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AICD NSW Division
Directors Briefing

Financial Statement Fraud
Corporate Crime of the 21st Century

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KPMG Centre
Wednesday, 8 June 2005

AUSTRALIAN INSTITUTE OF COMPANY DIRECTORS

ABN 11 008 484 197

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Financial Statement Fraud

What is financial statement fraud?

Definitions differ, but the common thread is that financial statement fraud involves deliberately misleading or omitting amounts or disclosures in financial statements in an attempt to deceive financial statement users, particularly investors or creditors. When we talk about 'fraud' in this context, we are probably using the term more widely to include wrongdoing that would not traditionally be seen as fraudulent in the strict legal sense. However, to be a fraud, the wrongdoing must be deliberate and intentional.

This might involve:

- The falsification, alteration or manipulation of material financial records;
- Material, intentional omissions or misrepresentations of events, transactions, accounts, or other significant information from which financial statements are prepared;
- Deliberate misapplication of accounting principles, policies, and procedures used to measure, recognise, report, and disclose economic events and business transactions; or,
- Intentional omissions of disclosures or presentation of inadequate disclosures regarding accounting principles and policies and related financial amounts.

For the purposes of this discussion, we are talking about financial statement fraud in a major public company context; a context that can affect confidence in the financial system. We are not talking about what might be called 'internal fraud' or a great many other types of dishonest conduct in corporate life. This is about projecting a false state of affairs on a large scale and in a very public context.

Having set those parameters, the psychology becomes very interesting because the likelihood of detection becomes so high that the conduct looks deeply irrational. However, sometimes perpetrators become convinced that they are surrounded by a sufficient number of insiders and external advisers that they will never be detected. It is at this point, that financial statement fraud becomes systemically dangerous. This is where the United States found itself in the Enron/WorldCom days and this is why the Sarbanes-Oxley legislation was passed so hastily.

Global context

Enron

In the 6 years before Enron's collapse, ASIC's American counterpart, the SEC, estimates that investors lost US$100 billion owing to faulty, misleading or fraudulent audits. As far back as 1997, Enron's auditors – Arthur Andersen – knew that Enron was inflating its income. By 2001, Enron was forced to reveal that its profits had been off by about 20% over a three-year period, ending when Enron filed for bankruptcy on 2 December 2001, and Arthur Andersen was indicted on charges of obstruction of justice for destroying Enron documents.

WorldCom

For WorldCom, whose accounts were also audited by Andersen, the fall from grace was perhaps even more catastrophic, with the loss of 17,000 jobs, and the group admitting to having inflated profits by nearly US$4 billion through deceptive accounting. The CFO, also improperly reported expenses as investments in an attempt to add some shine to the company's financial position.

On 15 March this year, Bernard Ebbers, the former CEO, was found guilty of fraud relating to the accounting scandal. He faces up to 85 years in jail when sentenced.

The CFO testified that he warned Ebbers that the only way the company could meet its earnings projections would be to make improper "adjustments" to the financial statements. Ebbers denied ever knowing about the adjustments, telling the court that he concentrated on strategy and left accounting details and decisions to the CFO.

Sentencing is set down for next week on 13 June.

Sunbeam

The story behind Sunbeam is another example of financial statement fraud. Sunbeam had long been languishing when it decided in 1996 to bring in Al 'Chainsaw' Dunlap. Dunlap undertook mass firings and started overstating losses in Sunbeam's corporate filings. As a result, so-called 'cookie jar' reserves were built up which enabled an inflated profit of some US$60m to be announced in 1997, supplemented by false sales figures. According to the SEC, the Dunlap and other executives employed a range of

fraudulent techniques, including recording revenue on contingent sales, accelerating sales from later periods into the present quarter, and using improper 'bill and hold' transactions. The SEC alleged that Sunbeam had engaged in 'channel stuffing', a technique aimed at boosting sales artificially at the end of a financial year by offering distributors and dealers special incentives to purchase more goods than they need. In its crudest form, channel stuffing involves a distributor merely oversupplying goods via its distribution channel that are later returned in kind by the recipients.

