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3 August 2002

Mr Bob Charles MP
Chairman
Joint Committee of Public Accounts and Audit
Parliament House
Canberra ACT 2600

[RE: Suggested changes to boost quality of accounting and auditing.]

Dear Bob,

The purpose of this correspondence and the attached submission is to detail several areas where I believe the corporate law can be tightened to improve the quality of reporting and auditing in this country. These suggested amendments have been partially inspired by the nature of the comments on truth and fairness made by various witnesses appearing before the committee. They are also due to my own professional work focusing on accounting and auditing matters. What will become apparent fairly quickly when the committee reads the suggestions that follow is that your committee can have great impact by focusing on several changes that will require only minimal additions to the law affecting the interpretation of accounting standards and the preparation of financial statements.

I must at the outset state I have some concerns with the very restricted focus of the debate over truth and fairness in financial reporting. One serious reservation is the absence of consideration about the role of the complete suite of legislation having an impact on the determination of a true and fair view. The role of the Corporations Act 2001 in this respect was reflected in the submission and testimony of Mark Leibler, for example. His analysis of the law is insightful but it does have some limitations because Mr Leibler confines himself to the Corporations Act and does not extend the scope of his inquiry into other parts of Commonwealth legislation that might assist in giving meat to the skeletal notion of truth and fairness embedded in Part 2M.3 of the Corporations Act. Financial statement presentation and the notions of truth and fairness are regulated by several parts of the legislative framework in this country. His arguments would have been enhanced had he included consideration of other pieces of legislation affecting the interpretation of accounting standards used to put together a set of financial statements. In my view this is necessary in order to obtain a broader view of the entire landscape of financial reporting regulation. There are also accounting standards that add flesh to the Corporations Act requirements for truth and fairness such as the accounting policies standard. That standard is legally binding and it contains useful guidance that should

result in a true and fair picture being presented to the users of financial statements if that standard is appropriately applied. I will explore a couple of specific amendments I believe will assist the committee in achieving what it seeks in relation to an improvement in the quality of financial reporting and auditing in this country. From observing the hearing held in Melbourne on July 26 it appears the committee has gone well beyond the initial consideration of audit independence and has extended the scope of the inquiry into general care and maintenance of legislative provisions having some bearing on the financial reporting framework as well as audit quality. This submission will cover the following areas:

- Role of the ASIC Act in the interpretation of the accounting standards used to prepare financial statements, and,
- Potential to optimise that Act to make the reflection of a true and fair view in financial statements,
- Misconceptions over what is meant by the use of 'black letter' accounting standards, and
- Need to reinforce use of commentary in the interpretation of accounting rules so substance over form is reinforced as a principle.

My previous submissions have highlighted my concerns about the lack of visibility of the regulator in the monitoring and detection of abuses of financial reporting. Some of the further evidence presented to the committee on July 26 served to add to my conviction that a reshaping of the way surveillance is conducted by the Australian Securities and Investments Commission is necessary in order to ensure not only compliance with accounting standards but also a healthy respect for the regulatory regime here in Australia. One of the greatest differences between what occurred some years back in Australia and the ASIC's endeavors more recently is that market place participants were genuinely nervous about the Commission stepping on toes and laying down the law in a very visible manner. A return to that visibility supplemented with a tougher focus on enforcing the presently available guidance would assistance in creating an environment where the miscreants in corporations are discouraged from bending the rules.

I would be pleased to answer any questions or provide further insights into the following suggestions should any committee members wish to take these issues beyond what appears in the submission.

Kindest Regards

Tom Ravlic SIA(aff)

Second supplementary submission to the Joint Committee of Public Accounts and Audit On the Independence of Company Auditors

Tom Ravlic SIA (aff)
Financial Journalist
August 2002

Executive Summary

1. The Corporations Act 2001 does not need any amendments or clarification regarding the financial reporting obligations for companies. Sufficient detail is provided in relation to a company's obligation for financial reports to be true and fair as well as in compliance with accounting standards.
2. The focus on the Corporations Act in the area of financial reporting is too narrow. Requirements affecting financial reporting are littered throughout various Acts and accounting standards. Those must also be considered for the Committee's deliberations in this area to make any reasonable inroads into making it tougher for companies to avoid accounting for transactions in the appropriate manner.
3. Appropriate amendments can be made to the Australian Securities and Investments Act 2001in order to include further detail in Section 228 dealing with the manner in which accounting rules should be interpreted. Section 228 deals with interpretations of the standards that are used to prepare financial statements that must at the end of the process be in compliance with accounting standards.
4. Principles of accounting are embedded in Australia's accounting standards, but some practitioners choose to omit those from consideration because they are not in bold type or 'black letter' requirements. Such principles include the amortisation of brand names and other intangibles that are cheerfully ignored because they are not 'black letter' rules.
5. Amendments to the ASIC Act 2001 are essential to ensure company accountants and their advisers give an equal weighting to all provisions of accounting standards irrespective of whether those provisions are in bold or ordinary type.
6. It will also be necessary to legislate so interpretations of accounting standards issued by an interpretations body are also regarded as a part of the commentary on an accounting pronouncement. Legal backing for such pronouncements should automatically result in the guidance produced by the international interpretations body, the International Financial Reporting Issues Committee (IFRIC), as being a part of the material to be used when interpreting the accounting standards for the purposes of complying with the objectives of Part 12 of the ASIC Act as well as the objectives set down in the Corporations Act relating to the preparation, audit, lodgment and distribution of financial statements.
7. 'Black letter' provisions in accounting standards do not cause nor permit people to capitalise costs as assets in a wanton fashion. The Committee cannot legislate against stupidity, self-interest, greed or materialism. It can, however, make amendments to the law that will enable auditors to better enforce provisions of standards dealing with accounting for the substance of transactions rather than their legal form.
8. International accounting standard setting is not heading down the track of accounting in the manner advocated by former SEC chief accountant Walter Scheutze. Nor is it heading down the way Professors Graeme Dean, Peter Wolnizer and Frank Clarke argue it should. Only a brave committee report would advocate the use of selling prices in financial statements as a way of changing the accounting model used for the presentation of financial data given that the Federal Government has endorsed the adoption of international accounting standards. A recommendation calling for the

adoption of mark-to-market accounting in our accounting framework is fraught with the danger that Australia would be out of line with its international brethren in an environment where the push is for convergence with a single body of accounting standards.

9. Committee members should consider recommending that in principle it would be desirable for companies to use market values for assets where they are relevant and reliable for the benefit of users of financial statements.
10. Committee should consider whether a single financial reporting act – a past recommendation of accounting bodies and other organisations – should exist to bring together all of the relevant legislative requirements that deal with financial reporting.

Beware the knee-jerk!

