CHAPTER 2

Report on Annual Report and the activities of ASIC

Introduction

2.1 The Chairman welcomed Mr David Knott to the hearing and invited him to make an opening statement. Mr Knott did not wish to make an opening statement and the Committee proceeded to questions.

General overview

2.2 The Committee questioned officers on a number of topics. They are listed below in the order in which they were raised during the hearing. The main issues included:

- educational and research work undertaken by ASIC regarding financial literacy of consumers;
- the performance of Australia's business leaders particularly in governance matters;
- rules relating to the calling of special general meetings by shareholders;
- the regulation of time share schemes;
- ASIC's funding—leasing of IT equipment, employee provisions (especially leave provisions);
- the increasing diversification of financial services offered by 'large conglomerates', the efficiency or otherwise of 'Chinese walls' within these organisations and the extent to which CLERP 9 addresses any deficiencies;
- accounting surveillance program of company accounts;
- the role of auditors, independence issues and international accounting (and audit) standards;
- executive options packages, their disclosure and evaluation, and practices that remove their alignment with corporate performance;
- disclosure of fees and charges associated with financial products, the Ramsay Report, and ASIC's ongoing work in this area;
- ASIC's surveillance work regarding stock analysts and their independence;
- ASIC's discussion paper on socially responsible investing disclosure obligations;
- progress on licensing under the FRS regime and the adequacy of funding; and
- regulation of the mortgage broking industry.

2.3 Of the matters listed above, the Committee, takes particular note of evidence presented by ASIC officers on funding, the adequacy of staffing levels to meet current and future demands, the recently introduced accounting surveillance program of company accounts, executive options and licensing under the FRS regime. These matters are dealt with separately in the following section.

Funding

2.4 In response to questions about the 7% increase in total revenue for ASIC and the growing demands on ASIC resources, Mr Knott informed the Committee that:

> The increased appropriation we received in this year's budget was very welcome and, we think, absolutely necessary in order to discharge our FSRA responsibilities. It was also a welcome increment to our general enforcement work. Presumably, we will have CLERP 9, in some form, in place to administer next year. There will definitely be some further budgetary implications for that. The whole financial reporting area, for example, will be raised under the CLERP 9 proposals. In short, we continue to be in dialogue with the government. We think the government is receptive to our position. We are conscious that there are, particularly right now, a huge number of competing claims on the budget, some of which, realistically, are higher priorities than the very important work we do. In all fairness, I have to acknowledge that. But we will be pursuing our dialogue with the government, particularly in relation to CLERP 9, to ensure that, whatever the outcome of that legislative reform, we are able to implement it efficiently.[1]

2.5 Mr Knott made the point that ASIC had been active over the last 18 months especially in the civil penalty area where it had used those sanctions in relation to a number of very large corporate collapses. He noted that such cases are protracted, expensive to run and defended by fairly well resourced opponents.[2]

2.6 He was confident that if ASIC reached a stage where any of those types of proceedings were in jeopardy by reason of funding ASIC would receive 'a sympathetic hearing from government'.[3]

Staffing levels

2.7 The Committee also sought information on staffing levels noting high employee provisions on the liability side, particularly for leave provision. In response to questions about managing staff leave, Mr Knott informed the Committee that it had been a priority for ASIC during the last 18 months to manage excessive leave accruals. He stated:

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1 *Committee Hansard*, p. CFS 36.

2 *Committee Hansard*, p. CFS 36.

3 *Committee Hansard*, p. CFS 36.

> As a management issue, I can assure you that the commission has been working on it with some commitment, as I say, for about the last 18 months. We are faced, of course, with the problem of trying to tackle this issue just at a time when we are under resourcing strains for our people that are unusual for the reasons that we have just discussed—the large cases and the like. It is not a good position to be in that people cannot afford to take leave because they are needed, but that is the situation particularly in the enforcement area, where a lot of this problem exists. So it is a matter that we continue to work on. I am hopeful that over time we will see that ratio change, but it will take some time. There is quite an inherited issue here.[4]

2.8 Mr Knott agreed to provide the Committee with a profile of leave and the plan ASIC has in place to wind it back over time.[5]

Accounting surveillance program of company accounts

2.9 The Committee questioned ASIC Officers on a recently introduced accounting surveillance program of company accounts and how it differs from previous surveillance programs. It was told that ASIC under this program was looking at three areas—capitalization of expenses, non-consolidation of controlled entities and the non-recognition of revenue.