These techniques created the illusion of a rapid turnaround, and dramatically boosted the share price, making the company more attractive to potential buyers, and boosting the value of Dunlap's own shareholding. The SEC launched a civil action in 2001 and Dunlap settled by paying a US$500,000 fine and agreeing that he would never again be an executive of a public company. Sunbeam sought bankruptcy protection in February 2001, citing US$3.2 billion in debt, some of it linked to Dunlap's acquisitions.

Parmalat

At the heart of the scandal lies a forged letter, purportedly from the Bank of America, saying that a Parmalat subsidiary, Bonlat, based in the Cayman Islands, had cash deposits of around €4 billion.

Until 1999, Grant Thornton was Parmalat's auditor. Italy's rules on rotation of auditors meant that the group then switched to Deloitte & Touche. However, those rules did not make much difference to the end result.

Standard practice is for auditors to write independently to banks for confirmation of cash balances. Grant Thornton did this, but seemingly relied on Parmalat's internal mail to deliver its letters seeking confirmation. This, as it transpired, meant that the letters were fraudulently intercepted and altered, allowing the deception to continue.

The Parmalat fraud was, at its centre, a very simple one, although there were lots of complex deceptions, including playing on the reputations of some big names in the financial system. The audited accounts from Bonlat showed cash balances that were consolidated by the parent and used to allay concerns about the high levels of debt the parent had on its balance sheet. No one asked why a group that had so much cash on

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deposit needed to borrow so much. There was much other false paperwork that was aimed at showing how the cash balance was built up, but this simple forgery was at the core.

It has been suggested that the one line in an audited balance sheet that no one questions is: cash and other short-term assets and that is where the Parmalat fraud lay hiding.

Regulatory responses

PCAOB

The Public Company Accounting Oversight Board was established by the Sarbanes-Oxley Act to watch over the accountants who watch over the accounts. Is there an equivalent in Australia? In Australia, the direct auditor oversight body is the Auditing and Assurance Standards Board (**AuASB**) which in turn is overseen by the Financial Reporting Council (**FRC**). The FRC monitors international developments in auditor independence and assesses the adequacy of auditor independence regulation in the Corporations Act and professional codes of conduct in relation to those developments[1]. While it has no enforcement powers of its own, it does have the power to compel the production of information relating to quality assurance, code of conduct and audit matters.

Sarbanes-Oxley Act 2002

The Sarbanes-Oxley legislation is well known and I will not deal with it in any great detail here, except to look at some very recent experiences of how it is working in practice. One viewpoint, was recently highlighted by *The Economist*, in an article titled '*Teething Troubles*'[2]:

> *Adecco is the world's biggest temp agency, with 5000 offices in 58 countries and some 700,000 temporary employees on its book at any one time. Its headquarters are split between Lausanne and New York, and it is listed in both Switzerland and America. At the end of 2003 its auditors, Ernst and Young, said they were not prepared to signs its accounts because there were material weaknesses. A quoted company ignores such a pronouncement at*

1 Section 225(2A) of the *ASIC Act 2001* (Cth)
2 Source: *The Economist* 21 May 2005

its peril. Adecco declared immediately – as it is obliged to do by stock-exchange rules – that there would be a delay in filing its accounts. The market assumed the worst, and Adecco's share price fell sharply.

For six months, as many as 160 auditors crawled over the company's books. Ludicrously, they checked every single transaction of more than $100 (in a company with an annual turnover of more than $20 billion). They soon determined there was no reason to suspect misappropriation or fraud. The problem, they said, was that the company's internal controls were weak, and that audit trail was not strong enough.

John Bowmer, Adecco's former chairman who came out of retirement to oversee the re-auditing, complains about the way in which, under such a process, the auditors are in complete control. There is no appeal and no turning elsewhere for a second opinion. It is, he says, 'a kangaroo court'. Many of these accountants working on Adecco's audit were former employees of Arthur Andersen, who were even more apprehensive than their colleagues of the PCAOB. At that time none of them knew quite what the new overseer of their industry would expect and how it would operate.

