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# The Mad Hatter's corporate tea party

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## Abstract

This paper aims to provide an insight into the corporate greed and consequent corporate collapses of companies such as HIH, One.Tel and Harris Scarfe in Australia, while concurrently, Enron, WorldCom and other companies were attracting the attention of the accounting profession, the regulators and the general public in the USA. It is argued that the rise in economic rationalism and the related increased materialism of both the public and company directors and managers, fed the corporate excesses that resulted in spectacular corporate collapses, including one of the world's largest accounting firms. The opportunistic behaviour of directors, and managers and the lack of transparency and integrity in corporations, was compounded by the failure of the corporate watch-dogs, such as auditors and regulators, to protect the public interest. If the history of bad corporate behaviour is not to be repeated, the religion of materialism needs to be recognised and addressed, to ensure any corporate governance reforms proposed for the future will be effective.

## Tea for two and me and you

There was a table set out under a tree in front of the house, and the March Hare and the Hatter were having tea at it: a Dormouse was sitting between them, fast asleep, and the other two were using it as a cushion, resting their elbows on it, and talking over its head. "Very uncomfortable for the Dormouse," thought Alice; "only, as it's asleep, I suppose it doesn't mind." The table was a large one, but the three were all crowded together at one corner of it: "No room! No room!" they cried out when they saw Alice coming. "There's plenty of room!" said Alice indignantly, and she sat down in a large arm-chair at one end of the table (from *Alice in Wonderland*, by Lewis Carroll).

The tea party of corporate greed has been exposed with a vengeance in recent times, with the CEOs and directors (the March Hares and The Hatters) having their fill; the regulators (the Dormouse) caught sleeping; and the accountants and auditors (Alice), joining the fray at the surreal tea party. Excess in corporate life is not new, as the party seems to come around every decade or so until the bubble seems to expand another size in absurdity and cost to the community, before it finally implodes once again (Hewett, 2002). However, this time, an increasingly angry public have seen their superannuation and pension savings savagely mauled and respect for corporate managers, regulators and the accounting profession has arguably sunk to an all time low. One of the big five global accounting firms, Arthur Andersen, has disappeared in the implosion, along with the well known collapses of Enron, WorldCom, Global Crossing and all the others. In many parts of the developed world, corporations reported to have been "cooking" their books have become constant news. In America, the recent list includes Adelphia Communications, the sixth largest cable provider in the country, which inflated its revenue with a \$3 billion off-the-books personal borrowing by the founding family; Xerox, which was fined \$10 million to settle fraud charges by the SEC

after it improperly reported a \$6.4 billion in revenue; while the story with WorldCom continues to unfold (Wallis, 2002). In Australia, the demise of One.Tel, Harris Scarfe and HIH Insurance, Australia's largest corporate collapse, have to some extent mirrored the American experience, albeit on a smaller scale.

The greed and consequent loss of confidence in the corporate sector is of concern to many Australians. According to the Australian Prudential Regulation Authority (2002), 46 per cent of all superannuation funds were invested in equities or unit trusts, totalling A\$245 billion. Accordingly, a large number of Australians have an interest in the performance of Australian companies, as their retirement incomes depend on the strength of the share market. Also, many Australians have a further interest in the share market through direct ownership of shares. These investors have a right to know that a company is being properly managed and have access to the information they need to make their investment decisions. Judging by the constant press, they have not been impressed with the feeding frenzy at the Mad Hatters corporate tea party.

In discussing the current corporate scandals, following Enron and WorldCom, Wallis (2002) argues that:

... the tree of the American economy is rooted in the toxic soil of unbridled materialism.

The reactions to the recent corporate collapses by governments and professional bodies have generally focused on regulations on corporate governance and on the enforcement of professional codes. However, as the following view indicates, there might be other fundamental elements in the corporate regime, which need to be examined more closely. Wallis (2002) observes that the entrepreneurial spirit and social innovation fostered by a market economy has benefited many, and should not be overly encumbered by stifling regulations. But left to its own devices and human weaknesses, the market will too often disintegrate into greed and corruption. Capitalism needs rules, or it easily becomes destructive. A healthy balancing relationship between "free enterprise" and public accountability and regulation is morally and practically essential.

Following a brief analysis of the concept of materialism, this paper discusses the three corporate collapses in Australia, namely, One.tel, Harris Scarfe and HIH. This examination highlights some common threads in the collapses, which include:

- inappropriate management compensation;
- creative accounting;
- failure of directors and managers to exercise due diligence;
- lack of adequate regulation; and
- lack of independence in the audit function.

