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Auditors and ASIC – A true and fair view

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In the United States we have recently witnessed the sudden collapses of Enron and WorldCom. Here we have had HIH, One.Tel and Harris Scarfe. While there has been a tendency to blame the auditors, these disasters have not been caused by auditing practices. Bad management is inevitably a root cause. But misleading accounts serve to exacerbate the destruction, with investors buying and selling on the stock exchange unaware of what the accounts are failing to disclose. Something is seriously wrong when the financial statements of apparently healthy but, in reality, doomed companies have largely complied with the demands of accounting standards.

I am on the public record for emphasising the dual legal requirements for audited accounts to comply with accounting standards and also to present a true and fair view. Additionally, I am on the record for criticising auditors, directors and ASIC for ignoring these legal requirements. This has caused some controversy, but I'm used to that. I welcome this debate in the public interest because it has the potential to change mindsets.

My view may be regarded by some accountants, with fixed views, as an extreme one. But I'm prepared to stand by it, if it ultimately improves the lot of the investor and shareholder.

The Corporations Act 2001 requires that financial reports of Australian public companies both comply with accounting standards and give 'a true and fair view' of the 'financial position and performance of the company'. If there is a conflict between the two requirements, then 'the true and fair view' must be reflected through further information to be incorporated in the notes to the accounts.

The explanatory memorandum which accompanied the 1998 amendments to the Corporations Law, inserting a reference, for the first time, to 'the financial position and performance of the company', stated that this approach was viewed as being consistent with 'information that is relevant to the assessment of performance, financial position and financing and investing'.

I am absolutely convinced that a move to market value and economically realistic accounting, through a 'mark to market' approach, is necessary to give such 'a true and fair view'. Yes, 'mark to market' raises some difficult issues, for example, in relation to the treatment of wasting assets and special purpose plant, but at the very least we must start with it and work backwards from there.

Some say that this would bring in too much subjectivity and too much judgement and ought therefore to be categorically rejected. But this is patently ridiculous. Is it seriously suggested that just because judgements may differ we have no option but to revert to a system of financial reporting that provides a largely irrelevant historical record of a company's financial dealings?

I am well aware that there is no agreement or authoritative court judgements on what 'true and fair view' means. I am also well aware that the requirement is to give 'a true and fair view' – not 'the true and fair view', so that there may be a range of acceptable views in any given case. But just because we cannot find a 'one size fits all' definition doesn't mean that we are entitled to render the concept totally devoid of content and therefore useless.

Whether or not 'mark to market' accounting is adopted, it is beyond argument that in many cases compliance with accounting standards can and does produce grotesque and misleading accounts that in no way comply with the 'true and fair view' requirement.

Let's take the case of a building acquired two years ago for \$20 million, now worth \$10 million, and included in the accounts at \$20 million simply on the basis that the undiscounted cash flows resulting from the sale of the building and net leasing cash flow produces in 10 years time, that figure of \$20 million.

You would have to be pretty stupid to believe that the \$20 million represents the true economic financial position and the \$10 million does not, but that's the kind of distorted result that accounting standards produce.

I fully support the view expressed recently by Keith Alfredson, Chairman of the Australian Accounting Standards Board, that once a set of accounts has been prepared in accordance with accounting standards, the directors and auditors 'then have to sit back and say, "Is there anything so wrong with these accounts that a reasonable reader would believe they do not give a true and fair view?"' But it's clear from recent evidence that, in practice, those who audit our companies either don't understand, or, more alarmingly, choose to ignore their legally mandated obligations to do just that.

The ability to sidestep such crucial legislative requirements is made possible by the fact that ASIC, the enforcement agency, either cannot, or will not, enforce the law.

In a recent media release ASIC invited the Chairmen of all listed companies 'to directly involve their boards in ensuring compliance with the relevant accounting standards'. But a search in that release for any reference to the 'true and fair view' requirement is a search in vain.

ASIC believes 'it would be a very heavy burden' to require every board of directors to separately enquire whether any set of accounts which complies with accounting standards also reflects 'a true and fair view'. Yet the assumption of this 'very heavy burden' is in fact a legal requirement.

In failing to enforce the law, is ASIC seriously suggesting that it is never possible to demonstrate that directors did not take all reasonable steps to comply with the "true and fair view" requirement?

What about my earlier example ?

And what about accounts which fail to disclose very substantial hidden reserves because of an accounting standard which requires goodwill be accounted for at cost less amortisation, notwithstanding that its readily realisable value, objectively determined, is far in excess of this?

Lets take another example. Two years ago, a company bought 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 will never appear in the accounts. And not even in a note to the accounts! True it may be that the buyer gets a bonanza, but what about the poor seller?

By the way, 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. So, if the milk bar in my example was branded, goodwill inherent in the name could be brought into account on this entirely different basis.

Of course, Australia is not alone, and certainly not the worst offender, with what I call legally mandated accounting distortions. Until recently, in the US, heavy reliance has been placed on accounting standards, there having been no requirement to provide a true and fair view.

Using as an example aircraft market prices pre- and post- September 11, 2001, Walter Schuetze, former chief accountant of the SEC, spectacularly highlighted the problems with the US approach in his testimony to a US Senate Committee earlier this year. Pre-September 11, the major airlines, to the extent that they own aircraft instead of leasing them, had, on their balance sheets, aircraft at the cost of acquiring them. Post-September 11, the market prices of each aircraft fell about fifty per cent - say from \$100 million to \$50 million. Yet, under the US Rules, those airlines continue to report each aircraft on their balance sheets at \$100 million. Under 'mark to market' accounting, Schuetze claims, each aircraft would be reported on the balance sheets at its real value of \$50 million.

It is no wonder, given recent events, that the law in the US has recently been changed to require CEOs and CFOs to certify, in effect, their belief that the company's accounts are true and fair.

Here, in Australia, the Corporations Act has long contemplated enforcement action by ASIC any time there is a failure to take reasonable steps to comply with the 'true and fair view' requirement.

But ASIC has never sought to enforce this requirement independently of compliance with accounting standards.

The real challenge for all of us now is to persuade directors, auditors and ASIC to better understand what the law requires and to encourage ASIC to take appropriate steps to enforce it.

The current debate highlights just how poorly served the investing public is by auditors. In other markets, we have focus groups to ensure that the customer's needs are targeted and satisfied. In the securities market the investor is the customer. But, in this market, unlike any other, the customer continues to be patronised by the arcane world of auditing practices, and doubly so because of ASIC's failure to police accounts according to legislative requirements.

Auditor independence is a core concern in Australia today. But 'independence' is only valuable to the extent that it enhances 'accountability' in financial reporting. 'Accountability', in turn, is only worth pursuing if it is directed at a meaningful outcome. If the legally mandated 'true and fair view' requirement is ignored, then reforms designed to enhance 'independence' and 'accountability' will not achieve the desired outcome, namely, financial reporting which is relevant to the needs of shareholders and potential investors.

The system we have here in Australia is pretty good. The key to avoiding further sudden and unexpected corporate collapses does not lie in radically overhauling the law. Tougher enforcement of existing law is what is required, now.

These are my opinions and personal ones at that. I'll leave it to you to decide whether they reflect a true and fair view of auditors and of ASIC.

Thank you.

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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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