ASIC

Australian Securities & Investments Commission

Everything the Company Director must know about Corporate Financial Disclosure and Continuous Disclosure

An address by Jillian Segal, Deputy Chair, Australian Securities and Investments Commission, to the Australian Institute of Company Directors Conference, "Governance & Disclosure – A Forum for Company Directors", Sydney, 31 October 2001.

Introduction

Thank you for inviting me to join you today. A conference on "Governance & Disclosure" is of course most timely as we begin to experience what appears to be the downside of the economic cycle. A number of high profile collapses such as HIH, One.Tel, Harris Scarfe, and more recently Ansett, of course, also focuses ones attention on governance issues.

Today, I would like to talk a little bit about ASIC's thinking on some of the key issues that are currently on its agenda, as well as issues that are hopefully of interest to you. As you would expect, ASIC's agenda is both full and diverse. As well as some high profile investigations, we have also been very focussed on FSR policy formulation and licensing implementation issues prior to FSR's planned start on 11 March 2002.

Before I delve into some other issues that I would like to talk to you about today, I would like to acknowledge the importance which ASIC places on its relationship with the AICD and its members. This importance is reflected in our involvement throughout the year in similar AICD functions across Australia, and in the AICD's involvement in groups chaired by ASIC. For example, the AICD is represented on our Corporate Governance Roundtable Group, which has been focussing recently, at the request of the Minister for Financial Services and Regulation, on identifying ways of promoting better corporate governance, and particularly in increasing the level of retail participation in corporate governance activities. We are considering issues such as electronic voting processes and simplifying notices of meetings to make them more investor friendly.

I am sure you will all agree that there are a whole host of issues that fall within the umbrella of "corporate governance", and disclosure is certainly one of them. You would have noticed the title of this speech in your Conference programs – "Everything the Company Director must know about Corporate Financial Disclosure & Continuous Disclosure". Whilst I cannot hope to cover all of the issues pertaining to corporate disclosure within the limited time available to me today, I will certainly try to highlight some key issues from ASIC's perspective. I will also comment on corporate governance more generally, the role of auditors and audit independence, and some of the current regulatory challenges of globalisation.

Disclosure

Corporate financial disclosure and continuous disclosure have been key priorities for ASIC over the last 12 months. Unfortunately, over this period, ASIC has had to intervene on issues of disclosure far too often and our focus on disclosure will need to continue. It is interesting to note that in his first major public address, the new Chairman of the SEC in the United States, Harvey Pitt, has singled out disclosure and, in fact, "the disclosure model as a whole", as a major priority. His address was in the context of financial accounts and I will comment on his remarks further later. However, at this stage, it is worth noting that within the

US context of quarterly reporting, he raised for consideration additional disclosure including the issue of "current" and even "trend" disclosure.

Corporate financial disclosure

Over the last few years, the trend in Australia has been progressively to relax the requirements for regulatory approval and pre-vetting of prospectus and other disclosure documents by the regulator. Detailed prescription of the contents of fundraising documents has also been removed. This trend reflects the view that responsibility for the contents of a prospectus should lie with those who are best placed to understand the proposal that is being offered, namely the directors and promoters. It also reflects the view that disclosure is the most effective regulatory tool and that prescriptive constraints can be relaxed, provided disclosure is maintained.

The Corporate Law Economic Law Reform Program Act 1999 (Cth) "CLERP" which commenced on 13 March 2000, removed the remaining requirement for ASIC to register prospectuses (which at that stage applied only to initial public offerings, managed investment schemes and debentures), and replaced it with a requirement that all prospectuses be lodged with ASIC (sections 718 & 727 of the Corporations Act).

Essentially, CLERP retained the general disclosure requirement (contained in section 710 of the Corporations Act) and allowed greater use of short form prospectuses (section 712 of the Corporations Act), extending the operation of the provision beyond prospectuses lodged by listed entities to all prospectuses. This move was designed to facilitate the presentation of prospectuses to retail investors in a manner best suited to their needs.

