



ASIC

Australian Securities & Investments Commission

**New directions in
Australian Auditing and Accounting Standards**

**ASIC: Policing acceptable standards of
auditing and accounting practices**

Presented by

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Introduction

The Australian Securities and Investments Commission is mandated to promote the confident and informed participation of investors and consumers in the financial system. A vital element in achieving this objective is ASIC's focus on the quality of published financial reports and on the audit process.

The accounting profession has been the subject of intense scrutiny in the past eighteen months. In the context of community, government and media scrutiny of corporate governance standards, in some cases crossing international borders, auditors in particular have felt the heat.

ASIC has been active in reviewing conduct, enforcing laws and standards where appropriate, and contributing to the debate surrounding financial reporting and accounting standards. This debate has seen outcomes, not only in the HIH Royal Commission Report of Justice Neville Owen, but also in the CLERP 9 Discussion Paper and proposed CLERP 9 legislation which is due for release in draft form shortly.

My topic today is 'Policing acceptable standards of auditing and accounting practices'. In seeking to address this topic I propose to divide my paper into three parts.

The first part of my presentation will focus on ASIC's current activities in regulating financial reporting and audit under the current provisions of the *Corporations Act*. In that respect I will discuss:

- a) the ASIC Accounting Surveillance Programme and outcomes from the most recent study
- b) possible avenues for surveillance in the next financial year, and
- c) CALDB referrals.

Second, I will spend a little time looking at current ASIC initiatives which, while arguably are not strictly 'policing' as such, nonetheless relate to proposed ASIC guidance in the context of accounting and auditing standards, and are relevant to what ASIC considers to be 'acceptable'. Issues on which I plan to touch are:

- a) recent ASIC initiatives in relation to options granted as remuneration, and
- b) deficiencies of defined benefit superannuation funds.

Third, given ASIC's continuing role and interest in broader accounting issues there are a number of developments currently on the horizon which I would like to touch upon during the course of the next hour. These developments are:

- a) the imminent release of CLERP 9 draft legislation

- b) ASIC's proposal to establish a Financial Reporting Panel to consider compliance in financial reports with the accounting standards and the true and fair view requirement
- c) the CLERP 9 proposal to give legal backing to auditing standards, and
- d) proposals relevant to the adoption of International Accounting Standards in Australia in 2005.

Policing financial reporting

a) ASIC's financial reporting surveillance programme

ASIC has an active financial reporting surveillance programme designed to promote quality financial reporting and compliance with the financial reporting requirements of the *Corporations Act*.

Clearly, compliance with the accounting standards helps to ensure consistent and comparable financial reporting between entities, which is vital to confidence in financial reports. We do not accept the so called 'clever' interpretations of accounting standards that are counter intuitive or treatments designed to obtain an outcome that does not reflect the true substance of transactions and financial structures.

As many of you will be aware, since 1998 ASIC has performed a regular semi-annual targeted surveillance programme on the financial reports of listed entities. We also examine and pursue matters that come to our attention from other ASIC programmes, complaints, media reports, and other market intelligence.

Our regular surveillance programme is designed in part to educate the market through means such as media releases, articles and liaison meetings with the profession in each State. We will also seek changes to specific financial reports and take action where appropriate.

Financial statements of selected listed entities are reviewed in relation to specific accounting issues and for compliance with particular accounting standards. The areas of focus are generally those where we suspect from our other activities, intelligence, liaison and other sources that there may be a level of non-compliance and may also include new accounting standards. These areas of focus are publicly announced by ASIC prior to the end of the financial reporting cycle concerned.

For financial years ended from 30 June to 31 July 2002, we decided to direct our attention to areas of accounting abuse of the type uncovered in a number of high profile cases in the United States. The surveillance focussed on:

- deferred expenses
- recognition of revenue, and

- recognition of controlled entities and assets.

The principal standards involved in the review's focus were:

- AASB 1040 Statement of Financial Position
- AASB 1018 Statement of Financial Performance
- AASB 1004 Revenue, and
- AASB 1024 Consolidated Accounts.

