

Arnold Bloch Leibler

Opening statement *by Mark Leibler AO*

*To the Joint Committee of Public Accounts
and Audit in its Review of Independent Auditing
by Registered Company Auditors,
Melbourne 26 July 2002*

- 1 The submission speaks for itself – especially the conclusions.
- 2 The bottom line is this:
 - (a) the law requires that financial reports comply both with accounting standards and present a true and fair view.
 - (b) if there is a conflict between accounting standards and a true and fair view then, in effect, a reconciliation is to be provided in the notes to the accounts.
 - (c) the suggestion that compliance with accounting standards ipso facto amounts to giving a true and fair view is unsustainable as a matter of law. The law has two separate requirements and expressly provides for how a potential conflict is to be resolved.
- 3 As a matter of law, accounts cannot be said to give a true and fair view if they provide a misleading picture of "the financial position and performance of the company". These latter words are not of my making – they are the very words used in the Corporations Act.
- 4 The words "the financial position and performance of the company", were first introduced into the Corporations Law in 1998. The explanatory memorandum which accompanied the 1998 amendment stated that this approach of linking "true and fair view" with "the financial position and performance of the company" was viewed as being consistent with "information that is relevant to the assessment of performance, financial position and financing and investing". I repeat, "information that is relevant to the assessment of performance, financial position and financing and investing".
- 5 I argue, and passionately believe, that a move to "mark to market" accounting is necessary in order to give a true and fair view. However, I recognise that this suggestion, if taken all the way, is viewed by some as controversial. For my part, I accept that "mark to market" raises some difficult issues, for example, in relation to the treatment of wasting assets and special purpose buildings and plant.

What I do say, however, is that in order to give meaning to the expression "true and fair view", at the very minimum, you start with "mark to market" and work backwards from there.
- 6 It is important, however, for the Committee to understand that the basic thrust of my thesis is not dependent on adopting a purist approach to "mark to market" accounting. Whether or not "mark to market" accounting is adopted, it is demonstrable and beyond argument that, in many cases, compliance with accounting standards can and does produce grotesque and misleading accounts which cannot be viewed as complying with the "true and fair view" requirement. Let's take, for example, the case of a building acquired for \$20 million, now worth \$10 million, and included in the accounts at \$20 million simply on the basis that the **undiscounted** – I repeat, undiscounted - cash flows resulting from the sale of the building and net leasing cash flow produces **in 10 years' time** – I repeat in 10 years' time – that figure of \$20 million.
- 7 Let me give you another example. It concerns the treatment of goodwill. A company buys a milk bar for \$500,000 of which \$400,000 represents intangibles, that is goodwill. Accounting standards require that goodwill be amortised over a period of not more than 20 years and that it be taken into account at cost less amortisation. If the readily realisable goodwill value of the milk bar increased by another \$1 million over 2 years, that key fact could never be gleaned from looking at the accounts. However, by giving effect to "the true and fair view" requirement, the notes ought to bring that additional value of \$1 million into account. In practice, this does not happen.
- 8 By the way, just in case you wondered, the goodwill which is represented by a brand name can be brought into account at fair market value and there is no requirement for amortisation.
- 9 The standards which mandate these different treatments are referred to by my accountant colleagues as accounting standards. **I say that they are more accurately described as legally mandated accounting distortions.**

- 10 My submission, I believe, demonstrates that accountants do not understand their legal obligations. Take Michael Coleman, National Managing Partner, Risk and Regulation of KPMG, who stated in evidence to this Committee:

"I believe that if 'true and fair' was returned to the primacy position that it was previously in, an auditor has another very strong tool, because an auditor then has to say to the board of directors or to the management, 'I'm sorry but the actual accounts, even though they may comply with accounting standards, are still not right. I don't believe that they are right?' I would really like to see the true and fair override reintroduced". (Evidence, 8 July 2002, PA213).

Mr Chairman, I put it to you that under the law as it stands today, without any amendment, the auditor would be obligated in the circumstances outlined by Mr Coleman to say to the board of directors "I am sorry but the actual accounts, even though they may comply with accounting standards, are still not right. This has to be rectified by way of a reconciliation note to the accounts". Mr Coleman's misunderstanding of the auditor's legal obligation is clearly reflected in the general practice of the auditing profession today. Alarming, he is not alone. Far from it.

- 11 I regret to say that ASIC bears a significant part of the responsibility for the failure on the part of auditors to carry out their legal responsibilities. ASIC is the enforcement agency. ASIC has an obligation to provide the audit profession with its view of what "a true and fair view" means. It is an independent requirement and cannot, as a matter of law, simply be equated to compliance with accounting standards.
- 12 I have with me a copy of the latest amended legislation that has been introduced into the United States Congress. Indeed, I believe it has just been passed by the House of Representatives. That legislation, if passed, will require each set of accounts to be accompanied by a statement signed by the CEO and CFO attesting to the appropriateness of the accounts and that they "fairly present, in all material respects, the operations and financial condition of the company". (S.302 of the 'Public Company Accounting Reform and Investor Protection Bill of 2002).
- 13 Isn't it ironic that just when the United States is introducing "a true and fair view" override, ASIC is writing to the chairmen of all public companies to inform them that they must be scrupulous in abiding by the accounting standards. **Moreover, and I don't say this lightly, today, when giving evidence before this Committee, ASIC issued an open invitation to directors and auditors to flout the law. Mr Rodgers said that the law should not be read as a general invitation to rewrite accounts, prepared in accordance with accounting standards, in order to give a true and fair view. But that is precisely what the law requires.**

What ASIC should have been telling public company chairmen is that whilst it is important to comply with accounting standards, this is not enough. And it is not enough as a matter of law. ASIC should have been emphasising that corporate financial reports must, independently of compliance with accounting standards, give "a true and fair view" and that compliance with accounting standards will not necessarily achieve this legal objective. ASIC has a duty to insist that an appropriately highlighted reconciliation statement should be incorporated in the notes to the accounts where this is necessary to ensure that they give "a true and fair view".

- 14 In the Media Release which this committee issued earlier this week, it made two significant observations:
- (a) "We now have a golden opportunity to get things right".
 - (b) "The regulatory bodies need to be firm in enforcing the law".

In my view, the committee got it right on both counts. Right now, the law as it stands is not being enforced. Right now, the critical need is to ensure that the law as it stands is enforced.

- 15 Finally, for the sake of completeness, I should point out that the Committee's enquiry deals with auditing and therefore my focus has been on the role of auditors. However, everything I have said applies, and with even more force, in relation to the legal obligations of public company directors.

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This publication is intended to provide a general outline and is not intended to be a complete or definitive statement of the law on the subject matter covered. Further professional advice should be sought before any action is taken in relation to the matters described in this publication.

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