

CHAPTER 3

CONTROLS OVER THE ACQUISITION OF SHARES BY DIRECTORS INCLUDING MANAGEMENT BUY-OUTS AND ANALOGOUS SITUATIONS

3.1 Introduction

3.1.1 The acquisition of a company's shares, particularly the acquisition of substantial control of a company by its directors or officers raises special questions in relation to general takeover law. 'Management buy-outs' have in recent times become a noticeable phenomenon and have particular implications for shareholders and the market in general. Such purchases may raise questions as to the proper dissemination of and access to information. Two recent examples of management buy-outs in Australia occurred in 1989 where executives of Industrial Equity Limited and Elders IXL launched bids for their own companies.¹

3.2 Regulation of Takeovers

The Takeover Code

3.2.1 Takeovers in Australia (including management buy-outs) are regulated by Chapter 6 of the Corporations Law, which creates a two stage market for the control of voting shares in companies incorporated in Australia. Up to a prescribed threshold, at present 20%, and beyond 90%, the market is largely unregulated except

¹ Evidence, pp.S510-513 (Attorney-General's Department).
NCSC, Annual Report, 1988-89, 1989, p.34.

by disclosure requirements such as the substantial shareholdings provisions.² Between 20% and 90% acquisitions of shares must be made in compliance with the Corporations Law.

3.2.2 Broadly, the Corporations Law provides that a holder of between 20% and 90% of the voting shares of a company cannot acquire more shares in the company (s.615). There are a number of approved methods of exemption from acquiring shares despite the prohibition in section 615 of the Law. The most commonly used ones are:

- . a takeover scheme (also known as a “Part A”) being an offer to all shareholders (s.634);
- . a takeover announcement (also known as a “Part C”) being an on-market offer to all shareholders (s.673);
- . the gradual acquisition of shares at a rate of no more than 3% every six months (s.618);
- . particular acquisitions approved by the other shareholders in the company (s.623);
- . acquisitions of shares in a company which has 15 or less members (s.619).

3.2.3 The Corporations Law regulates the procedure which must be followed by the offeror when making an offer under a takeover scheme or announcement and the response of the target company. The ASC has authority to excuse technical

² See Corporations Law - Chapter 6, Part 6.7 - Under these provisions a substantial shareholder of a listed company is required to disclose its interest to the company within 2 business days of acquiring the interest and to serve a copy of the disclosure notice on the ASX. A substantial shareholder is one with an entitlement to not less than 5% of the voting shares in the company.

breaches and grant exemptions from compliance with the Law and to declare that the Law applies as modified. In exercising this authority the Commission is required under section 731 of the Corporations Law to take account of the desirability of ensuring the acquisition of shares in companies takes place in an efficient, competitive and informed market, and is also required to ensure that:

- . the shareholders and directors of a company know the identity of any person who proposes to acquire a substantial interest in the company;
- . the shareholders and directors of a company have a reasonable time in which to consider any proposal under which a person would acquire a substantial interest in the company;
- . the shareholders and directors of the company are supplied with sufficient information to enable them to assess the merits of any proposal under which a person would acquire a substantial interest in the company;
- . as far as practicable, all shareholders of a company have equal opportunities to participate in any benefits accruing to shareholders from any proposal by which a person would acquire a substantial interest in the company.³

3.2.4 There are two principal methods under the Corporations Law for making a takeover:

- . a takeover scheme; and
- . a takeover announcement.

³ Evidence, p S506 (Attorney-General's Department). These principles are derived from the Second Interim Report to the Standing Committee of Attorneys-General on the Disclosure of Substantial Share Holdings and Takeovers, No.43/1969.

3.2.5 Under a *takeover scheme*, the offeror must send a **Part A statement** to each shareholder, the ASX and the target company. This statement, the contents of which are prescribed by the legislation, is designed to give offerees sufficient information about the offer and the target to enable them to make an informed decision. The target company's reply, a **Part B statement**, must be sent to the offeror and each person to whom the offer was made within 14 days from the date the **Part A statement** was received. A *takeover announcement* may only be made for shares in a listed company in which the offeror holds less than 30% of the voting shares. A dealer on behalf of an offeror makes an announcement, at a relevant official meeting of the exchange, that from 14 days after the announcement, for a period of one month, the dealer offers to acquire, on behalf of the offeror, at a cash price per share specified in the announcement, all shares that are included in the specified class of shares. On the day on which the offer is made the on-market offeror must serve on the target and its home exchange and lodge with the ASC its **Part C statement**. It must send a copy to all shareholders. The target company's reply, a **Part D statement** must be served on the home stock exchange within 14 days of the relevant takeover announcement.

3.2.6 Section 648 of the Corporations Law imposes an additional requirement where the offeror is connected with the target. This is deemed to be the case where the offeror already has 30% of the shares of the target, is a natural person who is a director of the target or where the offeror and the target have at least one common director. In these cases a **Part B statement** must be accompanied by a report of an independent expert:

- . stating whether in the expert's opinion, the takeover offers are fair and reasonable;
- . setting out the expert's reasons for forming that opinion; and

- . including any particulars that could influence the expert's unbiased opinion.

If more than one report is obtained each must accompany the **Part B statement**.

3.2.7 As noted in Chapter 1, the Corporations Law provides for a Corporations and Securities Panel which has the power to declare specific conduct unacceptable (during a takeover) or acquisitions unacceptable, even though that conduct did not technically involve a breach of the law. (Under the co-operative scheme this responsibility lay with the NCSC). As mentioned earlier in the report the High Court, in October this year, ruled that the Panel had the necessary constitutional underpinning to discipline individuals and companies in a takeover.

Australian Stock Exchange Listing Rules

3.2.8 Takeovers are also affected by ASX Listing Rule 3J(3). This Rule can be relevant to takeovers in two ways. The first is where the company has been taken over and the new controllers seek to sell assets to, or buy assets from, the company. The Rule requires the prior approval of shareholders in a general meeting before the company can purchase or sell assets to the directors, officers, substantial shareholders or their associates, among others, where the value of the transaction exceeds 5% of shareholders' funds. Those parties involved in the transaction, and their associates, are precluded from voting at the general meeting. An independent expert's report must be supplied to the shareholders, that report stating whether the transaction is fair and reasonable to shareholders other than those who are precluded from voting.

3.2.9 The second way in which the ASX Listing Rule 3J(3) can be relevant to takeovers is where the company, in making the takeover offer, is offering either cash or shares for securities in the target and those target company securities are held by directors or substantial shareholders of the offeror company.

3.2.10 ASX Listing Rule 3S(2) can also be relevant in takeovers in that it requires that the sale of the company's main undertaking shall be conditional upon ratification by shareholders in general meeting. At that meeting, any person who may benefit from the sale, and their associates, are precluded from voting.

3.3 Takeovers and Management Buy-Outs - Evidence to the Committee

Takeovers

3.3.1 The Committee was informed of the competing arguments as to economic value of takeovers. Out of these arguments other questions arose in the Committee's evidence such as: whether and to what extent takeovers should be regulated and to what end; the value of the control premium; and the possible conflict of interest between shareholders and management in a takeover.

Economic Value of Takeovers

3.3.2 Several submissions pointed out that in a general economic sense takeovers provide a means of removing assets from the control of poorly performing managers, or in stimulating improved managerial performance.⁴ With regard to shareholders, the mechanism for an orderly and comprehensive transfer of ownership of a company's shareholding, provides the means by which those shareholders can gain access to a price beyond the price ascribed to small holdings on the stock market.⁵

3.3.3 The LACA Committee in an earlier Inquiry also considered evidence as to the economic value of takeovers. In its report tabled in 1989, Mergers, Takeovers

⁴ Evidence, p.S416 (Mr A K Smith).

Evidence, p.S783 (Australian Securities Commission).

⁵ Evidence, p.S783.

and Monopolies, the Committee identified the following potential economic benefits of takeovers and mergers:

- . economies of scale arising from the integration of productive processes;
- . savings in formerly duplicated output (eg. route coverage), which can be particularly important in transport and other service industries;
- . reductions in transaction costs associated with financial operations;
- . asset rationalisation;
- . higher returns from the introduction of superior management techniques;
- . risk reduction through diversification of operations; and
- . capital formation.

3.3.4 Several potential costs were identified in evidence to that Inquiry:

- . increased corporate debt, arising from the debt-financing of takeovers, with subsequent tax revenue implications and foreign debt consequences (if overseas borrowings are used to finance takeovers);
- . detrimental effects on management, including emphasis on short term profits at the expense of long term planning;
- . diversion of funds from investment;
- . lessening of competition in a market, with the potential for collusion, market dominance and monopoly;

- . concentration of industry which is not in the public interest, eg. media;
and
- . detrimental social consequences, including loss of employment.⁶

3.3.5 The Committee noted in the report the lack of empirical data available concerning the effects of takeovers and that existing evidence is inconclusive on the matter. It concluded that whilst takeovers do assist in promoting efficiency there are costs involved, particularly in relation to taxation revenue and foreign debt.⁷

3.3.6 EPAC recently commented on takeovers in its paper, Trends in Corporate Debt that:

“As regards competition, the important positive aspect of takeover activity (either actual or threatened) is its role in bringing competitive pressures to bear on management that is either inefficient or too inclined to put personal objectives ahead of shareholder's interests; consequently, there would be an economic cost in impeding takeovers per se or in somehow restraining the provision of finance for takeovers.”⁸

3.3.7 Some of the disadvantages of takeovers, as suggested in evidence, are that they lead to the following detrimental consequences:

- . reduction in competition and concentration in industry;
- . foreign ownership and control of Australian assets;
- . reduction of investment opportunities for portfolio investors; and

⁶ House of Representatives Standing Committee on Legal and Constitutional Affairs, Mergers, Takeovers and Monopolies: Profiting from Competition?, 1989, pp.11-13.

⁷ *ibid*, p.15.

⁸ EPAC, Trends in Corporate Debt, Council Paper No.41, 1990, p.32.

- . disruption for employees;
- . break up of economic units or assets stripping for the personal gain of the bidder; and
- . diversion of management from long-term planning.⁹

Regulation of Takeovers

3.3.8 Arguments in favour of regulation include that shareholders' welfare is maximised by externally imposed legal rules limiting the ability of managers to resist a takeover offer. Being legally unable to avoid takeover offers, encourages managers to be efficient; this is beneficial to shareholders (as noted earlier) because it encourages the more efficient operation of the company and an improved return on shares. Further, the passive nature of most investment in equities is overcome because the provision for takeovers forces shareholders to monitor the performance of a company's management to enable them to judge the value of a proposed takeover.¹⁰

3.3.9 The ASC stated that it is important that the law provide a mechanism to ensure fairness to all shareholders in situations of change of control.¹¹ The ASC said that the law should not enter into judgments on the merits of takeovers, and noted an observation in a Treasury paper on takeovers that:

“Government ‘vetting’ mechanisms are unlikely to be able to distinguish between takeovers that will effectively improve returns from existing assets and those that will not. That particular function is best left to the market itself.”¹²

⁹ Evidence, p.S415 (Mr A K Smith).

¹⁰ Evidence, pp.S338-340 (Cencaz Pty Ltd).

¹¹ Evidence, p.S783.

¹² Treasury Economic Paper, No.12 (1986): quoted in Evidence, p.S783 (Australian Securities Commission).

3.3.10 The Commonwealth Treasury, in reviewing submissions to the Committee observed that:

“There is a strong case for not unduly impeding takeover activity in view of the role of takeovers in promoting an efficient use of resources in the economy.”¹³

3.3.11 Mr T Bostock of Mallesons Stephen Jaques, in a private submission, argued that takeovers should be left substantially unregulated. He stated that the legislation concerning the acquisition of shares is of inordinate length and complexity. The administration and enforcement of the takeover legislation has absorbed an unduly large share of Australia's regulatory and enforcement resources at the expense of enforcement of laws proscribing dishonest or deceptive conduct.¹⁴

3.3.12 Mr Justice Marks of the Victorian Supreme Court has raised some questions about the value of the legislation:

“This activity (takeovers) was not subject to regulation until some twenty to thirty years ago. The mischief was then thought to be the surreptitious assumption of power over corporate bodies without adequate prior knowledge of shareholders generally or their boards of directors or both... Over the years the takeover legislation has grown from a few sections in the Companies Act to a separate substantial code interwoven with the general network of companies and securities industry law.

The fact that the Code is written in unclear language, at times abstruse at others confused and without clear purpose, is less relevant here than the fact that there remains no provision which gives attention to the general effect of takeovers on the social and economic welfare of the community. The mischief originally targeted is still treated as principally that which may be wrought between the raider, the raided and its shareholders.

¹³ Evidence, p.S1231.

¹⁴ Evidence, pp.315-324 (Mr T Bostock).

There has been no shortage of takeover litigation. Much of it concerns predatory activity. Very little reflects that intelligent rationalisation of industrial and commercial activities which its apologists claim as its moral justification.”¹⁵

Participation in the ‘Control Premium’

3.3.13 As noted earlier section 731(d) provides for the following objective in regard to takeovers:

- that, as far as practicable, all shareholders of a company have equal opportunities to participate in any benefits accruing to shareholders under any proposal under which a person would acquire a substantial interest in the company.

3.3.14 Professor Baxt questioned the “uncritical acceptance of the proposition that all shareholders in a company have to be treated equally in the context of their shareholding.”¹⁶ He argued that:

“if disclosure is provided... meaningful disclosure - by the relevant person who is in a position of control, there is no reason why a premium should not be extracted by that person for the special market shares that he/she holds in a company.”¹⁷

3.3.15 The value of the existing requirement is that in the absence of the requirement for price equality, a dominant shareholder or group of shareholders could be in a position to sell an interest at a price above the prevailing market value to the detriment of minority shareholders not positioned to obtain a share of the control premium for their holdings.

¹⁵ Address delivered to the Melbourne University Law School Foundation Symposium on Commercial Law and Morality, November, 1988.

¹⁶ Evidence, p.S6 (Professor R Baxt).

¹⁷ *ibid.*

3.3.16 The Commonwealth Treasury, following a request from the Committee, commented on the proposition of equal opportunity of all shareholders in a takeover bid:

“It is more difficult to provide an economic rationale for the last of the Eggleston principles concerning ‘equal opportunity among shareholders.’ It is readily apparent that particular or large holdings of shares may be of special significance for the control of a company and may therefore be accorded higher value than other share holdings in the market place. It should also be noted that most shareholders are in fact institutional and other professional investors and may not need some of the protection afforded to them.”¹⁸

3.3.17 The Acting Secretary to the Treasury added that:

“Nevertheless, considerable emphasis is given in Australian law to ensuring that all shareholders are offered an equal price for their shares in takeovers.”¹⁹

Doctrine of ‘Auctioning Off’

3.3.18 The question was also raised during the Inquiry as to what extent, and when, the duty of incumbent directors and management to defend the target company against a bid should become an obligation to ensure that the body of shareholders get the best price for their interest?

