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

## INDEX

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## I INTRODUCTION

As an imperative, I am supplementing my Submission of 22 July 2002. I believe it is necessary to draw to the attention of the Joint Committee of Public Accounts and Audit ("the Committee") some major concerns which arise directly from the evidence given by Mr Malcolm Rodgers on behalf of ASIC before the Committee on 26 July 2002. (Evidence, 26th July 2002, PA 231 to PA 246 inclusive).

## II INCONSISTENCY BETWEEN ASIC'S SUBMISSION AND ASIC'S EVIDENCE

The first matter I feel obliged to address is the clear inconsistency between a significant aspect of ASIC's submission to the Committee (17 June 2002) and what was said by Mr Rodgers in evidence before the Committee on 26 July 2002.

In that evidence, Mr Rodgers maintained that the ASIC submission had not been "fully understood". (Evidence, 26 July 2002, PA 231) He said that ASIC should not:

> "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 … ASIC's support for the true and fair override should be construed as aiming at ensuring that accounting standards are applied to the substance of a transaction, not its form. We do not support the use of such an override in a way that might interfere with the uniform application of agreed accounting standards to the substance of transactions". (Evidence, 26 July 2002, PA 232)

Mr Rodgers' evidence is in stark contrast to the following assertions in ASIC's submission:

> "International standards should reintroduce to the law an overriding qualitative accounting consideration and audit opinion that the accounts truly and fairly report the financial condition of the corporation. The 'true and fair override' was removed in Australia some years ago because of perceptions that it was abused by some preparers, who used it to avoid standards they did not agree with. If it were to be reintroduced in Australia through the international harmonisation process, it should be accompanied by enforcement sanctions to prevent repetition of past abuses." (Submission, 17 June 2002, page 2)

The Committee should note that the ASIC submission refers to the "reintroduction" of a true and fair override. The second sentence extracted above makes it clear that what ASIC had in mind was the "reintroduction" of the "true and fair override" which had been removed in Australia because of perceptions that it had been abused. The final sentence confirms that ASIC supports the "reintroduction" of the "true and fair override" through the international harmonisation process provided it is accompanied by enforcement sanctions to prevent repetition of past abuses.

It is clear to me, and I believe it should be clear to the Committee, that the position put by Mr Rodgers in his evidence is in total conflict with the ASIC submission. Mr Rodgers could have advised the Committee that ASIC had reconsidered its position and now held a view, in relation to the reintroduction of the true and fair override, that differed from what had been advocated in ASIC's submission. Alternatively, he could have informed the Committee that ASIC's submission on this particular point had been incorrectly drafted and did not accurately reflect ASIC's position. What Mr Rodgers was not entitled to do was to suggest to the Committee that ASIC's position in relation to the true and fair override, clearly articulated in the submission, had in some way not been "fully understood" (Evidence, 26 July 2002, PA 231). The Committee, in my view, was entitled to expect a more forthright and frank response from ASIC on this critically important issue.

## III A CRITIQUE OF ASIC'S EVIDENCE ON "TRUE AND FAIR VIEW"

In his evidence, Mr Rodgers suggested that there was "some confusion" in my view of the "true and fair view" requirement, between what he calls "legal primacy and practical primacy". (Evidence, 26 July 2002, PA 232). As will become apparent, Mr Rodgers was making use of this rather quaint terminology to suggest to the Committee that ASIC regards itself free to decide which parts of the law it will choose to enforce and which parts of the law it will choose to not enforce – a rather remarkable approach emanating from a regulatory authority of ASIC's standing.

I draw the attention of the Committee to a number of statements made by Mr Rodgers in his evidence and ask the Committee to consider my comments on those statements:

1 "Under the Corporations Act, the application of the accounting standards determines the numbers in the balance sheet and the profit and loss account, which are at the heart of a financial report". (Evidence, 26 July 2002, PA 232)

Comment: Any accountant will understand that a financial report has to be considered as a whole, and that the actual numbers in a balance sheet and profit and loss account, without regard to the accompanying notes, can provide a completely misleading picture of the financial condition of a company. For example, contingent liabilities would normally be included in a note to the accounts, rather than in the body of the accounts.

