

FINANCIAL REPORTING

Background

3.1 Disclosures made by companies must provide a reliable portrayal of their financial condition and performance, be informative, and timely in order to sustain an informed market and ensure the development of market confidence. Currently companies provide financial and non-financial information to the market through a variety of means, including their annual financial statements and pursuant to the disclosure and reporting requirements contained in the Australian Stock Exchange's Listing Rules.

3.2 A number of submissions have suggested to the Committee that the financial reporting model in Australia needs to be improved. For example, KPMG told the Committee:

The financial reporting model must be improved to more transparently describe business operations, disclose leading indicators and trends and better inform investors about risks and performance.¹

3.3 PricewaterhouseCoopers succinctly summarised the need to consider reform in the area of financial reporting when they told the Committee:

Public trust in our capital markets can be strengthened, if all the participants in corporate reporting commit to...a robust global corporate reporting framework grounded in transparency, accountability and integrity. Transparency is the obligation to willingly provide to shareholders the information needed to make decisions.²

1 KPMG, *Submission No.34*, p.S313

2 Mr Anthony Harrington, *Transcript*, pa.136

- 3.4 This chapter will address some of the contemporary issues related to financial reporting in Australia, including a discussion of potential reforms.

Accounting standards

- 3.5 The accounting standards prescribe the rules and measures, which largely govern the form and content of a company's financial statements. Taken together, the more than 40 standards provide a comprehensive and complex financial reporting and disclosure framework. Several of the standards run to more than 50 pages in length and one, *AASB 1020 – Income Taxes* is nearly 150 pages in length.
- 3.6 The current framework for the development of accounting standards in Australia is contained in Part 12 of the *Australian Securities and Investments Commission (ASIC) Act 2001*. Heading this framework is the Financial Reporting Council (FRC), whose functions are listed in Section 225 of the Act and which include, providing broad oversight of the accounting setting process in Australia and providing direction to the Australian Accounting Standards Board (AASB). The AASB is responsible for the technical development work associated with the accounting standards.
- 3.7 The Committee has considered issues associated with Australian accounting standards under the following headings:
- Principle-based;
 - Harmonisation with international accounting standards; and
 - Quality of the measurement rules.

Principle-based

- 3.8 A number of submissions to the Committee contended that the accounting standards should be 'principle-based' rather than contain a series of prescriptive rules as this is the most effective way to best ensure that financial reporting practices reflect the economic substance, not the form, of the transaction.
- 3.9 For example, the Australian National Audit Office (ANAO) advised the Committee that accounting standards should clearly set down the intent of the standard setters so that companies and auditors are discouraged from

adopting schemes or techniques or using accounting practices designed to subvert those intentions.³

- 3.10 The ANAO further described the concept of moving to a more principle-based framework as follows:

I think we need to get the standards right. I like the idea...of principles based or making a clear message of what this standard is seeking to achieve and what it is seeking to stop...⁴

- 3.11 Mr Robert K. Herman, Chief Accountant with the United States Securities and Exchange Commission (SEC) recently commented that principle-based accounting standards are the best foundation for making financial reporting more relevant to investors and are more effective than prescriptive rules in enabling preparers and auditors to evaluate whether the overall impact of the method of reporting a transaction is consistent with the objective of the standard.⁵

- 3.12 The preparation of financial statements involves a large degree of subjectivity and the use of professional judgement. Ernst & Young nominated the area of judgement in the selection of accounting methods and in the selection of a method of disclosure as perhaps the area of greatest risk to auditors. They told the Committee:

One of the difficult issues in auditing and, I suppose in financial statement preparation, is exercising judgement in certain areas around the sorts of rules contained in the accounting standards.⁶

- 3.13 Mixed views were expressed to the Committee concerning the nature of Australia's accounting standards. For example, Ernst & Young described Australia's accounting standards as 'principle-based' which, with some exceptions (which are discussed below), largely reflect the international accounting standards.⁷

- 3.14 On the other hand, Mr John Shanahan told the Committee that Australia's accounting standards contained a lot of prescription and the Australian Institute of Company Directors suggested to the Committee that:

3 Australian National Audit Office, *Submission* No. 27, p.S234

4 Mr Ian McPhee, *Transcript*, pa.58

5 Herman, R, 'Testimony Concerning The Roles of the SEC and the FASB in Establishing GAAP', House Sub-Committee on Capital Markets, Insurance and Government Sponsored Enterprises, US Congress.

6 Mr Brian Long, *Transcript*, pa.91

7 Ernst & Young, *Submission* No. 57, p.S530

...what we have at the moment in accounting standards is a mixture, it is a composite of principles combined with some prescription.⁸

- 3.15 In the Committee's view, accurate and relevant financial reporting is more likely to occur when the disciplines contained in accounting standards are principle-based but supported by an appropriate level of description and prescription.