I think it is most important to reiterate ASIC's role in relation to fundraising documents. We know that many retail investors, and even some professional and media commentators, do not have a clear idea of the regulator's responsibilities in this area. At times, there have also been examples of promoters playing upon the point that a prospectus *lodged* with ASIC means an investment scheme is endorsed or even *guaranteed* in some way by ASIC. Let me make it clear that this is not the case. It is *not* ASIC's role to evaluate the "merits" of a particular company's business plan or investment scheme. ASIC's role is to ensure that directors and promoters provide investors with adequate information in fundraising documents so that they can make an informed decision about the merits of a particular offer. Therefore, the fact that a prospectus is lodged with ASIC does not mean that ASIC "approves" or "endorses" the nature of the proposal/scheme in any shape or form. In some cases, ASIC will look at disclosure documents in the seven day period between lodgement and the end of the exposure period. In other cases, we will only do so in response to concerns drawn to our attention.

Clearly, it is important for disclosure documents to be "lodged" with ASIC so that if there are concerns or complaints, the regulator has immediate access to the document. However, it is important that this responsive capacity is understood. We are therefore undertaking a research project to look at whether we can improve investor understanding through the inclusion of "warnings" in prospectuses, which would be designed to improve consumer understanding of the risks of investments, and the limited role of the regulator. From a policy perspective, we will also be considering what sorts of reforms may be desirable so that such warnings are included in investment offer documents.

As I am sure you all appreciate, we are committed to protecting investors and improving the quality of fundraising disclosure. We have placed, and will continue to place, interim and final stop orders on prospectuses that fail to disclose adequate information to potential investors. For example, we have issued stop orders over more than 50 companies this calendar year – these are all public actions, so please visit our website if you wish to see the full range of the orders we have issued. We are also in the process of amending some relevant policies in this area. For example, in light of growing concerns that disclosure practices in fundraising documents were not what they should be, ASIC recently provided interim guidance to both preparers and reviewers of disclosure documents about the provision of forward-looking financial information in such documents, particularly for start up enterprises. It appeared to us that too many prospectuses contained forward-looking financial information based on hypothetical assumptions contrary to our existing policy in this area. Our interim guidance paper now makes it clear that financial projections or forward-looking statements must be based on *reasonable* assumptions such as best estimates, and not on hypotheses.

Clearly, what are "reasonable assumptions" must be judged in light of the particular circumstances of each case. However, generally, we believe that any forward-looking information for a period beyond two years should be supported with some objective criteria, such as forward contracts locking in future revenues and costs. We also give due consideration to expert reports prepared in accordance with our recent guidance and industry standards. This interim position will be further developed and will be circulated publicly for consultation before a final policy is issued in this area. You can probably expect to see that document issued in November this year.

One issue that has been raised with us is the concern of those promoting new ventures, who argue that they are unable to produce reasonably based forward-looking profit statements. On the other hand, they assess the market as requiring future profit statements in order to price the offering. We have to balance this with the need to ensure that investors have a high degree of confidence in the reliability of information provided in a regulated fundraising document, so that all Australian companies can continue to seek to raise funds in the market place.

In some circumstances where we are concerned about an expert's report that has been arranged by the issuer, we will continue to appoint our own experts to report on prospectuses. If our expert shares our concerns, then we may issue an interim stop order on the prospectus, pending resolution of the issues. We tend to use such experts where the subject matter is very technical such as in biotechnology.

I believe that all of these activities will contribute to better information for retail investors and a better understanding of the regulator's role. As I said earlier, we are committed to protecting investors and improving the quality of fundraising disclosure.

Continuous Disclosure

As with prospectus disclosure, we are also committed to our ongoing campaign to ensure that companies comply with their continuous disclosure obligations under the Corporations Act and the ASX Listing Rules.

As most of you would know, in the early 90s, corporate Australia engaged in a vigorous debate about whether corporate reporting should be quarterly or continuous, introduced continuous disclosure rules, and substantially improved our insider trading laws. These were all done in an effort to create a market in which investors could trade on equal terms and with confidence in its integrity. Despite these efforts, today we are told there is the perception that wholesale market participants are advantaged, and have privileged access to information and trading opportunity over retail participants. Unfortunately, this perception is further perpetuated by continuing practices such as selective analyst briefings.

My view is that we are still fighting the war on "disclosure". I believe the problem is that prompt disclosure is not an integral part of our corporate culture.

Many companies seek to avoid disclosure unless they receive legal advice that it is absolutely required. Some examples of reasons for non-compliance we have come across include:

- Delaying releasing the bad news until they had some good news to "balance" it with;
- Delaying reporting a failure to meet a vital product development approval because they continued to accept management assurances that the technical difficulties were just about to be solved. This continued for nearly 12 months. (One needs to ask whether there were too many executive directors on the board?);
- Delaying, because having had concerns with the CEO making statements in the past, they required board sign off on the ASX announcements, but did not establish a process for dealing with them between quarterly meetings of the board.