3.3.19 A submission was made that the courts in the United States had developed a principle that the fiduciary duty of directors shifts at the point where the takeover of the target appears to be inevitable from a duty to protect the target company to a duty to get the best price for the shareholders, the doctrine of “auctioning off”, and this should be adopted in the Corporations Law.²⁰

¹⁸ Evidence, p.S1231 (The Treasury).

¹⁹ *ibid.*

²⁰ Evidence, p.S355 (Mr A K Smith).

3.3.20 In the United States the 1986 Revlon case established the so-called “Revlon duties”, which arise when a board has, in essence, put the company up for auction. In such circumstances, the board's duty is to sell the company in a fashion that maximises immediate shareholder value. However, in the 1989 decision concerning the hostile takeover bid by Paramount Communications Inc. of Time Inc., the court narrowed the circumstances in which the Revlon duties arise to when the target company itself initiates an active process to sell itself or effect a business reorganisation involving a clear break up of the company or, in response to a bidder's offer, the target company abandons its long term strategy and seeks an alternative transaction involving the break up of the target company. The judgement in the Paramount case represents a shift back towards the probable Australian position, requiring a clear case of directors acting for an improper purpose before intervention by the courts.

3.3.21 In the United States the courts apply the “business judgement rule” in assessing the validity of defensive tactics by target directors. If after reasonable investigation those directors who have no interest in the matter (other than as part of the general body of shareholders) take an action which in good faith they believe on reasonable grounds will benefit the company, there is a presumption in the directors' favour that the action is valid²¹. The courts, in the main, favour the view that the decision to commit corporate resources to a takeover defence is a matter within the normal business discretion of the target's directors and officers and could not be successfully challenged unless it could be proven that there were some serious failure on the directors' part. Since they can and do allege the corporate good as a basis for their defensive manoeuvres, the business judgement rule in the United States makes it well nigh impossible to attack any but the most outrageous defensive manoeuvres.²²

3.3.22 In Australia the case law in this area is still developing. While various formulations are used, it is apparent that the duties of the Target's directors is to

²¹ Renard and Santamaria, Takeovers and Reconstructions in Australia, p.11051

²² Clark, Corporate Law, p.582.

act for the benefit of the present and future interests of the existing shareholders. In one of those cases, the court felt that it may be within the scope of directors' fiduciary duties to seek a better price or another bidder for the target's shares.²³ In another case, the New South Wales Court of Appeal held that it is within the functions of the target and its directors to ensure that, where an unsatisfactory takeover offer is made, there is available to the shareholders such an offer as will enable the shareholders who desire to sell their shares in that context to obtain for them a price which is in the circumstances appropriate. The court also said it would be proper for the target to concern itself with who becomes a shareholder. An example was given that the company may lose a government licence or a customer may refuse to do business with the target if a particular person became a shareholder. In that situation it may be in the interests of the company as a whole for action to be taken. The court saw no objection in principle to a target company taking steps to achieve an alternative offer.²⁴

Committee's Conclusions

3.3.23 The Committee finds that the regulation of takeovers is in the interest of shareholders generally in that it ensures that they receive adequate information to assist them in deciding whether or not to retain or dispose of their investment when takeovers are proposed. However it notes that the time and resources involved, in the recent past, in the administration of the takeover code would seem to be disproportionate to the objectives sought to be achieved.

3.3.24 The Committee has not been persuaded that it would be in the interests of holders of small parcels of shares to remove sub-section 731(d) (the equal opportunity among shareholders provision) of the Corporations Law. The Committee believes there is no justification for altering the existing provision which provides that as far as practicable, all shareholders of a company have equal

²³ ICAL Limited v County Natwest Securities Australia Limited 13 ACLR 129.

²⁴ Darvall v North Sydney Brick & Tile Co. Limited (No. 2) 7 ACLC 659.

opportunity to participate in any benefits accruing to shareholders from any proposal to acquire the company.

3.3.25 It is possible that the existing provisions of Chapter 6 of the Corporations Law may have the effect of precipitating an auction by ensuring that other potential bidders are aware of the offer being made. The Committee is not disposed to support a proposal to create a legislative requirement for directors of publicly listed companies to actively seek out higher bids.

Management Buy-Outs

3.3.26 A management buy-out (MBO) in commercial parlance is a takeover of an existing business by the managers of that business and in the case of a 'leveraged buy-out' a reduction in the extent to which the company's capital is represented by 'equity' and the replacement of that equity with debt finance.²⁵

3.3.27 Frequently the management buy-out relates to a particular aspect of the company's operation and may involve the sale of a business or of a subsidiary, rather than the change in the company's share holding. Where the buy-out is at the shareholding level, a management buy-out is commonly also a leveraged buy-out, as management normally does not have the independent financial means to retain the existing level of shareholders equity. This has characterised the majority of takeovers that have taken place in Australia over the past decade: the purchase of the interests of the shareholders has been for cash financed by bank loans.²⁶

3.3.28 The Committee was told of some of the benefits and disadvantages of the MBOs. Some of the benefits are:

²⁵ Evidence, p.S782 (ASC).
Evidence, pp.504-5 (Attorney-General's Department).

²⁶ Evidence, p.S782 (ASC).

- . partial ownership by management of a large public company gives senior executives an incentive to improve the company's performance;
- . partial ownership provides motivation and encourages a sense of responsibility;
- . an MBO is sometimes the only alternative to a hostile takeover bid;
- . an MBO may sometimes offer a shareholder a higher price than a third party will offer;
- . the MBO is economically efficient, shareholders receive a higher return for their shares;
- . after a successful MBO management may convert the company from a public to proprietary company which may result in a reduced level of publicly available data being required; and
- . there may be tax concessions if management uses borrowed money to purchase company shares.²⁷

3.3.29 However some of the disadvantages of MBOs that were brought to the Committee's notice are:

- . the potential for insider trading;
- . the potential for directors to be placed in a position of a conflict of interest;

²⁷ Evidence, pp.S519-521 (Attorney-General's Department).
 Evidence, pp.S200-201 (Ernst and Young: Chartered Accountants).
 Evidence, pp.S350-353 (Mr A K Smith).

- . the adequacy of information available to shareholders and independent expert reports; and
- . financial assistance to the management purchasers.²⁸

Potential for Insider Trading and Conflict of Interest

3.3.30 The Attorney-General's Department told the Committee that in any MBO there is some potential for allegations of insider trading, because any proposal necessarily involves senior executives purchasing securities in the company which they manage. Further, directors are placed in a difficult legal position during an MBO. During a takeover, the director's duty is to act in the best interests of the company as a whole and, in normal circumstances, this includes the obligation to take reasonable steps to extract the best offer possible, or to take reasonable steps to show the inadequacies of an under-valued offer. On the other hand if they are involved with the offeror, the personal interests of the directors involved lie in obtaining control at the lowest possible price. Hence they may be placed in a position where they have a direct conflict of interest.²⁹

3.3.31 With regard to this situation the ASC observed that where key members of senior management are involved in a buy-out:

“there may be real difficulties in ensuring an adequate flow of unbiased information to the target's board to enable it to discharge its responsibilities under the Corporations Law to inform and advise target shareholders.”³⁰

3.3.32 Controls of regulations relevant to the actions of directors in the context of an MBO include:

²⁸ Evidence, p.S784 (ASC).

Evidence, pp.517-530 (Attorney-General's Department).

²⁹ Evidence, pp.S522-526 (Attorney-General's Department).

Evidence, p.S200 (Ernst and Young).

³⁰ Evidence, p.S784.

- . a listed company must not sell assets having a value (or where the sale price is) in excess of 5% of shareholders' funds where the purchaser is a director, officer, substantial shareholder, or an associate of any of those, unless the shareholders in general meeting approve the sale. Those shareholders who are involved in the sale are precluded from voting on the approval resolution. The directors must provide the shareholders with an independent expert's report as to whether the transaction is fair and reasonable to the other shareholders (ASX Listing Rule 3J(3));

- . a listed company must immediately advise the ASX of any material contract involving directors' interests (ASX Listing Rule 3L(5));

- . a director of a listed company is precluded from voting at a meeting of directors in regard to a contract in which he has directly or indirectly a material interest (ASX Listing Rule 3L(6));

- . company articles usually disqualify a director from voting in regard to a matter in which the director is interested;

- . directors are required to disclose any direct or indirect interest in a contract or proposed contract with a company (s. 231 of the Corporations Law);

- . at general law, each director has a fiduciary duty not to put himself in a position where there is a conflict (actual or potential) between his personal interests and a duty to the company. However, that rule can be, and is commonly, relaxed by the articles on the basis that appropriate disclosure of the interest is made and the director does not vote on the matter;

- . at general law each director has a fiduciary duty to the company not to make a secret profit for himself by the use of corporate assets, information or opportunities;
- . the Corporations Law backs up some of the general law fiduciary duties of directors by providing that directors must not only act honestly, exercise a reasonable degree of care and diligence but also they must not make improper use of information acquired by virtue of the office of director to gain an advantage for the director or to cause detriment to the company, or make improper use of the position to that end (s. 232);
- . if the MBO is subject to the takeovers provisions of the Corporations Law, an independent expert's report as to the reasonableness of the offer will be required if the offeror is already entitled to at least 30% of the shares of the target or if the offeror is a director of the target or there is at least one director common to the offeror company and the target (s. 648);
- . a person must not, in connection with any dealing in securities (which includes takeover offers or the making of a recommendation in relation to takeover offers) engage in conduct that is misleading or deceptive (s. 995);
- . insider trading prohibitions (s. 1002G); and
- . a person must not, in connection with the transfer of the whole or part of the undertaking or property of a company, give a benefit to a person who is a director (or an associate of a director) of the company, except in accordance with a members' approving resolution. The director is likewise prohibited from receiving such a benefit (s. 237).

3.3.33 The ASC stated that:

“The problems of conflict of interest and inside information in an MBO can only, under existing legal requirements, be satisfactorily resolved by the disclosure to the market generally of all relevant information possessed by the management interests involved in the buy-out.”³¹

3.3.34 In the ASC's view it is not possible to devise a set of procedures to overcome this problem in every instance, having regard to the many variations of management buy-out structures that occur in practice. It is noted that the Corporations and Securities Panel will be relevant to this matter in that it can declare an acquisition of shares in a company to be an unacceptable acquisition or declare conduct engaged in by a person in relation to shares in, or the affairs of, a company to have been unacceptable conduct. In that situation, the Panel can make any order that it thinks necessary or desirable to protect the rights or interests of any person affected. The ASC also noted that section 648 of the Corporations Law addresses the general problem in this area by requiring independent expert's reports where an offeror is connected with the target company. The ASC told the Committee that in its view the mechanism of the independent experts' report is the best means of overcoming the conflict of interest and insider information problems associated with management buy-outs.³²

Independent Expert Valuation Reports

3.3.35 As noted earlier, Chapter 6 of the Corporations Law regulates the procedures for takeovers. Where the offeror is connected with the target company (that is where the offeror is already entitled to 30% or more of the voting shares, has at least one common director or where the offeror is a director of the target), an independent expert's report is required to accompany the **Part B statement** (the target company's reply which is sent to shareholders):

³¹ Evidence, p.S784.

³² Evidence, p.S785.

- . stating whether, in his/her opinion, the takeover offers are fair and reasonable;
- . setting out his/her reasons for that opinion; and
- . including certain particulars which could influence the expert's unbiased opinion.

3.3.36 However even where an expert's report is obtained shareholders may not be adequately informed, and have difficulty in assessing whether the offer is fair and reasonable because the valuation may be faulty or not sufficiently independent. The Australian Institute of Valuers and Land Administrators expressed some misgivings about the quality of reporting by valuers and recommended that valuers be required to adopt international standards for the valuation of tangible assets; that the asset valuer should be appropriately registered in accordance with the requisite degree of skill and training; and that the person should be at arms length from the employing company.³³

3.3.37 The NCSC, when it was the national regulatory agency, also had sufficient concerns about the quality of some reports and the lack of independence of some experts to revise its policy statement (Release 102) on expert's reports in January 1990.³⁴ The release refers to the need for responsibility of the expert, the retention of specialists by him and the procedure leading to his opinion as to whether an offer is fair and reasonable or not and whether shareholders should accept. It also lists matters to be considered and valuations to be examined. The NCSC at the same time also released a practice note (Release No.351) which addresses the commissioning of reports and the process to be followed in the preparation of a report. The note points out the civil and criminal liability of experts for false or misleading statements in the report.³⁵

³³ Evidence, pp.40-59.

³⁴ NCSC, Annual Report 1989-90, Appendix 3.

³⁵ Evidence, p.509 (it should be noted that these directives remain in force under the new system).

3.3.38 Under the co-operative scheme the NCSC had a discretionary power to, amongst other things, declare acquisitions of shares or conduct unacceptable. This provided the Commission with the ability to enforce NCSC Release 116 which advised detailed requirements for disclosures to shareholders and an independent experts report. Under the Corporations Law the power to declare conduct and acquisitions of shares unacceptable is vested with the Corporations and Securities Panel whereupon it can make a wide variety of orders under section 734. Previously the NCSC both investigated cases of unacceptable conduct and made declarations as to whether the conduct was unacceptable. It was exercising, in effect, the powers of prosecutor and judge. The decision was deliberately taken to remove from the NCSC/ASC the power to adjudicate. This power was conferred on the Corporations and Securities Panel. Previously, companies were motivated to observe NCSC release 116 by a desire not to have their conduct declared “unacceptable”. As the ASC can no longer “enforce” the requirement of 116 by the threat of the exercise of its adjudicatory power, corporations have less motivation to comply with release 116. This has led the ASC to point out to the Committee that unless an obligation for disclosure and expert reports is imposed by law it is likely to be ignored in some cases.