Although it is generally acknowledged that the key failure of such collapses lies in the lack of effective corporate governance, the analysis that follows offers a different view. It is argued that the relationship of materialism and corporate collapses has been largely overlooked by the numerous corporate governance recommendations, which merely scratch the surface of the problems.

## The new religion of materialism

As demonstrated by Toms (2002), the collapse of a system of open corporate accountability was due to the rise of a clique of shareholder-entrepreneurs who instigated accounting manipulation. Toms' detailed analysis of the Lancashire cotton mills from 1870-1914, shows that social capital (namely, the capital contributed by workers) demanded accurate financial information, with the support of co-operative governance. But systematic wealth transfers in favour of cliques of promoters, directors and institutions, narrow the social base of share ownership, increasing the power of the cliques and reducing proper accountability. This cyclical effect can be seen also in agency compensation, a mechanism to minimise agency costs by aligning individual agents' interests with that of the organisation's. But as such a mechanism becomes the tool for wealth transfers, and prey to power and materialism, agency compensation becomes the rationale for creative accounting and ultimately the demise of corporations. Also, accounting and auditing rules develop according to the accountability demanded by collective capital, which is in turn the subject of manipulations by managerial agents, resulting in a failure to produce transparent information.

Looking once again at history, Toms (2002) claims that in many companies in the late 1890s, directors-owners consolidated their control via the mechanism of extraordinary general meetings. They put forward and secured approval for the adoption of new articles, allowing the plutocratic one share one vote system, voting by proxy, minimum shareholding qualifications for directors and the removal of the obligation to forward accounts to shareholders. Their rise to power is consistent with Marx's (1984) description of a "new financial aristocracy". Capital ownership centralised around cliques of richer shareholders able to exclude residual shareholders and to impose tightly controlled nominee managers (Toms, 1998; Tyson, 1968). Interlocking directorships and shareholdings became commonplace – a feature of those collapsed corporations.

Examples of creative accounting were facilitated by the changes in governance and monitoring structure that occurred as early as the 1870s. Auditors were recruited from the shareholder body of co-operative companies. In cases of suspected frauds, shareholder committees of investigation were set up but small investors lost in most cases (Toms, 1994). Such committees were ineffective, and although they were able to quantify losses *ex post*, fraudulent managers left companies, or were dismissed, well ahead of any possible prosecution. Combined with the speculative nature of the market, this placed considerable pressure on the audit function despite the less-than-attractive audit fees that were then the norm. It was also noted by Jones (1959) that the controlling cliques' use of loan finance had reduced the dependency on professional audit. He observed that, when necessary, boards simply over-rode the auditors' recommendations and used the plutocratic governance system to vote for increases in salaries and also in remuneration for the auditors, thereby compromising the independence of the audit function. Toms (2002) also noted that individual financial status and capital maintenance reputation were secured through accounting manipulations and dividend announcements and little reliance was placed on the publication or auditing of financial statements. In examining past history, Toms (2002) has successfully provided a portrait of how an open corporate accountability system collapsed, with features of shareholder-entrepreneurs, accounting manipulation and the failure of reliance on the audit function. Other authors have also highlighted the significant

pay-outs of under-performing directors and managers (Gordon *et al.*, 2003; Gettler, 2002; Gray, 2000) – this also questions the validity of the agency compensation concept.

The recent corporate excesses have not, therefore, happened in a vacuum. Gittens (2002) argues that in the last decade or so, we have entered a new age of materialism, as researched by the leading American social psychologist, David Myers (2000), in his recent book on the American paradox of spiritual hunger in an age of plenty. An appreciation of the cultural shift makes sense of a number of developments that have occurred in Australia and the USA and, to a varying extent, in many other developed countries. Gittens (2002) observes that the rise in economic rationalism in Australia since the early 1980s has been the politicians' reaction to the electorate's increased materialism and the higher material standard of living that a more efficient economy should deliver. The most senior politician in Australia, Prime Minister John Howard, when asked his opinion on the current corporate governance debate, was reported as saying that the debate was not as important as the Commonwealth Games, or as important as a number of other things that are really important. This type of attitude by the Prime Minister arguably exposes as cheap rhetoric his claim to be the best mate of the inspirational mum-and-dad shareholders, superannuation holders and self-funded retirees (Stephens, 2002).