ASIC assembled a special task force for the project comprising representatives from ASIC's Office of Chief Accountant and its Corporate Finance and Enforcement directorates.

We examined the financial reports of all listed Australian companies and we are in the process of examining the financial reports of all listed companies with years ending from August to December 2002.

Over 1,000 full-year financial reports of companies balancing from 30 June to 31 July 2002 were reviewed, and further information and explanations were sought from 31 companies. In addition, enquiries were made of some companies with qualified audit reports on their ability to continue as going concerns, and ten companies that had not lodged their financial reports were suspended from trading by the ASX.

The review confirmed our stated belief that there is no reason to believe that the type of accounting abuses identified in the United States pose a material risk in Australia. In relation to the overwhelming majority of companies, the review did not raise any systemic issues in the three areas examined.

The advance announcement of the areas of review, coupled with letters to the Chairpersons of all listed companies and pressure from auditors, is believed to have caused companies to closely re-examine their accounting policies in the three areas of focus and saw the adoption of more conservative policies in some cases.

In relation to the 31 companies from which additional information and explanations were sought, ASIC accepted the accounting policies and reporting of transactions by 13 companies but requested improved disclosure from 10.

Six companies changed their accounting policies in the areas of concern identified by ASIC. These companies implemented the changes in their 31 December 2002 half-year financial reports. These issues included the grossing up of revenues from agency transactions, failure to write down assets, recording asset revaluations to profit rather than against a reserve, using notional values rather than fair values of assets for acquisition accounting. At least one listed company has reissued its half-yearly accounts following our query.

Discussions and enquiries are continuing in relation to 16 companies where concerns remain with the application of an accounting standard or standards, and ASIC will take further action if these issues cannot be resolved. Some of the issues still outstanding include off-balance sheet reporting of loan securitisations through special purpose entities, over statement of the carrying amount of assets, inappropriate deferral of expenses as assets, and premature revenue recognition.

As a general rule, we encourage companies or their accountants who have doubts about the correct accounting treatment of complex and unusual transactions, whether in the context of the latest focus of the targeted surveillance program or otherwise, to contact us at an early stage prior to finalisation of their financial reports. We would expect however that the relevant matters be discussed with the company's auditors and the technical partners of the auditing firm prior to coming to us.

b) Possible avenues for surveillance in the next financial year

The financial reporting issues to be considered in the surveillance of financial reports of listed entities for years ending 30 June 2003 are currently being finalised and are subject to approval by the Commission. At this stage, however, they are likely to include disclosure of option values as remuneration of directors and executives and the treatment of surpluses and deficits in defined benefit superannuation funds. This should cause no surprises – they are already issues which ASIC is addressing in the public forum. I will return to these two matters later.

c) Referrals to Companies Auditors and Liquidators Disciplinary Board (CALDB)

A company's directors must take reasonable steps to ensure the company's financial report complies with financial reporting requirements of the *Corporations Act*. The auditors have obligations to qualify their audit report where those requirements have not been complied with and to report non-compliances with the Act to ASIC in accordance with s.311.

ASIC may apply to the CALDB to have the registration of an auditor suspended or cancelled where, amongst other matters, the auditor has failed to carry out or properly or adequately perform the duties of an auditor under the *Corporations Act* or another Australian law, or is otherwise not a fit and proper person to remain registered as an auditor.

Our power to do so is found in the *Corporations Act*. Structural, procedural and evidentiary matters are in the *ASIC Act*.

The CALDB may also require certain undertakings such as in regard to ongoing conduct, costs and/or professional development.

ASIC identifies matters to be brought before the CALDB from a range of sources, including complaints, press reports, investigations into corporate collapses, and the financial reporting surveillance programme. Auditors who are taken by ASIC to the CALDB include members of both large and small accounting firms in Australia.