Requirements for the preparation, audit, lodgment and distribution of financial reports are contained in the Corporations Act 2001. Those provisions of the Corporations Act have been subject to some analysis in recent weeks during the deliberations of the Joint Committee of Public Accounts and Audit as a result of the broad coverage received by the various examples of corporate collapse such as Enron, WorldCom, HIH, Harris Scarfe, One.Tel and Ansett over the past 12 months. The committee must divorce itself from these examples of corporate distress as it examines areas of potential reform to ensure any resulting changes to the legislative framework provide a lasting benefit to the investing public – the users of financial statements. Any amendments to the Corporations Act and other pieces of legislation dealing with financial reporting requirements should not result in outcomes that will forever be seen as ‘knee-jerk’ responses to what are a normal occurrence in the business cycle of a capitalist system.

Of dispute in recent discussions over the quality and reliability have been the requirements of the Corporations Act for financial statements to be both true and fair and in compliance with accounting standards. This debate is a dangerous one and the committee must progress with great caution in examining this area. One of the outcomes of crossing this territory could be a return to the wholesale abuses of the 1980s when companies sought to ignore accounting standards that were seen as being inconvenient by directors wanting to apply some lippy and mascara to the financial results. A system that does not advocate a primary adherence to a key set of accounting principles and associated standards will find itself in a situation where the result will be financial statements that lack comparability and consistency. It would be a nightmare for analysts and investors that turn to the financial statements for some idea of the company’s performance during a given reporting period. Without the consistent application of accounting standards companies would be able to churn out numbers that are determined on any basis a company chooses without adequate protection for the investor. Accounting standards exist for this reason. They are there to provide some certainty in relation to the rules that companies must apply to derive a profit figure. Evidence tended to the committee by the Australian Securities and Investments Commission should be considered in this context. Malcolm Rodgers was correct in his analysis of what companies must do in order to reasonably comply with the law. The standards exist and by following the accounting standards a company board could well be deemed to have made a reasonable effort to comply with the financial reporting provisions of the Corporations Act that are contained in Section 2M.3. What is needed is a clearer enunciation of how these rules should be interpreted in order to derive the true and fair view called for by the Corporations Act. Expecting all company directors to understand every possible accounting technique is unreasonable as is the expectation that each company director will understand the intricacies of the various corporate structures and off-balance sheet financial instruments that would make the accounts less transparent. Directors can only take reasonable steps to comply with the requirements of the Corporations Act in the preparation of financial statements and one of those may include how rules are interpreted in the context of the company’s accounts.

What results from the directors’ actions in preparing the financial report for the broader population of investors could be deemed as being compliant with accounting standards and

also reflecting a true and fair view. Compliance with accounting standards will not mean an automatic exclusion from presenting a true and fair view. There may be circumstances where the accounting rules may not accord with the preferences of particular accounting experts but the rules exist with a particular framework in mind. These debates have been had over many centuries and we are seeing a recycling of accounting theories time and again. This is the context in which the present debate over truth and fairness and the relevance and reliability of information is taking place. I delivered a presentation in April during which I lamented the poor understanding amongst those in the general community about the manner in which accounting operates[1]:

> *Financial statements do not in themselves produce what I would call 'lies'. They are documents prepared in a particular context and within a set of accepted rules of engagement that are unarguably inadequate in some respects. Consider the fundamental issues of how to determine what kind of number appropriate reflects the value of an asset a company controls. If an entity values something at historical cost or what it paid for something minus depreciation then that number is not necessarily a lie. Historical cost data does have limitations and it becomes less relevant as time goes on. This does not, however, mean it necessarily constitutes a lie. Market value accounting is equally problematic. Choosing to go with market values of some description may mean you sacrifice the ultimate reliability of an historical cost transaction with fair or market value accounts that might rely on estimates or educated guesses at times. Some people argue accounting should be based on what an item can be sold for on the open market or exit price accounting. Individuals backing this type of thinking would discount both historic cost and fair value models because they deem what a company could get for an asset on its books as being the more appropriate measurement tool. These are different ways of looking at the financial attributes of an asset. Each has its shortcomings and it would be madness for individuals to call any of the means by which assets are being measured an outright lie. The numbers are different because they are looking at a different aspect or attribute of an asset, for example. Are those numbers lies? Or are they just the results of the consequences of using a different type of measuring 'tool' for the job?*

This lack of understanding becomes amplified when various commentators wish to debate the relevance of asset values on balance sheets without properly investigating the reason why accounting rules had evolved to being what they are at present. We are operating in an ill-informed environment as far as the measurement debates in accounting are concerned[2]. It is unhealthy.

The analysis given to this area by lawyer and company director Mark Leibler is of great interest and contains great stimulus for much discussion, particularly in the area of accounting policy choice. His preference for mark-to-market accounting across the board is understandable and is worthy of further exploration by accounting standard setters at an international level. This debate is no longer one that could be led by the domestic standard setter imposing accounting requirements in the domestic setting that deal with mark to market accounting that are unlikely to be pursued by the international accounting standard setter in the form of the International Accounting Standards Board (IASB). It is the present policy of the Coalition Government to ensure the Australian accounting standards are brought into line with those of the IASB and it would be an extremely difficult to mount an argument in favor of mark-to-market accounting in an environment where various prominent political and accounting identities have argued forcefully for the adoption of accounting standards produced by the IASB. The JCPAA cannot make recommendations reflecting any preferences

[1] Text from speaker's notes prepared for an address to the Finance and Treasurers' Association and delivered on 11 April 2002. I have attached a copy of the prepared notes as an appendix to this submission.

[2] The evidence presented by Wolnizer, Dean and Clarke at the second committee hearing in Canberra is a welcome diversion from the usual lack of substance in public debate over accounting. While I disagree with some aspects of the views they hold it should be noted their contribution to the committee provides a considered analysis of the qualitative aspects of information resulting from the application of accounting standards. Committee members can use this evidence as a valuable opportunity to engage in some productive thinking about measurement matters as they relate to accounts.

for the measurement of assets and liabilities without moving into some rather choppy seas. Such a recommendation at the present time would be ignored by many in the accounting profession and political circles that are obsessed with converging two bodies of accounting standards into one. The question of measurement is one that will be left by the wayside in the intervening period while everybody tries to have the same rules. Only after most countries have adopted the same accounting rules will there be any thoughtful debate on the measurement criteria used to measure assets and liabilities.

While Mr Leibler's discussion of matters has a certain effervescence about it that guarantees it much attention it is a rather narrow examination of the financial reporting requirements as they exist in the corporate law of this country. That account of the application of the Corporations Act provisions relating to the preparation of company accounts needs to be supplemented by a discussion of the provisions of the Australian Securities and Investments Commission Act 2001 that contains several significant provisions that add much to the understanding of the intent of the law as it relates to financial reporting. Truth and fairness is achieved by applying accounting standards and related principles. The application of the accounting standards and the interpretation of the same is covered by the ASIC Act. You must first interpret and understand what a standard means before you can make accounting policy choices that can impact on the way the financial statements are to be dealt with.