The new religion of materialism could also explain why Australian CEOs have been awarding themselves unprecedented pay rises and have become much more ruthless in their attitudes to customers and employees. Corporate boards often justify astronomical salary and bonus payments by the need to compete on the international market and to reward CEOs for the impact they have on the share price. However, with the average wage for Australians with full time jobs being \$45,000 per year, it is not hard to imagine the reaction of most wage earners to the news that the CEO of Suncorp Metway took home almost \$30 million in salary, shares and severance pay during his final year at the company. When bank customers feel they are being exploited by having to pay higher fees for lower levels of service, their outrage is understandably aggravated by reports of record bank profits. The perception of employee exploitation is similarly heightened by revelations of multi-million dollar salaries and perks for senior executives, such as the remuneration in excess of \$7 million the CEO of the Commonwealth Bank received in 2002, including \$4 million for reaching ten years in his already well paid job. To many Australians, the growing gap between our highest and lowest paid employees is starting to look like yet another factor in the fragmentation of Australian society – and that is as much about morality and culture as about economics (Mackay, 2002).

This heightened materialism also provides a context for the apparent declining ethical standards among company directors and auditors. David Knott, the Chairman of the corporate regulator, the Australian Securities Investment Commission (ASIC), has lamented the outbreak of management greed, the failure of boards to put a brake on excessive and structurally unsound remuneration practices, the focus on short term pay-offs and the behaviour of analysts, and at least some auditors, in foregoing their ethics in return for record level fees and commissions (Knott, 2002b). At the same time, others have lamented the regulators caught sleeping. The insurance industry regulator, the Australian Prudential Regulation Authority (APRA), has come in for criticism in respect of the HIH Insurance collapse, with politicians and leading insurance executives claiming the regulator was not

adequately staffed to identify the weaknesses in the HIH Insurance systems (Kemp, 2001; Elias, 2001).

There is an old saying that power corrupts and absolute power corrupts absolutely. The same thing can be said about greed. Enough was never enough in a system fed by stock options, boardroom perks and consulting and underwriting fees (Turner, 2002). The seeds to the present crisis, particularly in the USA, were sown in the technology stock boom in the early 1990s, with the now bankrupt e-commerce companies then hailed as the way of the future. At the same time, the telecommunications revolution, in a new world of unregulated competition, required billions of investment in fibre optic cables, satellites and microwave towers. The strategic decision by One.Tel to invest in its own telecommunications system was a major reason behind its eventual downfall. These new technologies demanded financial manipulation schemes to convert expenses into capital expenditure, hide losses and ensure that share prices held up and options and unreal salaries and bonuses would continue to be paid to the Mad Hatter and his friends at the tea party. Even a first year accounting student could work out that this was financially unsustainable. The accountants, investment banks and law firms, who were the traditional gatekeepers of market integrity, were just like Alice in Wonderland at the Mad Hatter's party. They were caught up in the frenzy and wanted to join the party. Their independence collapsed under the threat of being left behind in the new economy revolution. The belief in the revolution was so pervasive, as well as the belief that the old rules no longer applied, that the gatekeepers became servants to the new players rather than independent guardians. The traditional brakes on the system no longer worked (Scott, 2002).

### **One.Tel, Harris Scarfe and HIH Insurance**

Three corporate collapses that have most focussed on corporate governance issues recently in Australia are One.Tel, Harris Scarfe and HIH Insurance. The Australian telecommunications company One.Tel was placed in administration and subsequently into liquidation in May, 2001 with estimated debts of A\$600 million. At the same time, the Australian Securities and Investment Commission (ASIC) announced it had commenced a formal investigation into One.Tel for potential breaches of the Corporations Law. The potential breaches according to an ASIC spokeswoman included possible insolvent trading, possible insider trading and market disclosure issues (BBC News, 2001). The joint managing directors, Jodee Rich and Brad Keeling, had received bonuses of A\$7 million each the previous year, when One.Tel reported a A\$291 million loss. At one stage, when the company had A\$33 million in bills due, there was only \$500,000 in the bank and a management report to the directors at the time did not mention the liquidity crisis. Creative accounting by One.Tel in capitalising expenses had attracted the attention of ASIC and its insistence that accounting practices be changed led in August 2000 to the company declaring \$245 million of costs that would otherwise be hidden (Barry, 2002).

After six months and a parade of high-profile corporate executives, the public hearings into the demise of the phone company One.Tel were wound up on 29 August, 2002, as the liquidator retired to consider whether grounds existed for legal action against those involved (Hughes, 2002). During the public hearings, the liquidator questioned 18 witnesses including One.Tel directors Lachlan Murdoch of News Limited and James Packer of the

Australian media giant, Publishing and Broadcasting Limited. Civil proceedings have been commenced against a number of former directors of One.Tel by the Australian Securities and Investment Commission, seeking declarations that they contravened their responsibilities under the Act; orders that they be banned from managing corporations or acting as directors; and compensation of up to A\$75 million. In the interim, appropriate orders have been obtained to restrict dealing in assets and to monitor travel (Knott, 2002b).