At any one time, ASIC has a number of matters before the CALDB in relation to conduct by auditors or liquidators. Since 1999, sixteen decisions relating to auditors have been handed down by the Board and a similar number in relation to liquidators.

ASIC has a dedicated team in our Enforcement directorate who specialise in CALDB referrals. Notwithstanding that the CALDB is itself created by the *ASIC Act*, ASIC is at arms length from the Board.

Depending on the case, we may agree to consent orders of the Board or resolution of a case prior to its appearance before the Board, and we maintain a monitoring role in relation to auditors who, for example, are required by the Board to undertake additional continuing professional development.

ASIC does not treat CALDB referrals lightly. We take seriously the cases where we believe a referral is warranted, and publicise CALDB decisions by way of media release and on our website. Although we are of the view that the auditing profession as a whole aspires to high standards – and indeed our most recent accounting surveillance program supports that view – we consider suspension or cancellation of registration to be an appropriate response where an auditor’s conduct potentially damages not only the reputation of the relevant corporation, but the auditing profession and the integrity of the financial reporting system. Reviews of CALDB decisions where decisions of suspension or cancellation are weakened by, for example, substitution of a reprimand can, frankly, be a source of concern for us.

Current ASIC Initiatives

a) Disclosure of options in director and executive emoluments

Section 300A of the *Corporations Act* requires the annual directors’ report in the case of listed companies to include details of the nature and amount of each element of the emolument of each director and each of the five named officers of the company receiving the highest emolument. Essentially, ‘emoluments’ means the amount or value of any money, consideration or benefit given, directly or

indirectly, to a director of a body corporate in connection with the management of affairs of the body or of any holding company or subsidiary of the body.

Section 300A was introduced into the *Corporations Act*, for listed companies only, by legislative amendments in 1998, following a number of both local and international reports looking at directors' remuneration. The same year, ASIC produced Practice Note 68 entitled 'New financial reporting and procedural requirements', which was intended to provide guidance in relation to new parts of the *Corporations Act* including Part 2M. Paragraph 60 of PN 68 states that the elements of emoluments to be disclosed would normally include, among other things, the value of options granted. ASIC did not, however, prescribe detailed accounting or valuation methods in relation to options issued.

ASIC has recently issued a draft information release containing proposed guidelines as to *how* listed Australian companies should include values of options in disclosures of directors' and executive officers' emoluments in their annual directors' reports and financial reports for years ending on or after 30 June 2003.

The proposed ASIC guidelines deal with the valuation methods to be applied and when to recognise option values for this purpose. These draw on the International Accounting Standards Board's exposure draft ED 2 'Share Based Payment' (ED 2), which provides an appropriate basis for valuing and recognising options for this purpose (and which has been issued by the AASB as Exposure Draft ED 108).

ED 2 provides clear guidelines on the types of option valuation models that can be applied. In the case of listed companies, exchange-traded options should be valued at their market price at the grant date, or in the case of other types of options by a valuation method that meets the requirements of ED 2 and the method chosen would be disclosed in the directors report. ASIC considers that these models can be applied to value all types of options granted to directors and executive officers.

The Australian Accounting Standards Board has recently announced its intention to require remuneration relating to options to be recognised on the same basis as outlined in ED 2.

The proposed guidelines would not deal with the expensing of options or other share-based payments in the financial statements. However, all entities preparing financial reports under the Act are encouraged to apply the guidelines in this release in determining remuneration of directors and executive officers for disclosure in their annual financial statements in accordance with accounting standards.