2 "The notes explain, and they can add, new information but they do not override or negate the information contained in the financial statements". (Evidence, 26 July 2002, PA 232)

Comment: Assuming this observation to be correct, it is equally correct that the body of the financial statements "do not override or negate the information contained in" any notes which are inserted to ensure that the financial report meets the legal requirement of "a true and fair view".

3 "Whether the financial statements and notes give a true and fair view cannot be determined until after the entity has prepared financial statements and notes in compliance with the accounting standards". (Evidence, 26 July 2002, PA 232)

Comment: I do not quite understand the significance of the observation. In any event, it is simply not correct. The financial statements and notes can be prepared by reference only to the requirement of giving "a true and fair view" and then those financial statements and notes can be examined with a view to ensuring that they also comply with the accounting standards. Whichever way the exercise is conducted, the financial report must both comply with accounting standards and give a "true and fair view". As Professor Ramsay stated in evidence given before the Committee, "I have no doubt that both are legal requirements". (Evidence, 26 July 2002, PA 221) The order in which the various critical steps are taken is a matter of convenience and does not impact on the legal requirements which are explicitly spelt out in the relevant provisions of the Corporations Act 2001 ("the Act").

4 "We do not see the law, and we do not think the law is to be read, as a general invitation to boards and auditors to rewrite the accounting standards when they prepare notes to the accounts". (Evidence, 26 July 2002, PA 232)

Comment: As I stated in giving evidence before the Committee on 26 July 2002, this observation is tantamount to ASIC issuing an open invitation to directors and auditors to flout the law. I draw the Committee's attention to the following :

(a) The law does not contain "general invitations" to boards and auditors to do anything.

(b) The law absolutely requires that financial reports must comply with accounting standards and separately give a "true and fair view".

(c) The law obligates (not invites – there is nothing voluntary about this) directors and auditors to include appropriate notes to the accounts to ensure that the financial report gives "a true and fair view" in cases where there is a conflict between that requirement and the accounting standards.

(d) In fact, the law mandates the precise opposite of what is implicit in the above cited statement from Mr Rodgers' evidence.

5 "The law requires a process which says that the numbers are determined and – I am talking about the numerical part of a financial report; the balance sheet, the profit and loss, the cash flow statements – must be derived by the application of the accounting standards. The numbers cannot be changed by any other process, including an examination of a true and fair view. What the current scheme in the law does is say that, although you must produce the numbers in that way, you may explain or add notes if you think that the numbers do not amount to a true and fair view" (Evidence, PA 233) (Emphasis mine).

Comment:

(a) The way in which Mr Rodgers deals with "the numbers" distorts reality. The balance sheet, profit and loss account and cash flow statement are not the sole repositories of "the numbers". Numbers are frequently included in the notes to the accounts. Furthermore, if, in order to give a "true and fair view", it is necessary to insert in the notes, by way of "additional information", a reconciliation statement containing relevant "numbers", then this is not only permissible, but in fact is required by law.

(b) Mr Rodgers' observation that "you may explain or add notes if you think that the numbers do not amount to a true and fair view" is an inaccurate statement of what the law requires. If "the numbers" don't amount to a "true and fair view" then you are legally obliged – you must - include in the notes additional information that is necessary to give "a true and fair view". (Sections 295 and 297 of the Act).

