OFF-BALANCE SHEET FINANCING

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I. INTRODUCTION

The distress or failure of a series of high-profile Australian companies in the wake of the stock market crash of 1987 drew attention to a range of accounting and commercial practices which many commentators regarded as dubious, even aromatic. Indeed, the first chairman of the Australian Securities Commission ("ASC") Mr Tony Hartnell was moved to observe that trying to defend Australia's financial reputation abroad was like trying to sell old fish.

The term 'off balance sheet financing' was commonly used by both commentators and practitioners to describe some of these doubtful accounting and commercial practices. This paper reviews some of the major techniques for 'off balance-sheet financing', and offers an assessment of the likely effectiveness of recent regulatory reforms in curtailing the use of these techniques in the future.

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II. MAJOR TECHNIQUES FOR 'OFF BALANCE SHEET FINANCING'

The term 'off-balance sheet financing' connotes ways of understating the level of a firm's liabilities in published financial statements.

Why would businessmen wish to understate debt? One of the popular themes in the accounting research literature is that managerial behaviour can be explained in terms of existing contracts. Accordingly it is argued that managerial behaviour is affected by whether the firm has borrowed under terms and conditions which require it to maintain a certain level of liquidity, or to work within specified debt-equity ratios, or to limit external borrowings.[1] Off-balance sheet financing reflects managers' wish to get around these 'debt covenants'. During the 1980s many Australian corporations raised funds through borrowings, and accordingly would have been subject to restrictions required by lenders in terms of 'negative pledge' or other borrowing arrangements. It seems likely that these debt contracts may have influenced those corporations' commercial and accounting practices.

One classic device used to 'window-dress' balance sheets is extraordinary simple: a corporation pays out current liabilities shortly before balance date - and this improves the reported relationship between current assets and current liabilities. A more complicated example of a similar practice was available from the 1987 accounts of Bond Corporation Holdings Limited:

> Bond Corporation Holdings Limited's 1987 balance sheet showed that $456 million raised from the issue of convertible bonds were shown as "accounts receivable" at 30 June, even though the proceeds of which were not received until 9 July 1987. Further, $299.9 million of those anticipated proceeds were recorded as having been applied "to repay certain term advances" ie reducing the amounts recorded as owing to creditors.

Another material adjustment to the accounts arose from a change in the accounting treatment of both the provision for taxation and the asset item, 'future income tax benefits' reduced both by $156 million during 1986-87. Together, the treatment of convertible bonds and the adjustment to the provision for taxation 'improved' the reported financial position. The company revealed a current ratio (current assets to current liabilities) of 2:1. Without the adjustments, the ratio would have been a less-impressive 1:1.[2]

Another area of controversy concerned the treatment of convertible notes and whether they should be classed as 'debt' or as 'equity'. Many leading Australian 'entrepreneurial' corporations chose to report convertible notes as shareholders' equity, thus enhancing reported debt-equity ratios. One little-noted amendment to the statutory requirements for financial disclosure was aimed at this practice:

1 RL Watts "Corporate Financial Statements: A Product of the Market and Political Processes" (1977) 2 *Australian Journal of Management* 53; R Leftwich "Evidence of the Impact of Mandatory Chanages in Accounting Principles on Corporate Loan Agreements" (1981) 3 *Journal of Accounting and Economics* 3; RL Watts and JL Zimmerman *Positive Accounting Theory* (1986).

2 "Window-dressing at Bond Corporation" *Australian Business* (24 February 1988) pp 77-8.

the changes (which affected the requirements for a standard-format balance sheet) took effect from 30 September 1987, and read:

> Schedule 7 to the Companies Regulations is amended by omitting from subclause 6(1)
>
> Total shareholders' equity'
>
> and substituting
>
> 'Total shareholders' equity.'

If the addition of a full-stop after 'total shareholders' equity' was intended to stop corporations from grouping convertible notes with shareholders' funds and thereby putting a better face on debt-equity ratios, then it can safely be observed that the amendment did not work.

While the terms and conditions of borrowing arrangements appear to influence commercial and accounting practices, they do not by any means explain those practices. Other factors are at work. It seems likely that one of these is simply that directors and company officers may sometimes desire to convey an illusion of financial prudence and managerial success. Rapidly increasing levels of debt relative to aggregate shareholders' funds may convey the impression that managers are adopting risky financial strategies. Even though some of the transactions used to keep debt off balance sheet may be described in the accounts in a form that it is interpretable by skilled analysts, managers may still act on the assumption that lenders or investors may not fully comprehend the significance of those disclosures. Managers may believe that many readers of financial statements may be fixated with reported income, or with the key financial indicators reported in annual reports or in the print media.

This alternative interpretation is not looked on with favour by those who invoke references to the supposed 'efficiency' of the securities markets. Some commentators suggest that managers who undertake these activities are wasting their time - since the market can see through their choice of accounting policies.

However, whatever inferences are drawn from the findings of empirical research studies into reactions to accounting disclosures, it is inescapable that those studies are concerned with aggregate market behaviour, and not with the way in which individuals make judgements on the basis of published financial reports. Furthermore, while the introduction of legal requirements for the disclosure of accounting policies has made published financial reporting more transparent, the fact remains that even the most skilled analysts can not 'see through' the full effect of many techniques for placing debt off-balance sheet.

