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**Three Cases of Corporate Fraud:  
An Audit Perspective**

By

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# Three Cases of Corporate Fraud: An Audit Perspective

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*May you live in interesting times* (Chinese Proverb)

## Abstract

In this paper we examine three cases in order to evaluate, in some detail and from an audit perspective, what can occur when management fraud and distortions in the financial accounts lead to adverse social, political and economic consequences. The cases analysed here are, for the most part, well known: Adelphia (U.S.), HIH Insurance (Australia) and Bond Corp (Australia). They are also significant in terms of the dollars misappropriated and in terms of the number of people involved or damaged as a result of the frauds. We attempt here to bring a fresh perspective to the stories around these corporate failures by examining the fraudulent activities in light of the auditor's role, and how the auditor could have enabled a better quality and more timely information to be disclosed about them. Audit implications inform the analysis of each case, and some common themes are found in a cross-case analysis evaluated using Birchfield's (2004) 'perfect storm' conceptual scenario. Recommendations for further research conclude the paper.

## 1. INTRODUCTION

In this paper we examine three cases in order to evaluate, in some detail and from an audit perspective, what can occur when management misrepresentations in the financial accounts lead to adverse social, political and economic consequences. The findings are informed by Birchfield's (2004) 'perfect storm' conceptual scenario and the American Institute of Certified Public Accountant's (AICPA) conceptual fraud 'triangle' of conditions that engender fraud.

The costs of fraud within an organisation can be costly to shareholders, to employees and to sometimes the public at large. The cases analysed here are, for the most part, well known: Adelphia (U.S.), HIH Insurance (Australia) and Bond Corp (Australia). They are also significant in terms of the dollars misappropriated and in terms of the number of people involved or damaged as a result of the frauds.

We attempt to bring a fresh perspective to the stories around these corporate failures by examining the fraudulent activities in light of the auditor's role, and by considering how the auditor could have enabled a better quality of information to be distributed about them in a timely manner. What the auditor did, what the auditor could have done and, sometimes most crucially, what they may have failed to do is part of our consideration and analysis. Audit implications conclude therefore the analysis of each case, and themes found in a cross-case analysis are evaluated in terms of Birchfield's (2004) 'perfect storm' conceptual scenario. Recommendations for further research conclude the paper. The three cases are: Fraud and Loss at Adelphia: A Wall Street Story, HIH Insurance Australia (2001): A Story of Corporate Collapse, and The Rise and Demise of Alan Bond (Australia).

## **2. FRAUD AND LOSS AT ADELPHIA: A WALL STREET STORY**

“I deserve more because my name is on the door” (Bennett et al, 2005).

From humble beginnings in 1952 as a small cable franchise with 25 customers, Adelphia had become the sixth largest cable company in the U.S. by the late 1990s. The year 2002 saw the disclosure of a massive accounting scandal which led to the company’s bankruptcy and subsequent reorganisation. Fraud at Adelphia has been described by the Securities Exchange Commission (SEC) as elaborate and extensive to levels not seen before in the U.S. (2005). This first case will analyse the fraud at Adelphia, and discuss the role Deloitte as external auditors played in failures to disclose this corporate disaster when it became clear they should do so.

### **2.1 History of Adelphia**

Adelphia was founded in 1952 when John Rigas paid \$100 for a cable TV franchise in the small town of Coudersport in Pennsylvania and ran it as a small family business with just 25 customers (Bennett, Thau & Scouten, 2005). The business expanded steadily to more than 6000 customers in 1972 and the cable company was formally incorporated as Adelphia soon after. Then in 1986, Adelphia became a publicly traded company on the NASDAQ stock exchange.

During the 1990s, the cable industry began to weaken, due to factors like the slowing economy, increased competition and overcapacity problems (Mahar & Fischer, 2003). During this period, Adelphia expanded into Internet access, paging services and business telecommunications and used a combination of cash, stock and debt to make various acquisitions across the US (Bennett et al, 2005). The late 1990s revealed that Adelphia had become the 6th largest cable operator in the country.

The discovery of fraud at Adelphia happened in March 2002 when Tim Rigas, the chief financial and accounting officer revealed in a conference call that the company had cosigned \$2.3billion loans that had been taken out by partnerships run by Rigas family members (Nuzum, 2004). Adelphia was jointly liable to pay back the loans but the full extent of the liability was omitted from the books. Following this revelation,

the SEC began an informal enquiry into Adelphia in April which turned into a criminal investigation for various fraudulent activities which dated back to mid-1999. Consequently, John Rigas and his family members all resigned from the company. The share price plummeted from \$28 in March 2002 to 79cents in June and was delisted from NASDAQ (Bennett et al, 2005). Soon after the company filed for bankruptcy protection and began a reorganisation.