## IV ASIC'S FAILURE TO ENFORCE THE "TRUE AND FAIR VIEW" REQUIREMENT

Both in my submission and in evidence before the Committee, I asserted that the law, as it stands, is not being enforced by ASIC. In his evidence, Mr Rodgers

disagreed with my assertion but did not explain the basis for his disagreement. I accept as correct the following evidence he gave:

> "there is no breach of the law simply because the financial statements do not comply with either the accounting standard requirement or the true and fair requirement. What must be shown is that directors did not take all reasonable steps to comply and that their failure to do so has caused the breach of 297 ['true and fair view' requirement]. It is not enough for ASIC merely to assert that a different result would have been arrived at". (Evidence, 26 July 2002, PA 232)

However, I am at a complete loss to understand how this explanation justifies ASIC's lack of enforcement action. Is ASIC seriously suggesting that it is never possible to demonstrate that directors did not take all reasonable steps to comply with the "true and fair view" requirement? What about the examples cited in my submission and in my opening statement to the Committee? What about accounts which fail to disclose very substantial hidden reserves because of an accounting standard which requires goodwill be accounted for at cost less amortisation, notwithstanding that its readily realisable value, objectively determined, is far in excess of this?

The Act clearly contemplates enforcement action by ASIC in the event that there is a failure to take reasonable steps to comply with the "true and fair view" requirement. Sub-section 344(1) of the Act provides that a director of a company contravenes that sub-section if he or she fails "to take all reasonable steps to comply with, or to secure compliance with", the requirements for financial reports, including the requirement that the financial report gives "a true and fair view of the financial position and performance of the company". Sub-section 1317E(1) of the Act states that if a court is satisfied that a person has contravened sub-section 344(1) "it must make a declaration of contravention". Once such a declaration has been made, sub-section 1317G(1) provides that a court may order a person to pay the Commonwealth a pecuniary penalty of up to $200,000 if the contravention materially prejudices the interests of the corporation or its members, or "is serious". In such a case, sub-section 1317H(1) enables a court to order a person to compensate the company for any damage it has suffered as a consequence of the contravention. Only ASIC has the standing to apply for a declaration of contravention or a pecuniary penalty order (Section 1317J).

The reality is that ASIC has never sought to enforce the "true and fair view" requirement independently of compliance with accounting standards. There is a compelling reason for this. Given that ASIC has adopted a view of the law which, in practical terms, does not require directors to ensure that accounts, apart from complying with accounting standards, "give a true and fair view of the financial position and performance of the company", on what basis can ASIC possibly engage in enforcement activity?

## V THE MYOB CASE

The following is an excerpt from a report published in The Weekend Australian Financial Review:

> "The Joint Committee of Public Accounts and Audit heard from ASIC policy and markets regulation executive Malcolm Rodgers, who later said Mr Leibler was misreading ASIC's position. He said ASIC's recent enforcement history included cases of breaches of particular standards with allegations that directors failed to produce true and fair accounts". (Bill Pheasant, The Weekend Australian Financial Review, July 27-28, Page 5) (Emphasis mine)

Mr Rodgers' comment to the media on "ASIC's recent enforcement history" was not reflected in his evidence given before the Committee. However, it was a matter which Mr Rodgers raised with me when we met on 19 July 2002. To illustrate his point that ASIC had attempted enforcement action in relation to the "true and fair view" requirement, Mr Rodgers gave me a copy of the decision of the Supreme Court of Victoria in ASIC v MYOB Ltd 41 ACSR 44 handed down by Hansen J on 15 March 2002. However, a careful consideration of Hansen J's judgement leads to the inevitable conclusion that the way in which ASIC argued its case reflects an approach which is inconsistent with what the law requires.

The issue in the MYOB case, according to Hansen J, was:

> "whether the financial report and statements of MYOB Ltd (MYOB) for the half year ended 30 June 2000 were prepared in accordance with the Australian Accounting Standard AASB 1015 'Acquisitions of Assets' (AASB 1015)".(page 45)

As will become apparent, it is not surprising that Hansen J described the issue in this way, notwithstanding that ASIC sought a declaration that MYOB contravened both Section 304 (failure to comply with accounting standards) and Section 305 (failure to give a "true and fair view") of the Corporations Law.

