ASIC review to examine who has control

Retail

Neil Chenoweth, Australian Financial Review, 24th March 2017

A landmark ruling by the West Australian Court of Appeal almost two decades ago dismissed retail group Harvey Norman's claim that its franchisees are independent – the key issue the the Australian Securities and Investments Commission is examining in its inquiry into the group's 2016 accounts.

Harvey Norman shares dropped 2.6 per cent to $4.24 on Friday morning after the company announced on Thursday evening that ASIC was conducting a "routine review'' of its accounts, before rallying late in the day to close at $4.38, slightly up on the day.

ASIC had directed Harvey Norman on Wednesday evening to reveal its inquiry, after finance director Chris Mentis told the ASX an *AFR Weekend* article last Saturday that said ASIC was investigating its accounts, was false.

Harvey Norman's admission came after heavy trading on Thursday that had chairman Gerry Harvey wade into the market to buy 1 million shares, on top of 2 million shares he bought on Monday. ''ASIC is undertaking a routine review of HVN's financial report for the financial year ended 30 June 2016 as part of its financial reporting surveillance program,'' Mr Mentis wrote.

Harvey Norman changed tack again, issuing a scathing letter to the ASX release late on Thursday night stating that reports in the *Financial Review* and the *Sydney Morning Herald* that ASIC was investigating Harvey Norman's accounts were ''further false statements'', urging journalists to contact ASIC for confirmation – a suggestion that appeared to take ASIC by surprise.

ASIC is legally barred from disclosing information about its inquiries.

It's believed that ASIC has put hundreds of questions to Harvey Norman. The extent of the information sought led Harvey Norman to request an extension of time to respond, which led the matter to carry over past the announcement of the half-year results in February.

Harvey Norman, which has engaged a range of consultants for technical advice, is expected to make a written response to ASIC shortly.

ASIC has three stages of accounting oversight. The first is a desktop review, in which ASIC staff examine a company's accounts without the company being aware of the process.

Where warranted, the review is then escalated into an inquiry with direct contact with the company, which is asked to respond to a number of queries and concerns.

If ASIC is not satisfied with the response from the company, it can pursue remedial action, beginning with a direction to reissue financial statements.

Three other ASIC inquiries, into Seven West Media, Nine Entertainment Co and MMA Offshore, which were conducted in the same time frame as the Harvey Norman inquiry, were completed in time for the release of the half-year results. The inquiries had the three companies write off a total $590 million on overvalued assets and investments, at ASIC's insistence.

Harvey Norman has admitted that ASIC is reviewing its financial accounts. PHOTO: SCOTT BARBOUR

ASIC launched what was originally a desktop review of Harvey Norman's accounts after the November 2016 annual meeting. This came after governance group Ownership Matters questioned whether Harvey Norman should consolidate the accounts of its 791 franchisees, and listed 16 areas that showed company control, including salaries and vehicle allowances paid to franchisees and a daily sweep of the franchisees' bank accounts.

While not disputing the accounts directly, Ownership Matters said the auditor's ''reliance on a 'significant accounting judgment' to assert that HVN does not control franchisees (and hence does not consolidate them) gives cause for concern. Either HVN controls a particular franchisee or it does not.''

In October, Harvey Norman detailed for the first time in its 2016 annual report how it had lent $943 million to its franchisees not only to fund their inventory and working capital, but also for unpaid franchise fees, rent and interest payments that had already been booked as profit. The figure rose to $1.15 billion in the latest half.

AFR Weekend has revealed that Harvey Norman churns on average 110 of its franchisees each year, or about 14 per cent, raising questions on how it accounts for losses in these franchises.

"The difficult question is how much economic influence does Harvey Norman have over the conduct of the franchises and their financial affairs,'' says Professor Stephen Taylor of the UTS Business School.

If franchisees depended upon Harvey Norman to support them through loans, ''it gets kind of tricky to figure out what is effectively a subsidiary and what's not'', he says.

In December 1999, the WA Supreme Court and Court of Appeal grappled with this issue after Harvey Norman tried to avoid the ban on Sunday trading by companies with more than 10 employees by arguing that franchisees operated independent stores.

Justices Eric Heenan and David Ipp found that the business of a franchise was conducted substantially for the interests of Harvey Norman, which received a management fee that worked out to be 50 per cent of the profit and that the franchises were not independent stores.

''Harvey Norman, either directly or through its subsidiaries, not only receives a large share of the profits earned by each of the franchisees but also, and in my opinion more importantly, it receives the accruing goodwill of the businesses which are conducted by the franchisees,'' Justice Ipp found.

In other ASIC inquiries, on March 7 MMA Offshore at ASIC's insistence wrote down $254 million off its property, plant and equipment. In February Seven West Media wrote down its Yahoo7 investment by $75.5 million and Nine wrote down goodwill by $260 million. Other ASIC-ordered writedowns last year include Hillgrove Resources ($86.3 million), Evolution Mining ($77.3 million), Energy Resources of Australia ($161 million), Panoramic Resources and a change of accounting by Melbourne IT.

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