## **2.2 Adelphia's Fraud Activities**

Known fraud at the company can be divided into three general categories according to the SEC complaint (SEC v Adelphia Communications Corp, 2005). The first is hiding debt in unconsolidated subsidiaries. Adelphia entered into co-borrowing credit facilities with various Rigas family owned businesses which they are jointly liable for the entire amount borrowed. Adelphia management kept this liability off the books by allocating the co-borrowing loans among its unconsolidated subsidiaries. Debt of the subsidiary was increased and Adelphia's bank debt was reduced by the same amount. It gave investors the false impression that the company was leveraging and paying off debts. The company made further misrepresentations in public statements and filings to keep up this appearance as well as creating sham transactions and fictitious documents to prove that the debts had been repaid.

The second category of fraud was the intentional misstatement of the company's performance to meet analysts' expectations and mislead investors that Adelphia exceeded their expectations for growth. Adelphia repeatedly misstated the key performance measures used by Wall Street analysts to assess the performance of cable companies. The number of basic cable subscribers is a key performance measure for a cable company because it provides a predictable cash flow that's unlikely to shrink in times of economic recession. To falsely inflate this count, for every quarter from 2000 onwards, Adelphia included cable subscribers from their unconsolidated affiliates and sometimes included customers who subscribed to Internet or home security services or other services entirely unrelated to cable. In addition to that, the company provided false information about the extent of cable plant upgrades and inflated their earnings by recording fictitious management fees, recognizing kickbacks as income and shifting expenses to unconsolidated affiliates.

The last category is represented by many fraudulent misrepresentations and omissions of material fact carried out to conceal self-dealing by the Rigas family. This included actions in which the Rigas family obtained more than \$1.3 billion in company stock and notes from Adelphia's funds through manipulation of their cash management system. Other self-dealing transactions included paying-off \$241 million of family personal debt from Adelphia's assets, paying \$26.5 million for timber rights on a Rigas property to preserve the view outside the Rigases' family home, spending \$12.8 million of company money to build a golf course and club house for exclusive family use all from Adelphia-owned funds. None of these transactions were disclosed to the investors.

Many of these transactions were facilitated by the ability to override Adelphia's cash management system, through producing journal entries in Adelphia's Millennium General Ledger systems shared by the Rigas family-owned businesses. The victims of this massive fraud have turned to the auditors who were the supposed "first line of defense against fraud" for further compensation (Gullapalli, 2005).

## **2.3 Adelphia Fraud Factors and Culture**

Hill and Albrecht (2004) suggested that, in combination, a booming economy; a corporate culture of moral decay and dishonesty; unachievable Wall Street expectations; high leveraging; executive, bank and firm greed; and other cultural and environmental factors can result in what they term a "perfect fraud storm" (cited in Birchfield, 2004). Many of these can help explain the fraud situation at Adelphia.

### *2.3.1 Booming Wall Street Economy*

From Adelphia's history, it is evident that the company had been growing at a rapid rate from their aggressive acquisition strategy in the 1990s. Adelphia's success at the time was accompanied by a stock market boom in the US which it saw its share price go from \$5.00 in 1997 to as high as \$86.56 in May 1999 (Bennett et al, 2005). As Birchfield (2004) discussed, management often incorrectly take credit for the company's success in boom times, and when things turn sour, more pressure is put on management to fulfill the expectations generated. This pressure may have contributed to dishonesty and fraudulent financial reporting at Adelphi.

### 2.3.2 *Unrealistic Market Expectations*

The unachievable expectation of Wall Street is another major source of pressure which encourages fraud. Wall Street is known to put an enormous pressure on companies' quarterly profit forecasts; this pressure was clearly felt by the Adelphia executives. James Brown the former vice president of Adelphia was quoted as saying: "... the numbers were made up because ... [we] didn't want to deal with the consequences that would result if [our company] had accurately reported the company's financial condition" (Grant, 2004). Those consequences would have included possible defaults on Adelphia's credit agreements and a sharp decline to the company's stock price.

Not willing to risk these consequences, Adelphia's finance division compared the company's actual results with results expected on Wall Street at the end of every quarter and they would "go back to see if ... [they] could find things to manipulate to improve the numbers" (Brown as cited in Grant and Nuzum, 2004). As simple manoeuvres were often not enough - such as shifting costs from one period to the next or changing agreements between affiliate companies, more elaborate schemes were developed to improve the financial statements.

