Auditors and the Reporting of Illegality and Financial Fraud

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Auditors' responsibilities have become the subject of renewed Australian and international interest in the light of the spate of the corporate collapses of recent years. Whilst this has continued to be the subject of debate over the last decade or more, the clarification of the rules in this area has become a matter of particular concern recently. This is especially so in relation to the reporting of financial fraud or illegality. This issue has become the subject of debate in a number of countries apart from Australia.

In the United Kingdom, for example, the enactment of the Banking Act 1987 in England authorised auditors of banks to communicate fraud and other financial concerns confidentially to the Bank of England. Also, s. 109(1) of the Financial Services Act 1986 overrides any duty that an auditor may have to a client not to communicate information, which the auditor has become aware of as an auditor, where the auditor in good faith communicates that information to the Securities Investment Board. In other words, s. 109 'creates a right and a power for the auditor to disclose appropriate information to the appropriate regulator' (Sweeney-Baird 1990, pp. 30-1). The recent decision of the House of Lords in *Caparo Industries plc v. Dickman and Ors* (1989) 1 ACSR 636 has also examined the implications of auditors' reports for potential investors in the company. The House of Lords found that there was a duty of care owed by an auditor to an individual shareholder but not generally to potential investors. This decision has received considerable discussion elsewhere and I will not traverse the same ground here. Suffice it to say that it has clarified the potential obligations of auditors for negligent action. However, it does not greatly assist us in discussing the issue of the responsibility of auditors for detecting financial fraud and illegality.

The United States has seen the publication in 1987 of the report of the Treadway Commission, the National Commission on Fraudulent Financial Reporting (*see* further Goldstein and Dixon 1989, pp. 439-74; *Corporate Crime Reporter 1987*, pp. 1-3). The Commission had been set up by the American Institute of Certified Public Accountants (AICPA) and several other American private accounting organisations. In addition to recommending that corporate management design and implement internal control systems adequate to prevent and detect fraudulent financial reporting, the Treadway Commission concluded that '[a]uditors can and should do a better job of communicating their role and responsibilities [as well as their findings] to those who rely on their work' (quoted in Goldstein and Dixon

1989, p. 471). There has also been an ongoing Congressional debate concerning the responsibilities of auditors to the investing public as reflected in 1990 United States House of Representatives hearings (Wyden sub-committee of the Energy and Commerce Committee) aimed at amending the Securities Exchange Act of 1934 to improve procedures to provide reasonable assurance of detecting illegal acts (see further Neebes 1990 and Congressional Record H8892, 4 October 1990). This legislation has received the support of the accounting profession in the light of criticisms made of auditors of the failed savings and loan institutions and in view of the possibility of even harsher legislation being passed (*see Wall Street Journal*, 14 September and 5 October 1990). It has been suggested that fraud and other criminal conduct played an important role in the collapse of about 40 per cent of the savings and loan institutions which had been taken over by the US government's Resolution Trust Corporation (Crenshaw 1990). This alleged widespread level of illegality had the effect of reviving questions about the independence of auditors in auditing large corporate clients such as the failed Lincoln Savings and Loan Association (Nash 1989). Although more than half of the profits reported by the Lincoln Savings and Loan were the result of sham transactions, its auditors, Ernst and Young, apparently claimed that their role was only to ensure that the firm's accounts complied with generally accepted accounting principles and not to determine the safety and soundness of the firm (see further Thomas 1989; Wayne 1989). The proposed new American legislation would require auditors to notify the Securities Exchange Commission (SEC) of possible illegalities by the company and to evaluate a company's internal control measures periodically.

In the United States the AICPA has recently promulgated a number of new Statements on Auditing Standards which, inter alia, have had the effect of increasing the responsibilities of auditors in detecting material errors and irregularities and in detecting violations of law and regulation which have direct and material effects on financial statements (Neebes 1990). However, the Chairman of the AICPA Auditing Standards Board recently argued that there are significant limits upon the capacities of the auditor to respond to financial fraud. As he put it:

> Two inescapable realities constrain the auditor's ability to assume broader responsibilities than those now contained in the literature to detect and report illegal activities. One, it must be understood that the operations of American businesses are today a broad, almost incomprehensible, array of legal requirements imposed at every level of government. Moreover, in circumstances in which publicly-held companies are engaged in foreign operations, the fabric of legal requirements becomes even more extensive and uncertain. The Auditing Standards Board, which developed the new standards on illegal acts, believed it simply would not be feasible to design an audit to provide positive assurance of detecting all material illegal acts. Two, it should be recognised that auditors, although highly trained and reliably regarded as experts in financial matters, are often ill-equipped or unable to arrive at legal conclusions concerning whether a specific activity or transaction comports with legal requirements. Here the auditor relies on legal counsel and other specialists. Even then, sometimes uncertainty associated with the interpretation of applicable laws or regulations

> or surrounding facts precludes a legal judgment (Neebes 1990, p. 13).

Consequently, Neebes went on to say that the response of the profession has been to reach the following 'solution to this problem' :

> First, it has defined an affirmative obligation to consider laws and regulations that are generally recognised by auditors to have a direct and material effect on the determination of financial statement amounts. Second, it has established auditor responsibilities with respect to audit discoveries of illegal acts which go beyond the concept of direct and material effects on financial statement amounts . . . Lastly, if an auditor concludes that an illegal act has a material effect on the financial statements, and the act has not been properly accounted for or disclosed, the auditor would express a qualified opinion or an adverse opinion on the financial statements. Such a qualified or adverse opinion would, of course, result in notification to the SEC of the illegal act (Neebes 1990, pp. 13-14).

However, the AICPA has strongly resisted proposals which would require an auditor to detect illegal acts which 'could materially affect the issuer's financial statement or operations'. Such a requirement has, not surprisingly, been seen as being impracticable (Neebes 1990, p. 19).

