



ASIC

Australian Securities & Investments Commission

REPORT 21

**Report on the review of
2001 & 2002 annual financial
reports of South Australian
securities dealers**

May 2003

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Executive summary

ASIC has held concerns that some licensed securities dealers and some auditors of their accounts are not complying with the Corporations Act and applying the reporting entity test in Australian accounting standards ("AAS") appropriately. The accounting standards provide a framework for consistent financial reporting across entities as well as defining certain accounting terms.

Importantly, calculations of Net Tangible Assets ("NTA") or Surplus Liquid Funds ("SLF") for compliance with licence conditions are based on Balance Sheet (Statement of Financial Position) figures and if they are not prepared in accordance with AAS, there is a risk that these NTA or SLF calculations will be defective.

ASIC conducted a limited regional review of compliance of financial accounts with AAS in accordance with ASIC Information Release 00/25 'Reporting requirement for non-reporting entities' ('ASIC's Release'). That release says in relation to licensed securities dealers:

"Licensed securities dealers and futures brokers would only be non-reporting entities in rare and exceptional circumstances (eg where a securities dealer does not carry on any business and has no proper authority holders)."

A sample of South Australian securities dealers' accounts for the years ending 30 June 2001 and 30 June 2002 were selected for review. This report provides an outline of ASIC's review, as well as discussing the findings and recommendations arising from the review.

The initial review of 2001 accounts identified a number of securities dealers who had not complied with AAS. It appeared that these securities dealers did not classify the entities as reporting entities and consequently had not complied with AAS when preparing their financial year-end accounts. Their auditors had also failed to issue qualified audit reports. A further limited review of 2002 accounts has also identified some entities that are continuing to lodge accounts which fail to comply with AAS and the Corporations Act ('the Act').

ASIC has also examined the correlation between entities that lodged accounts, which did not comply with AAS, and licensee difficulty in meeting the

licensing financial requirements. Our findings in this regard are detailed later in this report.

ASIC will be discussing with the accounting bodies education of their members on the requirements and ASIC will consider a further national review of licensee financial reports.

Background

In July 2000 ASIC published Information Release 00/25 "Reporting requirement for non-reporting entities" specifically addressing the issue of reporting requirements for licensed securities dealers.

In particular, ASIC's Release states that ASIC believes that licensed securities dealers and futures brokers would only be non-reporting entities in rare and exceptional circumstances such as a securities dealer who is not carrying on business and has no proper authority holders.

This has particular relevance to the information needs of clients of dealers and brokers where financial reports are in the public domain. Even in those cases, where the financial reports are not in the public domain, the requirement to lodge those financial reports recognises that ASIC is a user or potential user of those reports. Under accounting standards an entity will only be a non-reporting entity if it has no users dependent upon its financial report or all users of the report can command the information they require. Hence, if ASIC could not command the information it requires, dealers and brokers would be reporting entities. If ASIC can command the information it requires, then it requires financial reports prepared on a reporting entity basis, except in the rare and exceptional circumstances referred to above.

Subsection 860(2) of the Corporations Law (as preserved through the FSR transitional provisions) requires a holder of a securities dealers' licence to prepare annually, a true and fair profit and loss statement and balance sheet using prescribed accounting principles. Those financial reports should comply with Australian Accounting Standards and Form 711 of the Corporations Regulations requires the auditor to give an opinion on compliance with those standards. These financial reports along with an auditors report are to be lodged with ASIC within a prescribed period.

In relation to those who are subject to the financial reporting requirements of Chapter 2M of the Corporations Act, ASIC's Release also says that " Directors of an entity which identifies itself as a non-reporting entity and elects not to adopt the requirements of all accounting standards would be in breach of the requirement to comply with accounting standards contained in s 296 of the Act if the circumstances of the entity point to it being a reporting entity."

Securities dealers should consider carefully any proposed classification as a non-reporting entity and the subsequent preparation of financial reports given the importance of such a classification.

For new Australian Financial Services Licensees, section 989B of the Corporations Act requires a licensee to prepare a true and fair profit and loss statement and balance sheet. Information Release 00/25 continues to apply in determining whether the financial reports are prepared on a reporting entity basis.