Harmonisation with international accounting standards

- 3.16 Since 1996 Australia has pursued a policy of harmonising its accounting standards with the international accounting standards. The AASB, under the auspices of the FRC, has played an important role in this program.
- 3.17 The FRC announced on 3rd July 2002, that it had directed the AASB to work towards the full adoption of international accounting standards in Australia from January 1, 2005.
- 3.18 This announcement is consistent with the views expressed by the European Commission, which had previously endorsed the application of the international accounting standards within the European Union by the same date.
- 3.19 In the United States, the Financial Accounting Standards Board (FASB) has the stated objective of participating in international activities so as to increase the international comparability and the quality of standards used in the United States. It hopes the ultimate outcome of these efforts will be the worldwide use of a single set of high-quality accounting standards.
- 3.20 Strong support for the processes of developing international accounting standards and Australia's commitment to harmonising with those standards has been expressed to the Committee. For example, PricewaterhouseCoopers told the Committee:

...what we have achieved in setting accounting standards over the years is the establishment of a global board with the right skills and experience...⁹

- 3.21 Typical of the comments the Committee received in submissions was:
- ‘...(due to) the interconnection of global financial markets and the increasing number of Australian corporations either operating or seeking capital in international markets the harmonisation of Australian Accounting Standards with the International

8 Mr Stuart Grant, *Transcript*, pa.169

9 Ms Jan McCahey, *Transcript*, pa.143

Accounting Standards is an imperative. Improving the efficiency of Australian capital markets requires improvement in the accountability of private and public sector reporting, which leads to increasing demand for high quality, internationally comparable financial information'.¹⁰

3.22 KPMG told the Committee that increases in the comparability of financial information flowing from the process of harmonisation will lower financial information risk in the market and enable more efficient movement of capital.

3.23 However, they also identified that the process of harmonisation is likely to require companies to expend significant amounts of time and money understanding the differences between Australian and International accounting standards and in reflecting these differences in their financial reporting systems.¹¹ Pitcher Partners told the Committee that the relative cost of compliance was likely to be much greater on proprietary companies and identified that there is:

...a serious risk that changes to the financial reporting framework in Australia will not respond to the needs of privately owned Australian business, and will stifle rather than encourage growth.¹²

3.24 There is also evidence of some risks in adopting international standards. For example, Professor Bob Walker was recently reported as saying that the process of harmonisation had weakened several pre-existing Australian standards. He indicated there have been a number of initiatives that have been removed in the process of harmonising with international accounting standards, which have actually weakened some of our reporting rules.¹³

3.25 In addition, a number of submissions, while supportive of the policy of harmonisation, have highlighted that Australia should not accept lower standards while pursuing the goal of harmonisation nor that significant gaps are left or created in our accounting standards. For example, Ernst & Young told the Committee that:

...some Australian standards are of higher quality than their IAS equivalents – eg AASB 1017 – Related Party Disclosures. This standard has been effective as a deterrent to related party transactions and has had a positive effect on corporate governance in Australia. It would be a loss for Australian corporate

10 Deloitte Touche Tohmatsu, *Submission No.23*, p.S192

11 KPMG, *Submission No.71*, p.S652

12 Pitcher Partners, *Submission No.72*, p.S655

13 'Account Standards Third-Rate', *The Sun-Herald*, 30 June 2002

governance to substitute AASB 1017 with IAS 24, which, in our opinion, is a weak standard.¹⁴

- 3.26 Given these concerns the Committee notes that the processes leading to the adoption of international accounting standards must be sufficiently robust to deal with difficulties and disagreements as they arise and in particular, ensure that due recognition is given to good financial reporting practices in Australia. Moreover, sound processes are important to ensure that any contentious issues are resolved before the international accounting standards are presented to the Parliament for its consideration.¹⁵

Quality of measurement rules (the reliability of financial information)

- 3.27 A number of concerns have been expressed, in the media and to the Committee, as to whether the existing accounting standards are sufficiently robust to fulfil the role of ensuring the production of relevant and reliable financial reporting. For example, Professor Ian Ramsay was recently reported as saying:

We need to ask whether what is being disclosed and signed off on is meaningful. There is a real question about how much information is meaningful in terms of identifying major issues for companies.¹⁶

- 3.28 In their submission, Professors Dean, Clarke and Wolnizer suggested that financial statements prepared in accordance with the prescribed accounting rules will not disclose a company's financial performance or its financial position in any meaningful or serviceable way.¹⁷
- 3.29 In addition, Professor John Ryan contended in his submission that the proper application of the accounting standards does not guarantee consistent measurement of profit over time within a company nor for the same period amongst different companies.¹⁸
- 3.30 Mr Keith Alfredson, Chairman of the AASB, advised the Committee that the value at which assets and liabilities are recognised in financial statements is governed by the measurement rules contained in the accounting standards. He also indicated that, at the present time,

14 Ernst & Young, *Submission No.57*, pp.S530-531

15 Section 334 of the *Corporations Act 2001* makes accounting standards disallowable instruments for the purposes of section 46A of the *Acts Interpretation Act 1901*.

16 'Check the Change' *The Bulletin*, April 30, 2002, p.44

17 Professor Graeme Dean, Emeritus Professor Frank Clarke and Professor Peter Wolnizer, *Submission No. 11*, p.S83

18 Professor John Ryan, *Submission No. 9*, p.S73

Australia's *Statements of Accounting Concepts* do not address the issue of measurement.¹⁹