The ASIC Act

Provisions of the Australian Securities and Investments Commission Act 2001 specify how accounting standards used to prepare financial statements must be interpreted. Those requirements exist outside the Corporations Act and yet they have a significant impact on how a company must deal with the interpretation of the accounting standards in seeking to fulfill its obligations under the Corporations Act. Section 228 of the ASIC Act contains two paragraphs specifically targeted at ensuring the intent of accounting standards and the intent of Part 12 of the ASIC Act – the part of the legislation dealing with the accounting standard setting structure – are interpreted in a manner that reflects the objectives set down in Section 224 of Part 12 of the ASIC Act. The relevant section of the ASIC Act is attached as an appendix to this submission for the sake of brevity. It would be useful for the Committee to consider in its deliberations the interplay between these the two Acts before finalising any amendments to the legislation affecting the preparation of financial reports. The law related to financial reporting is somewhat fragmented between the two pieces of legislation and both Acts must be consulted to get a full appreciation of the Commonwealth legislation in this area. Change to the law must only be considered once the committee has analysed in some depth the provisions of both the ASIC Act and the Corporations Act having an impact on both the preparation of financial statements and interpretation of the accounting standards.

The changes to Part 12 of the ASIC Act came about as a result of the Corporate Law Economic Reform Program that resulted in significant amendments to the legislation that deals with accounting standard setting. It establishes the Financial Reporting Council and

gives that body significant powers to oversee and direct the accounting standard setter, the Australian Accounting Standards Board. It also sets down guidelines for the AASB's operations as well as the conditions for the appointment of individuals to the two bodies. An important part of the section of the ASIC Act is the enumeration of the objectives of Part 12 as set out in Section 224. This is the part that embeds the qualitative characteristics of accounting standards – characteristics described in more detail in the third of four statements of accounting concepts that are used in the development and assessment of proposed accounting standards[3]. It is these qualitative characteristics and functions of financial reporting set out in Section 224 that companies, their advisers and others need to bear in mind when interpreting accounting standards. When one gets to Section 228 – the section that requires the purposive interpretation of the standards to achieve the objectives of Part 12 – it is assumed the objectives of Part 12 of the legislation are understood and an individual interpreting accounting standards should interpret them in such a way as to meet the objectives of the Act. Pair this together with the requirement for compliance with accounting standards and achieving a true and fair view and it is unarguable the legislation impacting on financial reporting has sufficient firepower at this point to deal with the matters of concern to the committee.

This is not to say the law as reflected in the ASIC Act is perfect. There are some additions that could be introduced to ensure that accountants amongst others are reminded they should be accounting for the economic substance of transactions rather than the legal form that is so often used to get around accounting treatments that produce a less flattering financial picture. Additional words would also force accountants to use principles embedded in the commentary of standards when they are determining the appropriate accounting treatments for any transaction. Some commentators argue they are unable to enforce the commentary of the accounting standards because some clients believe the commentary is not as authoritative as the black letter. Eliminating this particular mindset from the profession would bring financial reporting in this country several steps forward because a failure to apply the principles embedded in commentary can result in accounting that is improper and fails to reflect the substance of transactions. Those words would be best located in Section 228 because the interpretation of the accounting standards occurs in both the planning of transactions and the preparation of financial reports.

In order to engage in further productive thinking on this matter it may be appropriate for the committee members to have in their mind the most attractive picture of a waterfall they have ever seen. My reference point tends to be the Niagara Falls scene in the Superman films because I remember it more vividly than anything I've noticed myself. Water flows from the top and down to the bottom. The ASIC Act 2001 sits on top of the waterfall as the interpretation of standards is critical in order to put together those financial statements that are required to be prepared, audited, distributed and lodged in accordance with the requirements of the law. Interpretation is the first step in achieving the goals of truth and fairness. If accounting rules are interpreted and applied in a mischievous or aggressive manner then the result will no doubt be a set of financial statements lacking in integrity. You must comprehend what the accounting requirements are before you are even capable of

[3] The statements of accounting concepts are available on the web site of the Australian Accounting Standards Board @ www.aasb.com.au. There are four statements of accounting concepts dealing with various facets of financial reporting.

meeting the requirements of the Corporations Act impacting on financial reporting. A sensible interpretation of accounting rules need to be ensured before you even begin to address the proposition that accounts must be both in compliance with accounting standards and true and fair.

The Corporations Act requirements sit at the bottom of the imaginary waterfall and those requirements should be deemed to have effect when it comes to compiling the financial statements. Interpretation of the accounting standards, of course, is a function of having the accounting rules use to compile the numbers that eventually wind up in a published report. It is important to recognise that the truth and fairness of financial statements will be dependent on the interpretation and application of the accounting pronouncements. The ASIC Act 2001 needs some additional paragraphs to ensure accounting standards are interpreted in a way that focuses on the substance of transactions rather than legal form.

Substance over form

Various witnesses during the committee's inquiry made reference to the use of principle-based standards rather than burdensome, prescriptive rules. It is often asserted the accounting literature in the US is more prescriptive and therefore becomes subject of some degree of playfulness engaged in by lawyers and accountants. That assertion could well be applied in Australian circumstances. Take for a moment the argument over whether Australian standards have any requirements for the amortisation of intangible assets such as brand names. This debate is one with which I have a high level of familiarity because this issue was one that was hard fought some years ago when one of the witnesses that appeared before the Committee, Jan McCahey, was the chief accountant at the Australian Securities and Investments Commission[4]. I have also heard many accountants go walkabout and ignore their own literature because it is inconvenient to keep one's eyes open where the accounting treatment the principles embedded within the literature may result in some pain working its way into the reported result.

This discussion must begin with an appreciation of a fundamental reality. Australian accounting standards require assets appearing on the balance sheet[5] to be assessed for recoverable amounts and, indeed, these standards require assets to be subject to the requirements of the accounting standard on depreciation[6][7]. Some accountants and business leaders appear to labor under the misconception that the depreciation standard applies only to those assets that have the characteristics of being fixed or tangible in nature. Nothing could be further from the truth. The principle that assets must have a useful life and a residual amount,

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[4] Ms McCahey's view on these matters was disputed by some accounting professionals at the time although I believe the guidance did exist for people that chose to consider it.

[5] The accounting standards affecting the balance sheet now refer to the statement of financial position. The notion of financial position is contained in the Corporations Act although the sections of the law that refer to the profit and loss statement, balance sheet and notes are yet to be amended. The committee could possibly recommend these terms be brought into line with the accounting standards if amendments to clarify wording in the legislation regarding financial reporting were to be recommended in the committee's final report.

[6] Accounting for depreciation of assets is regulated by accounting standard AASB 1021.

[7] Evidence presented by Coles Myer director Mark Leibler during the committee's hearing on 26 July 2002 referred to the absence of requirements to amortise a brand name. My analysis of the depreciation literature is in part inspired by his evidence.

where applicable, attributed to them is embedded in that accounting standard. While the standard primarily captures within its scope assets with a physical substance there is guidance in that standard directly relating to intangible assets and the fact the qualities of intangible assets may be similar to those of their tangible counterparts. Those accountants arguing that there is no legally binding guidance are in my view giving the lie to their argument that Australia is a principles-based jurisdiction. If principles are relevant in accounting then all of the principles embedded in the guidance should be applied. We cannot be taken seriously in this debate on the supremacy of principle-based accounting standards if the principles embedded within the accounting literature are themselves not understood or appropriately applied in accordance with guidance laid down in the accounting literature.

