

Across the board

A newsletter for Australian directors

AUSTRALIA

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It's all about expectations

Perhaps the most critical consequence of the continuing debate on corporate governance standards is the way in which it has heightened the expectations held of boards.

Shareholders, employees, creditors, analysts, regulators, legislators and the community at large are all expecting more of public company boards.

In this issue of our newsletter we look at these expectations in three important areas.

For a start, the Taxation Commissioner clearly expects boards to take their companies' taxpaying obligations more seriously. His public statements on the subject suggest the Commissioner is trying to enlist public opinion to increase the pressure on large corporates. He's backing this strategy with an increasingly rigorous compliance program. It's not the end of tax planning, but boards will need to satisfy themselves that their organisations' have adequate tax governance and risk management practices in place and working effectively.

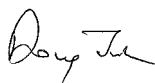
I suspect that most boards believe that financial statement manipulation and fraud is something that happens to other companies.

The board is ultimately responsible for the integrity of the financial statements, so it needs to be alert to the possibility of financial statement fraud and manipulation.

Financial statement fraud occurs in the presence of three factors: the existence of incentives or pressures to engage in such activity, the opportunity to do it, and an organisational culture that allows perpetrators to rationalise their behaviour. Our second article discusses how these factors are useful starting points in considering the extent to which your organisation might be vulnerable to financial statement fraud or manipulation.

Finally, many boards are now preparing for their companies' forthcoming AGMs.

Most of the issues likely to be raised by shareholders at the AGM are predictable, so boards and management should be able to be prepared for most shareholder questions and comments. The effort expended in identifying shareholder concerns is rarely wasted - it should result in a smoother, less acrimonious AGM, and a better-informed shareholder constituency. We provide some thought starters outlining issues likely to be on the list of shareholder concerns.



Doug Jukes
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Tax Commissioner's expectations on compliance

Income tax collections from large corporates have been outstripping growth in GDP. The ATO wants to keep it that way.

In a recent speech outlining the Australian Taxation Office's (ATO) FY 2005 compliance program, Taxation Commissioner Michael Carmody noted that overall company tax payments had grown by 75 percent in the past six years. Over the same period, collections from large corporates and wealthy individuals resulting from ATO audits grew by almost 500 percent.

In other words, the Commissioner is saying that when he takes a close look at large companies, he's usually successful in extracting a lot more tax from them.

Mr Carmody is unapologetic about this approach. Indeed, he says the ATO's audit successes are the reason "...why I have raised tax compliance and risk positioning as a corporate governance issue for boards".

Corporates should expect the ATO to meet or exceed its FY 2005 compliance targets. By directly linking the tax function to good corporate governance, the Commissioner is looking to the business community to be "compliant" in a way perhaps never seen before. Companies may not necessarily agree with the Carmody line. Still, they must adopt appropriate tax risk management policies and processes if they are to

effectively manage their tax liabilities in the context of their overall business strategy. If they think about it, most boards will probably want a "no surprises" approach to tax, which means they need to identify up front their main tax vulnerabilities.

ATO risk profiling

The increased transparency of the ATO's compliance activities is generally welcome. For example, the Commissioner has clearly described the ATO's risk profiling approach as a key method of identifying targets for closer scrutiny. This involves the ATO systematically risk profiling businesses using financial and economic indicators to evaluate trends in tax performance and identify instances where there are risks of tax being underpaid.

The ATO will extend its risk profiling activity beyond the large business segment to include small to medium businesses, specifically those with turnover of \$50m to \$100m.

The generic features that boards can expect the ATO to take into account in undertaking their risk profiling are:

- Significant variations in the amounts or patterns of tax payments compared to past performance and relevant economic indicators and industry trends.
 - Unexplained variation between economic performance, productivity and tax performance.
 - Unexplained losses, low effective tax rates, and cases where a business or an entity consistently pays relatively low tax.
 - A history of aggressive tax planning by the corporation, group, board members, key executives or advisers.
 - Weaknesses in the structures, processes and approaches to tax compliance.
 - Tax outcomes that are inconsistent with the policy intent of tax reform.
- Boards could usefully adopt this checklist as a starting point in their own assessments of tax risk.
- Financial or tax performance that varies substantially from industry patterns.



ATO access to board documents on tax compliance

On 22 September 2004, Tax Commissioner Michael Carmody provided an overview on the ATO's proposed guidelines for access to tax risk reports prepared for the Board of directors of large corporates.

In summary, access to corporate board documents on tax compliance risk will not be sought by the ATO during a risk review or an audit, except in "exceptional circumstances".