The retailer Harris Scarfe had been in operation for 150 years before it was placed into voluntary administration by the directors on 2 April, 2001, after discovering irregularities dating back six years. Four days later, the ANZ bank placed the company in receivership. In their report to creditors, the administrators highlighted that the systematic overstatement of profit had been funded by increased debt, both to the bank and the creditors (Peacock, 2001). After investigations by the Australian Securities and Investments Commission (ASIC) and official examinations by the company's receivers and managers, ASIC alleged the chief financial officer, Alan Hodgson, had altered Harris Scarfe's accounts to inflate the company's profits. In fact, Hodgson was found to have played a leading role in falsifying accounts and reports and had created a false picture that Harris Scarfe was in good financial health, permitting it to trade when it was virtually insolvent. In testimony given to the South Australian Supreme Court, Hodgson told the court that he had effectively authorised accounts to be changed on cue, if a particular profit result was required by the company's managing director or the chairman (Tabakoff, 2001). Hodgson was jailed for six years.

The ANZ bank has filed a suit against Harris Scarf's auditors, Ernst and Young and PricewaterhouseCoopers, seeking recovery of at least A\$70 million and alleging the auditors had been negligent because they failed to uncover the accounting discrepancies and irregular entries in the management accounts. Also, a shareholder has brought a class action against the directors, alleging that they engaged in false, deceptive and misleading conduct over a five-year period. The shareholder claims that as a result of the deceptive statements, investors paid more than the "true market value" of the shares and eventually lost the opportunity to sell their shares (Wood, 2002).

In March 2001, HIH Insurance was placed in provisional liquidation with reported losses of A\$800 million, although more recent estimates put the deficiency at between A\$2.7 and A\$4 billion, making it Australia's largest corporate collapse (Kehl, 2001). The HIH group comprised several insurance companies and was the biggest insurance underwriter in Australia. Its collapse had a widespread effect, as it was a major provider of all types of insurance in Australia, including much of the public risk cover. In fact, HIH was known as a price cutter and more willing underwriter than its competitors in the insurance industry (Brown, 2001) and an ex director, Rodney Adler, had claimed that excessive discounting was one of the contributing factors in the failure of the company (Gaylord, 2001). However, it was arguably the hostile takeover of Adler's company, FAI Insurance, for A\$300 million, without proper due diligence investigations, that marked the beginning of the end for HIH. The founder and CEO of HIH, Ray Williams, has since admitted that the price was too high (Brown, 2001). Also, HIH experienced major losses in its operations in the USA and the UK, which contributed to its eventual demise.

The Royal Commission into the affairs of HIH Insurance was announced in June, 2001. The terms of reference are wide ranging and will enable the Royal Commission to fully investigate the circumstances surrounding HIH's failure, the actions of Commonwealth and State regulatory bodies and whether changes should be made to the current legal framework (Insurance Council of Australia, 2002). In summary, the terms of reference are as follows.

1. The reasons for, and the circumstances surrounding, the failure of HIH prior to the appointment of the provisional liquidators on 15 March 2001 and in particular, whether, and if so the extent to which, decisions or actions of HIH, or any of its directors, officers, employees, auditors, actuaries, advisers, agents, or any other person, contributed to the failure of HIH; or were involved in, or contributed to, undesirable corporate governance practices, including any failure to make desirable disclosures regarding the financial position of HIH.
2. Whether those decisions or actions might have constituted a breach of any law of the Commonwealth, a state or a territory.
3. The appropriateness of the manner in which powers were exercised and responsibilities and obligations were discharged under Commonwealth, State or Territory legislation.
4. The adequacy and appropriateness of arrangements for the regulation and prudential supervision of general insurance at Commonwealth, state and territory levels including Commonwealth arrangements before and after the Financial System Inquiry reforms and different state and territory statutory insurance and tax regimes.

As the above terms of reference indicate, the Royal Commission into HIH Insurance was set up with wide ranging powers of investigation and its eventual recommendations, expected by March 2003, are likely to have a major impact on the future corporate regulatory environment in Australia. Also, civil proceedings have already been successfully prosecuted against three former officers of HIH in relation to a specific breach of the Corporations Act, involving improper use of company funds and a breach of duty. The Australian Securities and Investment Commission has sought declarations, banning orders and compensation, plus pecuniary penalties, and an investigation into possible offences connected with the collapse of HIH continues (Knott, 2002b).