It is difficult to describe the main techniques used in off-balance sheet financing with any confidence: after all, the aim is to conceal debt, and parties engaged in such practices are hardly likely to flaunt their success in the art of concealment. Consequently, empirical evidence of successful off-balance sheet financing is, by definition, unavailable. However one can speculate: and in this spirit it is suggested that the main techniques recently used in Australia in the cause of off-balance sheet financing were the following:

(i) Leasing;
(ii) Non-consolidation of finance subsidiaries;
(iii) Non-consolidation of 'subsidiaries' through the use of trusts as part of a group structure, shares with differential voting rights, or other devices;
(iv) Asset and liability 'set-offs';
(v) Complex transactions.

These various techniques will be briefly reviewed.

A. LEASING

The use of leasing is arguably the oldest, simplest, and most commonly understood device for off-balance sheet financing. A corporation which acquires equipment through a simple purchase transaction on credit terms must record both an asset and a liability in its accounts. On the other hand, a corporation which enters into a lease transaction may avoid those entries and merely record lease payments as expenses in the periods in which those payments are made or fall due. In that situation, obligations to make payments for leases may not be shown in the company's balance sheet (though Schedule 5 of the *Corporations Regulations* does require disclosure in notes to the accounts of the amount and timing of those obligations).

The accounting profession has long anguished over the accounting treatment of leases. Presently there is something of an international consensus among profession-sponsored standard setting bodies that it is appropriate to make a distinction between 'finance' and 'operating' leases.[3]

In terms of standards produced by the accounting profession, operating leases are, as described above, not recorded as giving rise to assets and liabilities (save for any overdue lease instalments). On the other hand, finance leases are treated in terms of their 'substance' rather than their 'form'; the transaction is seen as the acquisition of an asset on credit terms. Hence an entity entering into a finance lease would record both an asset and a liability in its balance sheet.

In the interpretation of these accounting standards, the question of whether a contract gives rise to an operating or a finance lease rests to a large degree on professional judgement. The tendency of lessees and their advisors to find ways of ensuring that lease liabilities were kept "off-balance sheet" has frequently been remarked upon. One commentator observed that the USA's Financial Accounting Standards Board ("FASB") "needed three years to issue the first of its lease accounting rules. An imaginative lease broker needed about three hours to come up with three new lease arrangements that would get around the rules".[4]

An editorial note in the accounting profession's AAS 17 "Accounting for leases" suggests that "it may not be appropriate for the same classification to be

3 See Australian Accounting Standard "Accounting for Leases" AAS 17 (1984); reissued 1987; International Accounting Standard IAS 17 "Accounting for Leases" (March 1982); US Accounting Principles Board Opinion APB 5 (1964); US Financial Accounting Standard FAS 13 (1976).

4 DL Gerboth "The Accounting Game" (1987) 1 *Accounting Horizons* 96.

adopted by the lessor and lessee". A commentary in the standard AASB 1008 "Accounting for leases" (which applies to corporations) states that standard will "normally result" in a particular lease being identically classified by the lessee and the lessor involved. In practice, it appears that quite different perceptions about the classification of leases may be held by lessor and lessee - with lessees having a greater tendency to regard leases as 'operating'. Definitive statistics are not available, but the following may be indicative:

> The 1987 Australian Bureau of Statistics annual survey of finance companies revealed that lessors classified their lease receivables as finance leases $8.3 billion, operating leases $8.7 million - a ratio of more than 950: 1.
>
> The 1987 annual report of Coles Myer disclosed finance leases $50 million, while operating leases totaled $4 billion - a ratio of around 1:80.

A recent Australian development has been the release of a Statement of Accounting Concepts SAC 4[5] which includes definitions of key concepts such as 'asset' and 'liability'. A careful reading of SAC 4 suggests that the treatment of operating leases as a form of off-balance sheet financing may itself be questioned: on the face of it, operating leases should also be regarded as 'liabilities' - which gives rise to further questions about the desirability of recording as an 'asset' the right to receive future services. It seems likely that there will be further debate about this issue in years to come.

Meanwhile, in the context of current regulatory requirements, those managers who are anxious to place debt off-balance sheet will continue to seek to enter into lease arrangements which will be classed as operating. Lease brokers continue to market leases which they claim are structured so as to get around accounting standards - claiming that this will enhance (reported) financial position and rates of return.[6]

B. NON-CONSOLIDATION OF FINANCE SUBSIDIARIES

In the 1920s, Australian stock exchanges pioneered requirements for the disclosure of information about the performance and financial position of subsidiary companies; later they were among the earliest regulatory agencies to endorse the use of consolidated financial statements.[7]. However, despite these path-breaking steps, Australian accounting rules concerning the form and content of consolidated statements were minimal until the 1990s. The company law did not provide definitive guidance. The most significant statement by the accounting profession was not an 'approved' standard, or even a profession-sponsored 'Australian Accounting Standard', but was only a technical guideline with little authority, issued in the 1950s.[8]

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5 "Definition and Recognition of the Elements of Financial Statements" (March 1992).

6 See for example J Nigem "What are the Most Effective Ways of Keeping Leases Off the Balance Sheet?", IIR Conference *Accounting and Tax for Off-Balance Sheet Financing and Synthetic Instruments* (10 September 1991).