The ATO is expected to issue a formal Practice Statement detailing the guidelines shortly. This will include the criteria under which documents will be determined to be "corporate board documents on tax compliance risk" and also what will be deemed to be "exceptional circumstances".

Full details will be provided in the next issue of Across the board.

Specific items on the ATO's "hit list"

Tax Consolidation and GST feature on the ATO's new big business "hit list" for FY 2005.

The ATO is paying close attention to the new tax consolidation regime, particularly companies reporting significant consolidation benefits. Specific consolidation issues of interest to the ATO are provided in the following table.

Tax Consolidation - Issues of interest to the ATO

- Ownership restructurings.
- Substantial movements in capital gains and losses, revenue losses, total debt and interest expense, and capital allowance deductions.
- Funding arrangements, function and location, both pre and post consolidation.
- Company income tax return form and schedule disclosures; especially transfer pricing and thin capitalisation schedule disclosures.
- Significant asset revaluations made as part of the consolidation process.
- Tax reconciliation items.
- Use of franking credits, foreign tax credits and losses in consolidated groups.
- Significant transactions with related parties outside the tax consolidated group.
- Tax consolidation notifications, including entries into and exits from consolidated groups.
- Market valuations used for forming, entering and exiting a consolidated group for loss utilisation and resetting asset values for tax cost setting purposes.
- Tax consolidation disclosures to the market or to ASIC.
- PAYG instalment rates for consolidated groups.



GST compliance remains an issue of concern to the ATO for FY 2005. A suite of 1200 GST compliance checks are to be undertaken including 250 audits and reviews focusing on the banking, financial supplies and insurance industries. Particular areas of focus are summarised in the table below.

Other items on the ATO's new big business "hit list" include losses that do not reflect a taxpayer's business activities, tax depreciation

allowances, taxation of financial arrangements and corporate financing, capital gains tax, foreign exchange gains and losses, employer obligations and superannuation issues.

GST - Issues of interest to the ATO

- GST aggressive planning
- Non-resident involvement in the GST system
- GST-free exports of goods and services
- GST and the supply of financial products and services
- GST treatment of unusual or one-off transactions (eg asset sales)
- GST treatment of mergers and acquisitions

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What boards need to know about financial statement fraud

Boards are becoming increasingly sensitive to the risk of fraud affecting their respective organisations. But how many have considered that they might be signing off on "fraudulent" financial statements?

One of a board's worst nightmares is that it signs off on financial statements that are subsequently shown to have materially misstated the organisation's financial position and performance.

If the misstatement is significant, the board is likely to suffer damage to its credibility, not to mention personal vulnerability to legal sanctions and civil liabilities that could ultimately arise from such an event.

Material misstatements can arise from a variety of causes, including simple error. Still, wise boards will be alert to the possibility that their organisation's financial statements could be impaired by fraudulent activity.

Much of the recent regulatory change such as, CLERP 9, the US Sarbanes-Oxley Act and the ASX Corporate Governance Council's Principles, has been aimed at improving the integrity and transparency of financial reporting. When coupled with the introduction of the revised Australian Auditing and Assurance Standard, AUS 210: *The Auditor's Responsibility to Consider Fraud in an Audit of a Financial Report*, it is timely for boards to reassess the approach to managing the risk of financial statement fraud.

Understanding financial statement fraud

Financial statements can be materially affected by fraudulent behaviour in two ways. The first is the undetected misappropriation of assets on the part of one or more individuals. This is theft, pure and simple. Experience shows that, although such defalcations are eventually detected, the sums at risk may be very large, even to the point of threatening the survival of a business.

The second is financial reporting fraud in which financial statements are manipulated to deceive the users of financial reports, including, in some instances, the board itself. It typically involves the overstatement of assets and/or revenue, the concealment or understatement of liabilities, or the construction of artificial transactions with the sole purpose of disguising the true state of the entity's affairs.

The motivations for financial statement fraud are varied, but often reflect the desire to meet earnings forecasts, clear executive compensation hurdles linked to profitability or market capitalisation, avoid breaching debt covenants tied to financial performance, or cover-up poor management decisions. Obviously such manipulation occurs at the senior management level, and may even reach as high as the CFO and CEO.

Some distinguish between the fraudulent manipulation of financial statements and the management of financial results. The former entails a deliberate, unambiguous breach of both the letter and the intent of the applicable Generally Accepted Accounting Principles (GAAP). The latter involves an aggressive, liberal or imaginative interpretation of the relevant GAAP, but will typically fall short of a total deviation from them. That is, the accounting treatment adopted is at least arguable.