In Australia, concern over the responsibilities of auditors faced with corporate illegality has also been evident in the spate of legal actions brought against auditors and the increasing realisation by auditors and regulators that the current laws imposing liabilities upon auditors to report illegality and financial irregularities are less than adequate. In 1987, the National Companies and Securities Commission (NCSC) announced that it would target auditors in its crackdown on accounting standards (Potter 1987, pp. 1-2). Notable recent cases of apparent audit failure include those involving Rothwells, Tricontinental and the National Safety Council, to mention but a few. At the same time we have seen new legislation in the form of the *Corporations Act 1989* (Cwlth) which has modified the law in this area. Arguably, this legislation still needs to be greatly strengthened if it is to be of more than symbolic value.

However, the view of the auditing profession in Australia is that it is management that has the role of detecting financial fraud and that the detection of fraud by auditors is seen as being secondary to the primary duty of reporting whether the accounts are 'true and fair' (Gay and Pound 1989). For example, paragraph 7 of AUS1 (*see* Parker 1991) provides as follows:

> While the auditor is responsible for forming and expressing an opinion on the financial information, the responsibility for its preparation lies with the management of the entity. Management's responsibilities include the maintenance of adequate accounting records and internal controls, the selection and application of appropriate accounting policies, and the safeguarding of the assets of the entity. The audit of the financial information does not relieve management of its responsibilities (*see* further Godsell 1990, p. 121).

However, it needs to be said that where large accounting firms also provide substantial advice on the preparation of a corporation's accounts, the thrust of the philosophy as expressed in AUS1 (Parker 1991) is much harder to justify, unless

of course auditing is entirely divorced from the remainder of accounting work for a corporation.

Auditors have argued that they should be able to avoid responsibility provided that they put in place an audit plan which provides a reasonable expectation of discovering material mis-statements in the accounts, rather than detecting all material fraud. In this context it is often argued that the public has unrealistic expectations of auditors and it has been left to the courts to seek to bridge the gap between public expectations and the views of auditors concerning their responsibilities.

Almost a century ago, the courts recognised the approach taken by auditors in the conclusion that the auditor was to be seen as a watchdog and not as a bloodhound (per Lopes LJ in *In re Kingston Cotton Mill Co (No 2)* [1896] 2 Ch 279 at 289, 290) . However, the courts have also come to recognise that the standards of care and skill are now more stringent than they were in 1896, when this colourful expression was articulated. As Moffitt J observed in *Pacific Acceptance Corporation v. Forsyth* (1970) 92 WN (NSW) 29 at 65): 'If fraud has taken place and is undetected by the auditor he is blameworthy in the eyes of the law [but] only so far as he has been negligent in determining the scope and character of his examination' (*see further BGJ Holdings Pty Ltd and Anor v. Touche Ross and Co and Ors* (1988) 12 ACLR 481 and *WA Chip and Pulp Co Pty Ltd v. Arthur Young and Co* (1987) 12 ACLR 25).

However, short of a breach of a statutory duty (per Corporations Law s. 332(10)), there is no obligation on the part of the auditor to report fraud if the auditor believes that the financial statements give a 'true and fair' view of the financial health of the company (Gay and Pound 1989, p. 127). Also, the auditor's duty of confidentiality to the client does not prevent the auditor from reporting a matter if he or she knows that a fraud has been committed. However, if developments in the United States are any guide, it may be only a matter of time before it will be seen as insufficient for auditors in Australia to say that they have taken reasonable steps to plan an audit and to leave it at that. As Gay and Pound (1989, p. 128) point out, in the United States the Statement of Auditing Standards SAS 53 issued in 1988 'the auditor is expected to detect material errors and irregularities, not just plan the audit to search for them. This is an important extension of the auditor's role compared to the position in Australia, as expressed in Statements of Auditing Practice AUP16'. As Godsell has noted, AUP16 points out that the failure to detect material fraud or error does not necessarily imply any failing on the part of the auditor (Godsell 1990, pp. 122-3). Paragraphs 6 of AUP16 states:

> Due to inherent limitations of an audit there is a possibility that material mis-statements of the financial information resulting from fraud, and, to a lesser extent, error, may not be detected. The subsequent discovery of material mis-statement of the financial information resulting from fraud or error existing during the period covered by the auditor's report does not, in itself, indicate that the auditor has failed to adhere to the basic principles governing the audit. The

> question of whether the auditor has adhered to the basic principles governing an audit is determined by the adequacy of the procedures undertaken in the circumstances and the suitability of the auditor's report based on the result of these procedures.

Paragraph 8 of AUP16 adds that

> The risk of not detecting material mis-statement resulting from fraud, is greater than the risk of not detecting a material mis-statement resulting from error, because fraud usually involves acts designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor.

Accounting Standards have the force of law except in so far as they are inconsistent with the *Corporations Act 1989* (*see further* Parker 1991). The principal provisions of the Corporations Act dealing with the duties of auditors remain largely unchanged from those appearing in the Co-operative Scheme Companies Code. Apart from expressing the section in gender neutral terms, Corporations Law s. 332 is in substantially similar terms to the Code s. 285. However, the ambit of the auditor's duties under s. 332(3)(a) is a little wider than the duties under Companies Code s. 285(3)(a) in that the new provisions require the auditor to reach a conclusion regarding the truth or fairness of all the matters dealt with in Division 4 of Part 3.6 and not merely the matters set out in Companies Code s. 269, which dealt with the profit and loss account, the balance-sheet and group accounts. This section contains the following principal provisions.

- Under s. 332(1) the auditor is required to report to the members on the accounts which are required to be laid before the company at an AGM as well as upon the company's accounting records and other records relating to those accounts. This provision also requires that the auditor report on group accounts if the company is a member of a group. This report is to be furnished to the directors of the company in sufficient time to allow them to comply with their duties under s. 315(2) to forward financial statements to members at least 14 days before the meeting.
- The contents of the auditor's report are spelt out in s. 332(3). The auditor is required to state whether in his or her opinion the accounts of the company are properly drawn up so as to provide a 'true and fair view' of **the matters required by Division 4 of Part 3.6** to be dealt with in the accounts, whether the accounts are in accordance with the Act and whether they are in accordance with applicable accounting standards. Where the accounts are not drawn up in conformity with the applicable accounting standards, the auditor is required to express an opinion as to whether the accounts would have presented a true and fair view if they had been prepared in accordance with such standards. Where the auditor does not believe this to be so, the auditor is required to give reasons for this opinion (per s. 232(3)(ii)). Also, where the auditor is of the opinion that the accounts are not properly drawn up as required or that there has been an unacceptable failure to comply with applicable accounting standards, then the auditor is

required to report the reasons for reaching these conclusions. Where the auditor is not satisfied with compliance with the approved accounting standards he or she is required by s. 332(11) to furnish a copy of the auditor's report to the Australian Accounting Standards Board within 7 days of providing his or her report to the directors.

