ASIC

Australian Securities & Investments Commission

Neighbourhood watch: Current and future expectations of regulators and market supervisors

An address by Jeffrey Lucy AM

Chairman

Australian Securities and Investments Commission

Australian Corporate Lawyers Association

National Conference 2005

Thursday, 10 November 2005

Hilton on the Park, Melbourne

Good afternoon. I am delighted to be here to speak with you today.

I'd like to congratulate the ACLA for organising an impressive national conference again this year and for providing a valuable forum for in-house corporate lawyers to come together and discuss important legal, regulatory and governance issues affecting Australian companies.

For my part, I'd like to contribute to today's discussions by sharing with you my thoughts, experiences and future expectations on a number of issues that are, in my view, crucial to confident, fair and efficient Australian financial markets.

I'd like to briefly discuss the importance of strong governance frameworks, the duties and responsibilities of the Board, company directors and management, and the importance of robust and reliable financial reporting in today's global business environment. The role of management and company directors is crucial to ensuring that financial reports accurately reflect the true financial position of a company and, more particularly, that those financial statements are clear of material financial fraud.

Undetected financial fraud is one of the greatest risks to an organisation's viability and corporate reputation, and it has the capacity to draw into its sphere all associated people, not only the guilty. It has been a fundamental factor in many of the corporate scandals we have witnessed over recent years and it is also an area in which ASIC and myself have a keen interest. For my part, I'd also like to see it receive due attention by corporations and their advisers.

Indeed, one of ASIC's key goals over the next 5 years, is to strengthen the integrity of Australian corporations by acting against corporate and financial fraud and misconduct by company directors and officers. I'll therefore spend the majority of my time here this afternoon raising with you some of the challenges I see before us in the fight against material financial fraud.

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Before I discuss that, however, I would be remiss if I did not acknowledge the important role that is played by in-house corporate counsels in respect of governance and corporate reputation.

Certainly, the role and expectations of the corporate counsel have expanded in recent years. These days, corporate counsels are required, not only to interpret the law and advise company boards of their legal obligations, but they also appear to have taken on something of a broad *gatekeeper* role in ensuring management pays appropriate attention to governance, disclosure, ethics, compliance, reputation and risk management – to name just a few. The role of the corporate counsel is an important one and carries with it significant responsibility and influence.

To my mind, corporate governance, integrity of financial reporting, and to some extent preventing fraud, are really the most recent additions to the corporate counsel's focus. More generally, these issues have also been subject to significantly more public interest over the past few years.

Governance is now globally acknowledged as a serious matter, with implications and consequences that are too important to be paid only lip service. Common opinion now sees a sound corporate governance framework as the foundation upon which the trust of investors and consumers is built, ultimately underpinning company performance and integrity.

A sound corporate governance framework must, of course, be supported by directors and officers who act honestly and with integrity, are diligent and inquiring and act in the company's best interests. Investors and consumers are entitled to expect this. After all, Directors are not there to look after themselves. They are there on trust and they have a clear fiduciary duty to the company and its shareholders.

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Much of this new focus on corporate governance and financial reporting has come about after the global spate of corporate collapses over the past few years. These collapses have provided food for thought as to what are the key factors inherent in corporate failure and how regulators and companies might work to avoid such failures in the future.

In ASIC's experience, material financial fraud is one of the key factors evident in corporate collapse and preventing this fraud is one of the key future challenges I see facing us – the regulator, and you - the business.

Indeed, if we consider the most significant, recent and highly publicised corporate collapses in Australia and overseas, we can see that the overwhelming majority of them involved material financial fraud. Companies collapsing through commercial causes (eg Ansett) are in the minority. However, collapses such as Worldcom, Enron, Adelphia, Parmalat and, in Australia, HIH, Clifford Corporation, Harris Scarfe and possibly Sons of Gwalia each involved an assortment of systematic fraudulent actions.

In many cases, fraudulent activities were facilitated or disguised by a range of other factors including:

- weak and ineffective boards of directors dominated by a charismatic, imperious chief executive;
- lack of internal controls and inadequate corporate governance structures;
- corporate cultures that 'covered up' problems;
- breaches of directors' duties, including reckless and inappropriate behaviour, corruption and greed;
- auditors who are not independent or sufficiently critical;
- poor or misleading disclosure to the market; and
- gross mismanagement of the business.

The observations I've made here are interestingly supported by some very recent research published last months and undertaken by the Maastricht Accounting, Auditing & Information Management Research Centre (MARC)

analysing the common characteristics of major business failures in the European Union over the last 25 years.

Using a framework originally developed by Argenti in 1976, the analysis classifies business failures into four categories related to the life-cycle of a frog where:

- a 'tadpole' is a business that fails because it is basically an unhealthy company;
- a 'drowned frog' fails because of over-ambitious management;
- a 'boiled frog' fails to adapt to change; and
- a 'bullfrog' fails because of a dominant manager and the occurrence of fraud or unethical behaviour.

Consistent with ASIC's observations, I am not surprised to see that the analysis I referred to earlier shows the largest number of failures (37%) belong in the 'bullfrog' category. Indeed, for the vast majority of cases in this category, the business failure is closely related to harmful, fraudulent or unethical actions by individuals or groups. In a limited number of cases, the illegal or unethical actions of the full management board caused the business failure. And in two cases, a lack of control regarding employees resulted in business failure.[1]

With fraudulent or unethical behaviour closely linked to the existence of a dominant management personality, the research into European business failures indicates that inadequate corporate governance is also an important factor in a significant number of business failures. Creative accounting was also frequently linked to the presence of a dominant manager.[2]

In only 35% of cases, the role of an individual auditor was questioned. However, the research found that the vast majority of these cases were almost exclusively associated with failures that are related to fraud.

