction with the financial statements, to make a declaration of solvency and each individual director to sign a solvency declaration which is then made available to all shareholders and to employees. In their view, that would make the system better than at present. The relatively small number of companies that are caught by the present small/large test—less than 2,000—would be better off by this other requirement. That is their thesis basically. Do you care to comment?

Mr Greenwell—I think we would support anything that removed the audit requirement. The audit requirement is one of the things that we are most concerned about from the small business perspective because we are talking figures of $25,000 or $20,000, as you heard earlier. If that particular option removed that cost to small business, then I would think we would be reasonably comfortable with that.

CHAIR—I note your reference to the introduction of the new tax system and that the goods and services tax will realise an overall improvement in record keeping practices. Would you like to enlarge on that and how you see that as perhaps overcoming whatever need there might be? I know you see the benefits as fairly limited, if existing at all, from the current procedures, but might that be an adequate replacement for them?

Mr Fisher—The fact is that the new tax system will result in having an improved accounting environment. We have spoken to a large number of small businesses and small business organisations and the general view seems to be that one of the benefits will be that many of those organisations or those enterprises that have not to date gone beyond the shoe box sort of accounting system are now moving into at least—I was going to say e-commerce, but probably not that far—an information technology world. That will also result in the information being more readily available and more readily understood by others. So it is really a byproduct, if you like, as far as that goes.

Ms Lee—One of the big improvements the GST will encourage is a much improved cash flow management in respect of the system. In addition, the audit requirements by the ATO and consistent monitoring would be expected to lead to the kinds of improvements in accounting record keeping. We feel it may reduce the need for these kinds of requirements that we have got here.

Senator GIBSON—The quarterly activity statement will basically show up whether this business is still viable or is not.

Mr Fisher—Exactly. That is right.

CHAIR—What sorts of factors do you think would need to be taken into account in a cost-benefit analysis to determine whether the public policy grounds justify the current regime?

Mr Fisher—From where we sit at the moment we fail to see that there are benefits to those other people. The expense that the small to medium businesses have to go through to get this audit is quite substantial—$25,000 is a figure I heard mentioned earlier by Michael Delaney. We have not given any thought or detailed consideration to how you might make that assessment, but from where we sit we just do not see any real benefits as it stands.

CHAIR—You have not done any specific cost-benefit analysis of the framework?

Mr Fisher—No. Most of our comments are based on material—submissions is probably too strong a word—that has been put before us in ministerials or letters to us complaining about the burden that has been put on them. It is probably fairer to say that it is more anecdotal than analytical.

CHAIR—Have you got any comments on the particular circumstances of the motor dealers?

Mr Fisher—One of my colleagues here has had some talks with them and might want to add some comments, but it does seem to us that, in terms of the criteria that must be satisfied, motor dealers and some heavy machinery manufacturing would be some of the areas where they would struggle to meet at least two of the criteria. Some of the MTAA's members are at that end of the market where they have a low turnover but a high value of equipment. Certainly for the manufacturers of things like combine harvesters six months may well go past where no sales are made, but then harvest time comes and there are significant sales, so there are a lot of assets sitting there for some considerable time.

CHAIR—As there are no further questions, thank you very much for your input, comments and answers to our questions.

Committee adjourned at 6.52 p.m.