- 3.31 On the other hand, the International Accounting Standards Board's *Framework for the Preparation and Presentation of Financial Statement* does include discussion on the bases of measuring the elements of financial statements. This framework, which is not inconsistent with the measurement practices contained in Australia's accounting standards, recognises that different measurement bases may need to be applied, depending on the circumstances, to produce relevant and reliable information in the financial statements. In summary, the measurement bases commonly used in accounting standards include the following:
- historical cost - assets are recorded at the amount of cash (or cash equivalents) paid to acquire the asset or at the fair value of the consideration, and liabilities are recorded at the amount of proceeds received for the obligation, or at the amounts of cash (or cash equivalents) expected to be paid to satisfy the liability in the normal course of business;
 - current cost - assets are carried at the amount of cash (or cash equivalents) that would have to be paid if that asset was acquired currently, and liabilities are carried at the amount of cash or cash equivalents that would be required to settle the obligation currently;
 - market or realisable value - assets are carried at the amount of cash (or cash equivalents) that could currently be obtained by selling the asset in an orderly disposal and liabilities are carried at the amount of cash (or cash equivalents) expected to be paid to satisfy the liabilities in the normal course of business; and
 - present value - assets are carried at the discounted value of the future net cash inflows that the item is expected to generate in the normal course of business, and liabilities are carried at the discounted value of future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.
- 3.32 Mr Tom Ravlic told the Committee²⁰ that mandating one method of measurement was not appropriate, rather, it is more critical to have a framework in place to ensure that the most appropriate measurement rule, in the particular circumstances, is selected. In this way, the financial information produced is more likely to be reliable and relevant. He

19 Mr Keith Alfredson, *Correspondence*, 5 August 2002. The statements of accounting concepts form part of the conceptual framework, which is a principle-based model used by the AASB for the purpose of developing and evaluating accounting standards.

20 Mr Tom Ravlic, *Submission* No. 61, p.S553-564

contends that the measurement rules, per se, do not give rise to unreliable results, but rather, the inappropriate application of those rules results in unreliable and irrelevant financial results.

- 3.33 In addition to general concerns about the veracity of the accounting standards, a number of submissions pinpointed contentious issues and deficiencies in the recognition and measurement rules in the Australian accounting standards. For example, PricewaterhouseCoopers told the Committee:

...there are a number of gaps in Australian accounting standards which mean that they do not reflect world's best practice in several areas. Some significant issues are not dealt with by Australian standards and while others are addressed, the requirements of the Australian standards on these issues are not as robust as those in the relevant international standards.²¹

- 3.34 Amongst the areas of concern referred to the Committee were issues associated with the accounting for:

- leases;
- financial instruments, including derivatives;
- intangible assets;
- executives' and directors' remuneration;
- share options;
- investment properties;
- pensions or superannuation accounting; and
- accounting for the impairment of assets, in particular, the veracity of the *recoverable amount* test.

- 3.35 The Committee explored two of these issues in further detail during the inquiry. These issues, which are indicative of the shortcomings highlighted above, highlight the need for further and continuing work to tighten Australia's and the International accounting standards to ensure they remain relevant to the production of meaningful and reliable financial information.

Leases

- 3.36 Mr John Shanahan suggested to the Committee that accounting practices allowed under the Australian accounting standard on leasing (*AASB 1008*) may not, in all cases, accurately reflect the true economic position of the
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21 PricewaterhouseCoopers, *Submission No. 60*, p.S548

leasing transaction, that is, that the leasee has acquired an asset and a corresponding liability.²² Further he told the Committee:

Clearly most leases are financing transactions...our accounting standard is so badly drafted (that) you can keep a lease off balance sheet. You can analyse the standard in such a way as to achieve your desired result.²³

- 3.37 PricewaterhouseCoopers told the Committee that these concerns should be addressed by proposals currently being considered by the International Accounting Standards Board (IASB) which should:

...revamp the rules on lease accounting so that all non-cancellable leases would be seen on balance sheets as liabilities and assets...²⁴

- 3.38 The ANAO suggests current concerns might be addressed if the stated purpose of *Accounting Standard AASB 1008 – Leasing* was expanded to say:

The purpose of this leasing standard is to prescribe the accounting for leasing transactions so that the use of leases as a means of off-balance sheet financing is to be restricted to a limited number of circumstances.²⁵

- 3.39 In conclusion, the Committee considers that the effectiveness of this standard should be reviewed to determine if it is sufficiently robust to ensure that the true economic outcome of all leasing transactions is reflected in financial reports.

Share-options

- 3.40 A number of respondents have expressed to the Committee their concerns as to the lack of an accounting standard dealing with share options, in particular the introduction of rules requiring the expensing of the value of these share options. For example, Ernst & Young told the Committee:

...legislation, perhaps through accounting standards, will assist in getting consistency in treatment (of equity-based compensation arrangements)...²⁶

- 3.41 In Australia at present, accounting standard *AASB 1017- Related Party Disclosures* requires the disclosure of certain information surrounding stock options in the notes to the accounts. Some enhancements to this level of disclosure is proposed in *Exposure Draft ED 106 – Director*,

22 Mr John Shanahan, *Submission* No.35, p.S325

23 Mr John Shanahan, *Transcript*, pa.164 / 165

24 Ms Jan McCahey, *Transcript*, pa.137

25 Australian National Audit Office, *Submission* No.27, p.S234

26 Mr Brian Long, *Transcript*, pa.91

Executive and Related Party Disclosures. Further, under the *Corporations Act 2001*, the Annual Directors' Report (which is not part of the annual financial report) must also disclose details of share options granted to the company's Directors.²⁷