7 RW Gibson *Disclosure by Australian Companies* (1971) pp 135-40.

8 Australian Society of Accountants' "Statement on Accounting Practice No 1" (April 1956).

Accordingly, when the accounting profession produced an accounting standard, AAS 24 "Consolidated Financial Reports" (June 1990) it was widely regarded as long overdue - as was the legally-enforceable standard AASB 1024 "Consolidated Financial Accounts" (September 1991).

During the 1980s some basic rules governing the preparation of consolidated statements could be found in the *Companies Act and Codes*, which established requirements for the production of 'group accounts'. In terms of s 266(1), group accounts could consist of either consolidated statements encompassing a holding company and its subsidiaries, or the separate financial statements of those companies, or some combination of 'partial' consolidated statements and separate financial statements of subsidiaries which were not otherwise consolidated.

The idea that consolidated statements need not include any subsidiaries which were engaged in activities inconsistent with those undertaken by other companies in a group was extensively debated in the accounting literature between the 1930s and 1960s.[9] However that debate seemed to have been largely 'resolved' by the introduction of requirements for reports on the financial results of business segments.[10] Certainly in the USA the FASB had put the matter beyond doubt by issuing a standard FAS 94 (1987) which formally required corporations to consolidate all subsidiaries, regardless of the nature of their business activities.

In the absence of any local accounting standards on the subject, the 1980s saw a number of leading Australian corporations fail to consolidate their finance subsidiaries. For example:

> The 1987 annual report of Elders-IXL included consolidated statements which did not encompass finance subsidiary Elders Finance Group Ltd. Instead, the consolidated balance sheet showed the investment in the subsidiary at net assets of \$403 million. Had Elders Finance been consolidated, the consolidated balance sheet would have included additional assets of \$3,907 million and additional liabilities \$3,504 million (less any inter-company loans).

With the issue of AASB 1024, the non-consolidation of finance subsidiaries is prima facie illegal. However issue of the standard has failed to persuade many members of the business community that it is appropriate to consolidate the accounts of subsidiaries engaged in another area of business activity: life insurance. The argument is that it would be misleading to show as assets of a group, the resources which are being held for the beneficiaries of life insurance policies. It is understood that the Australian Accounting Research Foundation

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9 EL Kohler "Some Tentative Propositions Underlying Consolidated Reports" (1938) 13 *The Accounting Review* 63; SC Kingston "Consolidations and Reorganisations" (1940) *New York Certified Public Accountant* 532; J Peoples "The Preparation of Consolidated Statements" (Aug 1957) 104 *Journal of Accounting* 32; LH Rappaport "Accounting and the SEC" (1963) *New York Certified Public Accountant* 642; VL Andrews "Should Parent and Captive Finance Companies be Consolidated?" (Aug 1966) 122 *Journal of Accountancy* 48.

10 Australia AASB 1005 "Financial Reporting by Segments" (1986).

is currently examining the question of whether subsidiaries which are life insurance companies should be exempted from the consolidation requirements.

C. NON-CONSOLIDATION THROUGH USE OF TRUSTS, AND OTHER DEVICES

The *Companies Code* definitions of holding company-subsidiary company relationships referred only to 'companies', so that it was open to managers to utilise unincorporated vehicles (joint ventures, partnerships or trusts) if they wished to avoid consolidating subsidiaries.

> Documents filed in London during a 1985 takeover contest disclosed that Entrad Corporation Limited's corporate structure interposed trusts between the parent company and what would otherwise have been regarded as subsidiaries in terms of the *Companies Code*.
>
> Subsequent annual reports disclosed that trusts and unconsolidated subsidiaries "contribute to profitability through the payment of management fees, interest and other charges to Entrad Corp Ltd" - suggesting that Entrad was in a position to 'manage' reported earnings through discretionary payments. The 1987 audited annual accounts disclosed in its statement of accounting policies: "As the provisions of the Companies (New South Wales) Code do not allow the consolidation of unit trusts, the assets and liabilities of those trusts have not been included in the consolidated accounts". This note misrepresented the *Companies Code*, which did not require the consolidation of trusts but equally did not prohibit the practice in the form of supplementary statements or additional columns accompanying the prescribed form of group accounts.[11]

It could be argued that financial statements which did not consolidate trusts did not provide a true and fair view of the financial position and performance of a holding company. National Companies and Securities Commission ("NCSC") staff indicated that they had obtained legal advice from the Commonwealth Attorney-General's Department that the presentation of a consolidated statement which incorporated the financial statements of trusts would not comply with the *Companies Act and Codes*. The NCSC, for its part, indicated that it would turn a 'blind eye' to the practice (as indeed, it did when some reputable corporations proceeded to adopt that procedure). One leading firm of auditors adopted the stance that without consolidation of trusts, accounts would not present a true and fair view.[12]

Yet, despite this public debate, the accounting treatment of interests in trusts remained a factor in the presentation of financial information which may (in the eyes of some) have contained a misleading representation of the affairs of those groups.

Another device for the non-consolidation (or de-consolidation) of subsidiaries relied upon differential voting rights of different classes of shares as a means of avoiding the *Companies Code* tests for defining a 'subsidiary'. A simple example is as follows:

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11 *Australian Business* (27 April 1988) p 93.