A legal mindset does predominate within the accounting profession. I am conscious of the fact that the gray letter guidance – the commentary in the accounting standard – is seen by some commentators as having a lesser importance that the parts of a standard that are set in bold type or 'black letter'. This mindset only serves to damage the credibility of financial reporting in this jurisdiction and it would be useful if the committee could find some manner in which to state within the legislation that the text of the standard must be taken as a whole when the document is interpreted by those preparing financial statements. The commentary should be just as legally binding as the bold text. Those accountants committed to fostering a culture of compliance in the interests of the capital market are already doing so. A provision in the legislation that gives requirements in bold and ordinary type of an accounting standard equal importance will also assist in giving auditors an effective stick with which to discipline clients refusing to account for the substance of transactions. An accounting standard on accounting policies known as AASB 1001 has within it guidance related to the selection of accounting policies that would provide relevant and reliable information and also result in accounting for the substance of transactions. The committee would be well placed to recommend the insertion of a paragraph that states all portions of an accounting standard being interpreted for the purposes of Section 228 of the ASIC Act are to be treated equally. This will eliminate any gaming of the accounting rules engaged in by advisers and clients that relates directly to the prominence given to various paragraphs in a standard with the use of bold type.

The beauty of such an amendment is it will also ensure a more stringent focus on accounting for the substance of transactions. This will require auditors to enforce with greater stringency the provisions of the accounting policy standard dealing with accounting for the substance of transactions. Companies themselves will be unable to use the excuse that there is something falling outside the bold type they do not need to pay attention to when pulling together the relevant information in preparing their financial statements.

There is a further issue the committee needs to consider. Interpretations of accounting standards are presently not recognised as a part of the law itself. Documents of an interpretations body such as the Urgent Issues Group or even the international equivalent are regarded as persuasive guidance for the profession. Company directors, however, are generally not bound by those interpretations if they are of a professional background where membership of the professional accounting bodies is not essential. Accountants that are members of professional accounting bodies must as a matter of course follow the interpretations of the UIG as well as the body of standards that is in effect in Australia. It may

be useful for the committee to determine whether including a reference to relevant interpretations of international or domestic accounting standards that deal with accounting for a specific transaction. This would then mean delays in domestic approval of an international interpretation could not be used as a reason for not following something that may be much tougher. The issue may well be one that could fall under the law for directors to take reasonable steps to comply with the requirements of the Corporations Act and related legislative provisions.

Black letter standards and compliance

The chairman of the committee spoke during the July 25 hearing of the fact it appeared black letter accounting rules were being used to capitalise costs that should have been expensed. It is not the rules themselves that cause this financial reporting charade but those that apply the rules. Accounting rules and accounting principles applied by ethical individuals will probably result in a reasonable picture being presented in financial statements sent out to users because most companies would be responsible about what they do in the area of financial reporting. It is not the accounting rules that cause the problems of failure to expense costs that are not a legitimate enhancement of an existing asset or, ipso facto, an asset in themselves. Badly behaved corporate executives, poorly briefed boards of directors, inadequately trained auditors and less than competent analysts are probably more to blame for the inability of the market place to decipher what is gone than the present accounting rules that predominate in Australia. Committee members should tread with caution when dealing with a general assumption that those engaging in less ethical and, indeed, illegal accounting practices are doing so by using ‘black letter’ accounting rules. The reverse is in fact the case. Those individuals are probably breaking the very accounting rules they should have been following from the beginning because the result was the capitalisation of costs that would not be considered as being acceptable under Generally Accepted Accounting Principles (GAAP). It is easy to blame the problem on perceived inadequacies of a reporting framework. The accounting standards and the company law in this country provide a sound base for going forward. All that is needed is a little tweaking to refocus wandering minds on the necessity to account for the substance of transactions rather than their legal form.

It is also prudent to suggest the committee might reflect on whether it would be more appropriate to move all of the financial reporting requirements in the law into one document so the above analysis should not have to be conducted by other individuals when similar debates are had in the future. One piece of legislation dealing with the accounting standard setting process, the interpretation of accounting standards and the obligations of directors and auditors related to the preparation, audit, distribution and lodgement of financial statements would be a more convenient manner for directors and others to locate the relevant legislative requirements. Accounting bodies such as CPA Australia have recommended this in the past.

Appendix One:

Suggested wording for two proposed amendments to the ASIC Act 2001

Insert the following after the existing paragraphs in Section 228:

Section 228 (3) An accounting standard interpreted for the purposes of complying with this Part must be interpreted giving equal consideration to the entire text of an accounting standard irrespective of presentational emphasis.

Section 228 (4) Formal interpretations of accounting standards issued by interpretations committees must be considered for an application of an accounting standard used in the preparation of financial statements to be deemed as being in compliance with the purpose of this Part and the intent of the accounting standards.

Appendix Two:

Speaker's notes for the FTA presentation delivered in April 2002.

Financial Reporting: Is the room to move narrowing?
Loopholes, black holes and regulatory risk

Tom Ravlic
Financial Journalist
April 2002

Do you shudder when you flip through the paper each morning? Are you feeling nervous about the world because there is so much in the papers about how accounting is causing problems in the world today? Accounting as an institution is apparently in a crisis or so commentators and some regulators have been telling us with rather monotonously regularity over the past year. Auditing is also apparently in crisis and auditor independence as an issue appears to be the flavor of the month. While the generation of interest in accounting and auditing matters may be useful and welcome because it forces people to think more about corporate governance much of what has appeared is not new at all. New sets of eyes might be looking at important ethical and financial reporting and risk management issues arising from the ashes of corporate misadventures. These issues, however, have their roots in the past and a mere glance at the old accounting literature points to the issues as having a reasonable vintage. Words written by one of the last century's key accounting thinkers in the US – Kenneth MacNeal – in 1939 paint what will be a rather familiar sentiment to some:

> *Financial statements today are composed of a bewildering mixture of accounting conventions, historical data and present facts, wherein even accountants are often unable to distinguish between truth and fiction. The toll which this situation levies on business management, and on the general public, is beginning to be recognised.*

The criticisms about accounting back in the first half of the 20th century are still being made and the merits of various accounting rules and concepts continue to be debated. The difference, of course, is that the past is pretty much foreign to most of those currently leveling various accusations at accountancy as a discipline and accountants as practitioners. They are still somehow qualified to attack accountants generally and auditors in particular for their performance.