- 3.42 The Institute of Chartered Accountants in Australia (ICAA) was recently reported as saying that there was a need to go beyond disclosure in the notes, to a requirement to expense the value of these share options in the determination of operating profit or loss. This is because incentive arrangements to managers made through share issue schemes are in essence, substitute payments for salaries and that by not doing so, a company can distort its reported financial performance.²⁸
- 3.43 In the United States, *Financial Accounting Statement 123 - Accounting for Stock-Based Compensation* establishes the financial accounting and reporting standards for stock-based employee compensation plans in the US. The standard indicates that it is preferable for the value of stock options to be recognised as an expense but allows companies to disclose the value in a footnote and therefore not in the determination of profit or loss. The Committee understands that virtually all companies chose the latter course of disclosure.²⁹
- 3.44 It was reported on 16 July, that the Coca-Cola company had announced it was changing its accounting treatment to expense the value of options granted to executives and employees. Mr Douglas N. Daft, the Chairman and Chief Executive was reported as saying:
- ...stock options are a form of employee compensation expense and the change in accounting ensures that our earnings will more clearly reflect economic reality...³⁰
- 3.45 It has recently been reported that the IASB plans to release an exposure draft on accounting for share based payments by September, which is expected to propose that stock options awarded to employees should be charged as an expense based on a fair value measurement method.
- 3.46 Mr Keith Alfredson, Chairman of the AASB, while expressing his support for the notion of expensing the value of share options, advised the Committee:
- In Australia there is a serious impediment to charging share options in the profit and loss account.³¹
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27 Section 300 of the *Corporations Act 2001*.

28 'Expensing share options urged by ICAA', available from <http://www.icaa.org.au/news>

29 It has been estimated that, as result of not expensing stock options, in aggregate US profits were overstated by nearly 20 per cent in 2000, *The Australian Financial Review*, 7 June 2002.

30 'Coke to Report Stock Options as an Expense', available from <http://www.nytimes.com>

- 3.47 He advised the Committee that he had raised this matter in writing with Senator the Hon. Helen Coonan, Minister for Revenue and Assistant Treasurer. In that letter he outlined the board's concern that the current taxation rules, in particular, those relating to the tainting of share capital, may present a serious impediment to the recognition of the value of share options.
- 3.48 The Committee supports the introduction of better accounting rules in relation to expensing share options. It notes, however, there are a number of practical issues that are likely to impact on both companies and individuals. These issues relate to taxation matters such as reduction in profits available for distribution, timing and recognition of income distribution and the treatment of dividends.
- 3.49 In conclusion, the Committee believes the value of share options should be recognised as an expense in the determination of operating profit or loss. However, the Committee understands that the introduction of changes to accounting rules may give rise to a number of practical issues that will need to be addressed.

Conclusion

- 3.50 As an integral part of the process of the adoption of the international accounting standards, the FRC and the AASB need to continue to address identified deficiencies in Australia's accounting standards, and where Australia's standards are of high quality or meet international best practice, ensure our standards are not diminished.
- 3.51 Rather than mandating any particular measurement rule or method, the Committee believes the more fundamental issue to be addressed, is the establishment of a clear framework governing the formulation of those rules. That framework must require that the method chosen best reflects, in the individual circumstances, the value of the assets and liabilities controlled by the company. In this regard, the most appropriate value will be the one, which objectively provides the most reliable and relevant result for the users of those financial statements.³²

31 Mr Keith Alfredson, *Transcript*, pa.252

32 As indicated at para 3.64, the terms 'reliable' and 'relevance' are key attributes of useful financial reporting. AASB 1001 (*Accounting Policies*) says that information is 'reliable' when users can depend on it to represent faithfully and without bias the transactions of a company and is 'relevant' when it assists users make decisions concerning their resources.

Recommendation 5

- 3.52 **In the process of adopting the international accounting standards by January 1 2005, as announced by the FRC, the AASB should ensure that those contentious issues and deficiencies identified by the Committee are resolved as a matter of priority at the earliest possible date.**

True and Fair View

- 3.53 In light of deficiencies in the accounting standards, it is of considerable concern to the Committee that it received conflicting interpretations of the application of true and fair view requirement in the *Corporations Act 2001*.
- 3.54 In regard to financial reporting, the *Corporations Act 2001* says:
- the financial report of a company, which is not a small proprietary company, must be prepared in accordance with the accounting standards (Section 296);
 - the financial report must give a true and fair view of the financial position and performance of the company (Section 297);
 - if the financial statements and notes prepared in accordance with accounting standards do not give a true and fair view, additional information must be included in the notes to give a true and fair view (Section 297); and
 - Auditors are required to form an opinion as to whether the financial report is in accordance with the Act, including section 296 and section 297 (Section 308).
- 3.55 There was considerable disagreement among the respondents on the notion of true and fair in the *Corporations Act 2001*. Some submissions have contended that the primary obligation should be to report on compliance with accounting standards and that the true and fair view should only be given secondary consideration. The Australian Institute of Company Directors advised the Committee:

The predominant requirement (in the *Corporations Act*) is compliance with the rules, which are embraced, in accounting standards. There is a secondary requirement, which is true and fair view, which we believe is somewhat neglected because of the focus on the specific requirements, because they are so extensive.³³

3.56 They added:

...the true and fair view has tended to be only if you do not agree with the standard, so it is one-sided assessment instead of an all-embracing assessment.³⁴

3.57 On the other hand, some respondents have suggested that the primary obligation should be to report a true and fair view, rather than compliance with the accounting standards or that the *Corporations Act 2001* should contain what is commonly termed a true and fair override.