3.3.39 The ASC suggested the scope of section 648 of the Corporations Law should be extended so that the requirement for an independent expert's report would apply in all situations where a person concerned in the management of the target was associated or had a material interest in the offeror. The discretionary power of the ASC to modify the law under section 730 would enable the statutory requirement to this effect to be modified where its application would produce artificial, or unduly onerous results.³⁶

3.3.40 Furthermore, the ASC suggested that there should be an explicit and enforceable statutory requirement for expert reports in all situations where shareholders are to consider transfer of a substantial interest. This could be

³⁶ Evidence, p.S785.

accomplished by importing into section 623 of the Corporations Law (which relates to acquisitions approved by resolution of the target company) a structure similar to that applied under section 648 for bids by an offeror connected with the target.³⁷

RECOMMENDATION 6

3.3.41 The Committee recommends that section 623 of the Corporations Law be amended to require that the notice of meeting be accompanied by a report by an expert stating whether the proposed acquisition of shares is fair and reasonable having regard to the interests of shareholders other than the vendor, purchaser, allottee and their associates.

Financial Assistance for Management Buy-Outs

3.3.42 Management buy-outs are frequently highly geared because the management may use a company with little asset backing as the offer vehicle. Buy-outs and takeovers are in practice often associated with programs of divestiture, loans, guarantees and securities which involve a company's assets and businesses. Such programs of assets divestiture are a concern generally in respect of the protection of the interests of shareholders.

3.3.43 A company is prohibited from giving financial assistance for the acquisition of its own shares under section 205 of the Corporations Law, subject to some exceptions. This section limits the provision of financial assistance for the purpose of acquisition of company shares, except subject to shareholder approval procedures and associated notices to the regulatory authorities.³⁸ Accordingly this section can be of particular importance for the protection of interests of the company's members and creditors where takeovers/buy-outs are contemplated.

3.3.44 The ASC suggested that the requirements of section 205 for shareholder approval by special resolution could be by-passed and that interests associated with

³⁷ Evidence, p.S786.

³⁸ Evidence, p.S786 (ASC).

the financial assistance may vote in support of the proposal.³⁹ The ASC referred the Committee to the proposals in the draft exposure Bill on Loans to Directors and Related Company Transactions and Executive Remuneration, recently circulated by the Companies and Securities Advisory Committee. Under these proposals (see Chapter 4) actions of the directors which will affect the material interests of the company are required to be submitted to a general meeting and approved by resolution of the shareholders. Directors with interests in the transaction would be prohibited from voting on the resolution. The ASC proposed that section 205 should be amended so as to link its requirements with those proposed in the draft Bill. The Committee does not agree that there should be a prohibition on directors voting but it considers that section 205 should be amended to make provision in terms of the following recommendation.

RECOMMENDATION 7

3.3.45 The Committee recommends that section 205(10) of the Corporations Law, relating to the circumstances where a company in general meeting can approve the granting of financial assistance for the acquisition of its own shares, be amended to provide the following further protection:

- . the notice of meeting must be accompanied by a solvency declaration by the company's directors, as would apply in a buy-back of shares; and
- . a joint and several obligation imposed on both the directors involved in the solvency declaration and the person financially assisted, to indemnify the company, to the extent of the financial assistance given, in the event that the company is wound-up within the 12 months following the giving of the financial assistance.

Committee's Conclusions

3.3.46 Concerning management buy-outs, the Committee believes the problem of potential conflicts of interest and insider trading can only be satisfactorily

³⁹ Evidence, p.S787.

resolved by the directors making full disclosure to their shareholders and to the market of all information relevant to a material transaction.

3.3.47 The Committee is of the opinion that where a takeover is being conducted the requirement for an independent expert's report should apply in all situations where a person concerned in the management is associated with the offeror.

RECOMMENDATION 8

3.3.48 The Committee recommends that the Corporations Law be amended so that the requirement for an independent experts report to accompany a Part B Statement by the Target be extended to situations where a person concerned in the management of the Target was associated with or had a material interest in, the Offeror. For this purpose:

- . the Offeror should be obliged to disclose in the Part A Statement the existence of any such connection;
- . the Law should be amended to require officers of the Target to declare to the Target whether they have any such connection; and
- . a material interest should be an entitlement of 5% or more of the Offeror or the holding of securities which, upon conversion, would give rise to such an entitlement.

The Committee further recommends that the Corporations Law be amended to afford the same protections to Target shareholders in the context of an on-market takeover, with the Part D Statement having to be accompanied by an independent expert's report in all situations where it would have been required in the case of a Part B Statement. Further, the Law should be amended to require that any such Part D Statement must be sent to all Target shareholders and not just lodged with the Australian Stock Exchange.

3.3.49 The need for an experts report in relation to an acquisition approved by shareholders in general meeting under the predecessor to section 623 was dealt with in NCSC Policy Statement No. 116. That Statement also dealt with the practical problem of the parties entering into pre-meeting arrangements.

3.3.50 While the Committee did not receive evidence in relation to the matter it seems appropriate to the Committee that more certainty be provided in relation to pre-meeting arrangements where an approval is to be sought under section 623 of the Corporations Law.

RECOMMENDATION 9

3.3.51 The Committee recommends, in relation to shareholder approved acquisitions, that the ASC consider making a class order under section 730 of the Corporations Law to permit pre-meeting arrangements on the terms identified in paragraph 31 of NCSC Policy Statement No. 116.

3.3.52 The Committee supports the concept of shareholder approval for transactions calculated to affect the company in a material way and in Chapter 4, the Committee make specific recommendation on this matter.

3.3.53 Finally, whilst there are indeed concerns related to MBOs the Committee's notes that there was general support in evidence to it that whilst buy-outs should be regulated 'a prohibition is not warranted.'⁴⁰ The Committee is therefore of the opinion the management buy-outs should not be prohibited but they should be subject to regulation to ensure fairness to those affected.

3.4 Minority Force-Outs

3.4.1 Provision is made in Chapter 6 of the Corporations Law for the compulsory acquisition of the shares of minorities.

3.4.2 Compulsory acquisition is frequently desirable in the aftermath of a takeover to consolidate the economic purpose of the takeover, to facilitate a process of rationalisation and it may have economic, taxation and administrative advantages

⁴⁰ Evidence, p.S201 (Ernst and Young).
Evidence, p.S530 (Attorney-General's Department).
Evidence, p.S783 (ASC).

in particular situations. What is of concern is the plethora of legal mechanisms currently available whereby force-outs of minorities can be achieved in circumstances where the rights of shareholders are not necessarily protected and there has been a degree of legal uncertainty for some years.⁴¹

3.4.3 Under the existing law several methods of compulsory acquisition and minority force-outs are possible, including:

- . acquisition pursuant to a court approved scheme of arrangement under section 414 of the Corporations Law;
- . acquisition following a takeover under the takeovers legislation, resulting in compulsory acquisition under sections 701 and 702 of the Corporations Law;
- . compulsory acquisition under section 411 of the Corporations Law;
- . reduction of capital to cancel minority holdings under section 195 of the Corporations Law; and
- . selective buy-back under section 206JA of the Corporations Law.⁴²

Acquisition Under Section 414 of the Corporations Law

3.4.4 If the bid can lawfully be made outside the constraints of Chapter 6 of the Corporations Law, it is possible for a bidder to mop up a small group of minority shareholders by using a procedure under section 414 of the Corporations Law. This would apply, for example, to situations where the bid was for a company with 15 or fewer members, a bid for a class of non-voting shares or a bid made by an offeror

⁴¹ Evidence, pp.S820-823 (ASC).
Evidence, p.S636 (Mr J Green).

⁴² Evidence, p.S820 (ASC).

already entitled to 90% or more of the target's voting shares. For compulsory acquisition rights under section 414 to be available, there needs to be a scheme or contract which would include an offer sent to all holders of the relevant shares. The offeror is entitled to invoke the compulsory acquisition powers if within 4 months after the making of the offers, the scheme or contract (ie. the offers) has been approved by the holders of at least 90% of the shares not held by the offeror (or its nominee or subsidiary). Notice is given to each shareholder affected within 2 months after the date when that 90% threshold is reached, that the offeror desires to acquire the shares of dissenting shareholders.

3.4.5 Where the offeror already holds at the date of the offer, more than 10% of the class of shares sought, there must be assents in respect of at least 90% of the shares not held by the offeror, and the holders who approve 'the scheme or contract' must number not less than 75% of the holders of shares not held by the offeror. The offeror must have offered the same terms to all holders of the shares not held by the offeror at the outset.

3.4.6 The ASC objection to this mode of compulsory acquisition is that the definitions of 'excluded shares' in section 414 which is designed to ensure that the offeror should be independent of assenting shareholders are so antiquated that they can easily be by-passed by the offeror. The offeror by transferring shares to a related company, which does not fall within the narrow definition of 'subsidiary' as used in the definition of 'excluded shares,' can avoid the object of the exclusion. The ASC submitted that the real intention of the provision can be restored by replacing the existing definition of excluded shares with a reference to 'shares to which the offeree is entitled.' This would then bring the provision within the scope of section 609 which has a broad definition of 'relevant interest' and 'associate.'⁴³

⁴³ Evidence, p.821.

Acquisition Under Sections 701 and 702 of the Corporations Law Following a Takeover

3.4.7 Compulsory acquisition pursuant to a regulated takeover under Chapter 6 can occur once the offeror has become entitled to not less than 90% of the shares in the class comprised in the offer. The offeror is required to have obtained this entitlement before the close of the offer period under the takeover scheme/announcement. If the offeror started with an entitlement of 10% or more, then not only must the offeror become entitled to 90% of the shares in the class, but 75% of the offerees must have disposed of their shares to the offeror within a prescribed time frame. On fulfilling this requirement the offeror has 2 months from the date of the close of the offer period to give notice in the prescribed form to the dissenting shareholders.

3.4.8 The ASC commented that these sections provide elaborate safeguards for minority interests. They ensure that compulsory acquisition can only proceed where acceptances taking the offeror over 90%, have been received from a significant number of parties not associated with the offeror.

Acquisitions Under Section 411 of the Corporations Law

3.4.9 Section 411 (section 315 of the previous Companies Act 1981) is mainly applicable to schemes of arrangement between a company and its creditors. However, the provision can apply also to compromises and schemes between a company and its members.

3.4.10 It came to be used in the pre-takeover code period (pre 1981) as a means of engineering a takeover where the offer was not unwelcome to the board of the target company. Where a compromise or arrangement is proposed the Court may, on the application of the company or one of its members, approve an explanatory statement under section 412 of the Law and order a meeting of the company. The statement is essentially a document to inform the members about the proposed compromise or scheme concerning the terms of which the Court is required to be

satisfied. The matters upon which the Court needs to be satisfied include whether the statement adequately explains the interests of the directors and the likely effect of adopting the scheme.⁴⁴

3.4.11 Upon the introduction of the takeover code there was inserted a new provision (now section 411(17)) directing the Court to approve a scheme only if it is satisfied that it is not designed to defeat the purpose of the takeover legislation. The section 411 procedure is still available where the company is already controlled in order to buy out the dissenting share holders.

3.4.12 It has been suggested that a problem arises when a scheme approved by this means could contain provisions, such as variation to the articles and the raising of new capital, which are detrimental to minorities without the safeguard of a requirement that interested parties abstain from voting upon such proposals.⁴⁵

Other Methods of Forcing out Dissenting Shareholders

3.4.13 The Committee was referred to a reduction of capital under section 195 of the Law as being a method which can be used to eliminate minority shareholdings in a company. However, a recent New South Wales Court of Appeal case decided that the court, in deciding whether to confirm a reduction of capital, is entitled to take into account the principle in the Law that the buyer of shares seeking to gain control of the company should ordinarily, “as a matter of fairness, give all members of that class the opportunity of sharing equally whatever premium the rights attached to that particular class of shares brings into existence”. The Court of Appeal noted that the takeover provisions showed a Parliamentary adoption of this generally accepted idea and that this should likewise apply in deciding whether to confirm the reduction of capital. The reduction of capital was refused in the circumstances.⁴⁶

⁴⁴ Ford *op.cit.*, pp.620-622.

⁴⁵ *ibid.*

⁴⁶ Catto v Ampol Limited 15 ACLR 307

3.4.14 A selective buy-back of shares under section 206JA of the Law (of up to 10% of the issued capital) must be approved by a resolution of a meeting of members by a majority of at least 75% of those who vote. The proposed vendors (and their respective associates) are precluded from voting on the resolution. In the case of a public company an expert's report is required. The selective buy-back is not a compulsory acquisition of a minority but merely a permission for the company to acquire a particular parcel of shares that the holder wishes to sell.

3.4.15 The rights attaching to shares can be altered in accordance with the procedure under section 197 and 198 of the Law. However, holders of not less in the aggregate than 10% of the issued capital can apply to the court to have the variation set aside.

3.4.16 It was also suggested that articles of association could be altered to permit compulsory acquisition.⁴⁷

3.4.17 The ASC noted in respect of many of these methods of minority force-outs that the procedures available were not subject to any provisions restricting interested parties from voting. The only recourse open to dissenting shareholders is to invoke the general oppression remedy under section 260 of the Corporations Law.⁴⁸ However, some protection is provided by the level of shareholder approval and in some cases court approval is required.

Committee Conclusions

3.4.18 The Committee accepts that existing provisions relating to compulsory acquisition, and minority force-outs are in need of review. It notes that in relation to reductions of capital, changes to rights attaching to shares, and other procedures involving the amendment of articles of association, there are no voting exclusions at all. A major shareholder may therefore use its voting power to expropriate the

⁴⁷ Evidence, p.5636 (Mr J Green)

⁴⁸ Evidence, p.5822 (ASC)

minority shares. The Committee considers this an area of the law that should be examined in detail. The aim should be to provide for compulsory acquisition at the same time ensuring that the legitimate rights of minorities are respected. The Committee therefore makes the following recommendations.

RECOMMENDATION 10

3.4.19 The Committee recommends that, in relation to compulsory acquisition of shares pursuant to a court approved scheme under section 414 of the Corporations Law, the Law be amended to provide that the rights of compulsory acquisition are not available unless the thresholds and their calculations are determined in the same manner as would apply to compulsory acquisition under section 701 of the Law in relation to a takeover.

RECOMMENDATION 11

3.4.20 The Committee recommends that, in relation to the compulsory acquisition of shares pursuant to schemes of arrangement, selective reduction of capital or pursuant to a power inserted in the articles, the Attorney-General ask the Companies and Securities Advisory Committee for it to report on ways in which protection against compulsory acquisition on unfair terms can be made consistently available for minority shareholders.

3.5 Selective Buy-Backs

3.5.1 Since April of this year, following amendments to the Corporations Law, companies have been permitted to buy their own shares under stringent conditions on a stock exchange. Provision for off-market buy-backs has been in place since November 1989. The new provisions allow companies to buy back up to 10% of their shares within a 12 month period, subject to the fulfilment of a number of procedural requirements, including the shareholders approving the inclusion of a buy-back power in the articles of association.