### 2.3.3 *Debt and Leverage*

Another major pressure on the company was the debt and leverage. Hill and Albrecht (2000, cited in Birchfield, 2001) acknowledged that the high levels of debt of large corporations placed enormous pressure on management not only to have high earnings to offset high interest costs but, also to report high earnings to meet debt covenants (as cited in Birchfield, 2004). It should be noted that cable companies have to borrow more and more each year to continue expanding, and even companies with strong operating cashflows generally spent every dollar on debt servicing, system rebuilds and digital set-tops (Broadcasting & Cable, 2002). Compared to other cable companies, Adelphia did not have particularly strong operating cash flow, usually relying on external financing (Mahar & Fischer, 2003), which would have placed further pressure on management to inflate earnings in order not to breach debt covenants.

### 2.3.4 *Rigas Family: Greed Realised*

Members of the Rigas family who founded and facilitated the growth of Adelphia into the cable giant in the late 1990s were accused by many for using the company as their



“personal piggy bank”. Based upon the transactions exposed in the lawsuits, it appears that the Rigas family were greedy beyond the usual luxuries indulged in by most corporate fraudsters. The control the Rigases held in Adelphia helped to facilitate many of the frauds occurring in the company.

When the company went public, the Rigas family still kept many private partnerships and family-owned cable operations; they leveraged these companies and bought Adelphia stock (SEC, 2005). Even though Adelphia had become the 6th largest cable company in the country, some analysts expressed concern that the Rigas family still ran it like a small private business and wanted to retain full control of the company (Bennett et al, 2005). John Rigas who is the founder of Adelphia was the CEO and Chairman of the Board. His three sons (Tim, Michael and James) were all directors and held senior positions in the company as Vice President of operations, Chief Financial and Accounting Officer (CFO & CAO) and Vice President of strategic planning respectively. In addition, John’s son-in-law was also a board member. Therefore, at all times, John Rigas and his immediate family held five of Adelphia’s nine Board positions and exercised voting control of Adelphia stock (SEC, 2004).

The Rigas family appeared to have an entitlement mentality and did whatever was necessary to maintain control of the company that the family had built up. Higgins (2002) noted a few of the luxuries indulged in by the Rigas family - like the golf course on family lands; using company credit to borrow \$2.3 billion to buy cable systems and Adelphia stock, or John Rigas's \$1 million monthly cash allowance from company checking accounts. It’s interesting to note that the extravagant spending of Adelphia money occurred after the company became public. This could be explained by an entitlement belief if the Rigas family expected higher shares of the outcomes because as the founders of Adelphia - they had invested more than others and played key roles in the expansion of Adelphia into the cable giant it had become.

The Rigas family was well respected within the small community of Coudersport, according to Bennett et al (2005), John Rigas was identified as the city’s most popular individual largely due to his involvement in the growth of Adelphia. The Rigas family were known by the Coudersport people as generous, approachable people who donated cable and internet connections to local schools, sponsored sports & cultural events and made personal donations to needy neighbours (Mahar & Fischer, 2003). Perhaps due to the respect people had for the Rigas family, nobody questioned their

ethics as the family came across as charming and unassuming (Bennett et al, 2005). Potentially, this may have contributed to the family's apparent entitlement assumptions – assumptions that led them to think that they deserved a larger share of Adelphia's resources.

The company's culture also may have contributed to the fraud. It seems that taking liberties with the truth became part of the modus-operandi at Adelphia. The former VP of Finance James Brown painted a picture in which the top executives met leisurely on Saturdays at Adelphia's headquarters to discuss how to manipulate results so that they were in compliance with loan agreements. As Brown admitted in court testimony: "I lied to investors when I met them. I lied in the company's filings. I lied in the company's press releases" (Grant, 2004). Tim Rigas lied on the conference call which revealed the \$2.3b off-balance sheet debt when he claimed that the family owned businesses had a "very strong ability" to repay the debt (Nuzum, 2004). It appears that lying had become routine for the Adelphia executives, even when they were supposedly coming clean about the company's true financial situation.

#### **2.4 The Auditors: Independence and Due Care?**

Deloitte was the external auditor of Adelphia from about 1986 until 2002, Deloitte suspended its audit work for the year ended 31 Dec 2001 because they claimed that they could not rely on the information provided by management and they needed an expansion on the scope of the audit (SEC v. Deloitte & Touche LLP, 2005). Soon after that, Deloitte was dismissed by Adelphia. The SEC charged Deloitte for professional negligence, breach of contract, fraud and failure to detect the massive fraud at Adelphia during the period from 1999 to 2000. Deloitte agreed to pay \$50 million to settle the charges without admitting or denying any wrongdoing. Two auditors were subsequently charged for improper professional conduct – Dearlove and Caswell who were the Audit Partner and Manager on the Adelphia engagement respectively (SEC, 2005).