12 *Australian Business* (10 August 1988) p 86.

> A holding company H owns 5 "A" class shares in a company S Ltd. A bank owns 95 "B" class shares. Both A and B class shares are entitled to one vote each. The A shares are entitled, in effect, to the profits of the venture being conducted by S, after the payment of dividends on the B class shares (in effect, bank interest). The B shares can be redeemed. On the face of it, S is not a subsidiary of H in terms of tests of majority share ownership, or capacity to elect the majority of directors.

A range of accounting issues arise from the use of trusts in group structures - particularly concerning the way in which a company should describe its accounting policies for the treatment of those entities, and the accounting treatment which should be adopted for any wholly-owned subsidiaries which acted as trustees for those trusts, in the light of NCSC Practice Note 328 "Disclosure in accounts of companies acting as trustees of trading trusts" (1986) which suggested that trustee companies should show the assets and liabilities of trusts in the balance sheets of the trustee companies. Such matters have yet to be considered by the courts.

A simpler device for avoiding consolidation might involve restrictions of shareholders to less than a majority interest - coupled with options to acquire additional shareholdings:

> When Elders-IXL sought to takeover Scottish & Newcastle Breweries plc, the target company commissioned a report from Arthur Young & Co on Elders' financial position. Arthur Young noted that Elders held a 50% interest in The Courage Pub Holdings Ltd and its subsidiaries ("Pubco"), while a subsidiary of Elders held approximately one third of Hudson. Moreover, Elders had an option to acquire an extra share from Hudson which would give it an outright controlling shareholding.
>
> Elders-IXL had reported a debt-equity ratio of 32 per cent. Arthur Young considered that if Elders had consolidated its finance subsidiary Elders Finance, consolidated Pubco, and treated subordinated convertible notes as debt (rather than as equity), then its debt-equity ratio would have been 210 per cent.

When the Australian accounting profession finally produced an accounting standard it elected to determine the ambit of consolidation in terms of a subjective test of 'control'. The rationale for adopting this test for consolidation was not articulated satisfactorily in either the standard or in prior exposure drafts or technical monographs; the argument has been presented in the form of assertions that interested parties 'need' information about an economic entity which is subject to common control. Even if one accepts that assertion, AASB 1024 does not even accomplish this result, since tests for consolidation are applied downstream from (say) a listed company, whereas that company and its subsidiaries may in turn be under the control of an exempt proprietary company which in itself is not required to place financial statements on the public record. Indeed, a common feature of most of the major corporate groups which have collapsed since 1987 was that a controlling shareholding was held by interests associated with their chief executives. An alternative perspective about the preparation of consolidated statements is that they are intended to amplify the accounts of a holding company. Adoption of this objective would suggest the adoption of tests of majority beneficial ownership to determine the ambit of consolidation. But other views might also be adopted - each suggesting the adoption of different tests to determine the scope of consolidated statements.[13]

Whatever the theoretical arguments, most accountants would expect that if a listed company held a majority beneficial ownership interest in another entity, then the latter would be regarded as a subsidiary and hence its accounts would be consolidated. However the use of a subjective test of control in AASB 1024 has already seen a continuation of the practice of 'non-consolidation':

> BTR-Nylex Limited, with a balance date of 31 December, was one of the first listed companies to prepare consolidated statements in 1992 subject to AASB 1024. BTR held a 50 per cent interest in a finance company, BWAC. The other 50 per cent was held by another listed company, Austrim Ltd. Two BTR directors were on the board of Austrim, and at 31 December 1991 Austrim was indebted to BTR for the purchase of the BWAC shares. BTR held an interest of approximately 18 per cent in Austrim, and accordingly, BTR had a beneficial interest of approximately 59 per cent in BWAC. However the audited accounts of BTR-Nylex did not include BWAC in its consolidated statements - evidently on the ground that it did not 'control' that company.[14]

D. ASSET AND LIABILITY SET-OFFS

Another technique for keeping debt off-balance sheet involved the 'setting-off' of assets and liabilities. To illustrate: suppose that a company had invested $100 million in a commercial property and borrowed $80 million secured by a charge against that property and the cash flows to be derived from rental. Rather than show an asset of $100 million and a liability of $80 million, the set-off technique would enable the company to report only a $20 million asset, which might be styled 'investment in real estate'. Hence that company's balance sheet would not reflect the actual gearing of a company, and might convey a misleading impression of its financial position. Even if full details of that arrangement were voluntarily disclosed in notes to the accounts of that company, those notes might be overlooked by the casual reader, or not comprehended by even serious readers.

The practice of set-offs came to public attention during the 1980s when one of Australia's leading corporations combined the use of a trust structure with 'project finance' to place major sums 'off- balance sheet':

> CSR Ltd's 1982 annual report showed that CSR's investment in and loans to the Delhi Australia Fund (DAF) totaled $147 million. Notes to the accounts explained that DAF was a financing trust in which CSR and the Bank of New South Wales Nominees Pty Limited held equal numbers of equity units. The units held by the nominee company were entitled to a fixed rate of return, whereas the units held by CSR were entitled to the remaining distributable net income of DAF.
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> Non-consolidation of DAF meant that CSR's consolidated balance sheet did not report $547 million of liabilities.