At one stage, there were three sets of lawyers employed to cover the accountants' backs, checking that their work would not lead to lawsuits after the event. The bills of 15 different law firms, pricing their services at rates of up to $800 per hour, were paid by Adecco. They were, says Mr Bowmer, 'charging like raging bulls. It was a fee fest.'

The whole process cost Adecco $120 million. By the time the auditors did sign the accounts, a decade's worth of auditing had been carried out in less than 12 months. The company's audit fee for 2004 was a mere $23.2M, in a year when fees for many big companies rose by over 50% because of Sarbanes-Oxley.

Do these things happen in Australia?

Financial fraud does not seem to occur on a large scale in Australia. It certainly happens, but not to the same extent as appears to have occurred in overseas

jurisdictions like the United States. We have asked ourselves why this is. The answers are no more than fairly loose 'hunches' that there are largely cultural explanations for the differences. We have less extreme forms of performance-related remuneration structures in our public companies. While we do focus on short-term results, we do so perhaps less than in the United States and hence the temptation to 'cook the numbers' is correspondingly lower. We also perhaps have slightly less affection for 'presidential' style CEOs who are able to override the checks and balances already in place.

So, what are the issues in Australia? They probably relate more to corporate 'spin' in issuing misleading announcements to the ASX; ranging from covering over or failing to disclose bad news, to the issue of information that is outright misleading.

Making false statements to ASX

Section 1309 of the Corporations Act makes it an offence to give false information to the ASX where the director or officer involved either knew it was false or misleading, or failed to take reasonable steps to ensure that it was not. This is the regulatory tool that is often used against executives who are seeking to disseminate misleading financial information about their company to the market. One important feature of s 1309 is that it does not require dishonesty or fraud in order for there to be a successful prosecution.

In a case where ASIC alleged a serious breach of a listed company's continuous disclosure obligations, it would consider using s 1309 against the directors and officers involved. ASIC is able to seek a fine of up to $22,000 per offence, plus a maximum of 5 years imprisonment, or both.

For less serious breaches of a company's disclosure obligations, ASIC has its 'infringement notice' power under which it can issue what are effectively optional fines against only the company itself. The fines range from $33,000 for a company with a market capitalisation of $100m or less, to $100,000 for a company with a market capitalisation of $1bn or over. If the company pays the fine, ASIC cannot take the matter further. If the company does not pay the fine, ASIC would have consider taking alternative enforcement action or letting the matter rest. ASIC has not used this power yet, although there are several matters under consideration.

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Harris Scarfe Holdings Limited

In the case of Harris Scarfe, ASIC prosecuted the CFO for alleged false entries over a period spanning five years. ASIC alleges that these entries lifted the apparent level of profits in the consolidated accounts of Harris Scarfe Holdings Ltd, and affected profit figures in the monthly financial reports to the board, as well has half-year and year-end to the ASX. Similarly, the Executive Chairman, in addition to a host of charges relating to directors' duties, was charged with seven counts of disseminating information that to his knowledge was materially false and likely to induce people to buy Harris Scarfe shares.

Avastra Limited

Only last month, ASIC brought charges against an auditor, Alan Bates, for his failure to comply with the audit independence provisions while an auditor of a listed company, Avastra Limited.

Bates pleaded guilty to charges of acting as the auditor of Avastra in relation to its 2001, 2002, and 2003 financial statements, while at the same time, acting as Avastra's company secretary. While these charges were brought under the previous auditor provisions of the Corporations Act, he also pleaded guilty to one charge under the *new* CLERP 9 provision, specifically relating to his preparation of an audit report regarding the 2004 financial year, during which time he was Avastra's company secretary. Mr Bates' activities and the subsequent charges brought against him came about as a result of the inspection of Avastra's financial statements, as part of ASIC's Accounts Surveillance Project.