- The auditor is also required by s. 332(3)(d) to report on any defects or irregularities in the accounts or group accounts or any omission from the accounts which would have the effect of not providing a true and fair view.
- The auditor is also required to form an opinion in regard to various matters set out in s. 332(4) regarding the adequacy of accounting records.
- Section 332(9) requires the auditor to report in writing to the Commission any failure upon the part of the company or the directors to comply with annual general meeting requirements set out in s. 245 or to comply with the financial statements requirements of s. 316.
- Probably the most important provision for our purposes is to be found in s. 332(10). It is worth setting out this section in full. This is in the following terms:

  Except in a case to which subsection (9) applies, if an auditor, in the course of the performance of duties as auditors of a company, is satisfied that:

  . there has been a contravention of this Act; and

  b. the circumstances are such that in the auditor's opinion the matter has not been or will not be adequately dealt with by comment in the auditor's report on the accounts or group accounts or by bringing the matter to the notice of the directors of the company or, if the company is a subsidiary, of the directors of any body corporate of which the company is a subsidiary;

  the auditor shall forthwith report the matter to the Commission by notice in writing.

The general penalty provisions in s. 1311 apply to breaches of the auditors' duties provisions in s. 332. Section 1311(1) provides that:

> A person who:
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> . . .
> b. does not do an act or thing that the person is required or directed to do by or under a provision of this Law; or
> c. otherwise contravenes a provision of this Law;
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> is guilty of an offence by virtue of this subsection . . .

As the amount of the penalty for a breach of s. 332(10) is not specified in Schedule 3 of the Corporations Law, or in s. 332 itself, s. 1311(5) provides that the applicable penalty for a breach of s. 332(10) will be a fine of $500. This fine is hardly a great deterrent although application may also be made by the Commission under s. 1292 of the Corporations Law to the Company Auditors and Liquidators Disciplinary Board to cancel or suspend for a specified period the registration of an auditor who has failed to comply with s. 332(10). Were the

latter penalty used it would of course constitute a more significant deterrent than the nominal fine which has been provided for in the legislation.

There have been no reported cases on this section or on its Companies Code predecessor. It seems that concern about the limited nature of this provision tends to arise following blatant failures on the part of auditors to report matters that come to their attention. For example, arising out of Mr Justice Stewart's Royal Commission of Inquiry into the activities of the Nugan Hand Group during the early 1980s, the Commission made various recommendations pertinent to the obligations of auditors. The Royal Commission had found that:

> . . . the key to an understanding of how it was that the Nugan Hand Group was able to be spawned in Australia and rapidly expand overseas, is to be found in the methods used to give the published accounts of Nugan Hand Ltd . . . a grossly false appearance . . . [I]t was the appending of the auditors' certificate to such accounts that thereafter gave them the status which automatically follows from the fact that a duly qualified auditor certified them. In the ordinary course of events the audited accounts of a public company are accepted at face value and no attempt is made to go behind them. Well aware of this Messrs F.J. Nugan and M.J. Hand unscrupulously published and proffered to the world at large the accounts of Nugan Hand Ltd to gain commercial acceptance and credibility for the company, and for themselves, not only in this country but overseas, and, in particular, in Hong Kong (Royal Commission of Inquiry into the Activities of the Nugan Hand Group 1985, p. 763).

The Stewart Commission went on to express concern about the fact that, after reviewing the views of the relevant accounting bodies, there was:

> . . . little or no consensus of opinion in relation to this aspect of the auditor's duty [i.e. to detect fraud], not only among auditors but also among those who rely on published audited company accounts such as those proposing to deal with the company on the strength of its audited accounts . . . Essentially this perceived difference of opinion, on the question of what is the extent of the auditor's duty to detect fraud, stems from two distinct interpretations of the duty which seem to be current. The distinction seems to be whether the auditor is under a duty to detect fraud that is, to specifically search for fraud, or whether, on the other hand, it is enough for the auditor to plan his audit so that he has a reasonable expectation of detecting material mis- statements in the financial statements resulting from irregularities or fraud. The latter view appears to be echoed in this country in the current Statements of Auditing Practice in respect of Fraud or Error (AUP16) issued by the Accounting Standards Board in June 1983 (Royal Commission of Inquiry into the Activities of the Nugan Hand Group 1985, p. 76).

The Royal Commission explained how the audit partner in the firm of accountants which audited the Nugan Hand accounts, and which had earlier prepared these accounts, came to certify the Bank's accounts as being 'true and fair' :

> Mr Pollard [the audit partner] said Mr Brincat [an employee at that time] completed the audit work for the accounts of Nugan Hand Ltd. Mr Pollard signed the annual accounts audit certificate because Mr Brincat was not yet a partner and therefore not entitled to sign. However, Mr Pollard admitted he had not looked at Mr Brincat's working papers and so was in no position to hold the opinion expressed above his signature (which was that the Nugan Hand Ltd

> accounts for 1974 gave a true and fair view of the state of the Group's affairs) because he himself had not done the necessary work. Mr Pollard said that when he signed the accounts he did not know whether they were true or not. He said the documents were probably just put in front of him and he signed them as he relied completely on Mr Brincat (Royal Commission of Inquiry into the Activities of the Nugan Hand Bank 1985, pp. 245-6).