The righteous indignation of a motley crew of journalists, accountants, investors and academics among others in the light of the collapses of Enron, Global Crossing, HIH, Harris Scarfe and One.Tel sent me scurrying to my bookcase to find something that adequately explains the phenomenon we are currently observing. My roving eye chanced upon a volume in which a reasonable collection of the letters, thoughts and novels of Johnathan Swift, the author of Gullivers' Travels, live. I only wish he was talking about accounting instead of political liars when in a most erudite fashion he said:

> *But though the Devil be the father of lies, he seems, like other great inventors, to have lost much of his reputation, by the continual imporvem3enets that have been made upon him.*[i]

Those who conclude the present accounting framework results in published lies in every instance - not just the few that have given rise to a rash of reformist zealots wanting to change the world in five seconds flat - would have to accept that accounting has lied to users of recorded numbers from the time the first digit representing an economic resource

was recorded. The present set of circumstances is a derivative of the past activities of accounting practitioners, accounting academics, elected representatives, the judiciary and, of course, those preparers whose inability to refrain from the pursuit of accounting novelty by engaging in intellectual malevolence has meant others have had to create and improve accounting regulation to plug holes. The minute a rule was created the room to move began to narrow at least in concept until those sufficient clever to engage in morphing financial arrangements to create another crack in the wall had done their damage. It is continuing to narrow as greater agreement emerges on key accounting treatments across the globe. Along with fewer differences in the literature operating in significant jurisdictions there will be less scope for roguish behavior. I still hold significant concerns about whether complete convergence is ever going to occur and to what extent differences between reporting frameworks are likely. I will address some of those issues later.

Another matter needs to be addressed in the context of accounting standards is why standardisation came into being. A recent critic panned standards and their existence as creating a 'refuge for the weak', referring particularly to the auditors called upon to make a judgment on whether a company's financial statements were a fair presentation of affairs. Far from being a 'refuge from the weak' the standards provide the auditors with a keen focus on the users of the end product. They set down the minimum requirements for corporate disclosures and the market is entitled to expect a company will meet those expectations. A generally agreed basis for accounting is essential as a means of communicating financial information. If everyone understands what is generally expected under the accounting framework then they can make a judgment about the governance psyche of the boards and managements of entities that choose for whatever reason to engage in reporting practices contrary to those permitted by the accounting rules. These entities should be needled and pricked by the market accordingly. Non-compliance with a reporting framework may also lead to outsiders having a better insight into the quality of both the behavior of management and the quality of a company board. This may be important information to those investors seeking to determine whether they remain an investor in a particular business.

A few in the accounting profession have indicated they yearn for a return to a 'true and fair' override so they can enforce accounting that looks at the substance of a transaction rather than the legal form. This call is equally as misguided as comments panning the trend over the past half-century for greater standardisation of reporting. A return to a government-sanctioned non-compliance with accounting standards would merely result in a drop in the quality of financial reporting, the erosion of audit judgment and yet another loss of investor confidence in financial markets. Companies that do believe they are hard done by and feel their circumstances require some kind of relief from compliance with accounting standards can have meaningful discussions with the corporate regulator. If the Australian Securities and Investments Commission believes a company's circumstance fits the very restricted criteria for granting relief from an accounting standard then it should be the arbiter. Corporations should not be given the option of flouting accounting standards whenever or wherever it suits. Some degree of certainty is necessary for users to have confidence in corporate reporting. Standards also

ensure that auditors are able to assist in regulating the market. They have a critical role shepherding clients to the right corner of the pen and away from the less virtuous path.

Financial statements do not in themselves produce what I would call 'lies'. They are documents prepared in a particular context and within a set of accepted rules of engagement that are unarguably inadequate in some respects. Consider the fundamental issues of how to determine what kind of number appropriate reflects the value of an asset a company controls. If an entity values something at historical cost or what it paid for something minus depreciation then that number is not necessarily a lie. Historical cost data does have limitations and it becomes less relevant as time goes on. This does not, however, means it necessarily constitutes a lie. Market value accounting is equally problematic. Choosing to go with market values of some description may mean you sacrifice the ultimate reliability of an historical cost transaction with fair or market value accounts that might rely on estimates or educated guesses at times. Some people argue accounting should be based on what an item can be sold for on the open market or exit price accounting. Individuals backing this type of thinking would discount both historic cost and fair value models because they deem what a company could get for an asset on its books as being the more appropriate measurement tool. These are different ways of looking at the financial attributes of an asset. Each has its shortcomings and it would be madness for individuals to call any of the means by which assets are being measured an outright lie. The numbers are different because they are looking at a different aspect or attribute of an asset, for example. Are those numbers lies? Or are they just the results of the consequences of using a different type of measuring 'tool' for the job?

The other area that causes great debate is the recognition of assets such as intangibles, internally generated and otherwise. This is a vexed area for debate and creates the equivalent of World War Three whenever companies argue they most important asset they have is not even on the balance sheet. The reality of life is that not all numbers are going to be reliably determined and in some circumstances not all so-called assets will meet the recognition criteria set down in accounting frameworks. The struggle for standard-setters is to try and ensure that what appears in financial is can be reliably measured and is a certainty to deliver economic benefits over time. This does not necessarily mean financial statements lie. They are constructed within a framework that might not reflect everything some companies or some users want to see. The framework embeds what you might a risk averse approach to accounting. If you cannot place a value on it and if there is no conceivable future benefit from it then it is not an asset. The two must be satisfied before the recognition criteria are met. This is probably more a prompt for companies and their constituents to further contemplate detailed narrative disclosures to explain what they believe to be the hidden 'El Dorado', the hidden value of the business.

Let me be somewhat bolder than that. I believe accounting does not lie. People do. People lie. People cheat. People spend time finding ways to play games with numbers. People seek to conceal and make life difficult for users of financial statements. Accounting itself is a tool that serves its purpose if it is used properly. The real problem is that accounting is used by some companies and some accounting advisers to produce outcomes that

breach accounting rules set by standard setters and result in accounts that are from the outset incomprehensible to those using them because the conventions set down in standards have not been followed to the letter. Circumstances surrounding the collapse of Enron are a classic example of this. Enron's financial statements were a symptom of a decadent corporate culture and the company's failure to comply with its domestic accounting standards was another manifestation of that particular organisation's malaise. Just because somebody throws a hammer out a window rather than uses it for a constructive purpose does not mean you have to redesign hammers in their entirety, restrict their use to certain age groups or ban them altogether. Refining the hammer's design over time so it can do its job more effectively, however, is probably desirable.

What I find disconcerting is that the acts of a group of people in a couple of entity's in the United States have led to an acceleration in the review of accounting and auditing regulation across the globe. Australia is right in the thick of this and it concerns me that proposals to overhaul various parts of the governance framework will create further disruption to the process of the setting of accounting rules that has just been reformed. The accounting standard setting functions as established by legislation and proclaimed in January 2000 should be left alone and further resources given to those functions to complete projects I regard are matters of urgency given the recent push for the development of guidance in various areas of reporting. There is no substantive reason why the Australian Accounting Standards Board and the Financial Reporting Council should be distracted from important work related to accounting standard setting because some people believe the FRC should take charge of areas such as the oversight of independence regulations. Members of the FRC have their hands full just dealing with the issues arising out of the setting of accounting standards alone. Further structural disruption will also create dissonance in an environment that is already highly strung because of the great demands being placed on limited numbers of staff to meet both domestic obligations and track the progress of the international standard setter. It is a matter of constant annoyance when I hear references to complaints that people want a more speedy integration of the International Accounting Standards Board's output. Their money should go where their mouth is and the wider they open it the more they should put in the board's kitty to increase resources. You cannot run the full length of the Hume Highway on half a tank of petrol and nor can standard setters meet all of the demands on their time with their current resources constraints.