Zurich Australia

More recently, ASIC accepted an enforceable undertaking from Zurich Financial Services and its wholly-owned subsidiary, Zurich Australian Insurance Limited, after they both failed to account properly for two reinsurance transactions entered into in 2000. While EUs have been accepted in relation to the accounts, investigations are continuing into the reinsurance arrangements themselves. Because investigations are continuing, I cannot comment further on this situation.

CLERP 9 and ASIC surveillances

The CLERP 9 reforms, coming into effect on 1 July 2004, protect and perpetuate the importance of auditor independence. ASIC is now conducting on-site visits to review the systems and processes that audit firms have in place to ensure compliance with the independence requirements under the *Corporations Act*. The surveillance, which commenced late 2004, reviewed the big-4 accounting firms, selected mid-tier firms, and any other firms where there is evidence of systemic independence issues that arise during the course of the our financial reporting surveillance program. This will be extended to include smaller audit firms, and over time, we endeavour to cover all audit firms on a systematic basis.

Audit independence requires that an auditor be independent in fact – as well as by perception. The greater the level of auditor independence, the more difficult it is for obviously questionable figures to be rubber stamped, and dispelling the culture of silence that has on occasion been a big part of the problem.

Culture of silence

This culture of silence is a problem that usually exists at middle management levels, and unless formal whistleblower provisions exist, is one that can quite often compound on itself. The APRA Report into Irregular Currency Options Trading at the NAB found it problematic that senior management bonuses will often be the result of profits and sales, and that it potentially created implicit incentive to inflate figures for financial gain. That type of remuneration structuring creates a greater disincentive than normally exists for middle management to speak up.

There needs to be a mechanism outside the normal reporting chain that facilitates information reaching the appropriate authorities (be they internal or external). This was recognised in the CLERP 9 changes, with Part9.4AAA of the *Corporations Act* providing protection for whistleblowers, and explicitly prohibiting victimisation. The whistleblower regime is aimed at enhancing confidence in the quality and accuracy of published results. While the details of the companies concerned remain confidential, there is already evidence that people in listed companies who come across financial irregularities are increasingly prepared to tell ASIC about them.

ASIC's Listed Company Accounts Surveillance Project

The Accounts Surveillance Project, in place since 2002, is an area where over a period of four years, the financial reporting statements of every Australian listed company will be looked at in detail by ASIC. This is because we look at about 450 reports a year. The primary focus of this project was compliance with accounting standards pertaining to **financial position**, **financial performance**, **revenue**, and **consolidated accounts**. Under the project, any blatant abuses of the accounting standards discovered by the surveillance will be considered as a possible candidate for enforcement action. ASIC's surveillance also monitors auditor independence, or the lack of it. It highlights the fact that auditor independence is fundamental to the confidence of the financial markets, and the integrity of a company's financial statements. It will also monitor adherence to relevant accounting standards, including the requirement for auditor and director sign-off. Our surveillance can also spot fraud, although we appreciate that this can be difficult from a high level review.

The first financial reporting surveillance had a mix of flavours to it, and was very much issue specific, concentrating on deferred expenses, recognition of revenue, and the recognition of controlled entities and assets. In the four months to February 2005, ASIC reviewed the full-year financial reports of about 400 listed companies for general compliance with accounting standards. Some of these reviews lead to further inquiries into the following areas:

- fair value acquisition accounting issues;
- carrying values of assets (particularly intangibles);
- appropriateness of deferral of expenditure and associated recoverability; and
- lack of disclosure in relation to appropriate accounting policies.

In an instance where an entity has not complied with accounting standards and the audit report was unqualified, ASIC might refer the auditor's conduct to the Company Auditors and Liquidators Disciplinary Board. Currently, while no specific issue is being closely monitored, the issues that have been emerging deal with inadequate AASB1047 (implementation of IFRS) disclosure, the carrying value and valuation of assets, together with questionable recognition of revenue, which continues to cause some concern.

HIH and financial statement fraud

Consistent with my earlier comments, there are not many decided cases in Australia relating to financial statement fraud. That is why I thought I would spend some time today discussing the collapse of HIH.