The case arose in a context where there had been a change in AASB 1015. AASB 1015 was issued by the Australian Accounting Standards Board on 4 November 1999. MYOB took advantage of a particular option offered by AASB 1015 in preparing its financial report and statements for the period ended 31 December 1999. On 17 February 2000, the Senate passed a resolution disallowing those specific paragraphs in AASB 1015 which had permitted MYOB to take advantage of this option. The disallowance was effective as at midnight on 16 February 2000. The MYOB directors had signed their report for the accounts to 31 December 1999 on 14 February 2000, 2 days before the disallowance became effective. Accordingly, it was common ground between ASIC and MYOB that the accounts for the period to 31 December 1999 complied with AASB 1015 as then applicable. However, the option which MYOB took advantage of in the preparation of its financial report for the period ended 31 December 1999 was, ASIC contended, not available to MYOB in respect of the half year ended 30 June 2000. Hansen J held that, on a proper construction, AASB 1015, having been properly applied once, i.e. on 31 December 1999, for measuring and recording the value of acquired assets, does not have to be reapplied in its post Senate disallowance form to balances in relation to prior acquired assets in successive years. In brief, ASIC was not successful on the basis that, on its proper construction, the later version of AASB 1015, following the disallowance by the Senate, was not applicable in respect of the treatment of assets already acquired in the financial reports for subsequent years of income.

For present purposes, the significance of the MYOB case lies in ASIC's argument that, not only did the financial report of MYOB breach AASB 1015 for the half year ended 30 June 2000, it also failed to meet the "true and fair view" requirement. However, if ASIC held the view that the 30 June 2000 accounts didn't give "a true and fair view" of MYOB's "financial position and performance", why didn't ASIC maintain precisely the same argument in respect of MYOB's financial report for the period ended 31 December 1999? After all, both sets of financial reports and

statements were prepared on precisely the same basis. Yet, as Hansen J noted, the financial report and statements for the period ended 31 December 1999 were "not attacked [by ASIC] in any way" (page 50) (Emphasis mine).

The "true and fair view" requirement is one which is quite independent of compliance with accounting standards. Yet, having regard to the manner in which the MYOB case was argued, the inevitable conclusion is drawn that ASIC interpreted the Corporations Law as though the legal requirement was to prepare a set of accounts which gave "a true and fair view of the financial position and performance of the company" in accordance with accounting standards. That interpretation of the law is clearly untenable.

## VI ASIC INVITES DIRECTORS AND AUDITORS TO IGNORE THE "TRUE AND FAIR VIEW " REQUIREMENT

In an article published in 1999 ((1999) 22 University of New South Wales Law Journal, 417), George Gilligan, Helen Bird and Professor Ian Ramsay, presenting the results of a research project, noted that from 1993 to 1998 ASIC had brought only 14 civil penalty actions relating to 10 case situations. According to the authors of the article, "the actual experience of civil penalties in practice has not matched their enforcement potential or the desire of the regulators themselves to implement them" (at page 437). The authors attribute this to a number of factors, including "a sense of uncertainty within ASIC about how the judiciary will deal with civil penalty actions" and "uncertainty about what the directors' duties provisions actually mean" (at page 438). However, an examination of ASIC media releases for the 3 year period ending December 2001 has revealed increased use of civil penalty actions by ASIC – against 30 people related to 12 case situations (Grant Moodie and Professor Ian Ramsay, "The expansion of civil penalties under the Corporations Act", (2002) 30 Australian Business Law Review, 61).