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13 See RG Walker "International Accounting Compromises: the Case of Consolidation Accounting: (1978) 14 *Abacus* 97.

14 "Consolidation Standard in Practice" *New Accountant* (28 May 1992).

In the heady days following the deregulation of the banking system 'non-recourse finance' became more popular: the full details of those borrowing arrangements were not revealed in some cases until the companies were in difficulties.

A variation in the use of set-offs involved 'debt defeasance' or 'liability assumption agreements' - an arrangement whereby debt was removed from the balance sheet in terms of an arrangement whereby assets were paid to a third party to be held in trust for the purposes of repaying the 'defeased liability. In 1984 the USA's FASB had permitted debt to be 'defeased' under strict conditions: the creditors had to agree, the sums had to be paid into a trust, and sufficient sums had to be invested in government securities so as to meet the emerging commitments for both principal and interest.[15]

Following press reports of the use of a 'principal only' debt defeasance by Hooker Corporation Limited in a deal which also produced a deferred 'profit' of some \$141.4 million[16] the NCSC intervened, and required Hookers to change its accounting so as to recognise an additional liability of \$111 million (representing, in this case, a commitment to pay interest on the defeased debt).[17]

Press reports called for the introduction of accounting rules on the subject.[18] The possibility that the NCSC might issue a Policy Release on the subject may have constituted a threat to the accounting profession's standing as the dominant producer of accounting rules. In any event, the profession's AARF was galvanised into action: an exposure draft ED 44 on "Set-off and Extinguishment of Debt" was introduced in May 1988, and quickly issued as an approved standard ASRB 1014 only six weeks later (June 1988).

At the time, one major auditing firm with large mining corporations as clients described the draft standard as requiring techniques which were contrary to 'generally accepted accounting practice'.[19] However the rules were duly introduced. ASRB 1014 permits set-offs "only where there is a right of set-off relating to those assets and liabilities" (and specified that such "right" must be recognised "at law or in equity").

One of the (possibly unexpected) outcomes of the introduction of this standard has been the suggestion that banks and other financial institutions should recognise receivables and payables arising from swap transactions. This subject remains contentions, though auditing practitioners have apparently decided that the sums payable under swap contracts are not assets or liabilities. As one commented, "there is a considerable interpretation gap between... [AASB 1014] and the practical issue of set-off".[20]

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15 Financial Accounting Standard FAS 76 "Extinguishment of Debt" (1983).

16 "Hooker's \$141m Book Exercise" *Australian Business* (20 January 1988).

17 NCSC Media Release 88/14 (30 March 1988).

18 "Debt Defeasance: Time for Some Standards" Editorial *Australian Financial Review* (7 April 1988); "NCSC Opens the Book on Defeasance Schemes" (31 March 1988).

19 *Australian Business* (3 August 1988) p 72.

20 IL Hammond "Accounting for Set-Off of Assets and Liabilities" IIR Conference *Accounting for Off-Balance Sheet Financing and Synthetic Instruments* (30 October 1989).

E. COMPLEX TRANSACTIONS

What is a borrowing? Consider the following hypothetical transactions:

> Company A sells a business to another company for $50 million, with an accompanying guarantee that the deal will be reversed in five years' time, together with compensation, if returns from the business do not reach a pre-determined rate.
>
> Company B sells a property to a banker for $100 million, and at the same time pays $5 million for a call option entitling Company B to repurchase the property for $115 million in one year's time.
>
> Company C sells shares to Company D for $100 million (which enables Company C to record a 'profit' on the transaction of $20 million). However Company D has a put option over the shares, and can return them to Company C for $115 million 12 months after the original 'sale'.

If one looked separately at these various arrangements one could identify three discrete transactions: one involving the sale of an asset, the other the granting of a option, and a third transaction arising if the option was exercised. If one looked at the arrangements as a chain of linked transactions, one might conclude that the arrangements were, in substance, 'borrowings'.

Accounting writers have occasionally averred that practitioners should have regard to the 'substance' rather than the 'form' of commercial transactions and arrangements. Indeed, Australian Accounting Standard AAS 6 "Accounting policies: determination, application and disclosure" (1986) states that members of the profession should ensure that "transactions and events should be accounted for and presented in accordance with their financial reality and not merely with their legal form". However, the standard gives no guidance as to what is meant by 'financial reality'.

More recently, the UK accounting profession has suggested an alternative way of identifying the 'substance' of what it termed 'special purpose transactions': suggesting that when considering such transactions, a suitable method of presenting them may be found by reference to a 'reasonable accounting analogy' - a relatively straightforward transaction that has an identical or similar 'commercial effect'.[21]

It seems fair to say that the Australian accounting profession has yet to come to grips with the issues posed by such arrangements. Meantime, government regulators have reacted in a rather ad hoc fashion to (major) perceived abuses. For example, the 1986 amendments to Schedule 7 of the *Companies Act and Codes* incorporated a last-minute addition concerning valuations of assets which were 'supported' by guarantees, warranties or indemnities.[22] That amendment is understood to have been a response to concern about the way a transaction between a listed company and an associate had led to a material profit being reported by the former, in circumstances where that profit was not fully realised. The same effect was still achievable through other means. In

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21 UK Accounting Standards Committee ED 42 "Accounting for Special Purpose Transactions" (March 1988).