Brincat subsequently became a partner with Pollard and Heuschkel. For five years from 30 June 1975 Brincat prepared the accounts for Nugan Hand Ltd as well as acting as the auditor for the company and its associates. At page 119 of the *Final Report*, Justice Stewart observed that 'In certifying those accounts each year he [Brincat] says he simply accepted Mr F.J. Nugan's version of various transactions'.

Another aspect of the Nugan Hand accounts which had concerned the Royal Commission had been the use of internal bills of exchange to represent inter-company debts. Neither Brincat nor his fellow partners had experience in their use and they therefore sought independent legal advice concerning them. However, as the Royal Commission noted at page 120:

> Mr Nugan intervened at this point and persuaded the partners including Mr Brincat to accept the view of his own solicitor, Mr J.L. Aston, that the use of internal bills was not inappropriate although it should be the subject of a suitable note to the accounts (*see also* the further discussion of this matter at p. 246 of the *Final Report*).

Justice Stewart added:

> The use of internal bills of exchange continued to be the subject of frequent discussions between Mr F.J. Nugan and Mr Brincat until, at a meeting three weeks before Mr Nugan's death, Mr Brincat said that he would qualify the audit report for the year ending 31 January 1980 to the extent of writing off between $4-5 million against the internal bills, thus exposing Nugan Hand Ltd as hopelessly insolvent.

The Royal Commission's recommendations included a call for the codification of the duty of auditors of public companies to detect fraud in a company. As Mr Justice Stewart put it at pp. 766-7 of his *Final Report*:

> To the extent that there does seem to be some uncertainty as to the scope of this duty it is obviously a matter of some concern. It is clearly undesirable for there to be any significant differences between the ambit of the duty as perceived by the auditor and the understanding held by the client and those proposing to deal with the company on the strength of the audited accounts. In the view of the Commission there is a need for the legislature to define precisely the auditor's duty to detect fraud and whether the duty extends to third parties who can be expected to rely on the audited accounts and to provide for penalties for the deliberate and reckless failure to carry out such duty.

The Royal Commission also recommended that the role of auditor and accountant to a public company be separated. After discussing these two recommendations with the accounting profession 'the [National Companies and Securities] Commission determined that it could not support [these] recommendations . . .' These NCSC recommendations were subsequently endorsed by the Ministerial

Council on Companies and Securities (NCSC 1989, p. 30). The NCSC (1989, p. 30) did, however, accept two other recommendations of the Nugan Hand Royal Commission. One of these involved the creation of a criminal offence for an auditor who certifies company accounts which the auditor knows contains false statements or which will create a false impression and the creation of a specific offence for an auditor who deliberately or as a result of reckless indifference fails to comply with the requirements of what is now s. 332 relating to the duties of auditors. To-date no further official action has occurred to create such a criminal offence.

More recently the Tricontinental Royal Commission was told that one of the reasons for the collapse of Tricontinental was that the auditors had been steered away from certain parts of the business. The former managing director of Tricontinental, Ian Johns, reportedly had in 1987 issued a written instruction to the internal auditor from Hungerfords to place more emphasis on the areas of capital markets, corporate funding and cash trusts, rather than the areas of corporate services and project finance (Kaspiew 1991). A number of other current negligence actions against auditors are also well known. For example, AWA Ltd is suing Deloitte Haskins and Sells for damages of between $39 million and $42 million for the loss of over $50 million due to the alleged failure of the auditors to warn the management of AWA of the speculative nature of foreign exchange dealings being conducted upon behalf of AWA by its former foreign exchange dealer Andrew Koval (Lampe 1991, p. 38). As Anne Lampe has reported: 'In its defence, Deloittes is arguing that the AWA board should have known about what was going on in its foreign exchange division, particularly given the magnitude of the transactions. It should have asked how 'millions of dollars of profit' emanated from that division (*see further* Burchill 1990, p. 20). Reference might also be made to similar actions for $264 million which have been commenced against Howarth and Howarth by a Price Waterhouse liquidator for its audit of the National Safety Council accounts (*see further* Burchill 1990, p. 20). Apart from the audit context, it has almost become commonplace to see actions for damages being brought against accountants as advisers in commercial transactions, as they are often the only group involved in a transaction which has any remaining funds (*see The Canberra Times*, 2 March 1990, p. 15; *Sydney Morning Herald*, 2 March 1990, p. 23; Peers 1991, p. 16; *Australian Business*, 23 January 1991, pp. 32-3). It is not surprising therefore that as of April 1990, some 44 per cent of the amount claimed against all accountants should have been made in relation to audit work. The next largest area of insurance claim was in relation to taxation work which accounted for 14 per cent of the total amount claimed against accountants (Blue 1990, pp. 84-5).

It is also of interest to refer to the special investigation report into Rothwells by Mr M.J. McCusker QC (1990). In that report, serious problems with the operation of the duties of auditors' provisions were again identified. The fact that the Rothwells accounts had been audited by KMG Hungerfords, one of the Big Six accounting firms, was used by Rothwells to assure the WA Government and the

public that Rothwells was 'basically sound' (McCusker 1990, p. 29). In many ways the parallels between the internal financial transactions of Nugan Hand Ltd and Rothwells are quite striking. Due to the wide range of Rothwells' financial transactions discussed by Special Investigator McCusker, it is possible here to touch on only a small number of these. As McCusker noted:

> In my opinion, however, the true 'cause' of the failure of Rothwells is to be found in its 'receivables', the debts owing to it which, as in the case of most financial institutions, constituted its major asset . . . compounding [Rothwell's 'woefully inadequate' financial records] was the manner in which the massive indebtedness of L.R. Connell and Partners and Oakhill [Connell's private company] to Rothwells at 31 July 1987, of $324m, was 'removed', and by journal entries purportedly replaced with 'assets' such as debts for millions of dollars owing by companies with $2 paid up capital, with recourse against the directors expressly excluded by the terms of the loan . . . (McCusker 1990, pp. 26-7).