Boards should recognise that the distinction between the two practices is often blurred, and that it can be a relatively small step from managing or massaging the figures to their fraudulent misstatement. The problem will be accentuated when senior management doesn't accept that the manipulation of financial statements can amount to fraud.

What should boards do?

Financial statement fraud is clearly a sensitive area as it's unlikely to occur without the involvement or complicity, or perhaps complacency of elements of senior management.

The board needs to tread carefully whilst retaining a healthy scepticism about the information it is given. After all, the history of business failures and scandals is

littered with the corpses of unsuspecting boards from whom vital information was withheld or concealed.

A useful starting point is to understand that all frauds - including fraudulent financial reporting and the misappropriation of assets - are the outcome of three factors:

- the existence of incentives and pressures to engage in such activity;
- the opportunity to do it, and;
- the “cultural” influences that allow perpetrators to rationalise their behaviour.

The board must deal with the issue on all three fronts.

For example, executive compensation schemes based on unrealistic profit targets provide an incentive for financial statement fraud. Similarly, a board or board audit committee that fails to properly understand and scrutinise changes in accounting treatments and policies creates an opportunity for financial reporting fraud.

A cavalier approach to compliance with accounting and other regulatory requirements suggests weak cultural constraints on fraudulent behaviour.

Robust controls and risk management systems will help deter and detect fraudulent misstatements, but can be subject to management overrides that

negate their effectiveness. Direct reporting to the board by internal audit unmediated by management can help, as can appropriate “whistleblower” procedures.

If particular risk factors or areas are identified, the board can consider bringing in external consultants to scrutinise the situation. CEO/CFO financial statement sign offs on the financial statements, as required under CLERP 9 and the ASX Corporate Governance Council's Principles, are a further comfort, but only if they are based on rigorous processes and controls.

Ultimately, it's a “tone at the top” issue. The board must make the effort to understand the reality behind the figures, and make it clear to senior management that departures from its required standards will not be tolerated.

This said, a board should be alert to the “red flags” that indicate the possibility of financial statement manipulation. They include:

- A CEO who is intimately involved in accounting entries.
- “Opinion shopping” among accounting firms, particularly with regard to revenue recognition practices.
- Unexplained differences between

management accounts and the annual financial statements, including significant “period 13” adjustments.

- Deferred expenses on the balance sheet.
- Complex or unusual transactions entered into close to year-end. Particular note should be taken of such transactions involving related parties.

What can boards expect of their auditors?

With the introduction of a revised Australian Auditing and Assurance Standard, *AUS 210: The Auditor's Responsibility to Consider Fraud in an Audit of a Financial Report*, boards can expect additional focus from their external auditors in detecting and dealing with financial statement fraud.

The revised standard applies to audits of financial information for periods commencing on or after 15 December 2004. (KPMG and the other big 4 firms will voluntarily comply with the revised AUS 210 in conducting audits in respect of periods ending on or after 31 December 2004 as a matter of best practice.)

However, it's important to remember that ultimate responsibility for preventing and detecting fraud remains with the board and senior management.



The revised standard does not change the auditor's responsibility to detect material fraud, but it does impose additional requirements on auditors in order for them to effectively consider the risk of fraud in the audit.

Changes in the conduct of audits should include:

- Increased understanding and documentation of the organisation's fraud prevention and detection controls.
- More meetings between auditors and senior management across the organisation, as well as key staff involved in financial reporting, to specifically consider fraud risks.
- An increased focus on fraud risk relating to intentional misstatements specifically from illegitimate revenue recognition and management override of controls.
- An increase in "unpredictable" audit procedures.
- Possible involvement of forensic accounting professionals in the audit process.

- Increased communication with board audit committees on fraud-related matters. Written representations on the results of management's assessment of risk of financial statement fraud.
- Notwithstanding the auditor's previous experience of management's honesty and integrity, a continuing mindset of professional scepticism.
- More robust discussion of management letter points.

In summary, a robust control environment and sound reward and remuneration structures, underpinned by a corporate culture that sets an appropriate "tone at the top" for ethical behaviour, is the board's best defence against financial statement fraud.

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Meeting shareholder expectations at the AGM

Thorough preparation is the best way to avoid a difficult annual general meeting.

Spring is in the air. For most listed companies it also means the annual general meeting is just around the corner.

It's not a prospect that fills the hearts of many boards with undiluted joy. In recent years AGMs have become more difficult for boards. Questioning is becoming more aggressive, and shareholders more prone to vent their displeasure at perceived shortcomings in company performance.

Both the ASX Corporate Governance Council's Principles and Recommendations, and the recently enacted CLERP 9 legislation are likely to prompt shareholder questions.