3.5.2 However, a selective buy-back of shares which is not an on-market purchase, an employee-share purchase, or an odd-lot purchase must be approved by a special resolution of the company.

3.5.3 The Attorney-General's Department informed the Committee that selective buy-backs are stringently controlled because an uncontrolled ability to make selective buy-backs could lead to unacceptable use of the buy-back power by directors. Certain shareholders might receive favourable prices for their shares, or may obtain control over the company.

3.5.4 As the legislation has only recently come into force the Committee has no comment to make on the matter beyond noting the need to prevent abuses of the provisions.

CHAPTER 4

DISCLOSURE REQUIREMENTS OF DIRECTORS

4.1 Introduction

4.1.1 Company directors in Australia are subject to a range of common law and statutory duties. The approach of company law has been to protect shareholders by subjecting the actions of company managers to a range of duties and obligations.¹ These include obligations to report and disclose information on the performance of the company.

4.1.2 The examination of information released by a company is a principal means by which shareholders determine the performance of directors and hence ascertain if the directors are acting in the best interests of the company. The availability of accurate and timely information on the financial position of companies is fundamental to informed judgement by shareholders about their investments.

4.1.3 Improved disclosure by directors to shareholders has been a matter of some debate in the corporate sector in recent times and has been the subject of recent reports by Commonwealth companies law advisory bodies.²

4.2 General Common Law and Statutory Duties of Directors

4.2.1 The common law and statutory duties of directors draw heavily on forms of words developed in case law around the turn of the century, with a view to

¹ Evidence, p.S534 (Attorney-General's Department).

² See paras 4.3.2, 4.3.3, and 4.4.8 to 4.4.17.

ensuring that directors, as fiduciaries, are bound to act in the interests of shareholders.³

4.2.2 Broadly directors have the following common law duties:

- . a duty of good faith in that they must:
 - act bona fide for the benefit of the company as a whole (that is in the interests of shareholders);
 - act for proper corporate purposes;
 - not make a profit from their position; and
 - not make or pursue a gain, or promote the interests of a third party, where there is an actual or potential conflict of interest or duty.

- . a duty to exercise the degree of care and diligence that can be reasonably expected of a person of his/her knowledge or experience.

4.2.3 The common law duties of directors have been, to an extent, codified in section 232 of the Corporations Law which provide that a director of a corporation:

- . shall at all times act honestly in the exercise of his powers and the discharge of duties of his office;

- . shall exercise at all times a reasonable degree of care and diligence;

- . shall not make improper use of information acquired by virtue of his position; and

- . shall not make improper use of his position to gain an advantage.⁴

³ Evidence, p.S748 (Australian Securities Commission).

⁴ Evidence, pp.S537-538 (Attorney-General's Department).

4.3 Requirements Concerning Disclosure by Directors

4.3.1 The Corporations Law, in addition to the duties mentioned above, imposes a number of obligations on directors to disclose matters to the company either at board level or to its members in relation to areas of possible conflict of interest. Some of the requirements of the Law include;

- . a director who is in any way interested in a proposed contract with the company must declare the nature of the interest at a meeting of the directors (s.231(1)). In the case of public companies, that disclosure must also be included in the directors' report accompanying the company's annual accounts sent to members (s.307);
- . the director's report accompanying the company's annual accounts must also set out whether a director has received or become entitled to receive a benefit because of a contract that the director or an entity *in which the director has a substantial financial interest*, has made with either the company or an entity that the company controlled (s.309);
- . a director who holds any office or possesses any property whereby duties or interests might be created in conflict with his duties as director must declare the nature and extent of the conflict at a meeting of the directors (s.231(6));
- . every company must keep a register containing details of its directors and certain other officers. That register must show particulars of directorships held by the director in other corporations that are public companies or subsidiaries of public companies (s.242). The register is open for inspection by members without charge. It may also be inspected by members of the public, but in this case a small fee may be charged. Copies may also be requested;

- . every company is obliged to keep a register of directors' holdings in the company and in any related company; and every director is bound to supply the information necessary for the compilation of that register (s.235). In effect, the director is obligated to disclose, and the company to record, particulars of any relevant interest he has in shares, debentures or prescribed interests of the company or any related corporation - including rights, options or contracts in relation to those shares - and the nature and extent of that interest. Changes in the information must be notified including any price received on sale of any interests. The register is open for inspection by a member without charge and by any other person on payment of a small fee. Copies must be furnished on request. The register of directors' shareholdings must also be produced at each annual general meeting of the company:

- . if at the end of a financial year there remains a loan made, guaranteed or secured by the company (or by one of its subsidiaries), to a director, a relative of the director or a corporation in which the director has an interest of more than 10%, the accounts of the company must include a note stating the total amount of the loan (Corporations Regulations Schedule 5 Clause 18(3));

- . the accounts must also include a note of the total of the income received by all directors of the company, directly or indirectly from the company or from any related corporation. For this purpose income includes all remuneration in connection with the management of the affairs of the company or any related corporation. The disclosure is made within bands of income of \$10,000.00 (Corporations Regulations Schedule 5 Clause 25); and

- . in takeovers, directors of each of the bidder and target must disclose in the documents used in the takeover their holdings and proposed

personal benefits (Parts A, B, C and D under Chapter 6 of the Corporations Law).

4.3.2 The Companies and Securities Advisory Committee (“CSAC”) in its report issued in July this year, “Report on Reform of the Law Governing Corporate Financial Transactions”, provided a draft Bill which would amend the Corporations Law. The Bill contains detailed procedures to monitor and control matters which are vulnerable to abuse by corporate controllers. These matters are loans to directors, loans to linked companies, asset transfers between companies, directors' interests in corporate transactions, executive remuneration and benefits arising from corporate asset transfers. The Bill employs 3 regulatory mechanisms to overcome possible self-dealing by corporate controllers or the intrusion of other conflict of interest considerations:

- . the prohibition of particular loan transactions;
- . “arms-length” consent rules; and
- . mandatory disclosure of various permitted transactions.

Aspects of the CSAC proposals are referred to later in this Chapter.

4.3.3 Accounting Standard AASB 1017, which applies to reporting entities with a balance date of 31 December 1991 or later, specifies disclosure concerning related party transactions. The standard places considerable emphasis on disclosure of transactions involving directors. Apart from disclosure of directors' loans, income and retirement payments (which are in any event required by Corporations Regulations Schedule 5) for transactions involving directors and director-related entities, those must be disclosed in the financial statements:

- . the aggregate amount of the transactions, the names of the directors involved and the nature of the terms and conditions;

- . the aggregate amount of interest revenue, interest expense, dividend revenue and doubtful debt expenses resulting from the transactions;
- . the aggregate amount of receivables and payables, and provision for doubtful debts; and
- . the aggregate amount of any other benefits derived by directors or director-related entities resulting from transactions, and the names of the directors concerned.

Under AASB 1017 a “director-related entity” includes relatives of the director and any entity under the significant control of directors or their relatives.

4.4 Requirements Concerning Company Accounts and Audits

The Corporations Law

4.4.1 An important aspect of company regulation are the requirements relating to the disclosure of financial information about a company. Generally, the company and its management are accountable for the manner in which shareholders funds have been dealt with. The provision of information to shareholders enables them to exercise their powers in general meeting more effectively, and assists existing and potential investors to decide whether to maintain, increase or purchase shares in the company.

4.4.2 The Corporations Law imposes numerous obligations on companies and directors to ensure that companies maintain adequate records and books of accounts. The accounts of a company are required to be kept in a manner which enables:

- . the preparation of true and fair accounts; and
- . the accounts to be conveniently and properly audited (s.289).⁵

4.4.3 The Corporations Law provides that:

- . a director has a statutory right to inspect the accounting records of his company at all times (s.289(9)); no member has such a right unless the articles allow it, but a member may apply to the court for permission to inspect books of the company (s.319);
- . the directors must lay before the annual general meeting the company's financial statements (balance sheet and profit and loss account) for the financial year together with the directors' statement, directors' report and auditors report (s.316); not less than 14 days before the AGM those documents must be sent to members (s.315);
- . directors are required, in preparing the balance sheet, to write off bad debts, make provision for doubtful debts, and ascertain whether any current assets are unlikely to realise the value attributed to them in the accounts, in which event those current assets are to be written down and adequate provision made for the difference in value (s.294);
- . directors must also find out whether the value of non-current assets exceeds the amount which would be reasonable for the company to spend to acquire the assets and if adequate provision for writing down the value is not made, to include explanations as will prevent the accounts from being misleading because of the over statement of the value of those non-current assets (s.294). Accounting Standard AASB 1010, which applies to all reporting entities in respect of financial

⁵ Evidence, pp.545-546 (Attorney-General's Department).

years ending after 29 June 1992, will also be relevant to the accounting treatment of the values of non-current assets;

- . directors are required to prepare a statement about the company's accounts; in it they must state whether or not, in their opinion the balance sheet and profit and loss statement give a “true and fair view”, and whether or not, in the directors' opinion, there are reasonable grounds to believe that the company will be able to pay its debts as and when they fall due (s.301);
- . for companies with a balance date of 31 December 1991 or later, directors must ensure that the financial statements are prepared in accordance with approved accounting standards; if the directors consider compliance with the standards would not lead to a true and fair view, they are required nevertheless to comply with the standards but add notes of such additional information as will give a true and fair view (ss.297, 298 and 299); and
- . for companies with a balance date of 31 December 1991 or later, the directors are required to prepare a consolidated set of accounts for the “economic entity” constituted by their company and the entities it controlled during the financial year (ss.295A and 295B); the notions of “entity” and “control” are defined partly by reference to Accounting Standard AASB 1024 and, in effect, cover not only subsidiaries but other incorporated and unincorporated entities controlled by that company.

4.4.4 Sections 1308 and 1309 make it an offence for officers to furnish false or misleading information to shareholders, among others. The company's financial statements would be subject to this overall requirement.

4.4.5 With regard to auditing, the Corporations Law provides that:

- . the auditor of a company is to be an expert and independent of management (s.324) and must report to members on the accounts and auditing records (s.331A);
- . an auditor has a right of access to the records of the company and is entitled to require from any officer of the company such information and explanations as the auditor desires for the purposes of audit; where consolidated accounts are required this right extends to each entity that the company controlled during the financial year (s.332);
- . the report must state whether the accounts are, in the auditor's view, properly drawn up so as to give a true and fair view of the matters required, that they are in accordance with provisions of the Corporations Law and that they meet the applicable accounting standards (s.331B);
- . if the auditor in carrying out the audit is satisfied that there has been a breach of the Corporations Law and the circumstances are such that the matter has not been or will not be adequately dealt with by comment in his report on the financial statements or by bringing the matter to the notice of the directors, the auditor must report the matter forthwith to the ASC (s.332).

Disclosure Under the Rules of the Australian Stock Exchange

4.4.6 In the case of listed companies, ASX Listing Rule 3B requires directors to report to the exchange half-yearly, i.e. within three months after the first half-yearly period in the financial year. The report is to include details of sales and other revenue, operating profits or loss before tax, income tax, and extraordinary items. It should state any material factors affecting revenue and/or expenses and

contain comments from directors on the results. The earnings per share, details of dividends and of the issues of securities must also be included. In addition, within 3 months after the end of the financial year, there is to be a preliminary final statement with comparable contents and dividend announcement.

4.4.7 The Listing Rules also require the notification to the ASX of other important information:

- . the first Rule mentioned in the ongoing obligations part of the Listing Rules is that the company must notify the ASX immediately of any information concerning the company or any of its subsidiaries necessary to avoid the establishment of a false market in the company's securities or which would be likely to materially affect the price of those securities (Rule 3A(1));
- . the company must notify the ASX immediately of any change in the general character of the business of the company or, in some cases, the business of any related company (Rule 3A(2));
- . the company must notify the ASX immediately of any acquisition or disposal by the company of a subsidiary and when doing so certain particulars have to be given (Rule 3A(3));
- . the company must notify the ASX immediately of any acquisition or disposal of fixed assets and/or investments where the assets being acquired or disposed of represent more than 10% of the listed company's consolidated fixed assets and investments or where the impact would result in an increase or diminution of the listed company's consolidated pre-tax operating profit or loss (Rule 3A(4)); with respect to such an acquisition or disposal the consideration, basis of valuation and conditions attaching to the sale must be also announced;

- . changes in officers of the listed company must be notified immediately (Rule 3A(14));
- . the listed company must immediately give details of its exposure to any person or company which goes into receivership or liquidation where that exposure is in excess of 5% of shareholders' funds of the listed company (Rule 3A(18A));
- . the company must give a half yearly report within three months after the end of the first half yearly period in the financial year (Rule 3B(1)); various rules provide for further disclosures to be made in the listed company's annual report (Rule 3C);
- . the company must immediately announce any decision to issue or recommend the issue of any securities to members, or any contract providing for an issue of securities whether to members or individuals (Rule 3E(5));
- . where a listed company (or persons acting in concert with it) trades in securities in another listed company that is related to the first listed company, the first listed company must disclose to the ASX details of the trading (Rule 3J(19));
- . where required by the ASX, a listed company must supply information concerning loans included in the company's assets, including the identity of the borrower, security held, interest rate, maturity date and whether the directors have any interest in the borrower (Rule 3J(22));
- . the company must announce, without delay, the particulars of any material contract involving directors' interests (Rule 3L(5));

- . there are special additional notification requirements for mining companies;
- . where the directors of a company are having discussions which may lead to a takeover offer being made they are obliged to maintain secrecy (Rule 3R(1)); once the company gives or receives a notice of intention to make a bid it must then immediately make an announcement (Rule 3R(2));
- . various acquisitions and disposals also require shareholder approval under Listing Rules 3J(3) or 3S(2) and these are referred to in Chapter 3 of this report;
- . the company must give advance notice of a proposal to issue shares in connection with the acquisition of mining tenements, technology or other intangible property (Rule 3T(1)); and
- . the company must notify the intention to establish an on-market buy-back scheme (Listing Rule 3V).

Recent Developments Concerning Requirements for Disclosure

4.4.8 The Attorney-General, the Hon. Michael Duffy, MP, told the Parliament in May during the debate on legislation amending the Corporations Law, that the Bill represented the second phase of the Government's corporate law reform program.⁶ The amendments then introduced provide for improved reporting requirements by directors in the financial statements issued to members. The more significant changes made, and which apply to all companies with a balance date of 31 December 1991 or later, are as follows:

⁶ Parliamentary Debates, House of Representatives, 29 May 1991, p.4213.

