ASIC
Australian Securities & Investments Commission

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The Secretary
Joint Committee of Public Accounts and Audit
Parliament House
CANBERRA ACT 2600

Dear Secretary

Review of independent auditing by registered company accountants

I refer to the review being undertaken by the Joint Committee of Public Accounts and Audit ("the Committee") on independent auditing by registered company auditors and to the submission made to the Committee by ASIC dated 17 June 2002.

This is a supplementary submission dealing with some issues that arose in evidence given on behalf of ASIC to the Committee on Friday, 26 July 2002, in particular in response to the submission and evidence provided by Mr Mark Leibler on the same date.

Enforcement of true and fair requirement

We do not understand Mr Leibler's views on the requirements of Chapter 2M.3 of the *Corporations Act 2001* concerning compliance with accounting standards and ensuring that financial reports give a true and fair view to be fundamentally different from our own. A detailed restatement of how we consider the relevant provisions operate is attached to this letter. While we may take issue with Mr Leibler on some matters of detail, we do not consider that it is necessary to resolve them for present purposes.

It appears to be common ground that:

(a) public companies must prepare an annual financial report which:

   (i) complies with accounting standards (section 296); and

   (ii) gives a true and fair view of the financial position and performance of the company (section 297);

(b) auditors must express an opinion about both these matters (section 307); and

(c) the true and fair requirement does not affect the obligation for a financial report to comply with accounting standards – rather any other information necessary to give a true and fair view must be included in the notes to the financial statement.

What is at issue are the merits of seeking to enforce the true and fair requirement in the manner suggested by Mr Leibler. Mr Leibler appears to be particularly concerned that companies and their directors and auditors do not appreciate that compliance with accounting standards and giving true and fair view are distinct statutory obligations.

While the general level of understanding of these obligations may be less than ideal, it is not apparent that any benefit would flow from seeking to enforce the true and fair obligation on the premise that compliance with the accounting standards alone would not ordinarily result in true and fair accounts. Indeed, we consider that such action is likely to be counter-productive.

It must be recognised that accounting standards are set on the basis that proper compliance with them should ordinarily result in financial statements that produce a true and fair view. It is an express object of Part 12 of the *Australian Securities and Investments Commission Act 2001* (ASIC Act) to facilitate the development of accounting standards that require the provision of financial information that is relevant to assessing performance, financial position and is relevant and reliable (section 224).

ASIC's approach to the financial reporting provisions is supported by advice from senior counsel.

Company directors and auditors need to be alert to the possibility that compliance with the standards may not always result in the presentation of a true and fair view (eg because strict compliance would render results misleading or because a standard has yet to be developed to cover a particular event or transaction). It would not, however, be appropriate to administer the Act in a manner which may give rise to an impression that the efficacy of the accounting standards is routinely to be "second guessed". We consider that this is consistent with the removal of the true and fair "override" from the legislation.

Furthermore, it would be undesirable for the subjective views of companies and their directors and auditors as to what constitutes a true and fair view to pervade the financial statements of public companies. This would tend to undermine confidence in, and the comparability of, public company accounts.

In our view, any perceived problem in the operation of an accounting standard is more appropriately addressed by review ,and if necessary amendment, of that standard.

Finally in this context, I take the opportunity to reminding the Committee of remarks I made when giving evidence to the Committee on 26 July 1992. I repeat that neither ASIC's Chairman David Knott nor ASIC should be taken to be advocating a return to the 1980s position where directors could choose to depart from accounting standards by forming a subjective view that the result would not have been true and fair. However, we see the need for emerging international standards to strike a more appropriate balance between two potentially conflicting approaches. We see the need for more emphasis on standards that contain principles requiring a focus on the substance of transactions; and less emphasis on detailed rules to be applied regardless of whether the result is a proper reflection of the economic substance of a transaction. This is a proposition directed toward the content and style of accounting standards and is designed to promote standards that will result in objects set out in Part 12 of the ASIC Act.

ASIC enforcement action to date

Mr Leibler's submission makes a number of assertions about ASIC failing to take action against auditors or more generally in relation to financial reporting breaches.

ASIC has been active in enforcing compliance with the financial reporting requirements for many years. For example, ASIC interventions in the period 1998-2002 have resulted in adjustments to financial statements of more than $3.3 billion dollars. Most recently Mr Knott on 12 July 2002 announced a major accounting surveillance project directed to areas of accounting abuse of the type recently uncovered in the USA. This project will involve a review of the next round of financial reports for all Australian listed entities.

Auditors who fail to comply with their obligations to form proper opinions about the extent to which a company has complied with the accounting standards and presented a true and fair view in its financial statements and notes are liable to be disciplined by the Companies Auditors and Liquidators Disciplinary Board (the CALDB). The CALDB has an important function that is supported by ASIC and ASIC frequently refers misconduct to the CALDB.