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[1] Bollen, Mertens, Meuwissen, van Raak and Schelleman, "Classification and Analysis of Major European Business Failures, Maastricht Accounting, Auditing & Information Management Research Centre (MARC), October 2005.

[2] Creative accounting itself was not found to be a key characteristic of European business failures.

As we look more closely at Australia's past corporate failures caused by material financial fraud, we can see the same patterns arising - clear greed exhibited by the perpetuators of the fraud – a general lack of integrity within the organisation – collusion to commit fraud by the company's leaders – the presence of dominating personalities who would bully, demand and push others and - a complexity of arrangements, sometimes globally, to disguise the fraud. A lethal mixture of ingredients!

In response to these collapses, we have seen legislative and quasi-legislative measures pop up around the world. We have seen the rules-based Sarbanes Oxley Act in the US and the CLERP 9 reforms in Australia. The Australian response focussed on strengthening the law in respect of corporate governance, disclosure, audit and financial reporting and introduced among other things, measures to improve the reliability and credibility of financial statements. It also supports Australian audit standards with the force of law and strengthens the obligations of auditors to detect fraud. In addition, we've also seen the Australian Stock Exchange release its Principles of good Corporate Governance.

These responses have been important in changing behaviours and increasing confidence, but I would suggest that they are primarily focussed on areas of non-financial fraud. That is, governance and financial reporting - they do not target the fraud itself.

What then should we be focussed on to prevent material financial fraud?

As a first step, I would suggest that fraud detection and prevention must occur within the organisation. Material financial fraud is, by definition, difficult to detect and it has the frightening ability to put at risk the on-going sustainability of the enterprise. It is often perpetrated through either 'collusion fraud' or a 'culture of fraud' that tolerates or facilitates fraudulent acts, paving the way for certain company demise (such a culture existed at HIH). Single frauds, though more common, are seldom company threatening.

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Prevention and detection naturally comes down to a strong corporate governance framework and the integrity and honesty of those individuals within the organisation who have responsibility to prevent financial fraud. This includes the Managing Director or CEO, other members of senior management, executive board members, non-executive Board members, the Company secretary, the Audit committee – and I will come back to the Audit committee shortly – related parties such as specialist advisers, bankers, lawyers, the internal auditors and the external auditors.

While these individuals may not each have actively participated in creating or perpetuating fraud in the previous instances of corporate collapse that I mentioned (although, certainly some did), the frauds still occurred under their 'watch'.

A strong audit committee, that challenges and probes these individuals - the company's management, advisors and auditors - is therefore a necessary foundation for an enterprise's on-going financial health. Over the last ten years we have seen substantial strides in the evolution of the audit committee. It is now one of the key elements within an enterprise for transparency and accountability and it is the unique point at which many of the individuals I referred to earlier come together to interact and report.

Indeed, it could be suggested that the evolution of the audit committee is far from over. I query whether the audit committee should be playing a bigger role in preventing material financial fraud? I think so, but what should that role be? What further changes could be made to the composition of the audit committee to improve it? How should any changes to its role be managed? What will a better practice model of an audit committee look like in another five years?

A particularly important issue to consider is its composition. To my mind, it is crucial that corporations ensure they have a strong, probing and clearly independent audit committee. The MARC research supports this

approach noting that "effective corporate governance, and in particular the audit committee, can act as a bulwark against dominant management which might behave unethically or illegally and in so doing put the business at risk. In this context, the composition and appointment of the audit committee is of particular importance."[3]

In China, for example, at least 50 per cent of the audit committee are required to be 'independent directors'.

I understand that the University of Melbourne[4] is also currently conducting research on this topic and has, in fact, found that the presence of an audit committee with a majority of independent members has a direct correlation to the financial performance of the company.

A strengthening of the duties and responsibilities of the audit committee in respect of preventing and detecting material financial fraud would be an important step in the fight against such fraud. The most obvious way to achieve this would be through their charters, although it could also be considered in law.

Another issue for us to consider is the role of the auditor and the auditing standards. A reliable financial report cannot be produced without some comfort on everyone's part that the numbers are not tainted or used to hide a material financial fraud. What level of inquiry do the Audit Committee and external auditor then need to undertake to comfort themselves that no fraud exists?

To achieve such comfort in Australia, I would suggest the need for a strengthening of the audit standards and appropriate internal controls. This would ensure that audit committees engaged with the company's methods of internal controls and the role of the governance and compliance framework within the company.

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[3] Ibid. p.8.
[4] Professor Ian Ramsay

Strong internal controls and probity of an independent audit committee are necessary measures for an organisation seeking to prevent financial fraud. Obviously the most efficient way to improve these measures, and avoid turning into a bullfrog, is for the organisation itself to implement effective corporate governance structures and arm its audit committee with a charter to test, detect and root-out financial fraud.

At the same time, ASIC can play its part and will. But more than anything, managing the risk of material internal financial fraud – and avoiding the bullfrog analogy - sits with the company, its directors, officers and advisers.

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