I won't discuss the detail of the guidelines any further at this point – I suggest that you look at the proposed guidelines in conjunction with ED 2. Perhaps a few additional peripheral points however:

- We have stated publicly that we will be reviewing compliance with these guidelines in our surveillance of financial reports and directors' reports of listed companies for the year ending 30 June 2003. Companies which fail to disclose the value of emoluments relating to options granted should expect ASIC attention.
- As I have already said, the guidelines pick up what is in the international exposure draft. The ED itself does not prescribe valuation to the 'nth' degree – rather the parameters outlined provide the appropriate basis for disclosure, and within those guidelines companies are able to choose a detailed calculation which produces a permissible result. I understand that we have had good feedback from the Big Four firms on this point.
- We see our guidelines as an interim measure to clarify the requirements of section 300A, pending acceptance of the standard by the IASB. Further, I understand that Treasury may be looking at more specific guidance for companies in CLERP 9. In the meantime, however, we consider it important to provide some degree of certainty in respect of director and executive disclosure. This is a topical issue, and one justifying the regulator's attention.

b) Deficiencies of defined benefit superannuation funds

Last month, ASIC announced that, in conjunction with the Corporate Superannuation Association (CSA), we were undertaking a survey of corporate sponsors of defined benefit superannuation funds to determine whether there is inconsistency in the reporting of assets or liabilities, and revenues or expenses, for surpluses or deficits in relation to those funds. CSA's members primarily constitute the large corporate superannuation funds in Australia and their corporate sponsors.

ASIC is of the view that Australian accounting standards require corporate sponsors to recognise liabilities in relation to the deficits in defined benefit superannuation plans, that arise because accrued benefits exceed plan assets. If a company is of the view that no liability to the plan exists, either as a legal or constructive obligation, the plan trustees and employees are entitled to know that the company is not underwriting the obligations of the fund.

Our interest in this area has been provoked by concerns that substantial deficits in superannuation funds caused by the falling share markets are not being recognised. According to APRA statistics there are over 400 defined benefit funds in Australia with approximately \$19 billion under management. While the prudential regulation issues are obviously concerns for APRA, we have responsibility for the financial reporting aspects of the corporate sponsors.

On the Horizon...

a) CLERP 9

The recent CLERP 9 proposals contain initiatives aimed at promoting improved transparency and confidence in Australian financial markets. ASIC's submission on CLERP 9 welcomed these initiatives and supported the focus on a stronger financial reporting framework.

As you may know, the CLERP 9 financial reporting and audit proposals include giving legal force to auditing standards, giving the Financial Reporting Council an oversight role in relation to setting of auditing standards, the establishment of a statutory requirement for auditor independence, and rotation of audit partners every five years, and strengthening the powers of ASIC to take action in relation to financial reporting deficiencies identified.

As we made clear in our submission in relation to the CLERP 9 Discussion Paper, in ASIC's view any structural reorganization of the key stakeholder bodies in relation to monitoring and enforcement of accounting and auditing issues needs to maintain clear dividing lines between the responsibilities of the Financial Reporting Council, ASIC and the CALDB. We see the division as follows:

- The *FRC* should be responsible for overseeing and monitoring the auditing and accounting profession as a whole. It should not be involved in surveillance, enforcement or disciplinary actions.
- *ASIC* should be responsible for surveillance, investigation and enforcement of the responsibilities of auditors and others in relation to financial reporting, and
- The *CALDB* should be responsible for determining disciplinary action against individual auditors that relates to their future practice as auditors.

b) Financial Reporting Panel

ASIC's submission on CLERP 9 included a specific proposal to refine and facilitate ASIC's financial reporting surveillance, investigation and enforcement role. We suggested that an expert Financial Reporting Panel (the Panel) be created under the umbrella of the Financial Reporting Council. Such a panel would consider matters arising from the published financial reports of individual companies and make determinations on the application of accounting standards and the true and fair view requirement in relation to those matters.

At present, if ASIC is unable to resolve with a company its concerns about the accounting treatment in the company's financial report, it must pursue the matter in court. The Panel would provide another mechanism for resolving such matters and the potential for consensual agreements to restate financial reports where necessary.

The current process whereby ASIC needs to commence legal proceedings to enforce contested financial reporting matters has disadvantages for the market, the company and ASIC. The Panel process would overcome these by:

- a) providing a means to consider matters on a more timely basis than the courts, thus ensuring that the market is informed about necessary adjustments to a company's financial report more quickly
- b) being less costly for the company and ASIC than judicial proceedings, and
- c) having matters assessed directly by experts in applying accounting standards and having regard to the substance of transactions rather than by courts who deal with technical accounting matters infrequently.