To improve disclosure, we need to appreciate that unless investors have confidence in the integrity of the market, we will have difficulties in attracting and maintaining investor support for our markets. We need to address the underlying attitudes towards disclosure, and above all, we need a commitment from all market participants towards changing those attitudes and developing a "culture" of voluntary disclosure and compliance, supported by effective regulatory sanctions against those who offend.

ASIC has worked hard over the last 18 months to improve disclosure practices and promote investor confidence. Some examples include:

- The *"Heard it on the Grapevine"* discussion paper and resulting better disclosure principles (released in August 2000), which suggest principles that companies should comply with in order to ensure equal investor access to information, and to promote better communication between listed companies and investors. Whilst I would not wish to comment on any particular matter in detail here, I do believe that these principles are now quite well known and investor concern has now focussed on ensuring equal access to information as there is a much stronger focus by the investor, the media and ASX on market disclosure obligations and particularly on selective analyst briefings.

ASIC welcomes the AICD's support for our campaign to improve continuous disclosure and to eliminate two-tiered information markets. I understand the AICD is currently working on a *Code of Corporate Information Disclosure*, for the benefit of its members. A number of other industry bodies have also recently published similar guides following the release of our principles. The Australasian Investor Relations Association (AIRA), for example, recently released its *Best Practice Guidelines for Communication between Listed Entities and the Investment Community* (2 August 2001), designed to enhance communication standards, assist compliance and improve the equality of access to information.

AIRA's best practice guidelines cover areas such as disclosure policies, the roles and responsibilities of a listed entity's communications officer, authorised spokespersons, recommendations regarding the dissemination of announcements, one-on-one meetings with investors and broking analysts, group briefings, conference calls, web-based communications, analyst reports and forecasts, broker-sponsored investor conferences, trading halts and dealing with the media.

I would encourage industry associations to co-ordinate their views and guidelines on good disclosure practices, and provide meaningful assistance to corporations.

- As you may know, as one of the first stages in our focussed work in this area, from February to July 2000, ASIC and ASX ran a two stage joint campaign in relation to the disclosure practices of listed technology companies, after which we released a list of "Top 10 Tips" for investors in dot coms. During this campaign, ASIC conducted surveillance visits of 20 listed "high tech" companies throughout Australia. As a result of our actions, 10 companies released additional information to the ASX either after being advised that ASIC would visit them or after the visit had taken place. Three of these companies released information only after negotiations with us. It is worth noting here that had these voluntary disclosures not been made, we would have taken civil action to seek to compel disclosure.

  A number of issues were identified as a result of the campaign – for example, directors ignoring the basics of good company disclosure, directors not meeting regularly, proper accounting records not being kept, and basic financial records not being prepared – and these were referred to ASIC's account surveillance program for follow up. Just recently, two high-tech start ups – Min-Tech 8 Limited and CBD Online Limited – also provided further information to the market following action by ASIC and the ASX.

- In May 2001, ASIC also undertook a surveillance project in relation to the disclosure practices of companies providing quarterly cash flow statements to the ASX. This project identified 18 high-tech listed companies, which had failed to disclose adequate information in their cash flow statements. Of these 18 companies, ASIC's action led to nine companies releasing additional information to the ASX. In relation to one other company, ASIC's enquiries led to the company appointing an administrator. Companies, and particularly new economy companies, are now aware that the requirement to lodge quarterly cash flow statements to the ASX does not in itself satisfy their continuous disclosure obligations under the Law.

> One of the main findings of our reviews has been the inadequacy of the compliance systems in place in many recently listed companies. In a few cases, we have required the companies concerned to obtain external reviews of their systems. Common failings include the lack of a published disclosure policy to staff and management, inability to deal with major issues in between formal meeting of the Board, and occasionally a willingness to continue to accept management assurances of project delivery when those promises should be questioned more closely.

You are all no doubt aware that disclosure is an issue that lies at the heart of the Financial Services Reform legislation, which I have already mentioned, and which will now commence on 11 March 2002. The FSR legislation will empower ASIC to seek civil penalties for market misconduct matters including breaches of the continuous disclosure provisions. This means that contraventions of the continuous disclosure provisions will be subject to both civil penalties and criminal consequences.