- . previously the obligation was to prepare "group accounts" and group accounts can take a number of forms, with a consolidated set of accounts being one of the available options; under the amendments, a set of consolidated accounts is the only option to be permitted;
- . previously the group accounts only dealt with the company and subsidiaries; under the amendments the consolidated set of accounts is for the "economic entity" constituted by the company and the entities it controlled during the financial year; the notions of "entity" and "control" are defined by reference to Accounting Standard AASB 1024 and, in effect, cover not only subsidiaries but other incorporated and unincorporated entities controlled by the company; and
- . previously directors did not have to ensure that the financial statements were prepared in compliance with the accounting standards if to do so would fail to give a "true and fair view". This was used by certain companies to avoid complying with standards and to rely on the more general, and more vague, test of "true and fair view" to adopt favourable (and dubious) accounting treatments. Under the new regime, compliance with the accounting standards is required in all circumstances and if this does not give a true and fair view the directors are required to add information and explanations as will give a true and fair view.

4.4.9 The ASX released in June this year an exposure draft of proposed Listing Rule amendments to become operative in January 1992. With regard to improved company reporting, the exposure draft of the amendments provides for:

- (a) strengthening the current requirements for immediate reporting under Listing Rule 3A(1) by requiring the disclosure to be in respect not only of the company but any other entities with which it is "associated" and that the disclosure is not only required to avoid the establishment of a

false market in the company securities but also where it is of material significance for interested parties wishing to be apprised of the financial position of the company (Rule 3A(1));

(b) *half-yearly reports and preliminary final statements to provide more information and in particular the half-yearly report would have to include:*

- . a condensed balance sheet describing major items of current and non-current assets and liabilities;
- . a cash flow statement, once an accounting standard has been introduced;
- . segmental information; and
- . greater detail regarding receipts/outlays and revenue/expenses; and

(c) disclosure of the effect of any change in accounting policy at the next available opportunity whether it be the half-yearly or preliminary final report (Rule 3B(2A)).⁷

The ASX exposure draft noted that quarterly reporting failed to gain the support of a majority in respect of the total submissions received in response to its earlier discussion paper.

4.4.10 As part of the corporate law reform program, in June 1991 the Attorney-General, the Hon Michael Duffy, MP, requested the Companies and Securities Advisory Committee ("CSAC") to examine the need for a legislatively-based continuous disclosure regime, and the nature of any such scheme. The CSAC report,

⁷ Australian Stock Exchange Limited, Proposed Listing Rule Amendments, Exposure Draft, June 1991, pp.16-20.

“Report on an Enhanced Statutory Disclosure System”, was issued in September this year and that report:

- . notes the deficiencies of the existing reporting requirements in the Corporations Law;
- . concludes that an enhanced statutory disclosure system will provide benefits including the protection of the interests of equity and debt investors, the promotion of efficient management and a better functioning capital market; and
- . recommends the introduction of a statutory-based system of continuous disclosure and half-yearly reporting requirements for all disclosing entities, and an upgrading of certain annual reporting requirements with the information disclosed to be placed on the ASC data base.

Those 3 main elements of the CSAC proposals are referred to below.

4.4.11 The first main element of the CSAC proposals is an affirmative obligation on directors of “disclosing entities” to make a timely disclosure of any “material matter” to the ASC and, where applicable, to the ASX. The “disclosing entities” include not just listed companies but also:

- . all other public companies with 50 or more members;
- . all other companies (or prescribed interests) with total gross assets in excess of \$10 million; and
- . public sector corporations that carry on a business.

4.4.12 All “disclosing entities” must report all beneficial or adverse “material matters”. A “material matter” under the CSAC proposals is:

- . any change in, or reassessment of, the disclosing entity of which equity or debt investors would reasonably require disclosure, for the purpose of their making an informed assessment of the assets and liabilities, financial position, profits and losses, or prospects of the disclosing entity; and
- . any matter that is likely to materially affect the price of the disclosing entity's debt or equity securities or is necessary to avoid the establishment or continuation of a false market in those securities.

4.4.13 Under the CSAC proposals the form of disclosure required is that, upon directors of a disclosing entity becoming aware of a “material matter”, they should, as soon as practicable and in any event within 24 hours, lodge with the ASC a “Statement of Material Matter”. A format for such a statement has been provided in the recommendations.

4.4.14 The second main element of the CSAC recommendations is that all disclosing entities that are presently required to lodge annual reports under the Corporations Law should also be required to lodge half-yearly reports with the ASC and that they be provided within 75 days of their fiscal half-year end. Half-yearly reports would include a profit and loss statement, a balance sheet, details of Statements of Material Matter lodged during the reporting period and a qualitative assessment of half-yearly results by directors. The proposed half-yearly reports would not need to be fully audited but they should be subject to a limited review by auditors. The CSAC report did not see a need for quarterly reporting at this stage.

4.4.15 The third main element in the CSAC recommendations is more comprehensive annual disclosure requirements for disclosing entities and exempt proprietary companies. Statements of Material Matter lodged in the period since the last half-yearly report would have to be listed. Exempt proprietary companies would be required to include a set of accounts in their annual return and would have to include key financial data.

4.4.16 The draft Bill contained in the CSAC report, "Report on Reform of the Law Governing Corporate Financial Transactions", published in July this year suggests some 80 new sections to be added to the Corporations Law to deal with matters viewed as vulnerable to abuse by corporate controllers. The report states:

"Following the corporate collapses of the 1980's, it has become evident that some corporate controllers abused their positions of trust by arranging for the shifting of assets around and away from companies and corporate groups, and into their own hands. They achieved this by various means, including remuneration payments, assets transfers or loan arrangements, on terms highly advantageous to themselves but to the detriment of these companies. In other instances, substantial inter-corporate loans were entered into with the apparent purpose or effect of disguising the true financial position of individual companies within a group. This was made easier by the lack of any general statutory requirement that shareholders either consent to, or be informed of, these transactions. These abuses generally involved significant losses of corporate funds, with adverse effects on investor and creditor returns and confidence. They also brought into question the integrity of Australian financial markets, with detrimental consequences for the national economy.

Some of these abuses highlighted shortcomings in the existing law; others the inability to counter such misconduct short of complex and costly investigations and litigation after the event. An additional problem was the legal impediments facing shareholders and creditors in obtaining standing to enforce corporate rights. Some of these abuses also involved possible breaches of the Australian Stock Exchange (ASX) Listing Rules. However doubts about the precise legal status and enforceability of these Listing Rules inhibited prompt and effective remedial action."

4.4.17 The major reforms which would be effected by adoption of the CSAC draft Bill, will:

- . extend the prohibition on loans to directors by broadening the class of regulated financial arrangements to include, in addition to loans, other arrangements amounting to disguised loans;

- . prohibit a company from entering into loans and similar transactions with its directors (and certain other persons linked with its directors); various exemptions would be available and some cases would require approval from shareholders;
- . prohibit a company from entering into loans and similar transactions with related or linked companies except in compliance with a strict members' approval procedure; other exemptions would also be available;
- . prohibit a company from entering into asset transfer transactions with associates, except in compliance with a strict members' approval procedure similar to inter-corporate loans; again, there would be other exemptions available;
- . require prompt disclosure to the ASC of all loans and asset transfers which require the approval of members, and all regulated financial transactions to senior officers (and certain other persons linked with these officers);
- . extend the obligations on directors to disclose their interests in transactions with the company and prohibit them from voting on those transactions at meetings of directors, where they have a material interest; and
- . overhaul the obligations of directors to disclose the benefits they receive from their companies, including those obtained indirectly through "service companies" or "consultancies".

4.5 Concerns About the Disclosure of Information by Directors and Companies - Evidence to the Committee

Inadequate Disclosure of Information

4.5.1 When presenting the Corporations Legislation Amendment Bill to the Parliament in May, the Attorney-General stated there have been in recent years:

“widespread abuses of the existing company accounting and reporting requirements under which the true financial position of a group of companies has been able to be disguised by off-balance sheet reporting. This has enabled the financial statements of the company to be manipulated in such a way as to mislead investors and the market generally regarding the real level of liabilities or performance of a company or the group as a whole.

...One of the consequences of these practices has been a significant loss of investor confidence, both amongst Australian and overseas investors, in the reliability of corporate financial information in Australia.”⁸

4.5.2 There was wide consensus in the evidence to the Inquiry that the legislative and non-legislative requirements for directors and the management of companies to disclose financial information, and to keep their shareholders, creditors and the markets informed concerning material transactions have been most inadequate.⁹

4.5.3 The Northern Territory Government in its submission to the Inquiry stated that:

“shareholders should, as far as practicable, be fully informed as to the affairs of the company and there does exist a real

⁸ Parliamentary Debates, House of Representatives, 29 May 1991, p.4214.

⁹ Evidence, p.S1202 (Hon. M Nevill, MLC).
Evidence, p.S235 (Australian Consumers Association).
Evidence, p.S947 (Fr A Gilbert).
Evidence, pp.S208-221 (Mr M McComas, County NatWest Australia).

need for directors to be subject to a greater duty of disclosure than at present.”¹⁰

Disclosure of Information - Legislative or Non Legislative Approach

4.5.4 To meet the problem of disclosure of information there are two approaches, both advocating continuous disclosure, currently under consideration. A proposal for further regulation under the Corporations Law advanced by the CSAC and proposals by the ASX to implement a regime of continuous disclosure through the ASX Listing Rules which have been described in paras 4.4.8 to 4.4.16.

4.5.5 In relation to the obligations to make disclosure to shareholders and the markets of major or “material transactions” there is also under consideration the CSAC report (and legislative proposals exposed for public comment) Report on Reform of the Law Governing Corporate Financial Transactions earlier referred to in para 4.4.16. The Committee has also received evidence (see para 4.6.1 to 4.6.16) proposing that the obligation to make such disclosure be dealt with through the ASX Listing Rules.

4.5.6 The ASC told the Committee that it supports the legislative approach proposed by the CSAC for the disclosure of material transactions. It acknowledged that the proposals are complex and contain detailed requirements that would impose substantial burdens on corporations and their officers. The proposed law would require a number of elaborate forms of documentation and substantial expenditure to maintain registers, and the referral of particular matters to shareholders and the ASC.

4.5.7 Whilst noting that there could be philosophical arguments that such burdens are unwarranted and penalise the law-abiding without catching the honest, the ASC asserted that:

¹⁰ Evidence, p.S893.

“Experience has shown that more general requirements, reliance on Listing Rules, and reliance on board room conventions do not achieve a sufficient level of compliance to maintain public confidence, by protecting the interests of shareholders and creditors generally. It is regrettable that detailed and complex statutory provisions... prove necessary.”

4.5.8 The ASC continued, stating that the need for such provisions was a function of both the legalistic and technical approach adopted by the courts on some occasions and of the “evident inability of self-regulatory mechanisms to maintain satisfactory standards of business ethics on a sufficiently comprehensive basis.”¹¹

4.5.9 Mr Henry Bosch, in his evidence alerted the Committee to the pit-falls of attempting to cover all eventualities in legislation. These were:

- . legislation is slow to enact, often taking 2 or 3 years where the issues are complex;
- . the slow nature of the legislative process produces inflexibility and precludes a quick response to new loopholes;
- . legislation may provide a cover for the unscrupulous who may adhere to the letter of the law but defy the spirit; and
- . legislative prescriptions may impose onerous burdens on the honest majority of companies;¹² and
- . alterations to the Corporations Law still require consultation with the States.

¹¹ Evidence, p.S779.

¹² Evidence, p.155-156, Melbourne, 2 August 1990.

4.5.10 Mr John Green, a partner with the law firm of Freehill Hollingdale and Page has, before the Committee and elsewhere, criticised the legislation operating in the Companies and Securities field because of the prolixity and technicality of its drafting. He has submitted that a different approach to law making is needed, if the problems noted above in para 4.5.9 are to be overcome. He has coined the phrase "fuzzy law" to describe the approach that he favours. Such fuzzy law would rely for its enforcement on the courts¹³:

"What it would do is give our courts room to move and an ability to reflect the changing values of our society. Something black letter law makes very difficult... It would encourage our courts to keep moving away from technicalities and towards substance. It would discourage loopholing..."¹⁴

4.5.11 Furthermore, fuzzy law would impose the primary obligation on the director/board of making the decision whether to act in a particular way or not, rather than "creating a smoke screen of words that create opportunities for people and their advisers to loophole around." With regard to disclosure Mr Green told the Committee at a public hearing in Canberra that:

"disclosure is really one of the most important and under-utilised defences to corporate crookery. Our disclosure mechanisms are not as good as we could have. For example the market might think twice about it if it knew that directors were trading in the shares, either buying or selling. That is something that the market would actually like to know."¹⁵

4.5.12 In the spirit of this approach, another witness Mr Malcolm McComas, Director of County NatWest Australia Limited (an investment bank) suggested the need for a higher standard of disclosure which should be demanded through the Listing Rules of the ASX.¹⁶

¹³ Evidence, pp.617-636, 1247-1260.

¹⁴ Evidence, p.S627.

¹⁵ Evidence, p.620, Canberra, 7 November 1990.

¹⁶ Evidence, p.S214.

Committee's Conclusions

4.5.13 The Committee supports the concept of continuous disclosure. Of the two proposals currently under consideration, the proposal put forward by the ASX which aims to achieve this objective through the Listing Rules is favoured by the Committee over that of the CSAC which advocates a legislative regime.

4.5.14 It is important not to increase the regulatory burden on companies, particularly smaller companies, at a time when business enterprises are emerging from the recession. The Committee notes that the CSAC proposals, as well as applying to listed companies, would apply to all other companies with 50 or more members; all other companies (or prescribed interests) with total gross assets in excess of \$10 Million and to public sector trading enterprises. The Committee believes that application of the requirement to listed companies is all that should be attempted at this stage.

4.5.15 The Committee's support is conditional on the coverage by the ASX in the Listing Rules being as least as extensive as foreshadowed in the draft new Listing Rules released for exposure in June and outlined in para. 4.4.9, and impose requirements that are not less than those identified by CSAC as required (see para. 4.4.12 to 4.4.15) and that they should preferably embrace the areas identified by Mr McComas in his evidence (reported in paras 4.6.3 to 4.6.12) regarding reporting on material transactions.

4.5.16 The Committee believes that if ASX Listing Rules are introduced with such breadth of coverage it should prove unnecessary to introduce further amendments to the Corporations Law (the CSAC proposal would involve 80 new sections).