3.58 The Australian Auditing and Assurance Standards Board told the Committee that the *Corporations Act* already contains an override, in the sense that it requires the disclosure of extra information if there are concerns that compliance with accounting standards doesn't give a true and fair view.³⁵

3.59 Mr Mark Leibler told the Committee that he considered that much of the evidence offered to, and the discussions before the Committee suggested that people did not properly understand the notion of the true and fair requirement. He indicated he was concerned that there may be a fundamental gap between audit practice, in relation to the true and fair view and what the *Corporations Act* requires.

3.60 Mr Leibler contends that the obligations to comply with accounting standards and to provide a true and fair view of the financial position and financial performance are separate tests, both of which must be satisfied. He told the Committee that the provisions of the *Corporations Act* provide the best of both worlds because:

...comparability and objectivity are enhanced by the requirement to ensure that the body of the accounts comply with accounting standards. On the other hand, the integrity of corporate financial reporting is preserved by the requirement to include in the notes to the accounts such information which may be necessary to give a true and fair view of the company's financial position and performance.³⁶

3.61 It has been suggested to the Committee that complying with accounting standards will, in most cases, produce financial statements, which portray a true and fair view. For example, the Australian Securities and Investments Commission (ASIC) told the Committee that the application

34 Mr Stuart Grant, *Transcript*, pa.169

35 Mr William Edge, *Transcript*, pa.80

36 Mr Mark Leibler, *Submission No.68*, p.S631

of accounting standards, should provide an expectation that the financial reports are reliable and present a true and fair view.³⁷

3.62 ASIC subsequently advised the Committee that the basis on which accounting standards are developed (contained in Part 12 of the *ASIC Act*) is designed to ensure that proper adherence to the standards should, ordinarily result in financial statements that produce a true and fair view.³⁸

3.63 In addition, Mr Keith Alfredson, Chairman of the AASB expressed similar views when he told the Committee that the accounting standards:

...provide an essential underpinning to the *Corporations Act* requirement that accounts are required to give a true and fair view.³⁹

3.64 The following extracts provide some justification for that reasoning. *Statement of Accounting Concept SAC 3 - Qualitative Characteristics of Financial Information*⁴⁰, identifies relevance and reliability as the key attributes that financial information should possess in order for financial reports to be useful to the users of that information. SAC 3 requires that these two attributes should be central to the selection of accounting policies and in the exercise of judgement.

3.65 The principles in SAC 3 are reinforced throughout the accounting standards, most significantly in Australian Accounting Standard AASB 1001 '*Accounting Policies*'. This standard requires that, for the substance of transactions to be reported, accounting policies should be selected and applied so as to ensure the resultant financial information is both relevant and reliable. The standard goes on to say:

For financial information to satisfy both the relevance and reliability concepts, it is necessary that the substance rather than the form of a transaction or other events is reported (in situations) where the substance and form differ. Reporting the substance of a transaction or other event requires that the information reported reflects its economic effect.

Determining the substance of a transaction or other event involves identifying all of its aspects and implications, and considering the position of each of the parties to it, including their expectations and motivations for entering into the transaction or other event.

37 Mr Malcolm Rodgers, *Transcript*, pa.233

38 Australian Securities and Investments Commission, *Submission* No. 66, p.S600

39 Mr Keith Alfredson, *Transcript*, pa.247

40 SAC 3 is part of the conceptual framework mentioned at paragraph 3.30.

- 3.66 While compliance with accounting standards may provide a strong expectation that the financial statements present a true and fair view. The Committee considers it inappropriate to conclude that, by meeting the requirements of section 296 (compliance with accounting standards), directors can be automatically taken to have satisfied (wholly or partly) the requirements of section 297 (true and fair view). For example, the effects on profit measurement and on the statement of financial position arising from shortcomings in the accounting rules over leases and share options, illustrate how compliance with accounting standards may not result in financial reports which give a true and fair view.
- 3.67 The Committee considers that the subjectivity and exercise of judgement, necessarily involved in the interpretation of accounting standards, and in light of the deficiencies in those standards (as illustrated above) means that compliance with accounting standards cannot guarantee that overall, financial statements will reflect a true and fair position in all cases.
- 3.68 Accordingly, the Committee considers, that to satisfy the requirements of section 297, directors and auditors make a separate assessment as to whether, in light of the totality of the circumstances, the financial statements present a true and fair view.
- 3.69 In other words, the Committee considers that directors and auditors must separately consider whether the financial statements comply with accounting standards and, at the same time, provide a true and fair view.**
- 3.70 However, the Committee does not consider this is the end of the issue. More fundamentally, it needs to be explained how a true and fair assessment should be made. There is currently no guidance in the *Corporations Act 2001* as to how to complete the assessment and, in the Committee's opinion, this is a major weakness. It is considered the *Corporations Act* should better enunciate how to meet the true and fair test.
- 3.71 The Committee considers attempting to define the term, true and fair would be difficult and may have the effect of limiting its interpretation. As Mr Leibler told the Committee:
- There is no agreement or authoritative judicial pronouncement on the meaning of the expression 'true and fair view'. Accordingly, in any given case, there may be a range of acceptable 'true and fair views'.⁴¹
- 3.72 Professor R. G. Walker told the Committee that in 1983, a review of corporate reporting by the former National Companies and Securities

41 Mr Mark Leibler, *Submission No. 68*, p.S632

Commission developed the following definition of the requirement for financial statements to provide a true and fair view:

...a true and fair view...means a representation which affords those who might reasonably be expected to refer to those accounts...information which is relevant to the decisions which may be made by those persons in relation to the purchase, sale or other action in connection with their securities or interests.⁴²

3.73 The Committee considers a better approach would be to establish a series of principles or a framework against which the assessment can be made.