### **Where were the accountants and auditors?**

So, just like Alice in Wonderland, did the accountants and auditors elbow their way into the Mad Hatter's corporate tea party? From the evidence presented so far, it appears likely that is generally the case. The liquidator's inquiry into One.Tel was told how multi-million bonuses paid to the founders Jodee Rich and Brad Keeling, were effectively hidden from public scrutiny by questionable accounting practices. The bonuses totalling A\$14 million were incurred in 1999, but a change in accounting policy treated the bonuses as deferred expenditure and treated them as set up costs associated with One.Tel's businesses across Europe and Australia. This treatment, along with other questionable accounting adjustments, had the effect of converting a loss into a profit. It was also claimed that the auditors had supported the questionable accounting (ABC Newsonline, 2002). However, when questioned by Michael Slattery QC for the liquidator, the One.Tel finance manager,



Steve Hodgson, agreed that the accounting policy adopted was what he regarded as a bit of a stretch (Hughes, 2002).

In the Harris Scarfe collapse, it appears that the accountants were running two sets of books, which was not picked up by the auditors. Apart from the fraudulent accounting by the chief financial officer, Alan Hodgson, referred to earlier, there were also, prima facie, independence problems with the Harris Scarfe audit committee of the board. The company had an audit committee comprising three members, two of whom were clearly internal (including Hodgson) and one of which was possibly independent, and they met only twice a year. An audit committee is meant to be an independent body to ensure efficient and effective communication between external auditors and senior management. So fundamentally, it could not work (Correy, 2001). Also, as noted earlier, the auditors are being sued by the major creditor, the ANZ bank, alleging negligence for not uncovering the discrepancies over a number of years.

In the case of HIH Insurance, there were also problems with the prima facie independence of the audit committee of the board. The chairman and another member of the committee were both former senior partners of Arthur Andersen, the auditors of HIH. Also, the other two members of the audit committee had business relationships with the company (Correy, 2001) and the finance director was a former Andersen partner. Unlike Enron that hid liabilities to boost its balance sheet, HIH attempted to pad profits as major parts of its business eroded. HIH did not set aside enough reserves to cover future insurance claims and overvalued some assets. Under questioning at the HIH Royal Commission, the finance director, Dominic Fodera, denied that carrying out his acknowledged responsibility to be prudent and conservative in assessing policyholders' claims required the use of a safety margin in claims reserves. This was despite the fact that the levels set by the company had proved to be inadequate in the past (AAP, 2002). Also, three different actuaries and the United States regulator warned that the company's US operations in 1999 and 2000 were under-reserved by tens of millions of dollars, but Fodera acknowledged that the US branch and head office in Australia chose instead to use their own calculations of reserves. He also admitted that when yet another actuary recommended an increase in reserves, the board was never informed of the fact (Walker, 2002).

So what does this all say about the accountants and auditors? From the investigations undertaken and reported so far, it is apparent that the accountants in One.Tel, Harris Scarfe and HIH Insurance, all joined the March Hare and the Hatter at the tea party of corporate greed. They were supposed to be ethical professionals providing quality financial control and advice to management, but just like Alice, they were determined to join the party. At this point in time, it is not so clear-cut with the auditors, although the evidence to date points to them being in Wonderland. As discussed earlier, the auditors were the gatekeepers, but became servants to the new players rather than independent guardians.

Therefore, it can be argued that some significant common issues are apparent from the brief overview of the above three cases. These issues are:

- the opportunistic behaviour of directors and managers in pursuing self-interest and undermining governance mechanisms. Such behaviour was demonstrated by failure

of due diligence in corporate affairs, interfering with controls and audit independence functions;

- failure of transparency and integrity in performance measurement and management compensation, resulting in the financial reporting functions being undermined, as demonstrated by the extensive practice of creative accounting; and
- the apparent failure of some of the corporate watch-dogs such as some auditors and government supervisory bodies.

### **Good corporate governance**

Before discussing the issues further, it is worthwhile to reflect on what constitutes good corporate governance. There are many publications in the field of corporate governance, but a useful and recent one is the *Principles of Corporate Governance*, issued by The Business Roundtable (2002), an association of chief executive officers of leading corporations in the USA. This association claims that the USA has the best corporate governance, financial reporting and securities markets in the world, which works because of the adoption of best practices by public companies within a framework of laws and regulations.