While ASIC has long supported the extension of the civil penalty remedy to market offences, we do not believe that these reforms alone will suffice. As you are all aware, the very basis underpinning the continuous disclosure regime is the provision of price sensitive information to the market in a timely fashion. Therefore, the ability to institute a quick regulatory response to contraventions of the continuous disclosure provisions is of particular importance, given that these types of contraventions have an immediate impact on the market. Whilst our intervention can speed up and, in some cases, cause proper disclosure, it is not always appropriate to take civil proceedings once the disclosure has actually been made.

It is for these reasons that we have raised for discussion and debate, the importance of fines for market offences such as late disclosure.

Corporate governance more generally

Whilst disclosure is an important aspect of corporate governance, and very often a reflection of the culture of compliance of the corporation, the focus more recently has been on the more general aspects of corporate governance. ASIC has repeatedly acknowledged that the best governed of companies can still succumb to competitive and economic forces and corporate failure does not *necessarily* imply poor standards of governance. In fact, generally, our standards of corporate governance have been regarded as a benchmark by many of our trading partners. Having said that, it is important not to be complacent about governance. We must continue to be vigilant in identifying problems and seeking to improve the integrity of our corporate environment.

As we have seen, when a company collapses, the perception amongst the public is that there has been a breach of the law. Whilst each year we experience approximately 7000 corporate collapses, increasingly significant collapses are being referred to the corporate watchdog, and it is fair to say that a number of significant collapses recently have directly affected many Mums and Dads – air travel, communications, and insurance products are all utilised by the average household.

Whilst we do not believe that these collapses indicate a systemic failure of governance, nor a return to some of the endemic features of the 1980s, as I noted earlier we cannot afford to be complacent, and of course, we will need to complete a number of our major investigations in order to be better informed as to the reasons behind such collapses. There has been public debate recently surrounding the suitability of our "unitary board" corporate governance model. Additional structures such as a "corporate senate" (elected by cumulative voting) have been suggested by some to veto resolutions of the directors in circumstances of self-interest. I do not wish to debate board models here today, and I do not think ASIC believes that the current model needs major overhaul. Nevertheless, corporate governance is not a static thing and even if basic structures remain the same, policies and procedures surrounding those structures should constantly be reviewed, particularly given the increase in retail participation in the equities markets and their perhaps different expectations.

In this regard, I think we should give close consideration to issues of director training. It is rather ironic that we spend large amounts of money (not to mention time) in developing and training our staff, yet we spend very little on similar programs for those who are in control of our corporations. As our Chairman stated in an address to the AICD in Perth only a few weeks ago, and as I have also stated publicly previously, more attention needs to be given to board training and assessment not only at the induction stage, but on a continuing basis so that boards are up to date on legal & accounting requirements, as well as details of their business. Organisations like the AICD, institutes of management and other stakeholder groups will be key drivers of change here.

Another issue related to board/committee structures and roles, as well as policies/procedures, relates to audit. The question of audit independence is a key issue in governance debates at present.

The role of auditors and audit independence

There is no doubt that recent events surrounding the collapse of high profile companies has brought the role of, and performance of, auditors back to the forefront of all our minds. As you would be aware, Professor Ian Ramsay's report on audit independence was released only a few weeks ago into the public arena. This report is an important contribution to the current debate within the community about how we can enhance standards within the profession and reform audit practices. Issues of international guidance and standards in this area, as well as oversight of Audit Committees, are raised by Professor Ramsay and deserve very careful attention. ASIC is also in the process of conducting a survey of Australia's top 100 companies in order to derive better information about current audit practices and other related work. We hope to be able to release this information shortly and contribute further factual data to inform the debate.

I should point out that whilst we acknowledge the importance of an "independent" audit, we do not believe that "audit independence" is the only issue of relevance.

There appears to be some uncertainty within the community about what exactly an auditor is expected to do. Consequently, I believe the debate about audit reform needs to be approached from a broader perspective, namely one that seeks to enhance not only audit independence, but also the community's understanding of, and expectations from, the auditing profession. Investors need to ask themselves how rigorous and investigative they want corporate audits to be and, most importantly, what they are prepared to pay for them.

Audit cost is certainly a key issue which needs to be reconsidered. Businesses appear to be placing less value on an audit and are less willing to expend resources on it whilst, at the same time, investors appear to be placing greater reliance on the "checking" process of an audit. We believe this "gap in expectations" is a key issue that needs to be debated. Governance issues relating to audit for directors should include questions such as:

- Does the scope of the company's audit receive the high level consideration, which is applied to strategic decision-making?
- Is the audit budget realistic to support a sufficiently investigative process?