3.74 To this end, the Committee agrees with Mr Tom Ravlic who told the Committee that the truth and fairness of financial statements is largely dependent on the interpretation and application of the accounting standards. He said:

A sensible interpretation of accounting rules needs to be ensured before you even begin to address the proposition that accounts must be both in compliance with accounting standards and true and fair.⁴³

3.75 Given this and in light of ASIC's comments at paragraph 3.62, the Committee considers a reasonable interpretation of true and fair can be made by reference to Part 12 of the *ASIC Act*. This part, as mentioned at paragraph 3.6, contains the framework within which Australia's accounting standards are developed.

3.76 Particularly relevant is Section 224 of the *ASIC Act*, which sets out the objectives of that Part of the Act. Amongst these objectives is facilitating the development of accounting standards to produce financial information exhibiting, amongst other things, the following 'qualitative characteristics'⁴⁴:

- allowing users to make and evaluate decisions about allocating scarce resources;
- of relevance to assessing performance, financial position, financing and investment; and
- are reliable and understandable.

42 Professor R G Walker, *Submission No 41*, p.S384

43 Mr Tom Ravlic, *Submission No. 61*, p.S562

44 These qualitative characteristics are consistent with the qualitative characteristics expressed in SAC 3.

- 3.77 Also relevant in this regard is Section 228 of the *ASIC Act*, which requires accounting standards to be interpreted in a way that is consistent with the objectives in Section 224.

Conclusion

- 3.78 The Committee believes a separate assessment is required to consider whether the financial statements, prepared in accordance with the accounting standards, produce a result which is true and fair.
- 3.79 The Committee considers that to provide a means for greater clarity and consistency, the assessment of true and fair should be made in light of the essential characteristics of financial information contained in Section 224 (a) of the *ASIC Act*. Including a reference to this section in Section 297 of the *Corporations Act 2001* would have the added benefit of ensuring that a true and fair view outcome is considered in the interpretations of accounting standards.
- 3.80 In order to further reinforce the application of the true and fair assessment, the Committee considers a further relevant amendment to section 297 (true and fair view) would be to replace the current footnote which says:

If the financial statements and notes prepared in compliance with the accounting standards would not give a true and fair view, additional information must be included in the notes to the financial statements under paragraph 295(3)(c).

With the following words:

In the case of conflict between sections 296 (compliance with accounting standards) and 297 (true and fair view), the notes to the financial statements must indicate why, in the opinion of the directors, compliance with the accounting standards would not give a true and fair view of the financial performance and position of the company. The notes to the financial statements must include a reconciliation to provide additional information necessary to give a true and fair view.

Recommendation 6

- 3.81 **That Section 297 of the *Corporations Act 2001* be amended as follows:**
- **add the requirements that, in undertaking the assessment of a true and fair view, directors must consider the objectives contained in section 224 (a) of the *ASIC Act* and must include a statement in the financial report that they have done so.**

- **delete the current footnote that states:**

If the financial statements and notes prepared in compliance with the accounting standards would not give a true and fair view, additional information must be included in the notes to the financial statements under paragraph 295(3)(c).

- **add the following new sub-sections:**

In the case of conflict between sections 296 (compliance with accounting standards) and 297 (true and fair view), the notes to the financial statements must indicate why, in the opinion of the directors, compliance with the accounting standards would not give a true and fair view of the financial performance and position of the company.

The notes to the financial statements must include a reconciliation to provide additional information necessary to give a true and fair view.

- 3.82 As discussed in Chapter 4, the auditor (separately from the directors) is required to form an opinion and report on whether the financial report presents a true and fair view. To further support the expansion of the true and fair view assessment, the Committee considers it appropriate that the *Corporations Act 2001* be amended to require auditors to also form an opinion and report on any additional disclosure made by directors pursuant to Section 297 (true and fair view).

Recommendation 7

- 3.83 **It is recommended that Sections 307 and 308 of the *Corporations Act 2001* be amended to require the auditor to form an opinion and report on any additional disclosure made pursuant to Section 297.**

Continuous disclosure

- 3.84 Shareholders and investors are demanding more frequent and informative reporting because it increases their ability to better understand the impact of the information being presented, and in particular the risks underlying that information.
- 3.85 The ASX administers a regime requiring the continuous disclosure of certain information (Chapter 3 of the ASX Listing Rules). Continuous

disclosure is defined in those Listing Rules as the timely provision of certain information to keep the market informed of events and developments as they occur.