In broad terms, the proposed Panel would be analogous to the UK Financial Reporting Review Panel. It is telling to note that since its establishment in 1991, the UK FRRP has resolved all 350 cases brought to its attention without having to apply for a court order.

The concept of the Panel is not new, but given the current initiatives to strengthen the financial reporting framework, it is an appropriate time to progress such a proposal.

c) Legal force for auditing standards

Effective enforcement of standards of audit practice requires a range of enforcement options so that the best option or combination of options can be chosen for a specific set of circumstances. While the CALDB process provides a valuable mechanism for considering the fitness of an auditor to continue to be registered as an auditor, it is not intended to address or provide remedies in relation to past practice.

The CALDB will have regard to auditing standards as a guide to what is expected of the reasonable auditor but the CALDB is not a court and does not make decisions on the application of auditing standards per se. The CALDB cannot impose fines for non-compliance with the auditing standards, nor can it give declarations on the application of those standards.

Some breaches of auditing standards would not warrant an application to the CALDB and possible cancellation or suspension of the registration of an auditor. Other matters are such that referral seems inadequate.

ASIC strongly supports the CLERP 9 proposal to give auditing standards legislative backing, with the auditing standards-setting process being under the oversight of the Financial Reporting Council. Legal force for auditing standards will give greater flexibility in addressing breaches of those standards – i.e. the potential for different breaches to attract different remedies under the law. Further, legal force would reinforce the importance of auditing standards, and increase the

likelihood that a change in the standards will have immediate effect across the profession, enhancing the system's ability to respond to any systemic problems.

We recognise that some of the present audit standards are not drafted in a way which will facilitate legal enforceability. If this proposal is enacted, careful thought will need to be given to how the standards should be re-written, and an appropriate transition period for the re-written standards.

d) International Accounting Standards

As you know, the Financial Reporting Council decided last year that Australia would adopt the requirements of International Accounting Standards for financial years commencing on or after 1 January 2005. ASIC supports this decision.

More recently, further support for this initiative has been provided by Treasury in the CLERP 9 Discussion Paper and by Justice Owen in the HIH Royal Commission Report.

Some of the International Standards differ quite significantly from the current Australian ones. By way of example the proposed IAS 38 'Intangible Assets' specifically precludes recognition of internally generated intangibles such as brand names and mastheads, and may result in significant changes in terms of both the reported financial position and financial performance of some companies.

The financial reports of companies applying the international requirements for the first time are required to include comparative information prepared in accordance with those international requirements. For companies with financial years ending 31 December 2005 would be required to include comparatives for the year ending 31 December 2004, which means that those companies must have balance sheets in accordance with the new standards at 31 December 2003.

Australian companies need to prepare now be ready for the introduction of the new requirements and consider the impact ramifications that some of these changes may have on systems and reported results.

Some members of the accounting profession have asked whether ASIC will enforce compliance with the new accounting standards in the first year of application. The answer is that those standards will be the law and ASIC intends to enforce them. ASIC does not intend to give relief modifying the application date given the advance notice of the new requirements, the need for consistent and comparable reporting by companies, and that relief would undermine the objective of adopting the international requirements.

Concluding comments

Today, I have outlined a few of the current developments in relation to financial reporting and audit. ASIC considers that these developments are important for ensuring investors and creditors are properly informed, and for the overall credibility of the Australian financial markets.

My topic today was ‘policing’, which implies the primacy of an enforcement role in relation to accounting and auditing. We do take that role, most obviously in our surveillance work and our referrals to the CALDB. However, our interest in accounting and auditing issues is clearly much broader – in some ways I would have preferred ‘policy-ing’ to ‘policing’ in the context of this presentation! We are keen to remain active contributors to debates concerning not only accounting and auditing standards, but the role of the professions and relevant law reform.