This does not mean that the AASB is performing to its optimum. While I have sympathy for the standard setters and, indeed, observe much of what they do from the public gallery I am disappointed with some of the recent discussions related to basic changes to AASB 1018 and also the vetoes of Urgent Issues Group abstracts last year. The board has spent time deliberated at length on some issues when it could just have moved on and let sleeping dogs lie.

Regulatory risk and the coming challenges

A critical issue that must be considered when compliance with accounting standards is considering is the whole notion of regulatory risk and whether companies fear being

pursued for poor reporting practices. One of the disturbing things in the recent debate over auditor independence is the myopic nature of the discussions has led people to contemplate auditor independence in isolation from all other mechanisms that assist in market regulation. Others have addressed the governance structures of companies and I do not intend to cover those issues here. What needs airing is the necessity for the Federal Government to seriously consider increasing funding to the corporate regulator and tying the funding to an increase in accounting-related activities by the ASIC. The Commission should be granted sufficient resources to increase the number of company financial statements that are the subject of review through it financial reporting surveillance program. Such a measure would – in my view – increase the odds of non-compliance with financial reporting being picked up and lead to further action. Without a wider net to catch financial reporting abuses in annual accounts the capital market suffers. Effective enforcement and judicial mechanisms also need to be in place to deal with the more extreme abuses of financial reporting. Without a ramp up in the regulation of accounting and disclosure issues there is little incentive for people to ensure their market disclosures are both high quality in compliance with market regulation.

When we talk about regulatory risk our discussions should not just focus on whether regulators are sufficiently vigilant enough to capture those doing the wrong thing. Regulatory risk occurs when companies and their accounting advisers render themselves exposed to enforcement action by the actions or inactions. We see some of these all the time. Almost too frequently companies fail to spend time responding to exposure drafts issued by standard setters because they believe those drafts are irrelevant until the final document is issued. They are also dismissive of standards that are issued until they are on the list of 'urgent and important' things that must be dealt because the accounting rule makers have set down a deadline for compliance. There is currently some debate about the manner in which the interaction between accounting standards and the tax law should be managed given the commencement of sets of new regulatory requirements. The Federal Government's tax consolidation regime is set to commence on the first day of the 2002-03 financial year. This happens to coincide with the implementation date for the new tax effect accounting standard that is set down for July 1 as well. While these changes are both complex it might be a revelation to some individuals that the tax effect accounting standard's implementation date was set back in late 1999 – a long time before the Federal Government began chopping and changing details of its tax consolidations regime. The implementation date has been around and known for longer than the tax consolidation regime. While I have some sympathy with those caught in the present conundrum I do believe this underscores the need for entities and, indeed, professional firms to encourage a greater focus on forward planning.. Keep an eye out for anything the Urgent Issues Group produces in the next few months on the accounting implications of tax consolidation and how that should be treated under the new tax effect accounting standard. This guidance will be critical to those of you in the midst of planning how you intend to tackle the challenges of tax consolidation and the balance sheet tax effect accounting model. The UIG's present intent is to issue something fairly soon. You might get it in time if you're lucky. The same is true for the implementation of the so-called 'Trilogy' of accounting standards. Those standards were issued back in late 1999. While I understand companies have had some challenges in determining how best to deal with the

shifting regulatory environment the point about the need to actively monitor and respond to change remains. More will be said about the 'Trilogy' and some of the inadequacies of our standard setting structure as it presently stands later.

Mitigation of some risks

There is no reason why companies themselves cannot mitigate some of the risks that emerge from the flow of regulatory change in the accounting area. One means by which companies may be able to forecast where things are heading in accounting standard setting is to monitor the work of the International Accounting Standards Board. The IASB has a new structure with full-time board members that meet each month. It is making swift progress in areas such as improvements to its own accounting standards, accounting for business combinations, revisions to the standards dealing with financial instruments and insurance contracts. It is also pushing ahead with considerations regarding the expensing of share-based payment, which is encouraging because there is a high degree of intellectual dishonesty about the failure of companies to account for these elements of compensation as compensation. The substance of those transactions – the substance of those arrangements – is compensation for services rendered or goods supplied. The fact companies fail to recognise these types of deals in their statements of financial performance as a rule means their results are always and without exception overstated. This nonsense about not recognising an expense also ignores a fundamental economic reality. People do not always do things 'pro bono'. There must be some kind of economic gain or some type of incentive for them in the process of which they are a part or else they would be sensible enough to find some means by which to spend time gardening while receiving social welfare benefits paid by the Federal Government. When individuals ply a trade somebody receives an economic benefit in the form of work having been completed. There is – I am assuming there is – some value attributable to that work. Why should it matter whether the payment is made by virtue of cash or in the form of some type of equity-instrument? The present model of accounting – a model that deals with the recognition and measurement of economic phenomena – requires there be an acknowledgement in company financial statements of the consideration given for services or goods received. I believe the only reason this is not occurring is because there is no rule requiring the recognition of these arrangements. It should be made clear that the current project being undertaken by the Australian Accounting Standards Board deals only with disclosure and not recognition in financial statements. Recognition and measurement will only be tackled when the IASB is closer releasing its exposure draft on what is a critical issue.

An alternative or opposing view to the expensing argument is put forward by former SEC chief accountant Walter Scheutze. Scheutze believes nothing changes in substance when options or shares are given to an employee. In those circumstances, Schuetze would argue, no asset had lost value nor was an expense incurred so nothing should hit the bottom line – the net profit figure – in the statement of financial performance. This is one of the by-products that result from the view Scheutze holds that accounting should gravitate towards reflecting as assets on those things that are capable of being sold 'tomorrow morning at 10 am for cash". It is a very different view of assets to that held by

most accountants in the world today and it is worth bringing up because his alternative perspective might help some people understand why things exist the way they do today. Schuetze also believes market value accounting must be introduced in order to ensure that the numbers in the accounts reflect what the market believes assets are worth. This takes us into the vexed debate about what a reliable basis of measurement may be and it is one of those things that could rightly be described as fun for the whole family. Embark on a discussion dealing with measurement in accounting and it would take much longer to finish than a game of Monopoly in the Ravlic household on New Year's Eve. That would be some feat.