The civil penalty provisions cover a range of matters – directors' duties, related party transactions, share capital transactions, financial reports, insolvent trading and managed investment schemes. Whatever criticisms may have justifiably been

levelled at ASIC in respect of its reluctance to invoke the civil penalty provisions of the Act, until now one could not have legitimately asserted that ASIC had publicly invited directors and auditors to ignore those legal obligations which ASIC perceived to be not readily or easily enforceable. Yet, this is precisely what ASIC did when, in giving evidence before the Committee, Mr Rodgers stated as follows:

> "I think it would be a very heavy burden generally to require every board of directors having in front of them a set of accounts produced in accordance with the standard to start from the proposition that an entirely separate enquiry was required that may well end up with them saying 'Well, we think this standard doesn't result or can't result in a true and fair view and therefore we have to override the standard on every occasion'" (Evidence, 26 July 2002, PA 236)

Yet, the assumption of this "very heavy burden" is mandated by law. And Mr Rodgers, speaking on behalf of ASIC, was inviting directors and auditors to flout the law when he told the Committee:

> "We do not see the law…as a general invitation to boards and auditors to rewrite the accounting standards when they prepare notes to the accounts". (Evidence, 26 July 2002, PA 232).

## VII THE ADVANTAGE OF AUSTRALIA'S LEGAL FRAMEWORK FOR FINANCIAL REPORTING

In Australia, we have the advantage of a legal framework which gives us the best of all worlds – in effect, allowing us to both have our cake and eat it – when it comes to the obligations of directors and auditors in relation to corporate financial reports. On the one hand, comparability and objectivity are enhanced by the requirement to ensure that the body of the accounts comply with accounting standards. On the other hand, the integrity of corporate financial reporting is preserved by the requirement to include in the notes to the accounts such information which may be necessary to give a true and fair view of a company's financial position and performance to the extent that this is not achieved by compliance with accounting standards.

## VIII THE IMPORTANCE OF THE "TRUE AND FAIR VIEW" REQUIREMENT, DESPITE DIFFICULTIES IN DEFINING ITS MEANING

The real challenge is to persuade ASIC to better understand what the law requires and then to take appropriate steps to enforce it. In saying this, I am under no illusion about the difficulties associated with enforcing something as vague and general as an obligation to "give a true and fair view of the financial position and performance of the company".

There is no agreement or authoritative judicial pronouncement on the meaning of the expression "true and fair view". It is certainly unclear, as a matter of law, to what extent "true and fair" necessarily implies mark-to-market accounting. Furthermore, the requirement is to give "a true and fair view" – not "the true and fair view". Accordingly, in any given case, there may be a range of acceptable "true and fair" views. In many cases, the accounting standards will produce results which fall within that spectrum of acceptable "true and fair" views. As accounting standards are improved and modernised, there will obviously be less scope for the operation of the additional "true and fair view" requirement.

However, there are instances – and I have given examples of them in my submission – where accounting standards will produce accounts which, on any view – if the words are to be given any meaning at all – will not give "a true and fair view of the financial position and performance of the company".

The Committee should take particular note of what Mr Alfredson, Chairman of the Australian Accounting Standards Board, said in giving evidence before the Committee:

> "The accounting standard sets a framework; it sets a measurement, a whole lot of rules, standards and principles – whatever you like to call them – but, in the end, accounts should be prepared in accordance with substance". (Evidence, 26 July 2002, PA 248) (Emphasis mine)

> "Accounting standards have to try and keep up with the business, but we will never stop financial engineering and structuring. Gosh, merchant banks parade all these things up Collins Street in Melbourne or Pitt Street in Sydney, or wherever – and what are they to do? Get debt off the balance sheet, get assets off the balance sheet and show a higher rate of return. It is all lacking in substance; it is all causing accounts not to be transparent". (Evidence, 26 July 2002, PA 253) (Emphasis mine).

> "I do think a true and fair view makes that extra comment that directors can prepare a set of accounts in accordance with accounting standards and anything they like to, but they then have to sit back and say, 'Is there anything so wrong with these accounts that a reasonable reader would believe they do not give a true and fair view??'" (Evidence, 26 July 2002, PA 248) (Emphasis mine).