- Is the board sufficiently involved in agreeing the terms of the audit mandate?
- Is the board sufficiently focussed on ensuring that substance is preferred over form in its financial reporting?
- Is the audit mandate determined by the independent directors (on the Audit Committee) or is it controlled/constrained by management?

Once again, the issue is about changing attitudes and developing a "culture" within the business community about the value of an audit and its contribution to shareholder value and security. To do this, we need a firm commitment from all market participants, including the AICD and its members.

As mentioned earlier, SEC Chairman, Harvey Pitt, recently touched on this sensitive issue in his first major address to a gathering of senior US accountants. He also noted that the debate was a wider one based on fundamental issues of disclosure. He raised a number of issues to further consider, including simplifying financial disclosures to make accounting statements useful to, and utilisable by, ordinary investors, as well as updating the financial model to include more information about intangibles, given the increasing relevance of intangibles to current business models. I agree that these are all important issues that we should ensure are part of the current governance debate.

Some recent regulatory challenges of globalisation

One cannot touch on governance and disclosure issues without discussing globalisation.

Globalisation yields challenges not only for industry, but for the corporate regulator as well. Today, we are faced with the issue of large Australian companies (most recently demonstrated by BHP/Billiton) wishing to expand their international presence, without giving up their Australian domicile. Whilst we recognise that a global presence by leading Australian corporations is important to our national interest and economy, we have to be careful to ensure that modifications and exemptions, which are granted to facilitate dual listed companies (or DLCs for short) can be reconciled with the continuing obligations applicable to mainstream corporate Australia.

As has been previously noted, the concept of DLCs is not one that is fully contemplated by our law or accounting standards. In light of the different regulatory requirements in relation to disclosure and financial reporting, which exist in jurisdictions in which companies wishing to utilise this structure are domiciled, ASIC has had to develop a policy framework around the concept of DLCs, which are harmonious with international regulatory rules.

You may be aware that ASIC has just released a Practice Note (PN 71) on the 3rd of this month, outlining our views as to the appropriate accounting treatment to be adopted by Australian entities in DLC arrangements. The Practice Note essentially provides guidelines to DLCs about financial reporting & disclosure to the Australian market of information disclosed in foreign markets. We believe these guidelines will provide certainty for Australian entities under DLC structures in complying with their financial reporting obligations, pending the release of an accounting standard dealing specifically with such arrangements. ASIC has asked the Australian Accounting Standards Board to develop rules to clarify the accounting treatment of DLC structures as a matter of urgency. In the meantime, ASIC considers it necessary to express its views as to how it expects the existing requirements of the Corporations Act and accounting standards to be applied to these structures.

It is important to understand that DLCs are not just Australian companies seeking to list their shares offshore. The DLC structure typically brings two listed companies together – one from Australia and one from offshore – in an arrangement under which neither company acquires shares in the other. The union is formed by way of complex agreements between the two parties and amendments to their respective constitutions. To date, the DLCs in Australia have involved companies in Australia and the United Kingdom, with additional listings in the United States. In developing our policy framework, we have therefore paid close attention to the approach taken by the United Kingdom, in order to maximise the consistency in regulatory responses by our two countries. For example, our Practice Note provides that where the fair value of the Australian entity is more than 1.5 times the fair value of the other entity at the time the DLC is created, ASIC will usually take the view that the Australian entity in the DLC structure has, in substance, acquired the foreign-listed entity. This is consistent with UK guidelines for applying acquisition accounting rather than merger accounting.

I should point out here that where the Corporations Act provides specific rights and protections for investors (for example, under the takeover provisions) we will continue to require that they be recognised in the DLC arrangements.

Conclusion

At the risk of stating the obvious, let me conclude by saying that it will be a challenging year for all of us, as we move forward under the FSR legislation, and as the regulatory landscape continues to evolve to meet community expectations, the demands of globalisation, and the consequent need for harmonisation in regulatory practices.

I am sure you will all agree that in this current environment of law reform, the need for constructive and thoughtful dialogue between all sectors of our community, including governments, regulators, industry participants and consumers, has never been more vital. With that in mind, I look forward to an ongoing interaction with the AICD and its members.