The recent jailing of Ray Williams (four-and-a-half years' jail with a non-parole period of two-years and nine months) related to a series of transactions where the true financial position of HIH was hidden from HIH shareholders and the regulators over a number of years.

While there has been a lot of press about HIH, it has not focused on the precise nature of the financial statement fraud involved. I thought I would quickly summarise it here:

Williams pleaded guilty to three counts, which can be summarised as follows:

NZ Prospectus

In October 1998, Williams authorised the issue of a converting note prospectus by HIH Holdings (NZ) Ltd. The Prospectus said that Societe Generale Australia Ltd, a co-underwriter of the converting notes issue, would take up as a priority allocation the lesser of 30% of the amount to be underwritten or A$35 million.

The prospectus did not disclose that HIH Insurance Ltd and SGA had entered into a transaction in October 1998 known as the 'total return swap' the effect of which, in very broad terms, was that HIH would pay the same amount back to SGA (ie a round-robin transaction making it look like SGA was investing in the notes when in substance it was not).

1999 Annual Report – Financial Reinsurance

In September 1999 in the HIH Insurance Ltd 1998/99 Annual Report, the operating profit was overstated by $92.4 million and in a section of the report titled 'Chief Executive's Review', Williams said:

> Going forward, we have also taken decisive action, through the purchase of whole account reinsurance protection, in order to protect all of our businesses from claims

development uncertainties including potential underwriting exposures to year 2000 losses.

HIH had entered an arrangement with Hannover Re, which purported to be two contracts of traditional reinsurance. Contrary to the assertion in the annual report, the Hannover Re arrangements were not traditional reinsurance contracts, but were 'financial' reinsurance contracts. Those arrangements were wrongly accounted for as traditional, rather than financial, reinsurance contracts, and this accounting treatment resulted in the overstatement of the operating profit by $92.4 million.

Williams knew that the Hannover Re transactions were treated as traditional reinsurance transactions in the Annual Report. Williams knew that the Hannover Re transactions were not traditional reinsurance transactions.

I will deal later on with some of the implications of financial reinsurance contracts for financial statement fraud more generally.

Letter of Comfort

In October 2000, Williams signed a letter of comfort addressed to noteholders who had bought notes issued by FAI Insurances Ltd, then a subsidiary of HIH, under a US$150M note issue.

The letter said that it was HIH's policy that its subsidiaries be managed and operated in such a way as to meet their obligations. The letter further said that the company followed this policy with respect to FAI.

The letter was false because:

1) Group shareholders’ funds for FAI and its subsidiaries had fallen below the minimum requirement of A$200 million for at least all of FY2000;
2) The auditor’s compliance certificate for the year ended 30 June 1999 and the audited accounts for the FAI group for the same year had not been provided.

Williams knew this and yet did not make any enquiries prior to signing the letter.

In sentencing Mr Williams, Chief Justice Wood said "...the individual responsibility of directors in not engaging in corporate conduct that involves dishonesty, or the making of false statements, cannot be overemphasised.[3]".

Some observations about the road ahead

Detecting and punishing financial statement fraud

In his judgment in R v Howard[4], Justice Kirby of the New South Wales Supreme Court said, in the context of the prosecution of Howard, another HIH executive:

> …those who commit such crimes are usually intelligent, and well able to afford expensive lawyers. Their crimes are often obscure. They depend upon subtle inferences arising from documentation, the so-called "paper trail". The paper is usually buried in a mass of other paper. Even where it can be uncovered, proof is usually difficult. Crucial documents are often missing. Motivation will sometimes remain obscure. Prosecution is therefore difficult. Successful prosecution even more difficult.[5]

Internal controls

One of the key US initiatives aimed at combating financial statement fraud was the requirement for internal controls mandated by section 404 of the Sarbanes-Oxley Act. This feature was not adopted in Australia and this remains one of the keys point of difference between our two systems. There are some aspects of the quality review concept in AUS 206, but the key theme of 404, relating to the testing of internal controls, has no Australian equivalent.