Accordingly, directors and auditors must be encouraged to examine accounts complying with accounting standards to ensure that, in all respects, they give the legally mandated "true and fair view". ASIC has an important role to play in providing that encouragement, backed by appropriate enforcement activity.

## IX CONCLUSION - GIVING REAL MEANING TO AUDITORS' "INDEPENDENCE" AND "ACCOUNTABILITY"

One of the core concerns of the Committee in conducting the present review is the "independence" of auditors. But "independence" is only of value to the extent that it enhances "accountability" in financial reporting. "Accountability", in turn, is only worth pursuing if it is directed at an outcome which is desirable and meaningful. If the legally mandated "true and fair view" requirement is ignored, then, in my view, reforms designed to enhance "independence" and "accountability" will not achieve a key substantive and commendable outcome: nothing less than financial reporting which is relevant to the needs of shareholders and potential investors.

**SECOND SUPPLEMENTARY SUBMISSION BY MARK LEIBLER**

**TO THE JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT**

**REVIEW OF INDEPENDENT AUDITING OF REGISTERED COMPANY AUDITORS**

This second supplementary submission responds to the following requests from the Joint Committee of Public Accounts and Audit.

> "The Chairman asked if you could prepare a set of words that could replace, or add to, sections 295(3)(c) and 297 to put in 'plain English' the intent of those sections. (PA 274)
>
> Senator Murray asked if you would provide the words to give effect in the law, to your suggestion that auditors identify the five most significant accounting issues... (PA 279)"

By way of response to the above requests, I submit the following marked up amendments and additions to the relevant Sections of the Corporations Act 2001. Please note that, in drafting the amendments, it occurred to me that limiting the accounting issues to a particular number was somewhat arbitrary and I have therefore drafted the relevant amendments in terms of "the key accounting issues".

* * * * *

295 (3) **Notes to financial statements** The notes to the financial statements must contain:

(a) as the first note, a reconciliation in accordance with section 297A(2); and

(b) disclosures required by the regulations; and

(c) notes required by the accounting standards; and

(d) a discussion of the judgements made on the key accounting issues including the application of the accounting standards:

## Reconciliation

297A (1) [**Relationship between sections 296 and 297**] Sections 296 and 297:

(a) have independent application; and

(b) must be given equal paramountcy.

Any conflict between sections 296 and 297 must be dealt with in accordance with section 297A(2).

(2) [**Content of Reconciliation**]

The notes to the financial statements must contain a reconciliation which, if the accounting standards:

(a) do not result in the financial statements giving a true and fair view in accordance with section 297, gives any additional information that is necessary to give a true and fair view; or

(c) do result in the financial statements giving a true and fair view in accordance with section 297, a statement to that effect.

## Audit

307 An auditor who conducts an audit of the financial report for a financial year or half-year must form an opinion about:

(a) whether the financial report is in accordance with this Act, including:

(i) section 296 or 304 (compliance with accounting standards); and

(ii) section 297 or 305 (true and fair view); and

(iii) section 297A or 305A (reconciliation); and

(iv) section 295(3)(d) and 303(3)(d), and whether that discussion is reasonable; and

(b) whether the auditor has been given all information, explanation and assistance necessary for the conduct of the audit; and

(c) whether the company, registered scheme or disclosing entity has kept financial records sufficient to enable a financial report to be prepared and audited; and

(d) whether the company, registered scheme or disclosing entity has kept other records and registers as required by this Act.

308 (1) [**Report to members**] An auditor who audits the financial report for a financial year must report to members on whether the auditor is of the opinion that the financial report is in accordance with this Act, including:

(a) section 296 (compliance with accounting standards); and

(b) section 297 (true and fair view); and

(c) section 297A (reconciliation); and

(d) section 295(3)(d), and whether that discussion is reasonable

If not of that opinion, the auditor's report must say why.

[**Note: similar amendments in relation to the half yearly financial statements should also be made**. **Section 307 refers to undrafted sections in respect of the half yearly accounts.]**