From 1991 to 30 June 2001, 249 matters were put to the CALDB:

Matter	**Number**
Failure to lodge triennial statement	167
Failure to adequately perform duties or not fit and proper person	45
Acting while disqualified from managing a corporation or incapable	37
Total	249

The outcomes of these matters were:

Outcome	Number
Registration cancelled	105
Registration suspended	41
Reprimands	11
Board refused to exercise discretion	10
Application withdrawn (generally after respondent voluntarily surrendered registration)	82
Total	249

Ramsay Report

At the hearing on Friday, 26 July 2002, ASIC was asked to provide the Committee with further information concerning comments made in a private submission by ASIC to the Parliamentary Secretary to the Treasurer concerning the operation of the CALDB. ASIC's submission dated 17 February 2002 was in response to the October 2001 report of Professor Ian Ramsay entitled *Independence of Australian Company Auditors* and covered a broad range of matters raised in Professor Ramsay's report.

ASIC's submission agreed with Professor Ramsay's recommendation that the ASIC Act be amended to expand membership of the CALDB and allow it to sit in more than one division simultaneously. This was not intended to indicate any concern that ASIC had with the ability of the CALDB to meet its current workload, and was merely a response to a matter raised by Professor Ramsay. ASIC saw it as useful for the CALDB to have the capacity to sit in more than one division going forward but is satisfied with the CALDB's its ability to deal with matters on a timely basis.

We are not aware of any response from the Parliamentary Secretary in relation to ASIC's comment and would not have expected a response given the nature of the submission.

If you have any questions or require any additional information about these matters, please contact me on (02) 9911 2680 or by email to malcolm.rodgers@asic.gov.au.

Yours sincerely

Malcolm Rodgers
Executive Director, Policy & Markets Regulation

ATTACHMENT

The Accounting Standards and the True and Fair Requirement

The Act gives the accounting standards the primary role governing in the preparation of financial statements and notes. This is the effect of section 296 which requires financial statements and notes to comply with the accounting standards.

Section 297, on the other hand, requires companies to add information to the notes if the result of the application of the accounting standards does not produce a true and fair view. The requirement in section 297 does not allow companies to change information required by those standards to be included in the profit and loss statement, the balance sheet or the statement of cash flows.

This means sections 296 and 297 operate conjunctively and in a logical sequence in which compliance with the accounting standards not only comes first in time but also comes first in determining the key disclosures at the heart of the financial statements and notes. The accounting standards decide what information is required to be in the profit and loss statement, the balance sheet and the statement of cash flows. The accounting standards also determine the content of the notes. However, they are not the only contributor to the notes and that is where the requirement to add information and explanations to ensure the overall picture is true and fair plays its part. The requirement to ensure the overall picture is true and fair is a requirement to supplement the information already contained in the financial statements and notes as a result of the application of the accounting standards by adding any supplementary information to the notes.

In this context, the requirement to ensure the overall picture is true and fair cannot change the information required by the accounting standards to be contained in the key statements (profit and loss statement, balance sheet and statement of cash flows and the notes required by the accounting standards) comprising the financial report. It can only supplement those disclosures. In practice, this means the extent to which the financial statements and notes do not give a true and fair view can only be assessed <u>after and in the light of</u> the application of the accounting standards. This gives the accounting standards a logical and practical primacy.

ASIC's view is wholly supported by the Explanatory Memorandum to the Company Law Review Bill 1997. The Explanatory Memorandum made it clear that the requirements to comply with the standards and to ensure the financial statements and notes present a true and fair view were not intended to produce differential results. As stated, at paragraphs 13.31-13.32 of the Explanatory Memorandum the requirement to ensure there is presented a true and fair view

> is consistent with the AASB's *Statement of Accounting Concepts SAC2: Objectives of General Purpose Financial Reporting* which requires that information that is relevant to the assessment of performance, financial position and financing and investing be included in general purpose financial reports….The obligation for the financial statements and notes to present a true and fair view will not affect the <u>primary obligation</u> to comply with the accounting standards….

In ASIC's view, this statement evinces a clear legislative intention that the framework for the way in which accounting standards are made and interpreted should not be viewed as requiring significantly different considerations to those that are relevant to the assessment of what is true and fair.

At the same time, ASIC recognises the requirements in section 297 and section 307 mean there is a valuable oversight role to be played by auditors to ensure that the overall picture is true and fair.

This view of the interrelation between the application of the accounting standards and the requirement to add information to produce a true and fair view has been underlined by the AASB in AASB 1018 *Statement of Financial Performance* which prohibits the practice of including statements that purport to be statements of financial performance that are not in accordance with the accounting standards (see para 4.6 of AASB 1018).

Similarly, auditing standard AUS 702 *The Audit Report on General Purpose Financial Report* obliges auditors to express a qualified opinion if a company makes additional disclosures asserting or implying that the application of a particular accounting standard has resulted in the financial report being potentially misleading. The auditor can only give an unqualified opinion if the auditor forms the opinion that, in the absence of the additional information, users would be misled and the additional disclosures are full disclosures of all relevant and reliable information and the presentation of that information ensures the whole is comparable and understandable.

The application of objective criteria in the accounting standards clearly promotes comparability between financial reports and reduces the risk of subjective variances in the treatment of assets, liabilities and transactions of the same kind by different companies.

Australian Securities and Investments Commission
August 2002