Financial instruments are of great interest to this particular audience and it would be remiss of me to not delve at least in part into what will be happening in the next few months. As some of you may be aware Australia presently has very little in the way of literature – it has nothing – dealing with the recognition and measurement of financial instruments. That gap is on its way to being filled with an exposure draft due in the next couple of months from the IASB that recasts IAS 32 and IAS 39. IAS 32 is a standard that deals with presentation and disclosure with which the AASB equivalent, AASB 1033, was generally harnonised. Australia has no equivalent to IAS 39 and the upcoming omnibus exposure draft that sources tell me is almost 350 pages long. The exposure draft will create a challenge for the AASB's constituents and everybody will need to focus on the issue when it becomes a matter for live debate. This is not the full-blown fair value model recommended by the Joint Working Group of Standard Setters towards the end of 2000. While it was an option entertained by the IASB last year the prevailing view is that fixing the current documents so they are made more roadworthy rather than opening up a long-term project that will result in output some years down the track. Expect an initial look at what the IASB intends to do with its financial instruments literature some time in June. The AASB intends to issue an invitation to comment when the IASB document is released and there will be an exposure draft issued down the track so Australian constituents can comment on a final version of the standard as it is intended for implementation.

Speed humps on the road to Damascus

I have my doubts about the prospects of the world ever achieving seamless convergence of financial reporting, particularly in the light of the recent decision in the case involving MYOB Limited and the Australian Securities and Investments Commission. That court action was a perfect illustration of why convergence will be forever hampered by the legislative and judicial processes within specific jurisdictions. That standard setting communities across the globe will hold hands over time and agree on accounting treatments but this does not mean the legislative and judicial authorities are going to look at interpretations of accounting rules the same way. The MYOB case saw a circumstance where two leading experts – authorities within their own firms on accounting matters – had their evidence dismissed in the courts because it was inadmissible as evidence. These individuals spend their lives dealing with accounting standards and accounting regulation – more so than any judicial authority – and their evidence is rejected because it fails to meet the criteria of admissibility. Add to this the fact that interpretations by the domestic

Urgent Issues Group are not recognised under the law and you have a situation where the UIG's views could be dismissed in a legal case as a result of the document not carrying the same weight as the accounting standard that caused the same problem in the first place. These types of issues pose great challenges to the Federal Government, which has indicated it supports the push towards international convergence. If convergence is to be successful then judicial processes will need to be changed so that the evidence of experts – regardless of whether it is laden with opinion or not – be accepted. Engaging in political rhetoric in support of the work of the IASB means nothing if legislative and judicial structures are not adequately set up to deal with the issues of potential conflicts of interpretation.

AASB 1018 and some so-called problems

In a sense the question embedded in the title of this presentation is too appropriate because the alleyway of financial reporting can be rather broad or narrow depending on how some people interpret the literature currently in force in Australia. We have seen some rather innovative readings of the standard that regulates the presentation of the statement of financial performance that would suggest flexibility and freedom to move is only limited by your ability to comprehend the English language or your good fortune to be able to navigate your way around a Macquarie Dictionary. The standard, known as AASB 1018, has caused a high degree of angst among the accounting and corporate communities because there is a view that the standard is vague and lacking in clarity in significant areas. This may be true in some circumstances. It is certainly not true in all and I view with a great deal of disappointment some of the complaints being made by people about the existing accounting rules. Before I dissect a couple of the issues I believe are no brainers and should never have caused hassles in a bit more detail it is appropriate to outline some of the concerns highlighted by the Australian Securities and Investments Commission and respondents to the recent appeal by the standard setter for feedback on implementation difficulties.

The ASIC conducted a surveillance program late last year. It reviewed the financial statements of 80 companies. Problems the Commission wrote to the board about include:

- Presentation of alternative statements of financial performance, which includes breakdowns of data on the face of the statement of financial performance investment analysts use to try to come up with a magical sustainable earnings figure. Any numbers that even remotely look as if they are to be used as a surrogate for the statutory profit result in a company's financial statements being non-compliant with AASB 1018.
- Totals coming before given prominence by companies using different types of presentation 'tricks' such as bolding numbers or making specific line items a different color than others.
- Appearance in some financial statements of abnormal items when abnormal items were generally understood to have been rendered taboo as a result of AASB 1018's introduction.

- Netting off of revenues and expenses: netting off is not exactly permitted in general terms and there was some concern that companies were not keeping themselves nice in this regard.
- Mixing expense classifications by nature and function: This involves the mixing and matching of different expense. Concerns were expressed about companies not reporting in accordance with what the spirit of the accounting standard. Some argue the standard is somewhat unclear. I beg to differ.

Nature and Function disclosures

I would like to spend some time on expense classifications. The standard appears to be quite clear in demanding that all expenses be classified using either their nature or their function. Classifying expenses by nature is really classifying expenses by their type. Classifying expenses by their function is relating the expense to the part of the business to which it applies. The exact words of the standard are as follows:

Classification of Expenses by Nature or by Function

5.3 *Borrowing costs* expense must be classified by nature. All other expenses from ordinary activities must be classified according to either their nature or their function and the amount in each class must be disclosed.

5.3.1 As with the classification of revenues in Accounting Standard AASB 1004 "Revenue", expenses are classified to provide information on different aspects of financial performance. This information is provided in one of two ways. Expenses can be classified according to their nature such as employee expenses or depreciation. Alternatively, expenses can be classified according to their function. In the case of a manufacturing or retailing entity, classification of expenses by function may involve the disclosure of *cost of sales*, distribution and administration expenses. In the case of a not-for-profit service entity, classification of expenses by function may involve disclosure of expenses related to service activities. It should be noted that the size of a specific item is not a basis for establishing a separate classification for that item. These classifications are illustrated in Appendix 2.

5.3.2 The choice of classification between nature or function depends on the nature of the entity and historical and industry factors. Both classifications provide an indication of those expenses which might be expected to vary, directly or indirectly, with the entity's level of activities such as sales or production. The entity chooses the classification that provides the most *relevant* information about its financial performance.

5.3.3 An entity engaged in providing services is more likely to classify its expenses by nature than by function. Where a manufacturer or retailer classifies expenses by nature, the change in inventories of finished goods and work in progress during the *reporting perio*d represents an adjustment to production or acquisition expenses to reflect the fact that either production or acquisition in excess of sales

has increased inventory levels or that sales in excess of production
or acquisition have reduced inventory levels. In some instances, an
increase in finished goods and work in progress during the reporting
period may be presented immediately following revenue, as is
illustrated in Appendix 2. However, this presentation does not
imply that such amounts represent revenue.

5.3.4 Entities are encouraged to present the disclosures required by
paragraph 5.3 on the face of the *statement of financial performance*.

There are an amazing number of companies that have mixed and matched nature and function to the point where their statements are arguably not in compliance with accounting standards. Companies such as David Jones Limited use cost of sales disclosures on the face of the statement of financial performance – a functional expense disclosure – and spend the rest of the document disclosing expenses according to nature. What function of the business depreciates and amortises? What function of the business spends money on advertising? If David Jones had set down the function route, for example, it would have things such as distribution and marketing as functional categories. Each of those will then have allocated to them the relevant depreciation charges, employee expenses and other related expenditures that fall within the ambit of those functions. David Jones does not appear to employ people to engage simply in depreciation and amortisation ‘activities’. The standard is not unclear as far as I’m concerned. It’s one or the other. It is definitely not both. A rather different example of this is the Spotless Group’s accounts. Spotless achieved disclosures by nature straight down the statement of financial performance. It achieved the so-called analyst’s numbers of EBITDA and EBIT without tinkering with the presentation rules. It is a good example of how some companies could have set their presentation of results down without further ado.