22 See clause 20 which had not been canvassed in a prior "Green Paper" (NCSC 1983).

1989 the NCSC issued a media release "Disclosure of put and call options" (Media Release 89/40) advising that "the Commission, after consulting the professional accounting bodies and the Accounting Standards Review Board, has come to the conclusion that the requirement to prepare accounts which are true and fair will not have been satisfied unless, as a minimum [information about] the existence of all put and call options related to assets or liabilities or potential assets or liabilities of material significance to the company [and] the potential financial effect.... in the event the option outcome differs from that brought to account". The Australian accounting profession has yet to issue standards addressing such issues, even though prohibitions on such practices have long been incorporated in standards issued in the USA.[23]

III. NEW REGULATORY ARRANGEMENTS - AND THEIR LIKELY IMPACT

The 1980s are now behind us. There have been some major changes in Australian arrangements for the regulation of companies and securities, and in particular for the production of accounting standards and the policing of financial reporting. The Federal government's *Corporations Law* is being administered by a new agency, the Australian Securities Commission.

It would not be accurate to describe these regulatory developments as a response to the aftermath of the 1987 stock market crash. Efforts to change Australia's regulatory arrangements had been initiated during the 1980s when the market was booming. A number of business associations and high-profile professional advisors had been active in lobbying for change in Australia's regulatory arrangements during a period which now can be seen as the last stages of the stock-market boom of the 1980s. The main concerns of these groups were varied. Some were openly critical at the hostility of the NCSC towards some of Australia's leading corporate citizens concerning their behaviour during takeover contests. Others were angered by the delays imposed by the NCSC and its delegates, the state Corporate Affairs Commissions ("CACs"), in 'pre-vetting' prospectuses and takeover documents. Only a few argued that the NCSC was not active enough in enforcement activities.

While the NCSC and the CACs were operating, a great deal of attention was placed on the regulation of takeover contests, but little on financial reporting. Indeed, it appears that it was only late in the 1980s that there were any instances at all of regulatory intervention concerned with remedying the dissemination by listed companies of deficient financial information. Hooker Corporation was given a year to adjust its reports; Westmex was made to change its accounting treatments involving use of an 'investment fluctuation reserve' (though the larger Industrial Equity Ltd was not). The NCSC professed support for 'self-

23 *Accounting Research Bulletin* 50 (1958); Financial Accounting Standard FAS 5 (1975).

regulation' by the accounting and auditing profession. Only in March 1987 - by which time the stockmarket was widely regarded as overheated - did the NCSC change its stance, with chairman Henry Bosch threatening 'crack-downs' on creative accounting.[24] Those 'crack-downs' never eventuated.

The author of a history of the USA's Securities and Exchange Commission ("SEC") started his book by observing: "when a new independent regulatory agency.... transfers its most important authority back to the private groups it is supposed to control, that is an event deserving respectful attention".[25] Australia's NCSC under the chairmanship of Bosch was not exactly a new organisation; nor did it have quite the same powers as the USA's SEC. But the NCSC's inactivity in relation to financial reporting during a period when creative accounting was rife, must also make that agency a candidate for respectful attention.

Since the 1960s, the accounting profession has assumed a dominant role in the preparation of accounting rules. Previously, the major requirements for financial reporting were embodied in companies legislation and, to some extent, in rules produced by Australian stock exchanges. The profession's guidelines - once described as "Recommendations on Accounting Principles and Statements of Practice" - were largely guides to practitioners on how to comply with the *Companies Act.*

Strong criticism of the profession in the aftermath of a series of corporate collapses in the 1960s[26] led to some reappraisal of the adequacy of these guidelines, which were renamed 'accounting standards' and invested with greater authority by the profession's ethical rules. Later the profession sought to have the company law amended to require compliance with the profession's standards; others saw merit in the establishment of a national accounting standards board.[27] The outcome was the establishment in 1984 of a government-appointed Accounting Review Board ("ASRB"), with a membership dominated by representatives of the accounting profession. The ASRB's brief was to 'review' and if thought appropriate, 'approve' standards submitted to it by the accounting bodies (and, potentially, other parties). The *Companies Act and Codes* were amended to require compliance with approved standards save where directors considered that compliance would prevent financial statements from presenting a 'true and fair view' of the profit or loss and state of affairs of a company (s 269 (8B)).

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24 "Accounting Crackdown" *Australian Financial Review* (25 March 1987); "NCSC on Prowl for Wayward Accounts: Bosch" *The Age* (30 March 1987); "NCSC May Crack Down on Dubious Accounting" *Australian Financial Review* (10 April 1987); "NCSC Plans Accounting Crackdown" *Australian Financial Review* (15 May 1987); "NCSC Targets Auditors in Accounting Crackdown" *Australian Financial Review* (9 June 1987).

25 R Chatov *Corporate Financial Report - Public or Private Control* (1975) p 1.

26 WP Birkett and RG Walker "Response of the Australian Accounting Profession to Company Failures in the 1960s" (1971) 7 *Abacus* 97.