- 3.86 Chapter 3 of the Listing Rules has general provisions which require the disclosure of any information (with certain exceptions) that a reasonable person would expect to have a material effect on the price or value of the entity's securities and specific provisions, which require the disclosure of information concerning a series of prescribed events.
- 3.87 In the United States, Mr Harvey Pitt, Chairman of the SEC, recently announced an intention to seek public comment on a proposal to significantly expand the list of items which require intra-period (or current) disclosure by public companies.⁴⁵
- 3.88 It was suggested to the Committee that the current continuous disclosure regime should be reviewed to ensure it captures timely and relevant information because a robust regime of continuous disclosure, supported by proportionate and timely sanctions, remains the best means of sustaining a well informed market.⁴⁶
- 3.89 In July the ASX, which considers the promotion of a culture of disclosure plays an important role in enhancing the quality of Australian companies, released a discussion paper titled '*Enhanced Disclosure*.'⁴⁷ This paper contained a series of proposed amendments to enhance the effectiveness of continuous disclosure listing rule (3.1). For example, amongst other things, the reforms are designed to:
- ...emphasise the responsibility of companies to make the disclosure necessary to avoid an uninformed market.
- 3.90 Ms Jillian Segal, Deputy Chair of ASIC recently suggested that many companies regard the continuous disclosure obligations as an impediment and that the corporate culture and attitudes towards disclosure and compliance need to be enhanced. She also indicated that a system of sanctions, including fines and penalties should be introduced for offences such as late or inadequate disclosure.⁴⁸
- 3.91 Mr Rodney Bennett also suggested to the Committee that in order to ensure the integrity of the market is maintained and to add discipline to the continuous disclosure process the regulators need to get tougher in

45 '*Accounting and Investor Protection Issues*', Testimony to US Senate Committee on Banking, Housing and Urban Affairs, March 2002

46 Australian Securities and Investments Commission, *Submission No. 39*, p.S375

47 available from <http://www.asx.com.au>

48 '*Current areas of concern to ASIC regarding corporate disclosure*', Jillian Segal, Deputy Chair, ASIC, 20 March 2002

relation to disclosure and financial reporting. He told the Committee this would encourage better compliance with the financial disclosure requirements and the lodgement of documents.⁴⁹

Conclusion

- 3.92 The continuous disclosure rules are a powerful tool to ensure the maintenance of a well-informed and therefore efficient market. The Committee supports the recent reforms proposed by the ASX to further improve the effectiveness of these rules and to clarify the disclosure obligations of companies.

Statutory oversight of financial reporting

- 3.93 Among the measures designed to enhance the integrity of corporate financial reporting has been the recent public announcements by the corporate regulators in Australia and the United States that they are adopting more robust mechanisms to monitor compliance with the financial reporting rules.
- 3.94 In Australia, Mr David Knott, the Chairman of ASIC announced on 12 July, that the Commission was developing a more rigorous accounting surveillance practice to apply to selected listed companies for the financial year ended 30 June 2002. The primary focus of the project will be to review compliance with a series of nominated accounting standards.⁵⁰
- 3.95 In the US, the SEC has proposed to significantly expand its review of financial and non-financial disclosures to focus on disclosure that is important to understanding the companies financial position and results and which, at least at face value, seems to conflict with accounting standards or be materially deficient in explanation or clarity.⁵¹

Conclusion

- 3.96 The Committee considers that a program of financial reporting surveillance, with appropriate levels of sanctions and penalties, is critical in the enforcement of accounting standards and compliance with the *Corporations Act 2001* and is pleased with ASIC's stated intention to increase its level of activity in the area of financial surveillance.
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49 Mr Rodney Bennett, *Submission* Nos. 4 and 24, pp.S47 & S199

50 ASIC Media Release, 12 July 2002

51 Testimony by Mr Harvey Pitt, Chairman of the SEC, concerning *The Corporate and Auditing Accountability, Responsibility and Transparency Act*, before the US House of Representatives Committee on Financial Services, March 2002

- 3.97 The Committee hopes that this increase in the level of activity is not a unique event, and suggests ASIC develop a systematic process that occurs each year and in which every listed company has an equal chance of being selected for review. As well as ensuring compliance with the accounting standards, it is considered ASIC might also evaluate whether the information contained in the financial statements is sufficient to provide a true and fair view.

Further reforms in the area of disclosure

- 3.98 Many submissions to the Committee have highlighted the need for further improvements in financial reporting and disclosure requirements so as to provide a more comprehensive view of the state of affairs and value of the reporting company. By way of example, the following is a selection of the views expressed to the Committee in regards to financial reporting reforms:

- The Institute of Chartered Accountants in Australia told the Committee:
...we see that the added benefit can be made by adding disclosures to the type of accounting that is being applied.⁵²
- The Auditor-General for Victoria suggested the financial reporting framework would be enhanced by a requirement for management to provide a written representation as to the effectiveness of the company's internal control structure and also provide a commentary on the main factors affecting the financial performance, financial position and financing and investing activities of a company.⁵³
- Ernst & Young advised that there was a need for a greater level of transparency in the reporting of accounting policies and suggested companies could be required to report upon:
...the quality of accounting practices where judgement has been exercised.⁵⁴
- PricewaterhouseCoopers told the Committee:
The Audit Committee and potentially the board...should comment in the annual report on the adequacy of their corporate risk management policies and procedures.⁵⁵

52 Mr Neil Faulkner, *Transcript*, pa.33

53 Auditor General Victoria, *Submission* No 25, p.S212

54 Mr Brian Long, *Transcript*, pa.95

55 Mr Anthony Harrington, *Transcript*, pa.141

- CPA Australia proposed there ought to be increased disclosure regarding matters involving estimates, assumptions or judgement.⁵⁶
- Mr John Hammond suggested to the Committee that listed companies should be required to report against a series of key performance ratios.⁵⁷

3.99 The following is a summary of recent activity in the areas in which the Committee considers reform is required in Australia.