In this case, the auditor was implicated because they gave an unqualified opinion on Adelphia's annual report for the year ended 31 Dec 2000. The main complaints included that during the audit, Deloitte failed to carry out audit procedures that would provide reasonable assurance of detecting the improper exclusion of debt from the

balance sheet, the improper netting of related party transactions and an overstatement of stockholder's equity. Deloitte attempted to shift the blame to Adelphia claiming that senior management purposely misled the auditors by withholding information and creating fictitious documents, a move that apparently angered members of the SEC and others (Solomon 2005).

In terms of audit risk, from at least 1998, Deloitte assessed the Adelphia engagement has "much greater than normal" audit risk. The auditors identified a number of overall risk factors, and some "specific risks" related to particular account balances examined during the audit. Many of these risk factors were directly associated with Adelphia's complex relationship with the Rigas family and the 72 various businesses run by the family.

In terms of management representations, Deloitte had doubts about the reliability of information and was well aware of instances where Adelphia management purposely withheld information (Solomon, 2005). Furthermore, the claim against the auditors stated that Deloitte knew about the multi-billion dollar borrowings guaranteed by Adelphia. For example, for the year 2000 audit, Deloitte suggested additional disclosure of the co-borrowing debt in at least six drafts of the annual report, but when management refused to make changes, Deloitte "acquiesced, without ever disclosing this issue or any other disagreement to the audit committee" (Frank, 2002). Deloitte apparently accepted management's explanation and signed an unqualified opinion on the audit.

Another factor which could have contributed to the auditor's lack of independence was the issue of fee dependence. As Adelphia was one of the largest and most long standing clients for the Deloitte Pittsburgh office, one wonders if the auditors may have been reluctant to lose this client. Furthermore, Deloitte had been the external auditor of Adelphia for over 15 years, and many audit partners had been involved with the Adelphia engagement for many years. Personal relationships could have formed given the context of the small town in Pennsylvania which Adelphia was headquartered and the high regard people had for the Rigas family – who were often referred to as the first family of Coudersport (Broadcasting & Cable, 2002).

It is pure conjecture whether the auditors could have been exonerated had they detected and reported the fraud in an earlier period of time, and had they not backed off under management pressure. Mark Schonfeld, the director of the SEC's Northeast Regional Office claimed: "Deloitte was not deceived. They didn't just miss red flags; they pulled the flags over their head and then claimed they couldn't see" (Frank, 2002)

It is not the responsibility of the external auditor to prevent fraud from occurring within an organisation, and therefore, Deloitte could not reasonably be expected to prevent this situation from occurring. However, in this case, Deloitte might have been able to detect the fraud earlier. At least from the information above, it appears that they identified the material misstatements in Adelphia's statements but failed to take action to prevent further damage due to a lack of independence.

The suit against the auditor ultimately became part of a "blame game" between the outside board members of Adelphia, Deloitte and the Rigas family (Frank, 2002). Even though Deloitte may have had some responsibility for the role they played which contributed to the fraud, the actions were driven clearly by the Rigas family who controlled Adelphia.

## **2.5 Closing Comments**

The Adelphia situations presents with most, if not all, of the factors known to create the 'perfect storm': the booming economy in combination with debt pressures and greed on the part of many players. According to Birchfield (2004), business frauds tend all to be responses to perceived pressure to perform, opportunities to deceive and a rationalisation for behaviour. Adelphia exhibited these traits in abundance, condoning lies, nurturing greed and slavishly following market demands. The case of Adelphia underlines many of the pressures and issues in the market which can contribute to a massive corporate fraud.