27 Report of the Accounting Standards Review Committee *Company Accounting Standards* (May 1978).

If these arrangements had produced an extensive package of tightly drafted accounting rules, then many of the problems associated with 'off balance sheet financing' during the 1980s might have been prevented. However, the early years of the ASRB saw conflict over the Board's priorities, and about the manner in which approved standards were to be drafted.[28] The Board's efforts to tighten up the drafting of the profession's standards were probably both its greatest achievement and the greatest source of conflict with the profession's AARF. However, at a critical stage in these procedures, NCSC chairman Bosch intervened. Expressing concern about the slow progress being made by the ASRB, Bosch claimed that in the absence of 'fast track' procedures it could take three years to finish a detailed review of all the standards "which were already, or soon would be, submitted to the ASRB" (NCSC Media Release 85/63). Bosch's intervention saw changes in the membership and the procedural arrangements followed by the ASRB; and control of the ASRB delivered to the accounting profession.

In the event, the output of standards from the reconstituted ASRB fell far short of Bosch's 1985 target for the rapid review and 'approval' of the 21 professional standards which were then on issue. Three years later the ASRB had only revised and 'approved' less than half that number.

A major impediment to the production of new rules was that the ASRB was dependent on the manner and frequency with which accounting standards were submitted from the profession's Australian Accounting Research Foundation. There is no doubt that individual members of the ASRB were conscious of this constraint. The 1986-87 annual report of the ASRB contained some strong statements about the need for a standard-setting agency which was not exclusively the preserve of "one sector of the community", and lamented the slow rate at which standards were being submitted to the Board by the AARF. The annual report commented that the Board had taken an interest in 'creative accounting' and then listed sixteen matters "on which it would be happy to receive standards". Almost five years later, only six of the 16 items on the list have been addressed (either through the issue of an exposure draft, finalisation of a standard, or direct mention in Statements of Accounting Concepts SAC 4, issued in 1992).

The ASRB might have done far more to curtail some of the more dubious accounting practices rife in the late 1980s, but what of the NCSC itself?

Why did the NCSC fail to enforce existing laws during the 1980s? During most of that period, the number of staff monitoring the financial reporting practices of companies and trusts operating in Australia's securities markets was less than that supervising a two-up game in Australia's smallest casino. Despite later claims that the Commission was hampered by a small budget, those arguments involve comparisons between the budget of the NCSC (around $7 million per annum) and the initial budget of the ASC (around $140 million) and

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28 RG Walker "Australia's ASRB: A Case Study of Political Activity and Regulatory Capture" (1987) 18 (70) *Accounting and Business Research* 269.

ignore the resources available for day-to-day administration by the state CACs. Rather, the record suggests that the NCSC and state CACs lacked the interest or commitment or will to intervene. Perhaps the reason was that key players (such as the NCSC's Henry Bosch) believed in the virtues of 'de-regulation' and 'self-regulation' by the stock exchange and the professions. Bosch was such a strong believer in 'de-regulation' (at least, until early 1987) that he reputedly set targets for NCSC staff to produce one de-regulatory initiative a month.

In the 1990s, Australia has a new set of arrangements for the regulation of companies and securities matters. Under the new Commonwealth regime, the ASRB has been reconstituted as the Australian Accounting Standards Board ("AASB"), and its membership has been enlarged to provide greater representation for 'users' of financial reports. It remains to be seen whether the Commonwealth will seek to retain Schedule 5 to the *Corporations Regulations* (which sets out a range of financial reporting rules), or whether it will be content to leave this area of rule-making entirely to the AASB. Meantime, the AASB remains bound to the profession's AARF through a contractual arrangement whereby AARF provides technical services to the Board.

While some of the techniques of 'off-balance sheet financing' have been addressed through the issue of legally-backed standards, the drafting of those standards remains fairly loose and accordingly it may provide difficult to enforce compliance with them (or indeed, to impose sanctions on those associated with non-compliance). While the drafting is far tighter than that previously used in the profession's standards, many of the legally-backed standards have been framed so as to require compliance only if certain items are 'material' - and the concept of 'materiality' has been defined in a manner which depends on the subjective determinations of directors (and auditors). Some standards are said to apply to particular types of assets or liabilities only if they are 'material'. ASRB 1014 on "Set-off and extinguishment of debt" was so drafted as to permit set-offs within the balance sheet, provided the full details were included in notes to the accounts.[29] More recently, AASB 1024 on consolidation accounting asserts that particular clauses within that standard will only apply if they have a material effect on the financial statements.

The accounting issues which arise through the conduct of complex transactions have yet to be addressed - and are not likely to reach the agenda of standard-setting bodies for some considerable time. There are grounds for concern as to whether the institutional arrangements for developing accounting rules are sufficiently flexible to cope with the rate of development of new financial instruments. One solution - adopted in the USA - is to establish a regulatory body which can deal with emerging problems, by producing authoritative interpretations of existing accounting standards. The USA's Emerging Issues Task Force ("EITF") is supported by the SEC and the FASB, and issues rulings on matters referred to it when there is a 'consensus' vote favouring a particular interpretation of existing rules. The EITF's record shows

29 "Set Off Standard Draft Misses the Mark" *New Accountant* (19 September 1991).

that it addressed around 40 topics a year, and it has been suggested that the availability of fast and authoritative responses from such a body may serve as a substitute for 'opinion shopping' by corporations among audit firms.[30]

Both the new and the old regulatory arrangements place considerable reliance on auditors, in providing some assurance that participants in securities markets are provided with information of high quality. The auditing profession emphasises that the preparation of annual accounts is the responsibility of company directors. Yet in practice, audit firms may be actively involved in the finalisation of financial statements to ensure that regulatory requirements are observed, or to correct or adjust the figures produced by their clients. Auditors may also be asked to assent to the adoption of particular accounting treatments for transactions and arrangements which may be somewhat contentious (including arrangements for 'off balance sheet' financing). These negotiations may create difficulties for auditors, particularly when directors seek to reinforce their stance with opinions from legal advisors or other major audit firms supporting the treatments they prefer.

