The announcement of the retirement of David Knott

The announcement of the retirement of David Knott, chairman of ASIC, has resulted in articles reflecting on his contributions to corporate regulation. The articles noted that David Knott would be difficult to replace, and praised his use of civil actions rather than criminal prosecutions. The use of civil actions was seen to have three benefits. The first is that because civil actions are heard before a judge rather than a jury, David Knott was freer to talk about the issues involved. Second, a lower burden of proof is needed in civil actions (McCann 2003, p. 25). Finally, Queensland Attorney-General Rod Welford stated civil actions 'dispense quicker justice' (Buffini & Merritt 2003, p. 4). In summing up Knott's contribution to corporate regulation, McCrann (2003, p. 25) states:

> nothing succeeds like success. Knott made a series of big 'wins' in civil actions against high-profile targets. In the process he became a public figure … And made a success of both ASIC and the Corporations Law.

This pending retirement has also caused this column to reflect on the influence of David Knott and ASIC in changing the role of directors to ensure financial statement reliability. The following analysis of David Knott and ASIC's contribution to changing directors' roles suggests this is considerable. The analysis will consider (1) Burns Philp's writedowns of assets, (2) development of the ASX corporate governance guidelines, (3) the case *ASIC v. Rich,* and (4) the ASIC campaign on insolvent trading and John Elliott's contravention of the insolvent trading provisions of the Corporations Act.

Investigation into Burns Philp's writedowns

The Burns Philp saga suggests that ASIC was envisaging a greater role for directors in ensuring financial statement reliability before David Knott was appointed chairman of ASIC.

ASIC published the *Report of the Investigation into Burns Philp & Company Limited* in December 1998. In September 1997, Burns Philp had announced a $700 million writedown of herbs and spices assets (ASIC 1998, p. 6), and later its share price had plummeted to $0.18 (ASIC 1998, p. 39). The report investigated the circumstances behind this large write off.

The report concluded 'there was no sufficient change in circumstances to explain the drastic alteration in the value of the herbs and spices businesses between the issue of the 1996 financial statements and the 1997 financial statements' (ASIC 1998, p. 29). The report further stated that it 'appears that the values attributed to the herbs and spices assets in the 1996 financial statements may have been materially overstated' (ASIC 1998, p. 30).

ASIC were particularly concerned about the write off that related to tradenames and despite the directors' having obtained three independent views about the values attributed to the tradenames in the 1996 financial statements, and the fact that the auditors had signed off the accounts, ASIC considered that the directors had further obligations in this area. In relation to the valuation reports of intangible assets, ASIC (1998, p. 42) concluded that the director should:

- consider whether the assumptions used by the valuers were reasonable, in the light of the directors' overall knowledge of the business
- consider the reliability of the source data used by the expert valuers
- undertake reasonableness checks of the values ascribed to the intangible assets by the expert valuers.

The report adds that if directors have concerns about valuations, they must raise those concerns with the valuers and ensure they are satisfactorily resolved (ASIC 1998, p. 42).

The report also considers the responsibilities of auditors in relation to valuation of intangible assets, and in doing so provides a quotation from Auditing Standard AUS 606 'Using the work of an expert' (ASIC 1998, p. 44). There is remarkable similarity between the points quoted from AUS 606 and ASIC's deemed responsibilities for directors noted above. This suggests that at least for valuation of intangible assets, ASIC considers that directors should undertake work similar to auditors and that the directors in this area become at the minimum quasi-auditors.

Development of ASX corporate governance guidelines

The ASX Corporate Governance Council published the *Principles of Good Corporate Governance and Best Practice Recommendations* in March 2003. Principle 4 of the recommendations is entitled 'Safeguard integrity in financial reporting'. This principle seeks to ensure companies have 'a structure to independently verify and safeguard the integrity of the company's financial reporting' (ASX, p. 29). David Knott played a key role in ensuring that the ASX developed these corporate governance guidelines.

On 16 July 2002, David Knott gave a speech launching the Monash Governance Research Unit wherein he criticised the ASX for not following the trend of overseas exchanges in reviewing best corporate governance guidelines. Knott suggested that ASIC could take over responsibilities in this area. After government pressure, on 1 August 2002, the ASX changed its mind and established the Corporate Governance Council, which later issued corporate governance guidelines. For a discussion of the above events, see the August 2002 edition of *Current Affairs in Auditing.* An editorial in the *Australian Financial Review* (13 August 2003, p. 54) acknowledges this as one of Knott's achievements when it states that:

> Mr Knott found the right balance in the corporate regulation debate, and won his argument with the Australian Stock Exchange over the need for corporate governance guidelines to be effectively annexed to the listing rules.