McCusker went on to add that:

> Since 1983, Connell had been a substantial borrower from Rothwells, mainly through his partnership (L.R. Connell and Partners) and his private company, Oakhill Pty Ltd. The borrowings were massive, and for the most part unsecured. Over the years, they had rapidly increased. But no-one reading the published Annual Report and Accounts of Rothwells would have appreciated that to be the case, for at the end of each financial year the 'Connell debt' would be 'removed'. This was done in various ways, amounting to transactions which were entirely shams, or (in 1987) mainly shams.

The effect of these 'sham' transactions was to remove the 'Connell debt' on each balance date and return it by journal entry on the following day with a view to ensuring that the public accounts did not reveal the extent of Connell's borrowings. The reversal of these journal entries received no consideration from the auditors, even though Schedule 7 of the Companies Code and Stock Exchange Listing Rules require the disclosure to the shareholders of any 'material contract', such as the sham assignment of the debts of Connell on balance day (McCusker 1990, pp. 52-3). McCusker referred to the 'perfunctory and tolerant manner in which the audits were carried out' by Carter and his associates (McCusker 1990, p. 54). No efforts were made by Carter to establish that debts existed or that the debtors were aware that their debts had been 'assigned'. Although debtor confirmation letters had been prepared by Carter to determine the amounts supposedly owed, none of these letters were sent to the alleged debtors, thus avoiding further notification of the sham nature of these transactions. As McCusker notes:

> The revelation of the fact that the $35m entry was a sham, which would have flowed from the responses to the confirmation letters, would have obliged the auditors both to qualify their report, stating the true position (as to Connell's debts), and to report the entire matter to the Corporate Affairs Commission, under s. 285(10) of the Companies Code (McCusker 1990, p. 56).

It was clear that 'the audit team was aware of the pattern that had developed, whereby large Connell borrowings were "extinguished" on each balance date' (McCusker 1990, p. 58).

In an analysis for the McCusker inquiry of the KMG Hungerford's audit of Rothwells, Deloittes had concluded that inadequate provision had been made by Rothwells for doubtful debts and that, upon the basis of the receivables, the auditors could not have reached a conclusion that Rothwells had made a proper provision for doubtful debts (McCusker 1990, p. 64). Similarly, a secret 1987 review of receivables by Price Waterhouse commissioned by Connell quickly found that Rothwells was in an extremely serious financial situation. Although the Price Waterhouse team were forbidden by a 'confidentiality agreement' from disclosing the contents of its review to anyone other than Connell, Pope, the Price Waterhouse partner who had led the review, was, as McCusker explained, 'astonished and concerned' when he saw the July 1987 Rothwells accounts as he believed that they were misleading (McCusker 1990, p. 32). Apparently, Pope felt compelled to comply with the terms of the confidentiality agreement as he knew that the WA Government's $150 million overdraft guarantee to Rothwells after the 1987 stock market crash was very vulnerable. Also, he was concerned that his client, Bond Corporation, had to be misled although it was also at risk from Rothwells. Legal advice had led Pope to conclude that he was precluded from disclosing what he knew.

Most of the 'Connell debts' to Rothwells were eventually 'cleared off the slate' by the agreement of the WA government to pay $400 million for a share in a proposed Petrochemical plant project which Connell and Dallas Demster had packaged. As McCusker noted, this effectively amounted to 'a gift of about $300m' to Connell 'enabling him to clear a large part of his direct and indirect indebtedness to Rothwells' (McCusker 1990, p. 39).

Looking further at the role of the auditor in this sorry tale, McCusker noted that:

> The evidence of Carter [the auditor] discloses a quite extraordinary approach to the assessment of what was a proper provision for doubtful debts. Asked . . . whether he sought to make some assessment of the credit worthiness of Rothwells' debtors (bearing in mind that the audit working papers revealed little in the way of such assessment), and whether he called for balance sheets or profit and loss statements in respect of Rothwells' debtors, he said:
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> > 'Not specifically because they would not have been available for the recent accounting period at that time . . .'
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> . . . The proposition that Connell 'stood behind the Rothwells' debts', as providing 'comfort' to the auditors, is a recurrent theme in the evidence of Carter (McCusker 1990, pp. 67-9).

McCusker went on to note that:

> No attempt was made by Carter, or by any of the Rothwells directors, to obtain a verified statement of Connell's net assets, so as to determine whether his 'wealth' (financed by extensive borrowings from Rothwells) was sufficient to meet his ever-mounting debt with Rothwells (McCusker 1990, p. 73).

Instead of undertaking any independent assessment of the accounts of Rothwells, Carter admitted that due to unavailable documentation 'to a large extent we were forced to rely on his (Hugall's) [a Director and Secretary of Rothwells] own

assessment of the company's prospects'. He added that: 'We relied more on in depth discussions with the directors . . . rather than looking at files' (McCusker 1990, pp. 70-1). Despite the finding of McCusker that Carter was fully aware that Rothwells was being used by Connell for very extensive borrowings (McCusker 1990, p. 119), no qualifications were made to their report on the Rothwells accounts by the firm of auditors. As McCusker noted:

> . . . Carter relied very heavily upon Lucas and Hugall in his audit of the receivables. They were both directors of Rothwells. That reliance, and lack of any objective evaluation, was not calculated to produce the 'independent audit' which the shareholders and the public are entitled to expect. Lucas was in charge of the loan portfolio. Many of Hugall's companies were in fact substantial borrowers from Rothwells. The audit working papers obtained by the investigation confirm his dependence on the word of Lucas and Hugall, as distinct from an evaluation of the records . . . The picture of the audit that emerges is one of a total failure to take any steps, independently of the executive directors, to determine the true state of the receivables, and an awarenesss that for several years the accounts and records relating to receivables had been and still were quite unsatisfactory (McCusker 1990, pp. 107-9).