Auditors are required by statute to express an opinion on whether a financial statements provide a "true and fair view" of a company's state of affairs and profit or loss. However Australian regulatory agencies have not sought to prosecute directors or auditors for that requirement. It has been suggested that the accounting issues were too technical or complex to put before a jury; or it was claimed that defendants would have no difficulty in finding expert witnesses to support the accounting treatments which were the subject of complaint.[31] As the NSW Registrar of Companies once wrote:

> On the happening of some.... event which raised doubts as to the validity of.... accounts, I would not for one moment contemplate a prosecution based on so slippery a concept as truth and fairness.[32]

Against this history of regulatory inaction, it is perhaps understandable that some members of the auditing profession have paid little regard to the overriding 'true and fair view requirement' and instead have been satisfied to ensure that accounts comply with accounting standards and with the statutory requirements. This approach by auditors might be seen as eroding professionalism. As a US commentator has observed,

> Strict conformity to accounting rules transfers responsibility for the results from the accountant to the rules.[33]

When the accounting profession controls the rule-making process, and regulatory agencies do not intervene to ginger-up that process or take competing initiatives themselves, one should not be surprised to find that accounting

30 "Emerging Issues Need Own Agenda" *New Accountant* (10 August 1989).

31 RG Walker *A True and Fair View and the Reporting Obligations of Directors and Auditors* (1984) pp 22-7.

32 FJO Ryan "A True and Fair View" (1967) 3 *Abacus* 95 at 107.

33 Note 4 *supra* at 98.

standards are not comprehensive, or drafted sufficiently tightly as to establish an effective code of conduct for financial reporting.

In any case, whatever accounting standards are produced to cope with new forms of commercial transactions, the effectiveness of those rules will be constrained by the overall package of statutory requirements for the accountability of commercial vehicles. There are major omissions in that package concerning the regulation of trusts - which are becoming an increasingly important vehicle for public investment. Trusts are not required to comply with the accounting standards produced by the AASB (and in practice often do not). Another major omission concerns the requirements for reporting on 'groups' of companies. The stated rationale for AASB 1024's emphasis on 'control' as the test for determining the ambit of consolidation is that users of financial statements are supposed to benefit from information concerning the financial status of a notional entity which is under common 'control'. However many of the recently-failed or distressed Australian listed corporations were in fact controlled by exempt proprietary companies - which were not themselves obliged to place their financial statements on the public record.[34] Hence AASB 1024 can not achieve its stated objective without further changes in the application of reporting requirements to exempt proprietary companies.

Further, the effectiveness of any regime of financial reporting regulation will depend on how well compliance with those rules is monitored and enforced.

The early signs were that the Commonwealth's takeover of control of companies and securities regulation legislation was not accompanied by a great concern with the arrangements for the timely reporting of financial reporting to the market. Indeed, the Commonwealth's legislation reflected an almost laissez faire attitude towards corporate financial disclosure. The *Australian Securities Commission Act* 1989 contained a statement of the objectives of the new government agency - but a notable omission from that statement were any clauses suggesting that the ASC would seek to ensure that the securities market was informed in a timely fashion about the circumstances of entities whose securities were publicly traded. Instead, the Act viewed the new body like a post-office: the ASC was simply to ensure that "documents, and.... information [filed with it] are available as soon as possible for access by the public" (s 1(2)).

Since then, after the Australian Stock Exchange produced draft proposals for the introduction of a regime of 'continuous disclosure',[35] the Companies and Securities Advisory Committee has recommended that similar provisions be embodied in the *Corporations Law*.[36] The ASC (which some had claimed should administer companies and securities laws, rather than engage in policy analysis) has recently promoted quite radical changes in the reporting

34 *Corporations Law* ss 325 and 326 and reg 3.8.02.

35 Australian Stock Exchange *Improved Reporting by Listed Companies* (October 1990).

36 See generally M Blair "The Debate Over Mandatory Corporate Disclosure Rules" (1992) 15 *UNSWLJ* 177.

requirements for all Australian companies, including the abandonment of reporting exemptions to exempt proprietary companies.

However, if the legislation establishing the ASC reflected a lack of vision, the staff of the new body have in their hands the opportunity to exercise considerable administrative discretion. One promising symbol is literally in their hands, on a daily basis. Coffee mugs issued to ASC employees display the agency's own version of its aims: "to achieve maximum credibility of Australian corporations and securities markets". If that aim is to be achieved in the 1990s, then the financial information on which markets necessarily rely must also be credible. There were plenty of mugs around Australia's securities markets in the 1980s.