The Business Roundtable's (2002) *Principles of Corporate Governance* call on companies to adopt a number of best practices in corporate governance, that, for example:

- require stockholder approval of stock options and restricted stock plans in which directors or executive officers participate;
- create and publish corporate governance principles so that everyone, from employees to potential investors, understand the rules under which the company is operating;
- provide employees with a way to alert management and the board to potential misconduct, without fear of retribution;
- require that only independent directors may sit on the board committees that oversee the three functions central to effective governance – audit, corporate governance and compensation; and
- ensure that a substantial majority of the board of directors comprises independent directors, both in fact and appearance (Business Roundtable, 2002).

An authoritative Australian publication on corporate governance was issued by a group of professional bodies in 1995, under the chairmanship of former regulator, Henry Bosch (Bosch, 1995). Most of the principles in this pronouncement are similar to the Business Roundtable, although the questions surrounding executive options and remuneration were not such big issues in 1995 as they are currently. What the above reports and others such as the Cadbury Report issued in the UK and the OECD corporate governance guidelines demonstrate, is that there is no simple universal formula for good corporate governance, as companies vary in complexity and size and the nature of business and community expectations are in a state of constant change.

What is essential, however, is that all involved in corporate governance, and particularly boards of directors, should adopt the practices best suited to the good governance of their

organizations in their particular circumstances. Best practice in Australia is arguably comparable to the best anywhere in the world but, as Bosch (2001) notes, there is far too little of it. Before directors can satisfy themselves that they understand what is really going on in the companies for which they are responsible, they must put in more time, pay more rigorous attention to their duties and make more use of the governance techniques that have been developed.

### **Bad corporate governance**

The above principles are indicators of good corporate governance, but how do we know bad corporate governance when we see it? In a submission to the HIH Royal Commission, a corporate governance research and advisory group, Institutional Analysis Pty Ltd, provided an analysis of the bad corporate governance practices at HIH Insurance before its collapse, based on publicly available empirical data from 2000/2001 company annual reports. Comparisons were made of the corporate governance practices at HIH with the corporate governance practices at the top 100 companies on the Australian Stock Exchange (“the S&P/ASX 100 companies”). Key findings included the following (Institutional Analysis, 2002):

- Among the S&P/ASX top 100 companies, independent non-executive directors comprised on average 45.3 per cent of the board, whereas there were no independent non-executive directors on the HIH board. An “independent director” is not financially or otherwise depending on the company’s affiliated persons (e.g. members of the board, auditor) and does not represent consultants or other businesses, which are, or have been, contracted by the company. The published 2000-2001 HIH annual report shows that of the four non-executive directors, Gardner and Cohen were both former partners of the auditors, Arthur Andersen, and Abbot and Stitt were both involved in the provision of legal services to the company.
- The HIH board was dominated by founders or relatives of founders, with potential conflicts of interest and loyalties to the company history and reputation. These issues may have coloured their judgment. HIH had two founders on the board and also Adler, the son of the founder of FAI, one of the core HIH businesses.
- In 54 per cent of S&P/ASX top 100 companies, the audit committee is exclusively comprised of independent non-executive directors. At HIH, there was not a single independent director on the audit committee.
- In 72 per cent of the top 100 companies, separate nomination and remuneration committees were established, as per the Investment and Financial Services Association’s guidelines. HIH combined the two committees.
- At the top 100 companies, the average percentage of CEO remuneration that was “at risk” is 33 per cent. The higher the proportion of a CEO’s remuneration at risk, the more closely aligned are his or her interests with those of shareholders. At HIH, none of the remuneration of the CEO was at risk.

As the above research indicates, corporate governance practice at the company that became the largest corporate collapse in Australian history, was somewhat less than world best practice.

### **The Ramsay Report**

In October 2001, Professor Ian Ramsay submitted his report, based on a study commissioned by the Commonwealth Government of Australia. Although it provides a blueprint for reform of auditor independence, the Commonwealth Government is delaying implementation of any of the recommendations until 2003. The Ramsay recommendations include (Ramsay, 2001):

- the establishment of an Auditor Independence Supervisory Board;
- changes to the ASX listing rules requiring listed companies to establish an audit committee, with ASX input into its role and composition;
- requiring auditors to make an annual declaration to the Board stating that they have maintained their independence;
- providing clarification on what constitutes “independence”;
- requiring registered auditors to adhere to the codes of ethics set down by professional accounting bodies; and
- closer regulation of the operations of auditors, including the rotation of partners and the increased disclosure of fees and non-audit services.