In response to a number of 'horror stories' from inquiries such as the Nugan Hand Royal Commission and the McCusker Investigation, the NCSC simply contented itself with issuing a Practice Note (Release Number 356) in September 1990 on the duties of auditors to report to the Commission under the predecessor of s. 332(10). This practice note largely restates the terms of Companies Code s. 285(10) [the equivalent of the present s. 332(10)] and provides a few examples of breaches and how these might be dealt with. For example, the Commission notes:

> 7. Where an auditor believes that the contravention can reasonably and effectively be remedied by the directors, and the directors are subsequently able to ensure that there will be no repetition of the contravention, the auditor is not required to notify the Commission and may simply report the matter to the directors . . .
>
> 10. Once the auditor has decided that the Commission should be notified pursuant to sec 285(10), such notification must be given without delay, i.e. not notifying the Commission until the directors' views can be sought on whether notification should be given to the Commission is not in itself a sufficient reason for delaying notification. In particular, the auditor should not wait until the conclusion of the audit to report a matter that becomes known at a preliminary stage of the audit.
>
> 11. Where the directors have been notified of a contravention of, or failure to comply with, the provisions of the Code and the auditor is not satisfied with the action taken or that timely remedial action will be taken, the Commission should be notified without delay.

In late February 1991, Arthur McHugh, the then Executive Director, Markets, of the ASC had occasion to comment on the ambit of s. 332(10). McHugh revealed that 'The Commission has recently had cause to re-examine this [section] and has reached the conclusion that the duty to report is wider in several respects than had previously been realised'. In particular, he went on to add:

> First, the duty to report arises forthwith and not at some indeterminate future time or at the conclusion of the audit.
>
> Second, the range of possible contraventions covers the whole gamut of the Law and certainly includes difficult but important areas like s. 232 (directors' duties).
>
> Third, and most controversially, the Commission believes that it is sufficient that the auditor form an opinion based on the available facts at the balance of probability degree of satisfaction. It does not require evidence that would persuade to say the degree required for a successful prosecution of the matter identified (Release Number 356; McHugh 1991, pp. 12-13).

The first two of the above points largely re-state matters already covered in the NCSC's September 1990 Practice Note on s. 285(10) of the Code. It will be interesting to see if the third matter raised by McHugh leads auditors to suddenly begin to come forward in greater numbers than has been the case in the past. I somehow doubt it, despite the existence of flagrant cases such as the Nugan Hand and the Rothwells cases referred to above.

Some recent Australian Empirical Data

With colleagues at the Centre for National Corporate Law Research at the University of Canberra, Stephen Bottomley and I undertook a study of the attitudes to corporate law of public company directors in the top 500 Australian companies drawn from the 1990 *Business Review Weekly* (BRW) listing of the top 500 companies. This study involved detailed interviews of over 100 directors from the top 500. A total of almost 150 interviews were conducted, two-thirds being with company directors and the remainder with advisers and observers such as corporate lawyers, auditors, liquidators and regulators. In the course of this study, directors had occasion to remark upon the role of auditors in relation to breaches of directors duties. It is useful to refer to their highly pertinent attitudes.

The auditor as target: As noted earlier, it has become fashionable to sue auditors rather than to seek to recover funds from the directors who may have been responsible for the financial failure. As one Adelaide lawyer interviewed as part of the top 500 study observed:

> A lot of companies never go into liquidation . . . [as] . . . there is no cash to finance an inquiry into what happened. Banks do not throw good money after bad. In addition it is too expensive to run complex corporate claims. Persons will not run it unless they are satisfied that the individual is worth suing as directors can shed assets. **It is more productive to sue auditors.** (emphasis added)

A question which received a wide response asked respondents to offer possible solutions to the situation in which attempts are made to enforce the duties of directors 'after the horse has bolted' or after the assets have been dissipated by directors who have behaved illegally. Respondents were asked whether there were any means of providing an earlier intervention or early warning of this type

of situation. Many respondents pointed to auditors as being the first line of defence in this area, as the following comments show.

One Sydney managing director of a leading public company echoed the views of many senior executives when he observed that 'There needs to be a better use of accounting standards, more stringent reporting and a larger question mark over the auditing profession'. Many directors argued that auditors should be required to assume greater responsibilities in regard to the detection of financial failure. As another Sydney director noted: 'Other than directors, the next best informed people are the auditors. Auditors have a duty to the public. They should assume further legal responsibilities'. Another Sydney director pointed out that it was necessary to impose greater responsibilities upon auditors as 'Auditors are the only ones able to raise the alarm'. As a Brisbane regulatory official also noted: 'the auditors' role could be bolstered as they are effectively the only people who could find anything'. A Brisbane director characteristically echoed this theme when he answered that 'audits have to be more thorough and you have to rely on auditors being more conscious of their duties'.

One solution which is frequently referred to is a greater resort to **audit committees**. The size of the company does, however, affect the enthusiasm that directors have for audit committees. Directors of smaller companies, unlike directors of larger companies, do not believe that audit committees can be justified. However, as a Brisbane director noted: 'you need an audit committee in any reasonably sized public company as a go-between for the board and management'. A chairman of an Adelaide company similarly remarked that 'larger companies have them but smaller companies do not worry about them. In larger companies they are very important and necessary'. An ASX official noted that audit committees are 'totally impractical for little listed companies as they cannot find the numbers'. As one Adelaide Big Six audit partner explained: 'Auditors will say things to audit committees which they would not put into writing. If the audit committee makes inquiries this is a potent thing. The honest director will only applaud these things'. The chief executive of an Adelaide based investment company noted that 'audit committees are a necessary thing to have. The National Safety Council is an example of how the CEO kept an auditor at bay'. As an Adelaide liquidator explained:

> One of the hallmarks of corporate collapses has been the one man rule situation. There is no doubt that the chairman-CEO role, which is common on founder driven companies, tends to be followed for better or worse. The use of audit committees puts a check on the authority of that person. It is a useful role if it works.

An audit partner in a Big Six Brisbane firm of accountants was somewhat more restrained in his support for audit committees when he observed: 'in some ways audit committees are a bit of a party as the auditor may not have total access to the Board as he may have had. I would like to see the best of both worlds. The auditor needs the audit committee and access to the whole Board'. Others were more critical of the capacities of such committees, although the general view of

these committees was a favourable one. As a Perth liquidator cynically observed of audit committees: 'Potentially they can be effective, but no more than the status quo'.