Pheasant (2003, p. 4) suggests another skill of David Knott was his ability to read the public's mood in relation to the corporate sector and to use this to his advantage. He states:

> Knott shrewdly tapped into the public cynicism which the wider community held for the corporate sector. Incisive barbs directed at the need for the Australian Stock Exchange to take up the cudgels for better corporate governance were initially repelled but ultimately found their mark as a political movement for action grew, culminating in the first speech by an Australian Prime Minister urging business to reform its own house.

The Prime Minister's speech to the Securities Institute of Australia (SIA) and the Institute of Chartered Accountants of Australia (ICAA) was delivered on 6 August 2002. It was a significant event that ensured Australia would adopt a co-regulatory approach where companies would self-regulate using corporate governance practices. This speech is reported in the August 2002 edition of *Current Affairs in Auditing.*

ASIC v. Rich

In winning its case against Greaves (the chairman of the board of directors and finance and audit committee of One.Tel), ASIC enhanced the importance of the ASX corporate governance guidelines by successfully arguing that the corporate governance literature is relevant when deciding that Greaves failed to show due care and diligence. Justice Austin stated that the literature on corporate governance may be 'sometimes vague and less compelling… Nevertheless in my opinion this literature is relevant to the ascertainment of the responsibilities … (of) Mr Greaves' (*ASIC v. Rich* 2003 NSWSC 85, 24 February 2003).

It was also held that the skills and experience Greaves possessed were also relevant to determine that he had responsibilities greater than other non-executive directors. Greaves was a chartered accountant and had substantial business experience, having been a finance director and chief financial officer of large listed Australian public companies.

It is suggested the Greaves judgement will have considerable impact on future cases involving directors and collapsed companies —HIH Insurance, in particular.

Campaign on insolvent trading and the John Elliott case

In April 2003, ASIC announced the results of a program entitled 'Directors Insolvent Trading pilot'. In January 2003, ASIC formed its National Insolvency Co-ordination Unit that worked with insolvency specialists from PricewaterhouseCoopers and Ernst & Young to 'target directors involved with companies suspected of insolvent trading' (ASIC 2003, p. 1). The aims of the program were:

- to make company directors aware of their company financial position:
- to encourage them to seek advice from insolvency specialists; and
- where necessary to take action to appoint voluntary administrators or liquidators.

In its media release announcing the results of the pilot program, ASIC included some operational and financial practices that indicate insolvency, such as poor cash flow, or no cash flow forecasts, disorganised internal accounting procedures, incomplete financial records, continuing loss making activities and accumulating debt and excess liabilities over assets (ASIC 2003, p. 1). To prevent or correct insolvency problems, the directors need reliable financial reporting data. Having obtained these data, the onus would be placed on directors to ensure that reliable financial data are reported to shareholders and other users of periodic financial statements.

Insolvency reviews were conducted for 130 companies, with 10 of these companies considering appointing voluntary administrators or liquidators (ASIC 2003, p. 2). For further details of the pilot program, you should read ASIC's media and information release '03-118', available from the ASIC website.

Given the pilot program on insolvent trading, the successful case launched by ASIC against John Elliott for allowing Water Wheel to trade insolvent became increasingly important. Bartholomeusz (2003, p. 3) states that:

> ASIC hasn't been particularly active or aggressive in bringing actions against directors of failed companies. With Elliott, it had an opportunity to pursue a high-flying target and took it. It appears it wanted to make a statement of intent on insolvent trading — and it has.
>
> This probably relates not just to the more aggressive and litigious posture ASIC has adopted since Knott has become chairman, but to the heightened consciousness in relation to insolvent trading after One.Tel and HIH.

Bartholomeusz (2003, p. 3) notes the significance of the case is:

> not that it breaks new ground in relation to either insolvency law or directors' duties, but that it reflects a relatively new-found determination by ASIC to step up its litigation in this area.

This concludes the section on ASIC's and David Knott's contributions to increasing the responsibilities on directors to ensure financial statement reliability. ASIC and David Knott have played pivotal roles in the changes instrumental to increasing and focusing attention on directors' responsibilities. Perhaps the last word on these developments belongs to Henry Bosch, the chairman of ASIC's predecessor, the National Companies and Securities Commission (NCSC). He stated that the budget of ASIC is now $160 million, whereas the budget was $7 million when he was head of the NCSC. He added (Buffini, 2003, p. 8):

> The ASX did a survey of share ownership about the time of the 1987 crash, and 9.2 per cent of the adult Australian population owned shares. It's 52 per cent now. There are votes in investor protection now. Times have changed.

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