OFFICE OF REGULATION REVIEW

INDUSTRY COMMISSION

Corporations Law
Simplification Task Force
Attorney-General's Department
BARTON ACT 2600

Attention: Mr Ian Govey

ACCOUNT AND AUDIT PROPOSALS

The Office of Regulation Review (ORR) offers the following comments on the Accounts and Audit element of the Corporations Law Simplification Program.

The ORR — located within the Industry Commission — is responsible for advising on the Commonwealth Government's regulation and review policy. The ORR reviews new regulations, monitors progress and participates in programs for the reform of existing regulations, and provides public information on regulatory matters.

Background

In making the following comments, the ORR seeks to assist the Simplification Task Force by:

- identifying relevant regulation review perspectives;
- discussing costs and benefits associated with the proposed regulatory amendments; and

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- where appropriate, commenting on perceived strengths and weaknesses in the proposed regulations.

The ORR offers some broad observations about the simplification of accounts and audits. In addition, of the 26 specific proposals made by the Task Force, the ORR comments specifically on aspects of eight: Proposals 5, 6, 7, 9, 11, 14, 15 and 25.

Accounts and audit simplification: general issues for consideration

Market failure

Regulations pertaining to accounts and audit are based on the premise that the market for the supply of information about the operation of entities is characterised by 'market failure'. In other words, key players such as shareholders, investors, auditors and regulators might have insufficient information to make informed decisions about financial asymmetries of entities. The ORR recognises that Task Force proposals, such as standardising forms of information, can enhance market efficiency.

Nevertheless, the ORR believes that it is desirable for the Task Force to identify areas of market failure in the provision of information. In seeking to redress perceived market failure, it is important to note that markets already encourage entities to provide information. For example, entities wishing to access services provided by capital markets or banks etc, need to prepare and provide detailed information. The ORR recognises that there can be disincentives for entities to release adverse information. However, to the extent that accurate information is already provided by entities because of demand for such information by markets, regulations are unnecessary.

In addition, where market failure is identified Task Force proposals should be 'efficient'. In other words, the goals of proposed regulations should be transparent, and proposals should seek to minimise costs to entities and society and maximise any benefits.

Identification of goals, costs and benefits of regulations

The 'Plan of Action' of the Corporations Law Simplification Program outlines priority areas for simplification, which include policies which 'place undue regulatory burdens on business'. To measure the burden of regulations on business, the ORR believes that the Task Force should identify and consider the objectives, costs and benefits of proposals under consideration.

However, in most cases existing Task Force proposals for simplification of accounts and audit do not analyse or discuss fundamental questions, such as the purpose of individual proposals, and their respective costs and benefits. It is important to note that the costs imposed by additional reporting requirement can be considerable in terms of increased costs and reduced competitiveness of Australian entities. In all cases, the benefits of proposed regulations must be identified and compared with costs. Merely simplifying corporations law might not yield significant benefits for commerce and industry, and the

Australian economy, if 'bad' laws are simplified. Thus, the onus is on the Task Force to identify fundamental issues, including the goals, costs and benefits of proposals.

There is an international dimension to presentation of accounts. As Australia becomes increasingly engaged in international business transactions, costs and benefits emerge from the efficiency of corporate information flowing between us and other countries. Whilst there may be perfectly good domestic reasons for arranging laws and regulations in our own way, the capacity of international business to readily familiarize themselves with our arrangements is a consideration.

Demand for information

The ownership structure of entities results in different demands for information. For example, it is unclear whether large proprietary companies should be required to provide the same amount of information as public companies. Where proprietary companies are required to provide additional information, the question should be asked, why is such information needed and under what circumstances should entities be required to provide such data.

It is also important to note that reporting requirements seek to ensure that information about the past performance of an entity is available. Yet past performance is not necessarily a useful guide to future performance, which is reflected in share prices which illustrate market perceptions about the future discounted income stream of an entity. It therefore is useful to note that no matter how detailed and comparable the data yielded by accounts and audits regulations, such information will always be of limited use in predicting future performance of entities.

Consistency of proposals with other rules and regulations

The existing proposals do not discuss or analyse the consistency of proposed regulations with other regulations and rules, such as stock exchange rules and regulations etc. Clearly, proposals of the Task Force, if implemented, will interact with other rules and regulations in a manner that effects the costs and benefits of proposals. Whilst each individual regulation might in principle have considerable merit and yield net benefits to society, the summation of regulations and they manner in which they interact can produce net costs, thus making society worse-off. Therefore, the ORR believes that it is essential for the Task Force to consider in greater detail the interaction and consistency of its proposals with existing rules and regulations in this area.

Role of the auditor

In specifying obligations of the auditor, the ORR believes that unnecessary rigidities should not be imposed that regulate the roles and functions of auditors. Regulations should also allow for flexibility in dealing with contingencies which might arise. For example, the question should be asked, do the proposals allow for auditors to attain a monopoly on certain reporting roles and should other qualified or interested persons have a role in reporting the financial disposition of entities?

Uniformity with accounting regulations

Whilst attaining uniformity of accounting regulations — providing for information efficiencies and allowing for comparisons between entities etc — could be a desirable objective, it is important that reporting requirements do not preclude the development and use of other standards which might evolve over time as a result of market demand, and yield useful information about the status of given entities. For example, any 'deemed to have complied' provisions need to allow for flexibility in the future for entities to use new and alternative mechanisms for providing information to players such as financial institutions, investors and regulators.

Proposal 5: A company which controls other entities will have to prepare annual accounts for the entity itself and for the whole group. This rule will not prevent the use of equity accounting in appropriate situations.

Issue: should 'control' be defined?