Many respondents did, however, point to **conflict of interest problems** which had the effect of undermining the effectiveness of auditors in responding to corporate financial failures. As one Perth corporate lawyer noted:

> Auditors have a marketing drive rather than a watchdog drive. You audit a company as if you are auditing a kindergarten so you can hang onto the job. Liquidators have more of an incentive as they know they will be paid.

A Sydney managing director of a large mining company similarly noted:

> Auditing is a complete wank. I have no faith in it. The big Six or Eight are concerned only with maximising their fees. No information is given to you in auditing.

An experienced Brisbane liquidator added:

> You cannot rely upon auditors as you rarely see balance sheets that are true and fair. During the 1980s audit firms took business risks in competing for audit work. Auditors also have a strong relationship with the company they are auditing. Ninety-nine per cent go to water if threatened with a loss of business.

This sentiment was confirmed by a Brisbane independent director who remarked: 'A lot of corporate failures are contributed to by auditors. Auditors are lax due to greed and power'. An Adelaide public company chairman explained this when he said that 'Companies always try to keep auditors very much on side. Auditors are paid by the company'. Consequently, as one Australian Securities Commission investigations officer noted: 'Auditors rely on the directors for the correctness of the accounts and the directors say they rely on the auditors for the correctness of the accounts. The buck does not stop anywhere'. A Brisbane mining company chairman pessimistically echoed this theme when he said that 'all the auditors and accountants in the world will not help . . . There is a tremendous amount of buck passing in the community'.

Nevertheless, it is also widely recognised that there were **limits upon the extent to which auditors could be relied upon** to detect possible financial failure and breaches of legal rules by public company directors. As one Big Six audit partner pointed out: 'The ASC seems to think that they ought to push more responsibility upon auditors such as a duty to report breaches of the Code. That would be useful [but] the difficulty is that as auditors you are not lawyers'. As many respondents also pointed out, the requirements of the legal system are such that legal action cannot be commenced against someone until the breach of the law has occurred. As an Adelaide CEO observed: 'It is like with a criminal. You cannot charge him for murder before he has done it'. Similarly, a Perth based liquidator noted that 'There is no solution as the law says you can only commence an action once the damage has occurred'. As a Melbourne respondent put it: 'sin has to be committed before litigation can occur'. An executive director of a Perth company also remarked that 'a crime is never committed until it is committed. The best you can

do is try and educate the directors'. However, some interviewees also saw auditing standards as letting auditors 'off the hook'.

The prevention of financial failure is also seen as being difficult because, as a Perth finance director noted, 'You cannot do anything about bad decisions and bad judgments . . . auditors do not make commercial judgments'. As a Brisbane audit partner in a Big Six firm of accountants added: 'Auditors define their role more narrowly than the courts do. The directors have to manage the company, not the auditors. There must therefore be a meeting of the ways between the courts and public expectations of what an auditor can do'. Ultimately, many would agree with the comment of an Adelaide accountant that 'auditors' responsibilities have to be clarified'. There was also some concern for the 'embattled auditor'. In conclusion, as one liquidator from a Big Six firm warned:

> We will now see a three to five year bayoneting of the wounded. Litigation will only enhance the incomes of lawyers and accountants. Juries will not understand and people will get off.

This prognosis is an all too common and depressing pattern which tend to characterise so many areas of corporate law enforcement.

Theorising about Audit Failure

Dr P.N. Grabosky (1991) has sought to provide a theoretically based social science explanation for the failure of auditors to perform satisfactorily. He offers three sets of explanations for such failure. These explanations fit well with the descriptions of the audit failures of the kinds identified by Mr Justice Stewart and by Mr M.J. McCusker QC. Grabosky's explanations are respectively described as inter-organisational, intra-organisational and individual level explanations. **Inter-organisational explanations** refer to demands within the accounting firm itself resulting from 'the highly competitive nature of the market for many professional services [which] may impose time and resource constraints on the professional adviser which invite or even necessitate the 'cutting of corners' during the course of an audit or an inspection'. Grabosky goes on to add that:

> Commercial imperatives may generate pressures on a professional adviser to attract new clients. Not all businesses are financially healthy or efficiently and honestly managed, although principals would like to portray them as such. In some cases, there may be a need to take on almost any prospective client, no matter how unsavoury they may be.

Intra-organisational explanations cover factors internal to the organisation itself. Grabosky points to a number of such factors. For example, he notes that 'Insufficient attention to the overall organisation and staffing of a project, [such as] the planning and supervision of a financial audit . . . can contribute to professional errors and omissions'. Furthermore, he points to problems arising out of the 'fragmentation of decision making which the servicing of some large corporate clients may entail'. Where a team of persons are at work on the audit no one person may have the complete picture. Specialisation may also have this

effect. As Grabosky (1991) puts it: 'the apportionment of limited tasks to individual members of a professional team can be done in a manner which impedes recognition of patterns of data which may be indicative of some anomaly'. This may therefore have the effect of leading individual practitioners to interpret the financial situation of the corporation as being less serious than it actually is. Where a person has only a partial picture of the audit situation there may be a reluctance to communicate bad news on the grounds that there may possibly be other explanations.

Finally, personal or **individual level explanations** refer to such factors as selectivity of perceptions, the inclination to disregard dissonant information, the interpretation of sensory data consistently with personal preferences and the adoption of a kind of tunnel vision by the professional. As Grabosky adds: 'Experienced professionals are able to place themselves in a state of mind which may be characterised as one of ambivalence or uncertainty, perhaps conditioned by reliance on the assurances and representations of others, which permit an interpretation of professional conduct as within the bounds of permissibility'.

Grabosky concludes his useful analysis by noting that audit failures 'would appear to arise most commonly from commercial pressure, where accountants underprice their services and then tailor their work to fit the fee. When failure occurs, the professional denies responsibility for diagnosing and investigating fraud'. This seems to have been an all too familiar pattern in auditing practice in Australia during the 1980s.