2.10 According to ASIC all three matters were at the centre of the Enron collapses. Mr Knott explained:

> We decided that, as a result of the decline in investor confidence following the American experiences and our own belief that the prime causes of accounting failure in America were unlikely to be manifold in Australia, we would effectively do a stocktake across the broad spectrum of the listed companies sector. In previous years we have targeted specific accounting issues and taken random analyses of a relatively small group of companies. This is a much bigger exercise.[6]

Executive options

2.11 The Committee discussed at length the matter of executive options. Mr Rodgers recognised that shareholders or a board of directors may agree to issue options as a way of aligning the interests of directors or executives with ordinary shareholders. According to Mr Rodgers, however, an issue arises where those directors or executives deal with those options in a way that effectively removes that connection—for example if they take a derivative position. He explained further:

> The world expects that an executive or director holding shares in that way has the same interests as every other shareholder in the movements of price,

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4 *Committee Hansard*, p. CFS 38.

5 *Committee Hansard*, p. CFS 38.

6 *Committee Hansard*, p. CFS 41.

> but that is not true, because of transactions. That clearly is a matter of concern to shareholders. In our view, it ought to be of concern to boards, particularly if they have been instrumental in deciding to grant executive options. I wrote last week to the ASX Corporate Governance Council…drawing their attention to the …matter.[7]

2.12 Mr Knott explained further:

> I am not even sure whether, at the moment, company boards would be routinely aware of the degree to which executives are entering into derivative transactions in relation to their derivatives or shares. I think the appropriate course is that, in the first instance, the council should consider it and form a view. If their view is that the practice is undesirable and there should be a standard that says that as part of remuneration practice, when options are granted, the executives must hold the options on the normal course, that would be a good outcome. I think your solution of disclosure is a secondary outcome if the practice continues. Our preference would be to see the practice cease.[8]

2.13 The Committee also discussed the matter of financial reports about options and their evaluation. Mr Knott provided the following detailed account of likely developments in this area:

> There is a provision in the Corporations Act that requires companies to value executive options. We have been discussing the apparent difficulties of meeting that obligation for some time. The difficulty basically is that, in relation to at least some types of options, the methodology for valuation is obscure. The new IASB, which, if endorsed, will come into force, as I understand, in 2004, is in relation to the expensing of options in financial statements and, as part of the standard, there is some guidance as to how options will be valued. That is actually the expensing issue.
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> The endorsement of that standard gives us a reference point for companies to consult in meeting their existing disclosure obligation under the Corporations Act. It would be our intention to say, 'You have an obligation to disclose the value of options. You have said it has been too difficult to do that. We believe you should refer to this new accounting standard, even though it does not apply until 2004 for expensing purposes. We believe you should refer to that now for valuation purposes', and we will be applying the law as if that were the case.[9]

Licensing under the FSRA regime

2.14 The Committee was particularly interested in obtaining information on the progress being made in licensing under the FSRA regime. It was told that about 250

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7 *Committee Hansard*, pp. CFS 47–8.

8 *Committee Hansard*, p. CFS 49.

9 *Committee Hansard*, p. CFS 51.

licenses had been issued under the new regime but the process is not going as quickly as ASIC would have wished. In explaining the extra resources brought in to deal with the new regime the Committee was informed that ASIC has put a case to government based on the number of licences that it thought it would issue. Mr Ian Johnston informed the Committee that:

> For every licence that we issue, we will have to deal with some applications for relief from the law. We have an idea of what resources we will need for the flow-on work as a result of that. Of course, it increases the regulated population on which we carry out compliance and surveillance activities. But we had put the case to government and received funding in respect of the numbers that we put forward.[10]

Conclusion

2.15 The Committee concluded its annual examination of ASIC after taking evidence for 2 hours and 46 minutes. During the hearing, ASIC officers undertook to provide the Committee with written responses to a number of questions taken on notice.

SENATOR GRANT CHAPMAN
Chairman

10 *Committee Hansard*, p. CFS 67.