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Submission to the Australian Government Productivity Commission enquiring into:

Regulation of Director and Executive Remuneration

We note that the *Issues Paper* observes: 'the terms of reference require the Commission to consider the relationship between remuneration and corporate performance – that is, the degree to which incentives have been built into the remuneration structure to align the interests of directors and executives with those of shareholders . . .[but] There is no accepted standard of performance (whether individual or corporate . . .' (p.7).

Immediately above that extract (in Box 1, p.7) the Paper notes that whereas 'corporate performance is not universally defined. Companies will highlight different measures of corporate performance through selected key performance indicators . . . profit, . . . return on equity, return on assets, return on investment . . .'

We accept that those descriptions are a reasonable reflection of the matters usually considered to be indicative of the corporate performance to which executives might reasonably lay claim to being achieved through their industry, justifying base salary components, legitimizing bonus payments and the like. This submission addresses the validity of those indicators when calculated with data set out in listed companies' financial statements prepared in accord with the Australian International Financial Reporting Standards (AIFRS).

Our general proposition is that:

The data set out in published financial statements prepared in accord with AIFRS are generally not serviceable for determining corporate wealth, profit, rate of return, return on assets, solvency, asset backing, debt to equity ratios or similar gearing indicators. Accordingly, we submit that assessments made of corporate performance based upon indicators calculated from conventional financial statement data are most likely misleading, incorrect, and the inferences drawn regarding executive performance drawing on those indicators, equally misleading.

Whilst various definitions relate to corporate performance, for example: various measures of profit, EBITA, share price movements, and the like, one way or another accounting data generally, and accounting components of profits and changes in corporate wealth are almost universally considered inputs to them in whole or in part. And in articulated income statements and balance sheets, each of the financial indicators noted by the Commission in the above extract generally has implications for both statements, insofar that misstatements of expenses, revenues, assets or equities flow through to effect each of the indicators. We draw the Commission's attention to the manner in which many conventional financial statement data are constructed, what they contain, what they represent. For example, for the most part conventional balance sheets drawn up in accord with the AIFRSs comprise some data indicative of actual cash and its equivalent (cash balances, deposits, and the like); amounts of money spent in the (sometimes distant) past (assets stated at cost and capitalised expenses) – that is money gone; the market value of some assets (listed securities, and other assets *marked-to-market*, etc,), money equivalents; assets stated at their estimated discounted future income streams (where both the streams and the discount rate are arbitrarily selected and based on expectations) – never money in the past, money at balance date or necessarily equal to any equivalent money sum guaranteed to be acquired in the future; purely fictitious items such as 'deferred tax debits'– purely the fallout from using a technique known as tax effect accounting – never money in the past or necessarily money in the future; goodwill – and similar items – the difference between the market value of assets acquired and the larger amount paid to acquire them – money gone, surely a loss by

everybody's reckoning! (See chapters from *Corporate Collapse . . .* and *Indecent Disclosure . . .*, below).

To that list we must inject the complication that mostly consolidated (that is *group*) accounts are used to determine corporate wealth and progress. Consolidated financial statements are not mere aggregations of the data in the balance sheets and income statements etc., of the related companies comprising the group, but those data after they have been manipulated in accord with the conventional rules by which consolidated financial statements are prepared. The AIFRSs have to be applied to the consolidated data, and may well produce financial signals contradicting those that might be given by the data of the separate companies comprising the group. The 'corporate group' is a legal fiction – cannot own assets – the so-called *group assets* are (unless there are specific contracts to the contrary) those of the separate companies and the *group liabilities* those of the separate companies (See chapters from *Corporate Collapse . . .* and *Indecent Disclosure . . .*, below)

In particular, we draw the Commission's attention to Figure 4.1, (p.82 in *Indecent Disclosure . . .*). Those data were reported in the balance sheet of a well known public company listed on the ASX. Those data accorded with the AIFRSs. It had an unqualified audit report, and satisfied the ASX Corporate Governance Council's Guidelines. We draw attention to our contesting of the serviceability of the balance sheet data for calculating valid financial indicators of the kind which the Commission suggests are likely inputs to assessing a corporation's performance. This illustration is supportive of our proposition that creative (misleading accounting) is more likely the consequence of complying with the standards than deviating from them, with the best of intentions on the past of accountants, without any intention to deceive. We submit that a critical the issue for this Commission is how habitually misleading data can sensibly be inputs to reliable performance assessments.

We acknowledge that the overriding requirement of the Companies Act is that companies' financials show a 'true and fair view' of its financial performance, financial position and cash flows. Few Annual Reports contain additional data to ensure that the 'true and fair' criterion is satisfied. In the absence of qualified audit opinions we can only assume that in the profession, the ASX and the investing community at large, 'true and fair financials' are generally taken to be the automatic outcome of complying with the requirement under the Act that the Accounting Standards are complied with. We submit, that is neither theoretically nor empirically defensible.

The financial indicators of corporate performance noted in the Issues paper cannot be calculated properly with the conventionally prepared data.

For clarification of our argument we attach separate chapters from:, *Corporate Collapse: Accounting, Regulatory and Ethical Failure*, F.L. Clarke, G. W. Dean, and K Oliver; Cambridge University press, 1997, 2003, Chinese imprint 2005, and enclose a copy of our more recent book, *Indecent Disclosure: Gilding the Corporate Lily, Frank* Clarke, and Graeme Dean, Cambridge University Press, 2007, in which we present more cogent explanations.

On the general problems with accounting data:
From: *Corporate Collapse . . .*
Ch.1 'Chaos in the counting-house'
Ch, 2 'Creative accounting – Mind the GAAP'

From: *Indecent Disclosure . . .*
Ch.4 'A very peculiar practice: Accounting under scrutiny'
Ch.10 'Patching: past, present, prospect'

On the specific peculiarities of 'corporate groups' and 'group accounts':
From: *Corporate Collapse . . .*
Ch.16 'Groupthink: Byzantine Structures'

Ch 17 'Groupthink - Group Therapy: Consolidation Accounting'
'Appendix: Improved Corporate Group Accountability'

From: *Indecent Disclosure . . .*
Ch. 7 'Commerce without conscience: Group enterprise or separate legal entity'
Ch. 8 'Groupthink: fact or fiction'
Ch. 9 An alternative group therapy to consolidation accounting'

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