Another explanation which overlaps with Grabosky's intra-organisational and individual level explanations of audit failure is to be found in **the effect of a domineering chief executive**, especially where that person is also the founder of the audited company. An important factor in deterring auditors from taking a forthright stand in the audit process is the existence of a domineering chief executive in the company being audited. This issue has been commented upon time and again in the literature on the duties of auditors. For example, the American Institute of Certified Public Accountants in developing a list of symptoms of financial statement fraud has highlighted the importance of a highly domineering senior management accompanied either by an ineffective board of directors or by compensation tied to reported performance (Raab 1987, p. 527). Similarly, Sorensen, Grove and Sorensen (1980, p. 228) have noted that 'Financial difficulties may force management into acts of questionable integrity, especially if there are a few dominant individuals running the business'. In the Nugan Hand Royal Commission report Mr Justice Stewart observed that Brincat, the Nugan Hand auditor, had 'described Mr Nugan [the founder of the Nugan Hand group] as a strong willed and overbearing person who exerted considerable influence over Brincat' (Royal Commission of Inquiry into the Activities of the Nugan Hand Group 1985, p. 120). Mr M.J. McCusker QC had also noted that the affairs of Rothwells were extremely closely intertwined with those of L.R. Connell and Partners and Connell's private company Oakhill Pty Ltd. The effect

of this was to give Connell considerable leverage over the affairs of Rothwells, as was evident by the 'loans' which he extracted from Rothwells and his capacity to control the flow of financial information, such as occurred in the 1987 review of Rothwells' financial condition which had been undertaken for him by Price Waterhouse.

Conclusion

It is clear that these are not comfortable times for auditors. They have prospered during the boom years of the 1980s when few questions were asked and standards were allowed to slip. However, the time has come to rewrite the Corporations Act provisions dealing with the duties of auditors. It is no longer adequate to allow the auditing profession alone to determine how it should be regulated. There are significant public interest issues at stake and the tax payer has had to meet the substantial costs of the failure of auditors to report matters which have clearly come to their attention, as was particularly well demonstrated by the McCusker investigation. It seems that when auditors did not know exactly what was occurring, they preferred to ignore financial impropriety and illegality rather than risk the wrath of their corporate clients.

Not only is there a significant public interest in greater responsibility being placed upon auditors, corporate management and shareholders are equally perplexed by the actions of auditors. As illustrated in the findings from the study relating to directors of Australia's top 500 public companies discussed above - companies which provide the bread and butter, not to say cream, of audit work - management is less than happy with the role of auditors during the 1980s. Not only do shareholders find the audited accounts of public companies to be less than helpful, management itself questions the value of the contributions which auditors have made.

What is extraordinary with apparent audit failures of the 1980s such as those involving Rothwells, Tricontinental and the National Safety Council is that a similar pattern of audit practice has been occurring for some time and that those who have warned about the consequences of this have generally been ignored. The warnings of Mr Justice Stewart in his Nugan Hand Royal Commission Report illustrate this and show that practices which became an art form in the 1980s existed during the 1970s and perhaps earlier. The complacency of the auditing profession in the face of repeated examples of audit failure over several decades is evidence of the need for firmer legislation. As the courts are unlikely to develop more appropriate rules in this area, it is inevitable that Australia must follow the United States path and seek to introduce more appropriate rules. Such changes will of course be passionately resisted by the accounting profession, but the justification for this cannot be strong. Whilst the audit failures of the 1970s may have tended to occur in smaller accounting firms, the examples of audit failure in the 1980s also come from the pinnacle of the profession, the Big Six or Big Eight accounting firms. If such larger firms are forced to cut corners and take

advantage of the ambiguities which accounts may present, then it is clear that the auditing profession needs to reassess its policies. If auditors are not prepared to do this, then arguably others should do it for them.

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Auditors ' responsibilities have become the subject of renewed Australian and international interest in the light of the spate of the corporate collapses of recent years. Whilst this has continued to be the subject of debate over the last decade or more, the clarification of the rules in this area has become a matter of particular concern recently. This is especially so in relation to the reporting of financial fraud or illegality. This issue has become the subject of debate in a number of countries apart from Australia. In the United Kingdom, for example, the enactment of the Banking Act

Financial statement fraud can take multiple forms, includingÂ Comparative ratio analysis likewise helps analysts and auditors spot accounting irregularities. By analyzing ratios, information regarding day's sales in receivables, leverage multiples, and other vital metrics can be determined and analyzed for inconsistencies. A mathematical approach known as the Beneish Model evaluates eight ratios to determine the likelihood of earnings manipulation, including asset quality, depreciation, gross margin, and leverage.Â Black box accounting is a method used to obscure financial reporting and confuse a financial statement reader without technically doing anything illegal. more. Financial Statement Analysis. Key Words: Auditor litigation, Fraud, SEC enforcement actions, Auditor responsibility. Data Availability: The data used in this study are available from public sources.Â the population of fraud schemes and those that involve fictitious transactions and events result in a higher incidence of litigation against independent auditors. We expect that juries and judges are more likely to hold auditors responsible for failing to detect frauds of these types. Further,we expect that attorneys filing lawsuits against auditors would anticipate such behavior. Fraud Audit Report Example. Beginnerâ€™s Guide. Accounting.Â (a). The XYZ Company provided no reports detailing the work performed under its consulting agreement. (b). The agreement between the Fraud Audit Corp. and The XYZ Company is silent on providing a report summarizing results or recommendations. (c). The Prudent Auditing Corp. manager who retained The XYZ Company indicated that all meetings with The XYZ Company occurred at the Prudent Auditing Corp offices. Economic and financial crimes can include a wide range of activities from fraud through to active manipulation of the stock market or laundering of the proceeds of crime (ACC, 2011). The modern globalised economy and new technologies create new opportunities for organized crime to exploit vulnerabilities for profit (ACC, 2011). While there seems to be broad agreement on the meaning of such concepts as money laundering, corruption, and tax evasion, the terms financial abuse and financial crime are far less precise, and in fact are sometimes used interchangeably.Â Economic and financial crimes comprise a broad range of illegal activities, including fraud, tax evasion and money-laundering (United Nations, 2005). The concept of financial crime, as such, is not new.