In particular, CLERP 9 permits shareholders to submit questions to their company's auditors on certain issues involved in the audit. While the provisions of CLERP 9 come into effect for financial years beginning on or after 1 July 2004, some shareholders might be tempted to jump the gun at this year's round of meetings. Boards should discuss this possibility with their auditors, and develop a coordinated response.

More generally, shareholders are likely to become agitated if they feel the responses to their questions are evasive or lacking in frankness. Many of these questions are predictable. For example, the Australian Shareholders' Association (ASA) has

already signalled its main concerns for this year's reporting season. These include financial performance, links between executive remuneration and company performance, the criteria for issuing share options, performance rights and similar incentives to executives and directors, the valuation of intangible assets, risk management and internal controls.

The ASA has also indicated it will use AGMs to ask auditors about the processes for verifying inventories and/or receivables and the valuation of intangibles. It will seek detailed explanations of any audit qualifications, the reasons why alternative accounting treatments have been adopted, and the likely effect of IFRS on the company's financial performance.

Unsurprisingly, the ASA warns it will take a close interest in non-binding shareholder votes on executive remuneration for financial years beginning on or after 1 July 2004. It says it will probe the relationship between remuneration practices and company performance, as well as the "social context" of executive remuneration.

It's also worth noting that the legendary Warren Buffet is encouraging shareholders to ask specific questions of the auditors of companies they invest in. Whilst Buffet is primarily addressing US investors, KPMG understands that some Australian

companies have already received Buffet-style questions directed to their auditors.

This is what Buffet is suggesting shareholders ask of their auditors.

1. If the auditor were solely responsible for the company's financial statements, would the statements have been prepared in any way differently from that chosen by management?
2. If the auditor were an investor, would the auditor feel he had received the information essential to a proper understanding of the company's financial performance during the reporting period?
3. Does the auditor know of any operational facts that caused the company's sales or profit to move significantly from one period to the next?
4. Is the company using the internal audit procedures that would be followed if the auditor were CEO?

KPMG believes these questions relate to acceptable choices and are more appropriately answered by boards and management. However, everyone involved (i.e. auditors, boards, board audit committees, CEOs and CFOs) will need to develop a strategy for dealing with this line of questioning.

Smart boards will view the AGM as a means to enhance the reporting and disclosure process rather than an ordeal to be endured. This approach reinforces the case for thorough preparation.

The following list of potential “generic” shareholder questions is offered as a thought starter. It is by no means exhaustive. Most companies will also face questioning on specific matters arising from their own operations and performance.

Corporate governance

- What action has the board and management taken to embrace the spirit of recent corporate governance reforms?
- Will the chairman comment on whether these corporate governance changes will be effective in enhancing shareholder protection?
- Is the company better governed now than it was a year ago?
- What are the qualifications and experience of the company secretary?

Director independence and performance

- How does the board review the independence, background and skill set of its members?

- How does the board deal with potential director conflicts of interest?
- Has the board undertaken a formal performance evaluation of its overall effectiveness, and of the contribution and performance of individual directors? What were the results?

Audit committee

- Has the audit committee undertaken any additional responsibilities over the past year?
- Is the audit committee satisfied that management has allocated sufficient resources to ensure the integrity of the financial reporting process?
- How does the board determine the “financial literacy” of its audit committee members? Who is the audit committee's “financial expert”, and what are this person's qualifications and experience?

Risk management and internal control

- What, in management's opinion, are the three to five most significant financial reporting or other risks faced by the company? What should shareholders know about additional market or other risks that may affect the company's financial or operational outlook?

- What processes support the CEO and CFO sign-offs to the board regarding the financial statements providing a “true and fair view”?
- What processes support the CEO and CFO sign-offs that the integrity of the financial statements is founded on a sound system of risk management and internal compliance, and that this system is operating effectively and efficiently?
- Will the board establish a system that encourages both employees and non-employees to report concerns about accounting, internal control and other matters on a confidential and anonymous basis? Were any such matters reported during the year?

Internal audit

- Why doesn't the company have an internal audit function?
- Has the scope of internal audit's work changed over the past year? Over this period, have the resources devoted to internal audit been maintained, increased or reduced?
- Has internal audit found any internal control weaknesses or unusual events that shareholders should know about?

- Does the reporting line and interaction between internal audit, the board audit committee and management reinforce the objectivity of the internal audit function?