RECOMMENDATION 12

4.5.17 The Committee recommends that a regime of “continuous disclosure” by Listed Companies should be introduced, implemented and enforced through the ASX Listing Rules.

4.5.18 As noted earlier the ASX does have a significant regulatory role with respect to aspects of the activities of companies under the Listing Rules, including the disclosure of information. The Listing Rules are based upon four principles which have been developed to further the Exchange's stated objective of maintaining a “fair, efficient, well informed and internationally competitive market.”¹⁷ The market information principle provides that:

“the market must be advised by timely disclosure of any information which may affect security values or influence investment decisions, or in which security holders, investors and the exchange have a legitimate interest, or which is publicly disclosed elsewhere. It should be produced according to the highest recognised standards and where appropriate should enable ready comparisons with other like information.”¹⁸

4.5.19 The ASX regards the Listing Rules which flow from this principle as being fundamental to maintaining an informed market. The Exchange notes that while there may be some argument that these rules could be prescribed by law, the ASX accepts the responsibility in the absence of another regulator.¹⁹

4.5.20 As was pointed out to the Committee by Mr Bosch, the Listing Rules have a number of advantages when compared to ‘black-letter law,’ including that they “have the force of law and are much more flexible.”²⁰

¹⁷ Evidence, p.S1024 (Australian Stock Exchange).

¹⁸ *ibid.*

¹⁹ *ibid.*

²⁰ Evidence, p.155.

4.5.21 The ASC and the Shareholder Action Group²¹ however drew the Committee's attention to problems with the enforcement of Listing Rules. In relation to 'related party transactions' (deals/transactions between a company and interests associated with the directors)²² the ASC noted that doubts as to the precise legal status of the obligations resulting from the Listing Rules have inhibited action.²³ Also a recent case highlighted the difficulty of enforcing the Rules in court actions because they are drafted "in what might be termed commercial or discretionary language rather than the precise language the court expect in statutes."²⁴

4.5.22 The Committee recognises that the language in which the ASX Listing Rules as expressed could be inappropriate for the wider purposes that the Committee has in mind. It concludes that the ASX should arrange for the drafting of the Rules so that they are expressed in language appropriate for interpretation by a court. It also believes that this process would be enhanced if the Attorney-General exercised his powers to disallow Listing Rules which do not conform to this requirement.

RECOMMENDATION 13

4.5.23 The Committee recommends that the Listing Rules of the Australian Stock Exchange be re-drafted by those versed in statutory drafting so as to have the Rules expressed in a language and style which both facilitates clear interpretation and increases the ability to enforce such Rules in the courts. The Committee further recommends that the Attorney-General announce that he will disallow, under section 774 of the Corporations Law, any further alterations to the Listing Rules which do not comply with the Committee's recommendation on the matter of style.

4.5.24 As a result of a recent decision of the courts, there is doubt about the extent to which the Listing Rules can be enforced against directors of a company where the Listing Rule imposes the obligation on the company alone. The case was

²¹ Evidence, p.S68.

²² Evidence, p.S113 (Australian Shareholders Association).

²³ Evidence, p.S775.

²⁴ *ibid* (see TNT Australia v Poseidon (No.2)(1989) 15 ACLR 80).

decided by the Full Court of the Queensland Supreme Court in Hillhouse v Gold Copper Exploration NL (1989) 7 ACLC 332. There the Full Court found that it had no jurisdiction to make orders against directors concerning compliance with Listing Rule 3J(3) on the grounds that the Rule did not apply to the directors but only to the company. The fact that the company must act through its directors and any direction to comply with the Rule would have to be executed by them does not mean that they personally can be subjected to enforcement action under section 777 of the Corporations Law. The Committee believes that the Court should be able to enforce the Listing Rules against the directors as well as the company and recommends:

RECOMMENDATION 14

4.5.25 The Committee recommends that section 777 of the Corporations Law be amended to provide that where the Stock Exchange Listing Rules apply to a listed company, the directors of that company are deemed to be under an obligation to procure the company to comply with the Listing Rules and the directors can be subjected to orders of the court concerning compliance with the enforcement of those Listing Rules.

The enforcement of ASX Listing Rules would be further enhanced if the directors of a company could be directly accountable and recommends:

RECOMMENDATION 15

4.5.26 The Committee recommends that, conditional upon the Stock Exchange Listing Rules being re-drafted in a language and style which facilitates clear interpretation and increases the ability to enforce them, section 777 of the Corporations Law should be further amended to provide that the court may, as one of its orders, impose penalties (payable to consolidated revenue) on the directors of a company which has failed to comply with Listing Rules and such failure has been the occasion of the Stock Exchange suspending trading in the company's securities. Such amendment would also have to provide protection for, first, directors who are in the process of having the company de-listed and, secondly, the directors should not be subjected to double jeopardy.

4.5.27 The Committee notes that in August of this year the Attorney-General released for public comment an exposure draft bill proposing amendments to the Corporations Law. The sessional orders of the House of Representatives provide

that a Minister or the House may refer pre-legislative proposals to parliamentary committees. The LACA Committee suggests that, with regard to further proposals for reform of the Corporations Law, the Attorney-General give thought to referring draft exposure bills to the Committee for consideration and review.

4.6 The Nature of Disclosure of Information - Evidence to the Committee

Need for Changes to the ASX Listing Rules

4.6.1 Mr McComas of County NatWest Australia Limited was quite critical of the disclosure provisions prevailing at the time of his submission (June 1990). He stated that:

“The lack of meaningful disclosure has enabled the management of certain companies to undertake transactions that have caused a significant transfer of wealth from shareholders to management and selected large shareholders associated with management... During this process shareholders have had limited opportunity to intervene and question... the motives of the directors of companies in which they own shares.”²⁵

4.6.2 Mr McComas categorised the lack of disclosure as follows:

- . a lack of sufficient detailed information to understand the financial implications of material transactions such as acquisition, divestment and the issue of new shares;
- . inadequate reporting in a timely and detailed manner; and

²⁵ Evidence, p.S209.

an inconsistent and haphazard approach to the content and method of disclosure in each of the above circumstances.²⁶

4.6.3 Mr McComas believed reporting in these areas could be improved without legislative intervention. He stated the Listing Rules are “the appropriate way of regulating the quoted public company sector.” As noted earlier Mr McComas advocated a greater use of the ASX Listing Rules to require disclosure, but, he argued that detailed changes are necessary to the rules. He pointed out that at present the rules do not require companies to seek shareholder approval for major acquisitions. In the case of a takeover where the consideration for the offer comprises an issue of new shares, shareholders can be disadvantaged and have holdings significantly diluted, and be powerless to consider and vote on whether the acquisition is in their best interests. In such cases, he stated, shareholders are not formally advised of a material transaction until the publication of the annual report some considerable time later.²⁷

4.6.4 In suggesting that detailed changes are required to the Listing Rules Mr McComas drew attention to the listing requirements applicable to material transactions in Britain; where all transactions involving publicly listed companies are divided into classes according to the size of the deal and the relationship between the parties. Various classes of transaction require shareholder approval in addition to the publication of a detailed information memorandum on the transaction for circulation to shareholders.

4.6.5 Mr McComas provided a detailed review of the practice regarding material transactions in the United Kingdom.²⁸ For classifying a transaction the size of the deal is determined by comparing the listed company that is acquiring or disposing of assets with the size of the assets, profits, the amount of the consideration for the purchase or sale and where the consideration is funded by an issue of equity capital,

²⁶ Evidence, p.S210.

²⁷ Evidence, p.S214.

²⁸ Evidence, pp.214-218.

the amount of the new share capital to be issued. (If any of the comparisons produces, for the asset to be acquired or sold, a value of 15% or more of the relative value of the listed company, then the transaction is Class 1. If the value is 25% or more, the transaction is Major Class 1. If it is more than 5% but less than 15%, the transaction is Class 2 and so on).

4.6.6 There are specific requirements for the contents of company circulars sent to shareholders in relation to the various class transactions, which include that:

- . the directors must state if the company has sufficient working capital available to it, and if not how it is proposed to provide the additional working capital;
- . a litigation statement regarding any legal/arbitration proceeding pending or threatened against the group which may effect the group's financial position;
- . a summary of the principal contents of each material contract entered into by the company in the last 2 years;
- . a statement of the aggregate value of the consideration for the transaction and how it will be satisfied;
- . a statement of any variation in the total payments to directors of the company;
- . a statement of any significant change in the financial or trading position of the groups since the last date published; and
- . an indebtedness statement given at a date no more than 28 days prior to the date of the circular.

4.6.7 In addition to the above requirements, if the transaction is an acquisition of a company, the statements should be made for the acquiring company and the target on a combined basis. This will include details of:

- . director's service contracts;
- . consideration passing, the extent and nature of interests of directors, terms which are unusual in their nature or conditions significant to the business of the company; and
- . information on the group's financial and trading prospects for at least the current financial year and where a profit forecast appears, the principal assumptions with appropriate notes. This will usually include a proforma balance sheet showing the impact of the acquisition.

4.6.8 Mr McComas pointed out two noticeable features of the British system which strongly contrast with Australia:

- . the information published in the company circular must include a responsibility statement from the company, existing directors and other persons authorising the contents of the documents; and
- . any increase in authorised share capital can only take effect to the extent necessary to satisfy a specific issue of new shares. A blanket approval for a \$1 billion increase in authorised capital could not be put to shareholders for approval other than in connection with a specific transaction that would, in most cases, require authorisation by shareholders under the class test.²⁹

²⁹ *ibid.*

4.6.9 Mr McComas submitted that these requirements provide a meaningful level of disclosure to shareholders where a company is proposing a transaction of a size that may affect shareholder wealth. He stated that the requirement for such information has become a standard feature of the corporate and professional advisory community in the United Kingdom. The provision of such detailed financial and descriptive material in Britain by the offeror company is in marked contrast to the practice in Australia.³⁰

4.6.10 Furthermore in discussing the need for detailed changes to the Listing Rules, Mr McComas went on to state that shareholders should be given the opportunity to vote on material transactions and understand the financial implications of such deals. This would force companies proposing such transactions to quantify the financial impact of the deal. It will not, he argued, reduce the ability of the company to undertake major or innovative deals. It will merely require of them to be conditional on shareholder approval if they are of a size as to potentially dissipate wealth. Mr McComas submitted that the Stock Exchange rules such as 3J(3) provide ample precedent for the form of shareholder mandate. Additionally, Mr McComas submitted that shareholders should be given the right to make formal Inquiry of any aspect of the company's activity and receive a considered detailed response to be published in the annual proxy statement, which is the practice in the United States.³¹

4.6.11 The ASX released in June this year an exposure draft of proposed Listing Rule amendments to become operative in January 1992. Proposed new Listing Rule 3Y incorporates a number of core ASX Listing Rules into the one new section. The new Rule has been adapted from the listing requirements applicable to material transactions in the United Kingdom. The new Listing Rule 3Y sets out the requirements of a listed company to disclose significant transactions which are proposed and to refer to shareholders other proposals. The proposed new Rule divides such proposals into 4 categories:

³⁰ Evidence, p.S217.

³¹ Evidence, p.S218.

- . a proposal which it is considered will have a significant impact on a listed company (“a 5% transaction”) must be disclosed to the market;
- . a proposal which it is considered will have a very significant impact on a listed company (“a 20% transaction”) must be disclosed to the market and to shareholders more directly;
- . a proposal which it is considered will have at least a significant impact on a listed company and in which one party is a related party (“a related party transaction”) must be disclosed to the market and referred to shareholders for approval; and
- . any proposal which involves an issue of securities and in which one party is a related party (“an issue of securities transaction”) must be disclosed to the market and referred to shareholders for approval.

4.6.12 The ASX says that the purpose of the proposed Listing Rule 3Y is to draw together in one section the various ASX requirements relating to significant transactions by listed companies so as to achieve the following:

- . setting a uniform threshold criteria of 5% of shareholders' funds on net operating profits;
- . removing the overlap between certain Listing Rules;
- . increasing the requirements for disclosure of substantial transactions beyond that currently specified in Listing Rules 3A(4) and 3J(3); and
- . specifying more clearly the circumstances where disclosure of substantial transactions to the market is required.

Frequency and Content of Disclosure

4.6.13 Many witnesses advocated more frequent reporting by companies both to the Stock Exchange and to shareholders. Mr McComas supported half-yearly reporting which would include a profit and loss statement with supporting notes on material matters, and a proforma balance sheet showing cash, indebtedness, current assets and liabilities. He also called for quarterly reports of profits and losses which would include revenue and profit details, a proforma balance sheet and a summary cash flow statement. He pointed out that this is the practice in North America.³² Quarterly reporting was also suggested by the chartered accountancy firm Ernst and Young³³ and the Securities Institute of Australia.³⁴

4.6.14 Professor Walker of the Australian Shareholders' Association referred to the specific problem of 'related party transactions,' and told the Committee that there had been a failure to compel disclosure of deals between a company and interests associated with directors in either annual reports or in reports to the Stock Exchange.³⁵ Professor Walker and Mr McComas recommended cash flow statements as a requirement of the Listing Rules. Similarly, Mr C Westworth, a partner with Ernst and Young, supported a requirement for cash flow statements. He told the Committee at a public hearing that "a lot of cash can flow out of a company over 12 months."³⁶ However a disadvantage of the proposal is a possible tendency for it to cause the management to focus unduly on the short term cash flow rather than the longer view.³⁷

³² Evidence, pp.S212-213.

³³ Evidence, p.S204.

³⁴ Evidence, p.S79.

³⁵ Evidence, p.228, Sydney, 3 September 1990.

³⁶ Evidence, p.289, Sydney, 3 September 1990.

³⁷ *ibid.*

4.7 Concerns About Accounting and Auditing Practices - Evidence to the Committee

4.7.1 Numerous submissions were critical of the accounting and audit professions. As Mr McComas told the Committee:

“public examinations undertaken by liquidators in recent months have revealed numerous cases of secret commissions, premature recognition of profits, inflated asset values and hidden management contracts that went undetected in the audit process. The failure to disclose the financial impact of material acquisitions, divestments and other financial arrangements... has forced analysts to spend considerable time recreating accounts to determine the true financial impact of a transaction to earnings and shareholder funds.”³⁸

4.7.2 Indeed the Attorney-General told the Parliament in May:

“There have been widespread abuses of the existing company accounting and reporting requirements... such... as to mislead investors (about)... the real level of liabilities or performance of a company...”³⁹

4.7.3 Professor Walker of the Department of Accountancy at the University of New South Wales, as Chairman of the Australian Shareholder's Association told the Committee that the lack of suitable accounting standards enabled some Australian companies to issue misleading financial statements.