The reviews

The review was conducted in two stages with an initial selection of the financial statements of 94 South Australian based licensed securities dealers for the financial year ended 30 June 2001. These financial statements were reviewed to determine application of Australian Accounting Standards, including compliance with the reporting entity requirements as outlined in ASIC's Release.

Where financial reports did not appear to comply with AAS, further analysis was undertaken to determine if there was a correlation between the non-compliance with AAS and the licensee's difficulty in meeting the financial requirements. Where the financial report did not appropriately apply AAS, ASIC warned licensees that their 2002 financial report must apply AAS. Licensees were notified that enforcement action by ASIC might be considered where licensees failed to comply with their reporting obligations in their 2002 financial report.

Where ASIC identified financial reports that did not comply with AAS and a registered auditor had issued an unqualified opinion on those financial statements ASIC sought clarification from both the licensee and the auditor. Furthermore, where breaches of licence conditions had occurred these matters were referred for enforcement action.

Stage 2 of the campaign then reviewed financial reports of 45 securities dealers for the year ended 30 June 2002 to determine if the financial reports complied with AAS.

A further review of auditors' reports was also undertaken at this time.

Findings

2001 Financial Year

The initial review of the financial reports of all licensees identified 34 licensees which declared they were non-reporting entities and did not apply AAS. A further 4 licensees failed to lodge financial reports.

There were concerns with 5 of the 34 licensees that reported as non-reporting entities for the year ended 30 June 2001 in relation to compliance with their SLF or NTA licence conditions . Of these 5 licensees;

- 3 licensees provided additional information and demonstrated compliance with licence conditions.
- 1 licensee applied for and was granted cancellation of the licence
- 1 licensee was found to be in breach of SLF requirements and has now rectified this position.

In relation to the 4 licensees that failed to lodge financial reports, the following action was taken:

- 3 licences were cancelled
- 1 licensee submitted its financial reports and subsequently satisfied the licence condition

This first stage review identified a number of financial reports that had not applied the relevant accounting standards and were accompanied by an unqualified auditors' report.

2002 Financial Year

The further review of 45 financial statements for the 2002 financial year included 34 licensees from stage 1 of the project who had reported as non-reporting entities in the 2001 financial year as well as 11 securities dealers who were either granted a licence subsequent to the 2001 reporting period, did not lodge financial reports during the 2001 financial year or fell under the exceptional circumstances referred to in ASIC's Release.

The 30 June 2002 review identified 27 licensees who had prepared financial reports as a reporting entity and had complied with AAS.

ASIC undertook an investigation on 1 licensee regarding a breach of the "Net Tangible Assets" licence condition. Following this investigation, the licensee has taken appropriate action to ensure that it complies with the financial requirements of its licence.

This second stage review also identified 2 licensees who qualified as having exceptional circumstances discussed in ASIC's Release because the licensees had no proper authority holders and as such were not classified as reporting entities.

This review identified a further 3 licensees who reported as non-reporting entities with one of these matters now being considered for potential enforcement action.

Overall results

As a result of this campaign, 10 licences were revoked (including 3 in the 2001 financial year review). A further 2 licensees were issued with ASIC notices to produce documents and have subsequently lodged financial reports.

Generally the review identified that for licensees and auditors, the level of awareness and understanding of responsibilities in relation to preparation of annual financial reports was poor and audit opinions expressed on the financial reports of licensees can be inadequate.

ASIC has found that in many cases the accountants preparing the financial reports for securities dealers were from the firm that audits those financial reports and that they often deal with ASIC's enquiries on behalf of the licensee. This may breach the audit independence requirements imposed on members of Australian accounting bodies by those bodies.

Generally the limited review identified that compliance with the reporting entity requirement by licensed securities dealers and auditors was poor. However, the licensees and auditors concerned provided a positive response in terms of future compliance when contacted by ASIC.

Other matters

Given the large number of financial reports that did not comply with AAS within the selected sample, ASIC will consult with the accounting bodies as to

ways in which they may be able to educate their members on the reporting requirements for licensees.

ASIC will also consider undertaking a national review of financial reports lodged by securities dealers and the associated audit reports in the future.

The circumstances in which a licensed securities dealer will not be classified as a reporting entity are very limited. A carefully considered approach based on experienced accounting advice is recommended before that classification is made, given the ramifications of an incorrect election.

ASIC will publicise the findings of any ongoing national review as they emerge.