The bodies that represent the interests of accountants and directors have been publicly supportive of these measures. The Institute of Chartered Accountants in Australia (2002) welcomed the Ramsay recommendations as a significant step towards improving the role and effectiveness of audits in Australia, whilst maintaining harmony with global standards. CPA Australia (2002) was also supportive, noting that the report enshrines best practice audit principles, reinforces the vital role of auditors and gives the public highly visible assurance on matters of auditor independence. The Australian Institute of Directors (2001) also welcomed the Ramsay report and its recommendations. However, some further reforms to augment Ramsay could include an outright ban on non-audit services being provided to audit clients, as provided for in the US Sarbanes-Oxley Act (Stephens, 2002).

### **What about directors and executives?**

A serious attempt to change corporate culture must venture into the boardroom itself. Mooted reforms in this area, some of which are in the US Sarbanes-Oxley Act, include (Stephens, 2002):

- simplifying the form of financial statements for the average investor;
- requiring public companies to disclose rapidly, and in plain English, material changes to their financial condition or any other significant news;
- prohibiting loans to directors and corporate officers;
- mandatory forfeiting of incentive remuneration in the event of accounting restatements;
- making CEOs and chief financial officers responsible for the accuracy of financial statements;
- requiring that stock options be expensed in the accounts of a company;
- subjecting officers, directors and auditors to a greater risk of litigation; and
- gaoling executives and directors who deliberately mislead or who withhold information, especially if in doing so they benefit themselves at the expense of the shareholders.

None of these reforms, however, would in any way restrict the ability of directors to make decisions. They merely strengthen the hand of shareholders and regulators to hold them responsible for these decisions. They extend the principles of mutual obligation beyond the welfare system and into corporate governance.

### **Black-letter law versus principles**

Bosch (2001) argues that there is little scope for legal changes on corporate governance and financial disclosure, in that detailed black-letter law, or rules, are often only a roadmap for the unscrupulous, as was demonstrated in the Enron off-balance sheet transactions. However, an underlying theme to the numerous calls in the business press for reform in Australia is that the USA response to its corporate scandals will, by virtue of the primacy of its capital markets, become *de facto* standards that Australia must adopt. Nevertheless, with the notable exceptions of HIH Insurance and One.Tel, Australia seems to have weathered the demise of one of the longest bull markets in history, without producing the excesses that characterised previous bubbles. The reforms introduced in Australia in response to corporate malfeasance in the 1980s, appear to have held up under pressure. There were reforms to corporate law, accounting standards and stock exchange disclosure standards after that debacle, which threatened Australia's access to foreign capital and markets. Also, there were reforms to corporate culture and notions of good governance (Bartholomeusz, 2002).

The strength to the responses in Australia in the 1980s, lies in their nature. Unlike the US regime (including the raft of changes made during 2002), Australia has tended to favour "fuzzy" laws and rules – statements of principle rather than black-letter law. In combination with codes of best practice, such an approach tends to encourage companies and people to lift their gaze from regulatory minimums to the principles involved. It is arguably vital that Australia maintains a principles-based approach to regulation and self-regulation. As noted by Bartholomeusz (2002), in making technical compliance with the law less of an issue than compliance with its spirit, the Australian system has offered scope for good governance and practice to evolve and respond to the corporate environment and community expectations.

Whilst the Australian government has not yet committed itself to corporate governance reforms pending the reporting of the Royal Commission on HIH Insurance expected in March 2003, the Labour party opposition issued in late August 2002, a discussion paper on "Improving corporate governance". Issued by the Shadow Minister for Finance, Small Business and Financial Services, Senator Conroy (Conroy, 2002), the paper lists a range of policy commitments, which include:

- doubling the penalties for serious breaches of the Corporations Act;
- introducing legislation to protect corporate whistleblowers;
- implementing the recommendations of the Ramsay Report on independence of company auditors and, in addition, banning the provision of certain non-audit services to audit clients;
- requiring auditors to specifically report to shareholders and to a company's audit committee on instances of aggressive accounting;
- requiring auditors to attend and answer questions at annual general meetings;

- requiring the full disclosure of arrangements governing executive remuneration and enforcing the requirements for disclosure in the Corporations Act;
- expensing share options;
- providing to all shareholders any information provided to analysts during an analyst briefing; and
- improving analysts' independence by ensuring that they always act in the interests of the users of the reports – not in the interest of the analyst or the firm which employs the analyst.