“Some of the companies we have seen fail in recent years have in my view had very defective accounts and this was obvious to sophisticated readers. For example, Qintex adopted the very unusual practice of capitalising trading losses. It was buried in the notes. Its accounts revealed that it had valued resorts among other assets at cost which included interest and trading losses during the development period and the

³⁸ Evidence, p.S211-212.

³⁹ Parliamentary Debates, House of Representatives, 29 May 1991,p.4214.

development period of a resort can be four or five years. I do not believe those accounts were adequate. I do not believe they provided the true and fair view because they did not disclose the quantum of trading losses that were being capitalised.”⁴⁰

4.7.4 Professor Walker mentioned an incident involving Bond Corporation Holdings Limited.

“Bond Corporation, for the half-year ended December 1987, reported a profit of over \$100m. Seventy odd million dollars of that came from what was known as the Rome property deal, whereby an interest in a company which owns some Italian real estate was on-sold to a \$2 shelf company at a profit. The \$2 shelf company in turn had the right to put that asset to another Bond company... in my view, that transaction was not realised outside the group and should not have been treated as a profit... In any event, the half-yearly profit was fictitious. Later the company reversed that profit...”⁴¹

4.7.5 Mr Bosch commented on the matter of accountancy practices to the Committee:

“I certainly think the most common set of circumstances which gave rise to the disadvantaging of shareholders was the use of, what I used to call, creative accounting, but which would probably be called cosmetic accounting.”⁴²

4.7.6 The Institute of Chartered Accountants in Australia and the Australian Society of Accountants in a joint submission to the Committee noted the evidence to the Committee critical of accounting standards and stated that:

⁴⁰ Evidence, p.212, Sydney, 3 September 1990.

⁴¹ Evidence, p.224, Sydney, 3 September 1990.

⁴² Evidence, p.170, Melbourne, 2 August 1990.

“problems in financial reporting identified in evidence... have at times resulted from non-application or misapplication of the accountancy standards rather than deficiencies in those standards.”⁴³

4.7.7 Several particular matters concerning accountancy and auditing were brought to the Committee's attention during the Inquiry:

- . related party transactions;
- . the existence of a loophole in the Corporations Law whereby the ‘true and fair’ view provision has prevailed over the accountancy standard;
- . the need for an effective consolidation standard; and
- . the role and responsibilities of auditors.

Related Party Transactions

4.7.8 Numerous submissions expressed great anger at the activities of company directors conducting transactions with interests associated with the directors or controlling shareholders.⁴⁴ As noted earlier in this section Mr McComas observed that there has been in certain companies “a significant transfer of wealth from shareholders to management.”⁴⁵

4.7.9 The Australian Shareholders' Association told the Committee that this is:

“... a problem which appears to be occurring fairly regularly now. We have had Rothwells, where some \$500m was said to

⁴³ Evidence, p.S641.

⁴⁴ Evidence, p.S113 (Australian Shareholders Association).
Evidence, pp.S33-69 (Shareholders Action Group).
Evidence, p.S227 (Australian Consumers Association).
Evidence, p.S338 (Coopers and Lybrand).

⁴⁵ Evidence, p.S209.

have been lent to interests associated with a controlling shareholder. We have Quadrax, where \$16.5m has been lent to a company associated with controlling shareholders... General Investments Australia Limited - where \$13.5 had been lent to a company associated with a controlling shareholder. In all the cases the independent shareholders were not adequately informed of what had been going on.”⁴⁶

4.7.10 As noted earlier in this chapter Professor Walker has stated:

“There has been a failure of regulations to restrict and compel disclosure of deals between a company and interests associated with directors... (which) has contributed to the losses incurred by shareholders...”⁴⁷

4.7.11 The Shareholders Association argued that there is a pressing need for a statutory requirement for disclosure by listed companies of such transactions.⁴⁸

4.7.12 The Institute of Chartered Accountants and the Australian Society of Accountants (hereafter, the Accounting Bodies) in their joint submission noted that an accountancy standard covering related party disclosure was released by the Accounting Standards Review Board (ASRB) in 1989. It noted that the Board subsequently considered comments on the effectiveness of the standard.⁴⁹ The Committee notes that Accounting Standard ASRB 1017: Related Party Disclosures, which was gazetted in October 1989, was replaced in December 1990 by AASB 1017: Related Party Disclosures and the new standard applies to the financial years ending on 31 December 1991 or later.

4.7.13 Professor Walker commented on the standard, he told the Committee that:

⁴⁶ Evidence, p.209-210, Sydney, 3 September 1990.

⁴⁷ Evidence, p.228, Sydney, 3 September 1990.

⁴⁸ Evidence, p.S113.

⁴⁹ Evidence, p.S646.

“the standard which is now on the books is very weak... if I could just explain one point, the payment by Qintex of \$43m to interests associated with managing directors would only have to be disclosed in the following form: the company has paid management fees to a company associated with one of the directors; this represented 100% of the management fees paid. There is no requirement to even disclose the dollar amount of those payments.”⁵⁰

4.7.14 The payment of fees to directors and related party transactions has been a source of great controversy in the corporate sector, particularly in relation to the legal duties of directors. It is worthwhile to note a particular example. Report No.1 of the liquidator of Rothwells Limited (the McCusker report) observed that, after reconstructing the company's accounts, loans from the company to companies associated with Mr Connell (L R Connell and Partners and Oakhill Pty Limited) in 1987 totalled between \$324-500m, which represented 53-82% of the total assets of Rothwells.⁵¹

4.7.15 It was instances such as these that has led to demands for greater disclosure requirements for directors in the submissions to this Inquiry. Mr Henry Bosch believed there is a need for “new legislation as quickly as possible.”⁵² Mr Robert Samuel, National Audit Partner, Coopers and Lybrand said that there is “an urgent need... (for)... appropriate disclosure of related party transactions.”⁵³

4.7.16 Accounting Standard AASB 1017, which applies to “reporting entities” with a balance date of 31 December 1991 or later, specifies disclosure concerning related party transactions. While related party transactions are a common feature of the activities of many entities, to the extent that they have not been conducted at fair value, the financial position of the entity may be affected. The standard therefore requires disclosure of the identities of the related parties involved in related party transactions, and groups those related parties into classes. The

⁵⁰ Evidence, p.229, Sydney, 3 September 1990.

⁵¹ T Sykes, ‘Rothwells: the Truth at Last,’ Australian Business, September 12, 1990.

⁵² Evidence, p.160, Melbourne, 2 August 1990.

⁵³ Evidence, p.338, Sydney, 4 September 1990.

standard places considerable emphasis on disclosure of transactions with directors. They are deemed material regardless of the quantum of the amounts involved. Apart from disclosure of directors' loans, income and retirement payments (which are in any event required by Corporations Regulations Schedule 5) for transactions involving directors and director-related entities, there must also be disclosed:

- . the aggregate amount of the transactions, the directors involved and the nature of the terms and conditions;
- . the aggregate amount of interest revenue, interest expense, dividend revenue and doubtful debt expenses resulting from the transactions;
- . the aggregate amount of receivables and payables, and provisions for doubtful debts; and
- . the aggregate amount of any other benefits derived by directors or their director-related entities resulting from transactions, and the names of the directors concerned.

For transactions involving related parties other than directors and director-related entities, similar disclosures are required except that the transactions are grouped into classes and the amounts aggregated.

The True and Fair View

4.7.17 The joint submission by the accounting bodies pointed out to the Committee that (at the time the submission was prepared) the requirement of subsection 298(2) of the Corporations Law that true and fair is paramount to the exclusion of the accountancy standards had created a loophole:

“under which unscrupulous directors, aided by unethical professional advisers, can avoid the provision of meaningful information to the shareholders and the ASX.”

4.7.18 Mr Bosch commented in regard to this matter that:

“At the moment the law gives priority to true and fair and it is possible for companies to argue that a departure from an accounting standard has been done because it would be not true or not fair to adhere to the standards.”⁵⁴

4.7.19 He informed the Committee that during his period as Chairman of the NCSC he was anxious to prosecute a company for departure from an accounting standard and as a result of the true and fair requirement, he was advised that:

“there was no significant possibility of a win... thought needs to be given to giving priority to the standards above true and fair which is so open to subjective valuation.”⁵⁵

4.7.20 The accounting bodies at a public hearing in Melbourne also indicated the dilemma then faced by auditors because of this situation:

“The dilemma is, from an auditor's point of view, that he has really got two rules... pressure comes from the client in that he believes the true and fair view, which was the original part of the Act, is the overriding statement. Therefore, he puts pressure on the profession to say, ‘Well, in spite of it not complying with the standard, it does show a true and fair view.’ I think this is the dilemma that we face as a profession at the moment.”⁵⁶

4.7.21 The situation was further complicated by the existence of different standards applicable to the same situation. This left it open to the directors and the internal auditors of a company to argue that despite a particular standard not being observed the accounts nevertheless gave the true and fair view required by the legislation. This even applied where there was a standard in conflict with one of the approved ASRB standards. The requirement in the legislation for the accounts to

⁵⁴ Evidence, p.169, Melbourne, 2 August 1990.

⁵⁵ Evidence, pp.169-170, Melbourne, 2 August 1990.

⁵⁶ Evidence, p.648, Canberra, 7 November 1990.

conform to the approved standards was over ridden as the accountants could argue that the accounts still reflected a true and fair view. As the accounting bodies expressed it the Committee:

“The true and fair override prevents the implementation in full of the approved accountancy standards. There is a body of accounting principles which acknowledges different accounting treatments for different transactions. So, if you can prove of the directors are of the opinion that application of some other accounting principle would give a true and fair view, they as the persons responsible for the preparation of the accounts are entitled to do so.⁵⁷

4.7.22 The accountancy bodies submitted that the (then) legislative provisions should be amended to reverse the positions so that the primary obligation is to observe the approved accounting standard.⁵⁸ Professor Baxt noted that a problem with such a proposal is that the standards are neither settled nor comprehensive.⁵⁹

4.7.23 The Committee notes that due to recently introduced amendments to the Corporations Law, for companies with the balance date of 31 December 1991 or later, directors must ensure that the financial statements are prepared in accordance with approved accounting standards. If the directors consider compliance with the standards would not lead to a true and fair view, they are required nevertheless to comply with the standards, but must then add notes of such additional information as will give a true and fair view (ss.297, 298 and 299).

⁵⁷ Evidence, p.135, Melbourne, 1 August 1990.

⁵⁸ Evidence, p.657.

⁵⁹ Professor Baxt in an article published in 1970 traced the history of the legal interpretation of the expression true and fair. He shows that progressive interpretation of the expression true and fair. He shows that progressive interpretations by the Courts in the UK and Australia had resulted in a situation where the Courts being reluctant to reach conclusions in conflict with those of the commercial and accounting professions had interpreted ‘true and fair’ increasingly to conform with what were the accounting and commercial conventions, despite what common sense might suggest was a wide divergence from the literal meaning of true and fair (True and Fair Accounts - A Legal Anachronism, 1970, 44 ALJ, p.541).

Consolidation of Group Accounts

4.7.24 The need to consolidate all controlled entities in group accounts was also stressed to the Committee during its evidence gathering phase.⁶⁰ Mr Robert Lynn of Coopers and Lybrand informed the Committee that an accountancy standard had been prepared requiring controlled entities to be consolidated but (at the time) it would have conflicted with the then Companies Code, because the code defined a subsidiary in terms of ownership rather than control.

4.7.25 He said that the absence of such provision has had widespread consequences. In relation to off balance sheet financing, he pointed out that group accounts have been prepared that fail to show all the liabilities and assets of a group because some have been placed in a vehicle which does not legally meet the definition of a subsidiary and, therefore, is not consolidated. Secondly, he noted that profits have also been generated through the sale of assets by a company to a vehicle which it controls but which is not legally defined as a subsidiary. If that vehicle were to be consolidated the profit would be eliminated on consolidation of the groups accounts.⁶¹

4.7.26 The failure to close this loophole, Mr Lynn said, had been a source of great difficulty to auditors and has resulted in some financial reports which are "at least, not readily understandable, if not misleading, because they fail to show the real economic substance of a transaction."⁶²

4.7.27 The Committee notes that due to recent amendments to the Corporations Law, for companies with a balance date of 31 December 1991 or later, the directors are now required to prepare a consolidated set of accounts for the "economic entity" constituted by their company and the entities it controlled during the financial year (ss.295A and 295B). The notions of "entity" and "controlled" are defined partly by

⁶⁰ Evidence, p.S643 (Institute of Chartered Accountants).

⁶¹ Evidence, p.338, Sydney, 4 September 1990.

⁶² Evidence, p.339, Sydney, 4 September 1990.

reference to AASB 1024 and, in effect, cover not only subsidiary but other incorporated and unincorporated entities controlled by that company.

Role and Responsibilities of Auditors

4.7.28 As noted earlier a number of submissions were critical of auditing and accounting practices. Mr Lynn when addressing the Committee acknowledged that “the profession of which I am a member is under some pressure.”⁶³ He referred to the problem of monitoring compliance with auditing standards. Whilst auditing standards are set by the Australian Auditing Standards Board (a professional body), they have no statutory backing and it is simply not known to what extent these standards are complied with.⁶⁴

4.7.29 Mr Lynn submitted an urgent need for auditing standards to be monitored. He told the Committee that:

“... you can usually detect if an accounting standard has not been followed. That is not so with auditing standards; you do not know how an auditor has conducted an audit... There has got to be some sort of review instituted that can monitor the compliance of auditors with auditing standards.”⁶⁵

4.7.30 He continued that cases of audit failure arise where:

“... an auditor has been totally negligent... where an auditor has made an error of judgement in a very difficult situation and where the auditor is almost a victim of conspiracy.”⁶⁶

4.7.31 The submission of the accountancy bodies also referred to the “alleged cases of audit failure referred to in evidence received by the Committee” which they

⁶³ Evidence, p.342, Sydney, 4 September 1990.

⁶⁴ Evidence, p.343, Sydney, 4 September 1990.