Alternative financial statements

Some companies presented their statement of financial performance with what they felt were analyst-friendly numbers in a table that strips back items the company believes should be regarded an non-recurring or not relevant when considering sustainable cash flows. The standard says with some degree of clarity that numbers purporting to provide alternative measures of performance are not permitted. The exact wording from the standard is this:

Prohibition of Alternative Statement

**4.6 The financial report must not contain a statement that purports
to be a statement of financial performance where that statement
is not in accordance with a Standard.**

4.6.1 The statement of financial performance is prepared in accordance
with the requirements of this Standard unless this Standard is
overridden by another Standard. In addition to disclosures required
by a Standard, the entity may disclose additional information about

financial performance. Such additional information is usually presented in the notes in the financial report. Paragraph 4.6 prohibits any additional disclosures from purporting to be a statement of financial performance.

It is interesting to note that you can look at the 30 June 2001 financial statements of Fosters Group Limited and pick a number. You can find the net profit, sure you can, but there's a lot more thrown into the bargain. Origin Energy did a similar thing. These are alternative versions of a company's performance. While the information may be relevant to investment analysts in some respects it is an alternative measure of financial performance that distracts from the statutory net profit. Any reading of paragraph 4.6 of AASB 1018 would clearly delineate the presentation of anything other than the statutory net profit as the profit figure for that particular reporting period is prohibited.

Audit firms and safeguarding reputation

A couple of issues come to mind here regarding the role of auditors and the audit process. When there are issues such as the disclosure matters the ASIC and others have pointed to that stick out like a sore thumb audit firms are exposed to reputation risk with regard to the work on that particular client. Disclosure is a very public element of financial statements. If disclosures do not line up with the demands set down in accounting standards then it is open for companies to be subject to questions from the regulator and others in the market place. The care and diligence of audit firms can also be questioned. While an audit might be done with the greatest of care and all steps may be taken to ensure audit obligations are followed instances of what might be seen as non-compliance with presentation rules leave the audit engagement team open to a fundamental question: did anything else slip through? Disclosure matters can no longer be considered a second rate cousin to measurement issues and when relevant disclosures are not made in accordance with the accounting rules it is among the first things that can be detected by sensitive readers of financial statements. Care must be taken for the audit firms' own sake to ensure that these things are dealt with appropriately and in line with the appropriate rules. They can do without the accompanying reputation risks at any time, particularly in the present environment where the accounting profession is under such scrutiny. Funnily enough, that type of thing could also in some small way undermine the perception of the value of the audit itself.

The Fourth Estate

During this presentation I have been raising some issues of concern about the behavior of the accounting profession, the corporate regulator, companies and their financial statements and accounting standard setters. Each of those is worthy of criticism to some degree because no one institution has performed at the height of its potential. The same is true for the institution known as the Fourth Estate and I could not regard myself as being credible if I was to stand before you criticising other segments of the community without passing some sobering reflections on the lacklustre performance of the media when

covering issues that involve any level of technical complexity. Most analytical or comment pieces are written by individuals with a lack of knowledge of the subject area. There are some notable exceptions, but most commentators seem to miss the mark.

Basic facts are gotten wrong on a frequent basis. Sensitive readers of the financial pages will know exactly what I mean when I say that factual inaccuracies are too commonplace in the coverage of accounting and auditing matters. You begin to wonder what other parts of the newspaper are laced with half-truths if the accounting material that appears is clearly so far out of touch with reality. The same comments I made regarding auditors and signing off on statements that were arguably in non-compliance with AASB 1018 apply to the practitioners in the media. Both sets of watchdogs have within their ranks individuals that are guilty of producing work that is of questionable quality. Both sets of watchdogs need to be prepared to reprimand those within their own ranks that are letting the side down.

The number of mistakes in print, for example, will greatly outweigh the measly number of corrections, clarifications or 'We were wrong' boxes in newspapers. Few people will seek corrections in a newspaper. Many more would rather let sleeping dogs lie than corresponding with the newspapers editor to fix inaccuracies in a subsequent edition of the newspaper. This does nothing for the credibility of the press generally and the financial press in particular. It is also rather hypocritical for journalists to pursue the auditing profession with a degree of zealotry because some auditors have made mistakes on the job and signed off on financial statements that have material shortcomings when news editors, sub-editors and reporters lend their names and the name of their news organisation to copy that is at times laden with material errors. It speaks volumes when some people complain about the accuracy of a newspaper article without making an effort to seek some kind of correction if they are the affected party. It just goes to show how poorly the press is regarded by the very audience that is the user of the information printed each day or broadcast on television. Some people just could not be bothered to force the issue at all.

What is particularly of concern is that this in itself fails to add anything to the financial markets other than confusion and dissonance. Financial journalism and its practitioners have an 'expectation gap' of their own. How can the users of the information in a daily newspaper be expected to make a reasoned decision on any issue if the facts with which they are presented are not facts at all? How can the by-line of any writer be taken seriously if the context of the story clearly misrepresents the facts? This does not mean there is no room for interpretation. Interpretation is fine if it is based on what is seen but when the basic unit of currency with which the journalist conducts their work – the 'plain vanilla' fact – we should regard the quality of reportage and analysis to be less than reliable.

Breaking a news story first is a wonderful feeling. I know that feeling well . Being first and being right gives you a great rush of adrenalin. That is an appropriate feeling. I cannot, however, understand the appeal of being first and being wrong. Leading the pack on some kind of 'race to the bottom' by making mistakes is not my idea of fun nor should

it be the goal of others in the media game. There is a grave need for financial journalists to be conscious of the fact they take their own credibility in their hands when they deal with complex technical matters and get it wrong. Getting facts wrong or basing analysis on a misunderstanding of a true situation is just as bad as audit failure. Both circumstances result in the publication of information that is less than robust and that may be extremely misleading if the individuals concerned were not applying themselves to the fullest extent possible.

Financial journalists are like any part of the governance mechanism in a society. When the financial journalist underperforms by producing inaccurate and misleading material the state of being of financial markets is all the poorer. The fourth estate is like any other part of the community and it needs to serve the public interest. Poor performance from the media watchdog simply means that the credibility of the press goes down and with that the perception of the media being a reliable source of insight. If I was asked to choose between placing my trust in the signature of an auditor at the bottom of an audit report or the byline of a journalist in today's environment I'd probably have to side with the former every time.

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[i] Swift, Jonathan (1710) The Art of Political Lying in Van Doren, Carl (1988) The Portable Swift, Penguin Books, Hammondsworth, Middlesex, England.