On 16 May 2005, the SEC released a statement containing some clear messages about the first year of experience of section 404. While concluding that 404 was working, the SEC had the following comments, urging more common sense in the way it was being implemented:

- there is a mechanical, and even overly cautious, way in which the rules and standards are being applied. Management and external auditors must bring reasoned judgment and a top-down, risk-based approach to the 404 compliance process.

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[3] Wood CJ, R v Williams [2005] NSWSC 315 at page 49, para 48

[4] R v Howard [2003] NSWSC 1248

[5] Kirby J, R v Howard [2003] NSWSC 1248, para 59

- a one-size fits all, bottom-up, check-the-box approach that treats all controls equally is less likely to improve internal controls and financial reporting than reasoned, good faith exercise of professional judgment focused on reasonable, as opposed to absolute, assurance.
- internal control audit must be better integrated with the audit of a company's financial statements.
- section 404 should be appropriately tailored to smaller companies.

The final chapter at Andersen

Andersen was convicted in June 2002 of obstructing justice by shredding a large number of documents and deleting e-mails about Enron. Andersen then collapsed. Just a few days ago, America's Supreme Court, in a unanimous decision, overturned the firm's conviction.

The Supreme Court overturned the conviction on the fairly technical ground that the lower court judge failed to direct that the jury had to conclude Andersen knew its actions were illegal in order for the conviction to stick. The Supreme Court did not acquit Andersen, but sent the case back to the lower court for a retrial. However, it is thought that prosecutors are unlikely to pursue the case further.

Prediction – financial reinsurance to remain a hot topic

What is financial reinsurance and why does it tend to crop up in the context of financial statement frauds? Financial (or finite risk) reinsurance is a very complex area, but think of it as a specialised form of reinsurance where the financial and strategic considerations take precedence over the risk transfer motivation. It is also known as financial reinsurance, asset-intensive reinsurance or non-traditional reinsurance.

One of the key objectives is the enhancement of the original insurer's ('cedant's') financial statements or operating ratios (eg the amount of risk-based capital or the premium to surplus ratio). This is why the technique seems to be closely linked with financial statement fraud.

In any reinsurance transaction, there are a number of risks that can be affected: for example, **underwriting risk** (claims), **timing risk** (uncertainty about the timing of

payouts), **credit risk** (uncertainty that the reinsured will pay the premium and that the reinsurer will meet its obligations to the reinsured) and **asset risk** (uncertainty that assets will realise expected future values). Financial reinsurance involves the re-allocation of some or all of those risks either prospectively or retrospectively. It is often aimed at smoothing out the impact of fluctuating underwriting fortunes. Given its complexity and seemingly limitless flexibility as to the ultimate outcome, financial reinsurance seems to have been attractive to fraudsters and very difficulty for auditors and regulators to deal with.

Justice Owen put it this way in Volume 1 of the 2003 Royal Commission reports into the collapse of HIH:

> During the inquiry, questions emerged about the use of alternative risk-transfer products—often called financial reinsurance. Traditional reinsurance is primarily directed at the transfer of risk. On the other hand, financial insurance (of the type employed by FAI and HIH) is more like a deposit arrangement, which, whether or not it is accompanied by risk transfer, is primarily directed at the appearance of the balance sheet. Reinsurance is a legitimate and, when properly used, effective mechanism for insurers to augment their capital base. There is, however, a place for financial reinsurance, properly used, as well as for traditional reinsurance: nothing in this report should be taken as indicating the contrary. I do, however, have real concerns about the use—or, more accurately, the abuse—of reinsurance and its susceptibility to manipulation

Latest update on General Re

It is interesting to note in today's press the story about the ongoing investigation into financial reinsurance practices at AIG in the United States. The latest development is that a senior executive at General Re has agreed to plead guilty to conspiracy charges in connection with an alleged conspiracy with other AIG executives to mislead shareholders and auditors in connection with a 2001 financial reinsurance transaction. The SEC had alleged that the parties had engaged in creating sham transaction documents to allow AIG to make false accounting entries.