Further policy options are suggested in the following areas:

- auditor independence and the integrity of financial statements;
- executive remuneration;
- corporate disclosures and information for investors;
- the composition of boards; and
- analyst independence.

There are undoubtedly some useful points raised in Labour's discussion paper that will improve corporate governance in the future. However, a careful reading of the detail leaves the impression that this paper, if implemented, would lead Australia down the path of black-letter law rather than strengthen the principles-based approach that has arguably served Australia well in the past.

However, despite the optimism of writers such as Bosch (2001) and Bartholomeusz (2002), the stories of excess and incompetence emerging from the public enquiries into the collapses of companies such as One.Tel and HIH Insurance, and the corporate scandals surrounding WorldCom and Enron in the USA, have made investors nervous about the standards of corporate governance in Australia (Skeffington, 2002). That anxiety has prompted the Australian Stock Exchange (ASX) to set up a corporate governance council, which includes representatives of key business and professional groups, to review governance standards as part of ASX's efforts to ensure the Commonwealth government does not force new legislation on companies. The council plans to recommend amendments to the ASX's listing rules and to the Corporations Act. The council has also set corporate governance requirements for companies to include in their annual reports to shareholders. It wants companies to release quality information on share and options schemes, audit committees, external auditors, accounting standards and "shareholder empowerment". If companies are not able to comply, they will be required to explain why.

### **Shaping the winds of change**

The Ramsay Report, the HIH Royal Commission, investigations by ASIC and the ongoing agitation and analysis in the financial press, will all impact on the future direction of audit regulation and corporate disclosure and governance in Australia. In particular, the recent release of the discussion paper on the next phase in the Commonwealth Government's Corporate Law Economic Reform Program (CLERP 9, 2002), addresses a number of key issues. These include recommendations on expanding the role of Australia's Financial Reporting Council; suggestions for improving audit quality and accounting standards;

principles for continuous disclosure; and recommendations to improve shareholder participation and information availability. The current government strategy is to introduce into parliament in 2003 what Treasurer Peter Costello claims will be corporate accountability laws defining world's best practice (Gordon, 2002). However, will the long list of proposed corporate reforms solve the problems of the unbounded opportunistic behaviour of directors and managers in pursuing self-interest to the detriment of the long-term well-being of the companies they run? Will compliance on mandatory disclosure of remuneration and non-audit services, accounting requirements for options, and making CEOs responsible for the accuracy of the financial statements, prevent excessive compensation schemes, lack of audit independence, and creative accounting?

In commenting on the dangers of materialism as discussed earlier, Mills (2002) identified five central dangers, which result in:

1. displacement of an ontology of consciousness;
2. a simplistic and fallacious view of causality;
3. the loss of free will;
4. renunciation of the self; and
5. questionable judgements concerning social valuation practices.

It can be argued that these five dangers in turn can be transformed into:

1. a failure to exercise due diligence;
2. a short-term mentality of the relationship between creative accounting and compensation;
3. compromised integrity and objectivity;
4. socialisation with powerful groups; and
5. rationalising creative accounting and other opportunistic behaviour.

It is startling how close the above five deductions reflect the current corporate world, as observed in the recent corporate collapses in the USA and Australia.

This paper has attempted to challenge some of the current thinking on corporate governance reforms. It is argued that changes in the structure of the corporate governance and compliance regime will not necessarily change the risks associated with the problems in the corporate environment. Stewardship and agency principles have existed over decades and accountants and directors have been champions of the capital market and its intellectual power, but history shows that the religion of materialism needs to be recognised, and addressed, if meaningful change is to occur. As the capital market has evolved alongside the rapid growth of technology and globalisation, there has arguably been an unhealthy shift in attitudes in the corporate world that has also existed in earlier times in the development of modern corporations. Is the history of corporate behaviour just repeating itself? It is important to understand this phenomenon if any proposed reforms are to be effective.

In concluding this paper, we return once more to the tale of the Mad Hatter's Tea Party ... this piece of rudeness from the (corporate) March Hare and Mad Hatter was more than

Alice (the auditor) could bear: she got up in great disgust, and walked off; the Dormouse (the regulator) fell asleep instantly, and neither of the others took the least notice of her going, though she looked back once or twice, half hoping that they would call after her: the last time she saw them, they were trying to put the Dormouse into the teapot! "At any rate I'll never go *there* again!" said Alice as she picked her way through the wood. "It's the stupidest tea-party I ever was at in all my life!" Let us hope, at least for the sake of the credibility of auditors and the accounting profession, and the public that have in the past placed their trust in them, that history does not repeat itself.

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