The ORR believes that a definition of 'control' in the Corporations Law should only be considered if there exists a problem with the interpretation of control as currently defined by the Accounting Standards Review Board in the accounting standard AASB 1024: Consolidated Accounts, which is either:

- not capable of being rectified by recommending a change to the standard; or
- if it can be shown that a definition of 'control' in the Corporations Law will be more efficient in correcting an existing problem.

Issue: are there circumstances when an entity could be relieved of the obligation to prepare consolidated accounts?

There will be instances where small companies will have wholly owned subsidiaries or control other companies, but the size of the group will still be comparatively small. A company group made up of small proprietary companies, the total of which fails the reporting test for a large proprietary company, should not be required to lodge consolidated accounts.

Proposal 6: As at present, disclosing entities will also have to prepare half-year accounts. If the entity controls another entity, it will only need to prepare consolidated half-year accounts.

Where markets result in entities continuously disclosing information about their performance, periodic reporting requirements might not be necessary. Bearing in mind previous ORR comments regarding market failure, if there is a case for annual reporting requirements, a separate case needs to be made justifying half yearly reports on the basis that they yield benefits that exceed costs.

Proposal 7: Accounts will comprise: a profit and loss statement, a balance sheet, a cash flow statement, notes to these 3 statements, additional disclosures required by the Law or the accounting standards.

The proposal 'additional disclosures required by the Law or the accounting standards' potentially embraces a wide range of regulations which might impose substantial costs on firms. An attempt should be made to identify these requirements — for example do they include laws governing equal employment opportunity, directors fees etc — along with an assessment of their likely costs and benefits. Any regulations that impose costs on firms and society which exceed tangible benefits should be specifically excluded from this proposal.

Proposal 9: The rules under which banks and life insurance companies are exempted from some of the accounting requirements in the Law will be repealed. These exemptions will, however, be preserved until the accounting standards currently being developed for these bodies are completed.

Issue: should the temporary exemption be given by regulation or by ASC class order?

The ORR believes that it is likely to be more efficient to have the ASC grant the exemption because:

- it will be faster and easier for the ASC, which has considerable experience in these matters, to grant the exemption; and
- the Corporations Law will not be cluttered with information that would be redundant once the accounting standards are approved.

Proposal 11: The directors will be required to prepare a report on the accounts. In this report, the directors must: state the accounts give a true and fair view, declare whether the company is solvent, and discuss and analyse the entity's financial condition and results of its operations.

Issue: should the auditor be required to express an opinion on the discussion and analysis? What would be the form of this opinion? For instance, should the auditor be required to state whether the discussion and analysis is consistent with the financial statements?

The proposal appears to be based on the premise that directors' reports need to be improved and that having the auditor comment on the directors' report will result in an improvement in the content. Requiring an auditor to express an opinion on the discussion and analysis by the directors is likely to result in an insignificant increase in information to shareholders, as auditors do not have the depth of knowledge of the operations of the company that the directors do.

In addition, by giving auditors an additional responsibility there is a real danger that the proposal will further widen the 'expectation gap' between what the public expects an auditor to do and what is actually done. The ORR believes that such a proposal may increase the 'expectation gap'.

The question should be asked, will this proposal overcome identified problems which cannot be resolved by means other than further regulation? The ORR suggests one possible approach which could be debated further, to require the auditor to attend the annual general meeting and be required to answer relevant questions. This would allow auditors to discuss the directors' report, their audit report and the methodologies they employed, so that shareholders can learn their true role and views. In addition, auditors would have the chance to respond to the shareholders, the people who indirectly employ them.

Proposal 14: Accounts (including consolidated accounts) which are required to be lodged with the ASC will have to be audited. The director's declaration about solvency will also have to be audited.

Issue: should the Law require auditors to comply with standards made by the Auditing Standards Board? If so, what should be the sanction for failure to comply with standards?

Legislative backing for auditing standards should only be implemented if it will overcome an identified problem more efficiently than any non regulatory option.

Audit reports are important to investor decision making and it is the investor who pays for the appointment of the auditor and the audit report. It has been widely acknowledged that the standard of audit work is sometimes inadequate, as has been illustrated in part by the flood of legal actions against auditors for negligence. This view is supported by the ASC's decision to undertake a surveillance program for auditors to raise the standard of their work.

Whilst the idea of embodying the auditing standards in the Corporations Law has some attraction, the question must be asked, is it the most efficient and effective solution? Could the current form of limited self regulation undertaken by the accounting professional associations be improved so that they self regulate, as has been done in England and Wales? This could be a more cost effective method of regulation than enshrining the standards in the Law.

Sanctions for failure to comply with standards needs to be set at a level which will result in the maximum public benefit. To achieve this various factors including the level of compliance that is desired, the costs of administration of the sanctions, the benefits of compliance with the standards and the cost of the sanctions deterring new participants into the auditing market, all need to be carefully considered.

Proposal 15: As at present, an audit report for annual accounts will state whether the accounts: comply with the Law, and give a true and fair view of the entity's financial position.

Issue: should the form of an audit report be specified in the Law? If not, should it have to state anything in addition to the two matters mentioned here?

Unless it can be demonstrated that the present system is not effective or that incorporating the form of reports in statute will result in benefits outweighing costs, the format should not be incorporated in statute.

Proposal 25: As at present, the ASC will be able to exempt companies from compliance with particular accounting obligations.

The grounds for granting of such exemptions, and the goals, costs and benefits of specific types of exemptions, have not been identified. The Task Force proposal should include a requirement for the ASC to undertake a detailed cost-benefit analysis prior to the granting of such exemptions.

The contact officer on these matters is Mr Barry Oliver whose telephone number is 2642228.

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