Auditor independence

- Has the audit committee / board formulated a policy concerning the additional services the external auditor is permitted to provide to the company?
- How does the company evaluate non-audit services that may be provided to it by its auditor?
- How does the audit committee / board evaluate the auditor's performance?
- How many years has the current audit engagement partner worked on the company's audit?
- During the year, did the auditor issue a management letter or in any other way raise concerns about the company or its financial reporting?
- Did the external auditor discuss alternative generally accepted accounting principles (GAAP) to those used by the company in preparing its latest financial statements?

IFRS

- How is the company managing its transition to International Financial Reporting Standards (IFRS)?
- What are the likely financial consequences for the company of IFRS?
- Will the company be able to pay dividends after the adoption of IFRS?
- When does the company plan to disclose the financial consequences of IFRS?

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Regulatory and accounting watch list

A summary of major regulatory and accounting releases expected during October to December 2004 is presented below.

This summary is provided to assist you in identifying items for further discussion with management, internal or external auditors as appropriate.

General

- ASX listing rule amendments (reporting on mining and exploration activities)

Accounting Standards

To be released by the Australian Accounting Standards Board

Revised Standards

- AASB 1039 Concise Financial Reports
- AASB 1046 *Director and Executives Disclosures by Disclosing Entities*

To be released jointly by the Australian and International Accounting Standards Board

New/Revised Standards

- IFRS/AASB 3 *Business Combinations* (scope of standard)
- IAS 39/AASB 139 *Financial Instruments: Recognition and Measurement*:
 - Fair value option
 - Transition and initial recognition of financial assets and financial liabilities
- IAS 19/AASB 119 *Employee Benefits*:
 - Actuarial gains and losses, group plans and disclosures
- Extractive industries - exploration for and evaluation of mineral resources

New Exposure Drafts

- Business combinations-Application of the purchase method (phase II)
- Short term convergence projects:
 - Amendments to IAS 12 *Income Taxes* (joint project with the FASB)
 - Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (joint project with the FASB)
 - Amendments to IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*

Interpretations of accounting standards

To be revised/withdrawn by the Australian Urgent Issues Group (UIG)

The following UIG Abstracts are under review to determine whether they will be retained for 2005:

- UIG 13 *The Presentation of the Financial Report of Entities Whose Securities are "Stapled"*
- UIG 17 *Development and Customer Contributions in Price Regulated Industries*
- UIG 40 *Non-reciprocal Transfers Within an Economic Entity For Monetary or No Consideration*
- UIG 42 *Subscriber Acquisition Costs in the Telecommunication Industry*

- *UIG 47 Professional Indemnity Claims Liabilities in Medical Defence Organisations*
- *UIG 51 Recovery of Unfunded Superannuation of Universities*
- *UIG 52 Income Tax Accounting Under the Tax Consolidation System*
- *UIG 53 Pre-Completion Contracts for the Sale of Residential Development Properties*

To be released by both the UIG and the International Financial Reporting Interpretation Committee (IFRIC)

Final Interpretations

- Emission rights (D1)
- Determining whether an arrangement contains a lease (D3)
- Decommissioning, restoration and environmental rehabilitation funds (D4)
- Applying IAS 29 *Financial Reporting in Hyperinflationary Economies* for the first time (D5)
- Multi-employer plans (D6)
- Scope of SIC-12 *Consolidation- Special Purpose Entities* (D7)
- Members' shares in co-operative entities (D8)
- Employee benefit plans with a promised return on contributions or notional contributions (D9)

Draft Interpretations

- Service concession arrangements
- Waste electrical and electronic equipment

Overseas regulation/guidance

United States

Final Statements to be released by the Financial Accounting Standards Board

- Short-term international convergence:
 - Accounting changes and error corrections
 - Exchanges of productive assets
 - Earnings per share
 - Inventory costs
- Equity based compensation
 - Transactions with employees
- Interpretation of Statement 143 *Accounting for Asset Retirement Obligations*

New Exposure Drafts

- Business combinations:
 - Purchase method procedures including combinations between mutual enterprises
 - Non-controlling interests
 - Combinations of not-for-profit organisations
- Short-term international convergence:
 - Income taxes

Interpretation of Statement 87 *Employers' Accounting for Pensions*/Amendment of Statement 35 *Accounting and Reporting by Defined Benefit Pension Plans*

United Kingdom

Revisions to *Internal Control: Guidance for Directors on the Combined Code* (the Turnbull report). The revised guidance on internal control and risk management is expected to take effect from 1 January 2006.

More information

For more information on the topics discussed in this newsletter contact your KPMG partner or local KPMG office.

For tailored corporate governance advice contact KPMG Board Advisory Services +61 2 9335 7560.

Additional information on emerging issues and developments is also available via KPMG's Audit Committee Institute www.aci.kpmg.com.au

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