⁶⁵ *ibid.*

⁶⁶ Evidence, pp.344-345, Sydney, 4 September 1990.

argued “suggest a failure to comply with the Auditing Standards and Statements of Auditing Practice (and other existing professional obligations).”⁶⁷

4.7.32 The accountancy bodies stated that there must be amongst the profession a general recognition that non-compliance with accounting and auditing standards is unacceptable. The bodies agreed with Mr Lynn about the need for review of compliance of auditing standards:

“The quality of financial reporting can be improved by more effective review of the application of accounting and auditing standards and practices by strengthening and expanding the accountancy professions existing surveillance procedures by a coordinated approach with various other participants in the review process, for example the Australian Stock Exchange.”⁶⁸

The submission suggested the establishment of a joint panel of self-regulating bodies to monitor financial reporting.⁶⁹

4.7.33 The Accounting bodies stated that unreal expectations appeared to have developed in the community about the information that audit reports should disclose. They called this the ‘audit expectations gap’, and went on to inform the Committee that:

- . an audit report does not a guarantee the future viability of an enterprise, nor that the information contained in the audited reports is completely accurate;
- . the financial statements are prepared by the company not by the auditor. The essence of the auditing function is the independent opinion on accounts prepared by another. The auditor is required by

⁶⁷ Evidence, p.S641.

⁶⁸ *ibid.*

⁶⁹ *ibid.*

law to certify that the accounts in his opinion have been drawn up so as to give a true and fair view of the matters required; are in accordance with the law and in accordance with approved applicable accounting standards;

- . the auditor's responsibility is not to discover all fraud that may have occurred or to ensure that there are no errors in the accounting records. There is an obligation to express an opinion as to the truth and fairness of the prescribed matters together with a statutory duty to report to the ASC certain malpractices that are uncovered; and
- . to report on the adequacy of the internal audit of the entity under audit. The internal auditor should detect shortcomings in the internal audit and be in a position to deduce from this the commission of frauds and errors.⁷⁰

4.7.34 The Corporations Law provides that an auditor is obliged to report to the ASC 'if he/she is satisfied' that there has been a breach of the law and that if the auditor is unable to deal with the matter by bringing it to the attention of the directors or by referring to it in the audit report. The obligation to report overrides both contractual and professional confidentiality and failure to do so can expose the auditor to prosecution. The accountancy bodies suggested that the term 'is satisfied' presents problems because it requires a high degree of proof and so should be replaced by the expression, 'having reasonable grounds to suspect.'⁷¹

4.7.35 The ASC stated that, "the key function for ensuring satisfactory standards of corporate accounting is that of the auditor."⁷² The ASC noted that where shareholders suffer loss as a result of reliance on audited accounts which fail

⁷⁰ Evidence, pp.647-657.

⁷¹ Evidence, p.S650.

⁷² Evidence, p.S835.

to contain matters that should have been recorded, an important remedy lies against the auditor.

4.7.36 The ASC referred to a recent case decided by the House of Lords (Caparo Industries case).⁷³ A shareholder who relied on the company's accounts (which had been negligently audited) in deciding to make a takeover offer sought to recover the loss in an action against the auditors. The House of Lords decision limited the duty owed by auditors to shareholders to matters related to the management of the company and not to shareholder interests as potential purchasers of sellers of shares. In its submission, the ASC considered that the decision in Caparo could well be followed in Australia.⁷⁴ The Caparo case was distinguished in the subsequent English Court of Appeal case of Morgan Crucible Co PLC v Hill Samuel & Co⁷⁵ on a basis which suggested that auditors would be liable for financial statements prepared as part of a published takeover defence, but they would not be liable to shareholders in respect of the annual statutory audit, which was the Caparo case situation.

4.7.37 Professor Baxt referred to the Caparo decision in his evidence to the Committee. He was of the view that the implications of the decision were very undesirable and that the legislature should intervene to reverse the decision if the Australian Courts were to follow it.⁷⁶

4.7.38 The ASC contended that Caparo may have the effect of leading auditors to believe that the liability to which they are subject through the courts is less than they might have previously expected and that this is undesirable. But that the finding goes to the identity of the parties who may recover damages where an audit has been negligent rather than going to the standard of care that might be expected of the auditor.⁷⁷

⁷³ Caparo Industries PLC v Dickman (1990) BCC 164

⁷⁴ *ibid.*

⁷⁵ (1991) BCC 82

⁷⁶ Evidence, p.37, Melbourne, 1 August 1990.

⁷⁷ Evidence, p.S835.

4.7.39 The ASC also discussed whether the legislative sanctions available are adequate to maintain the proper standards of auditors. It noted the statutory duty of auditors to inform the Commission of breaches of the legislation and accounts. The ASC also pointed out that its consent is required under sub-section 329(5) of the Corporations Law for the resignation of auditors. NCSC release No.162 indicates that the overriding concern in granting or refusing consent is to ascertain whether the auditor is seeking to avoid the consequences of a difficult decision that is needed to uphold the independence of the audit function. The power to cancel or suspend the registration of a registered company auditor for failure to discharge their duties is conferred not on the ASC but on the Companies Auditors and Liquidators Disciplinary Board. The ASC must make application to that Board if it considers that an auditor should be disciplined. The ASC submitted that in practice this complicates the enforcement of auditor's duties by requiring a substantial level of investigation before the ASC can take action to rectify breaches

4.7.40 The ASC proposed that it should have the power to obtain an order from the Court, where circumstances indicate a breach of proper auditing standards, and that the company should be ordered to submit to the audit of its accounts in certain specified respects, by another registered company auditor approved by the Court.⁷⁸

Other Matters of Concern

'Due Process' of Standard Setting

4.7.41 Professor Walker of the Australian Shareholders' Association was critical of the exclusive control the accountancy profession has concerning the setting of accountancy standards. The events of the 1980s, he argued, showed how unsuccessful the profession's standards have been and that Parliament should take a greater role.⁷⁹ He also referred to the divergent interests amongst the profession between auditors and accountants:

⁷⁸ Evidence, p.S836.

⁷⁹ Evidence, p.228, Sydney, 3 September 1990.

“... auditors in my view, would generally like to see precise standards, corporate accountants prefer them drafted a little more loosely.”⁸⁰

4.7.42 Mr Christopher Westworth, a Partner of the chartered accountancy firm, Ernst and Young, was asked to comment on these observations. His concern was that accounting standards are now included into company law, so that accountants are “quasi-lawyers trying to interpret fine points of wording.”⁸¹ For Mr Westworth the trend for a more legalistic approach to standards creates problems in interpreting the standard sensibly and encourages a practice of looking for loopholes.⁸² The much broader expression, “that accounts should give a true and fair view”, Mr Westworth stated, provides a much broader and more sensible approach to material that has to be disclosed.⁸³

4.7.43 Mr Westworth did refer to the matter of the accountancy profession having a monopoly on the prescription of the standards. He argued that it is the interests of the entire community that are affected and so “for accounting standards to be useful they need input from people other than accountants.” The Committee agrees but notes that the Australian Accounting Standards Board has as one of its functions “to engage in such public consultation as may be necessary to decide whether or not it should make a proposed accounting standard” (s.226 of the Australian Securities Commission Act).

4.7.44 Mr Lynn of Coopers Lybrand also made a suggestion regarding the accountancy standards. His firm recommended to the Committee that the corporations legislation:

⁸⁰ Evidence, p.229, Sydney, 3 September 1990.

⁸¹ Evidence, p.280, Sydney, 3 September 1990.

⁸² Evidence, p.287, Sydney, 3 September 1990.

⁸³ Evidence, p.280, Sydney, 3 September 1990.

“be made neutral as far as accounting issues are concerned so that the Accounting Standards Review Board can quickly issue whatever standards are needed at a particular time without having to wait for changes in the law.”⁸⁴

4.7.45 Mr Lynn suggested that greater parliamentary/business involvement in the preparation of accounting standards could be accommodated. He did not, however, favour legislative prescription of standards, as such a mechanism would be cumbersome and ‘would not be conducive to the timely issuance of standards which often are required fairly quickly to deal with an emerging problem.’⁸⁵

4.7.46 The Committee agrees that it is desirable that the provisions of the Corporations Law not impede the Accounting Standard setting process and recommends:

RECOMMENDATION 16

4.7.47 The Committee recommends that the provisions of the Corporations Law not impede the prompt application of accounting standards so that the Australian Accounting Standards Board can quickly issue whatever standards are needed at a particular time without having to wait for changes in the Law.

Corporate Conduct and Suggestions for Reform

4.7.48 There is now substantial public evidence about the serious malpractices carried out during the 1980s by senior management and directors of numerous notable public companies. A continual theme in submissions to the Inquiry has been the unacceptable conduct of some directors and interests associated with management which seriously disadvantaged shareholders.

⁸⁴ Evidence, p.339, Sydney, 4 September 1990.

⁸⁵ Evidence, p.353, Sydney, 4 September 1990.

4.7.49 Two discussion papers, one entitled, 'A Draft Code for the Conduct of Directors' and the other, 'Corporate Practices and Conduct' were brought to the attention of the Committee by the Australian Institute of Company Directors.⁸⁶

4.7.50 Whilst Chairman of the NCSC Mr Henry Bosch commented that the latter paper was prepared "in an attempt to clarify and raise the standards of conduct in Australian business."⁸⁷ It was drafted by a working party, chaired by the NCSC and including the ASX, the Business Council of Australia, the Institute of Chartered Accountants and the Institute of Company Directors. Mr Bosch stated that the paper was prepared:

"In response to the perceived damage to the reputation of Australian business as a result of the activities of a small minority of people in some prominent companies."⁸⁸

4.7.51 The discussion paper sets out principles of conduct and practice for company directors and boards, it encourages greater disclosure of information and recommends:

- . public companies should include a majority of non-executive (independent) directors;
- . public companies should have audit committees, preferably comprised of non-executive directors; and
- . in most cases the role of chief executive officer and chairman should be separated.⁸⁹

⁸⁶ Evidence, p.354, Sydney, 4 September 1990.

⁸⁷ NCSC, Annual Report 1989-1990, p.10.

⁸⁸ *ibid.*

⁸⁹ Evidence, p.S458 (Business Council of Australia).

4.7.52 A very large number of organisations and persons who made submissions to the Inquiry suggested or supported one or several of these proposals, particularly the establishment of audit committees. The Business Council of Australia,⁹⁰ the Australian Shareholders' Association, the Institute of Company Directors, Mr Henry Bosch, Ernst and Young, the Institute of Chartered Accountants, the Society of Accountants and the Australian Securities Commission all advocated the creation of audit committees.⁹¹

4.7.53 The accountancy bodies observed that audit committees are not a panacea for all of the problems of the corporate sector, but they do:

- . affirm the real and perceived independence of external auditors;
- . improve the quality of audit reports;
- . improve the channels of communication between the auditor and the board and the internal auditor;
- . provide an overall check on management performance and reduce the influence of dominant chief executives; and
- . improve the effectiveness of the internal function.⁹²

⁹⁰ *ibid.*

⁹¹ Respectively,
Evidence, p.S112;
Evidence, p.S355;
Evidence, p.S162;
Evidence, p.S284;
Evidence, p.S653; and
Evidence, p.S712.

⁹² Evidence, pp.S653-655.

Committee's Conclusions

4.7.54 The evidence to the Committee on accounts and auditing practices covered an extensive range of matters including:

- . true and fair view test;
- . consolidated group accounts;
- . related party transactions;
- . role and responsibility of auditors;
- . preparation of accountancy standards; and
- . proposals for public companies to have audit committees.

4.7.55 The Committee notes that in the past few months there have been significant developments in relation to the questions of the true and fair view test, consolidated group accounts and related party transactions:

- . as mentioned earlier in this Chapter, for companies with a balance date of 31 December 1991 or later, the problems of the abuse of the true and fair view test have been addressed;
- . for those same companies there is now an obligation to consolidate accounts with respect to a much wider range of entities, namely those that are "controlled" and whether they are incorporated or unincorporated;
- . in relation to related party transactions, AASB 1017 will cause more detailed disclosure to be made;

further, there are 3 detailed proposals which attempt to deal with related party transactions and matters of general disclosure which, if implemented, would see further improvements; these are the CSAC "Report on Reform of the Law Governing Corporate Financial Transactions", the CSAC "Report on Enhanced Statutory Disclosure System" and the ASX exposure draft of proposed Listing Rule amendments to become operative in January 1992.

4.7.56 Substantial evidence was submitted to the Committee with regard to auditing practices and the role of auditors. Leading auditing companies highlighted the lack of knowledge as to compliance with auditing standards. The accountancy bodies mentioned the need for more effective review of the application of accountancy standards and expanding existing surveillance procedures. The Committee urges the professional bodies to strengthen their practices in this regard otherwise the Parliament may have to take a greater regulatory role if self-regulation and enforcement is seen as weak.

RECOMMENDATION 17

4.7.57 The Committee recommends that the Australian Auditing Standards Board should be given similar recognition in the Corporations Law as the Australian Accounting Standards Board. A unit should be established by the Australian Auditing Standards Board to monitor the compliance with the prescribed auditing Standards.

4.7.58 Section 332(10) of the Corporations Law currently obliges auditors to report to the ASC if they are 'satisfied' a breach of the law has occurred. The accountancy bodies convinced the Committee that the use of the term 'satisfied' presents problems because it requires an unduly high degree of proof before the auditor can make a report. It also highlights inadequacies in the qualified privilege protecting auditors.

RECOMMENDATION 18

4.7.59 The Committee recommends that section 332(10) of the Corporations Law be amended so that auditors, required by the provision to notify the Australian Securities Commission of malpractices that the audit has revealed, should be obliged to report the matter where they have 'reasonable grounds to suspect' rather than needing to be 'satisfied' that the malpractice has occurred.

4.7.60 The Committee is also favourably inclined to a proposal of the ASC to promote the maintenance of proper auditing standards and enable the Commission to respond in extreme cases of abuse of audit and accounting practices. The ASC proposed that it have a power to obtain an order from the Court, where circumstances indicate a breach of audit standards, that the company be ordered to submit an audit of its accounts (in certain respects) to a registered company auditor approved by the Court.⁹³

RECOMMENDATION 19

4.7.61 The Committee recommends that, where it is established that the auditors of a company have breached proper auditing standards, the Court should have the power to order that the accounts of that company be audited by an auditor appointed by the Court.

4.7.62 In addition because of the notorious abuses and activities by senior corporate figures and the need to monitor activities of senior management the Committee strongly supports the establishment of audit committees for public companies. The Committee makes a recommendation on this matter in chapter 5.

4.7.63 The Committee believes its recommendations will go some way to ensure that directors responsibilities for disclosure will be of such a scope as to prevent the abuses apparent in the 1980s in the corporate sector.

⁹³ Evidence, p.S836.