Internal controls

3.100 The reliability of financial information is heavily dependent on the maintenance of a system of internal controls. The internal control system can be defined as:

The policies, processes, tasks, behaviours ...designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- effectiveness and efficiency of operations;
- reliability of financial reporting; and
- compliance with applicable laws and regulations.⁵⁸

3.101 There have been numerous calls for greater levels of public reporting on internal control arrangements. In Australia, for example, a research study commissioned by the accounting professional bodies in 1993, recommended, amongst other things, that management should be required to report on the effectiveness of their company's internal control processes.⁵⁹

3.102 More recently, in 1997 the Organisation for Economic Cooperation and Development recommended, amongst other things, that management should be encouraged to make statements concerning their internal control mechanisms,⁶⁰ and in 1999, the Institute of Chartered Accountants in England & Wales, provided guidance on appropriate levels of disclosure about processes to assess the effectiveness of the risk management practices and internal control systems.⁶¹

56 Mr Brian Blood, *Transcript*, pa.21

57 Mr John Hammond, *Submission*, No.19, p.S143

58 '*Report of the Committee of Sponsoring Organisations of the Treadway Commission*', Committee of Sponsoring Organisations (COSO), 1992

59 ICCA, *Exhibit No. 5*,

60 '*Convention on Combating Bribery of Foreign Public Officials in International Business Transactions*', Organisations for Economic Cooperation and Development, 1997, <http://www.oecd.org>.

61 '*Internal Control – Guidance for Directors on the Combined Code*', Institute of Chartered Accountants in England and Wales, September 1999

- 3.103 A key part of an effective internal control system is a risk management process. The Institute of Chartered Accountants in England & Wales has recently suggested that companies should provide more disclosure on their major business risks and detail those strategies in place to deal with them. In a paper titled '*Working for better risk reporting*'⁶² the Institute claims that investors need a proper understanding of the risks affecting the business and that there would be benefits to companies disclosing more information on their risk management processes, including whether there is an on-going process for identifying, evaluating and managing the significant risks faced by the company; and what action the company takes to manage those risks.
- 3.104 Section 404 of the *Public Company Accounting Reform and Investor Protection Act, 2002* in the US requires management to provide an assessment of the effectiveness of their internal control structure in the annual report. The same section also requires the auditor to attest to, and report on that assessment.

Management Discussion and Analysis

- 3.105 Another area where there have been calls for greater disclosure is in relation to information to assist users in the assessment of a company's performance. This is commonly termed as *Management Discussion and Analysis* disclosure.
- 3.106 For example, the 'Expectation Gap' research study mentioned previously, recommended companies provide in their annual reports an outline of the entity's objectives and strategic plans and comment on the impact of material changes in accounting policies.
- 3.107 In their submission, CPA Australia told the committee that:
- ...listed public companies and other disclosing entities be required to prepare a *Management Discussion and Analysis* report to be included in the financial report...⁶³
- 3.108 Professor Ramsay was recently reported as saying:
- Perhaps management or directors should be required to address the three or four most critical accounting issues and make some prominent disclosure in the annual report – in other words, discuss whether the financial statements would be different if other assumptions were made.⁶⁴

62 Available from <http://www.icaew.co.uk/index.cfm>.

63 CPA Australia, *Submission* No. 33, p.S298

64 '*Running an audit of the Auditors*', Sydney Morning Herald, 20 April 2002

- 3.109 Mr Harvey Pitt, the Chairman of the US Securities and Exchange Commission recently highlighted that informative and timely disclosure by public companies was one of the key areas for reform. In particular, he proposed a series of reviews of the SEC's disclosure rules to require companies to provide the following information in their annual reports:
- critical accounting policies – require companies to identify and provide more precise disclosures about the application of their most critical accounting policies, including an analysis of the sensitivity of estimates derived from those policies;
 - off-balance sheet obligations and contingencies – disclosure of transactions and the nature of relationships with unconsolidated entities, including description of their business purpose and economic substances and disclosure of the factors impacting on off-balance-sheet financing arrangements; and
 - trend information – inclusion of information about trends and forward-looking information.⁶⁵

Conclusion

- 3.110 There was clear evidence provided to the Committee calling for improvements in financial reporting and disclosure requirements so as to provide a more comprehensive view of the state of affairs and value of the reporting company. As discussed in other sections of this report, the traditional model of corporate reporting and auditing is no longer tenable as shareholders and other stakeholders seek more comprehensive information. Stakeholders are also demanding assurances on aspects of a company's performance outside the narrow scope of the financial reports. In recognition of these changes, the Committee considers that enhancements to the level of disclosure, particularly in the areas identified (although this list is by no means exhaustive), is critical to improving the usefulness of financial reporting.
- 3.111 This recommendation is made in the context of Recommendation 3, which calls for corporate governance standards in the *Corporations Act 2001* and Recommendation 10, relating to an expansion in the scope of the audit. It also picks up the Committee's view, in paragraph 2.41, that information on performance management or appraisal arrangements for directors and executives should be disclosed.

65 'Testimony Concerning Accounting and Investor Protection Issues', Harvey Pitt, Chairman SEC, United States Senate Committee on Banking, Housing and Urban Affairs

Recommendation 8

3.112 It is recommended that the Australian Stock Exchange amend the Listing Rules to require additional reporting by companies in the following areas:

- **commentary on internal control systems, including risk management processes;**
- **management discussion and analysis;**
- **commentary on the main factors affecting reported financial performance and financial position;**
- **commentary on the key judgements made in the application of accounting policies;**
- **results for a set of key performance indicators pointing to the health of the organisation; and**
- **details of directors' and executives' performance appraisal or management systems .**