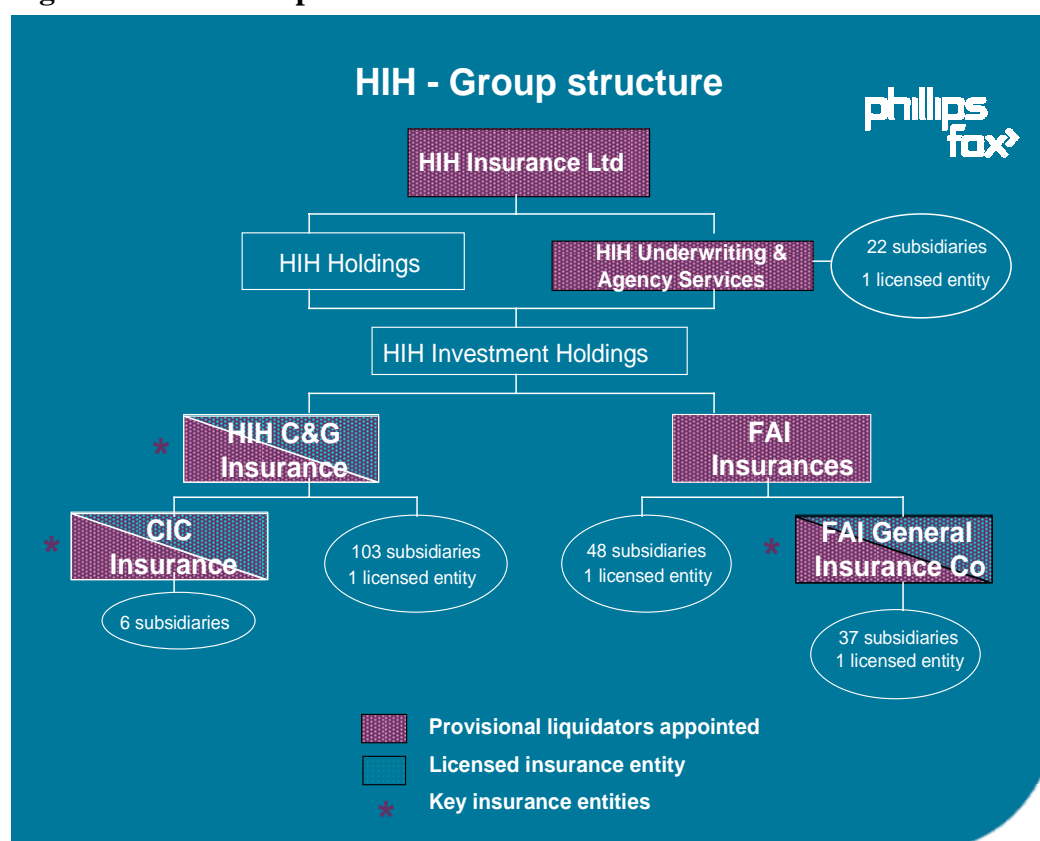
Focussing on the auditors does not reveal a comforting picture. In this instance, Deloitte as the supposed gatekeepers neither escaped liability (they were required to pay \$50m to settle the charges of professional negligence and other wrongful conduct) nor apparent guilt. Although wrongdoing on the part of Deloitte was not proven in

court, our analysis highlights the need for auditors to maintain their independence – and the *appearance* of that independence -- in all audit engagements and to maintain their integrity in the face of management pressure. In particular, the Adelphia case highlights the need for auditors to properly assess related party transactions and adjust their risk assessment accordingly.

### 3. HII INSURANCE: A STORY OF CORPORATE COLLAPSE

HII Insurance was once Australia's second-largest general insurer with net assets totalling \$939 million at 31<sup>st</sup> June 2000. Only nine months later the company was placed into provisional liquidation with debts estimated at between \$3.6 billion and \$5.3 billion. Failings in corporate governance, regulation and auditing and along with poor management decisions have been attributed to the cause of the collapse.

**Figure 1: HII Group Structure**



Adapted from [www.bila.org.uk](http://www.bila.org.uk)

This analysis will discuss the collapse of the HII and the activities undertaken which led to the demise of the company. There will be an analysis of the auditor's role in the collapse and reasons as to why they may not have identified the fraud and finally. Conclusions look to implications of these actions on the part of management, boards and of course, the auditor.

#### 3.1 Background: HII Insurance

HII Insurance was established in 1968, when Ray Williams and Michael Payne incorporated MW Payne Liability Agencies Pty Ltd to the underwriting insurance

business in Australia. Williams and Payne were both directors of the company and Williams held the position of CEO (Owen, 2003). The company's sole business activity was the writing of workers compensation insurance in the Victorian market and, as this became a very successful business operation, it led to the expansion into other states within Australia. In 1971, a British Insurer, CE Heath plc, acquired MW Payne Liability Agencies Pty Ltd; however Williams continued to act as director and chief executive (Figure 1).

In 1985 and 1986 legislative changes to workers compensation insurance in Victoria and South Australia had dramatic effects on the insurance industry and resulted in reduced business (Owen, 2003). The company reacted with a diversification strategy and expanded its underwriting into other insurance classes such as property, commercial and professional liability. It also expanded offshore to Hong Kong and California. This initiated the expansion and growth strategy which subsequently led HIH into its demise (Table 1).

In 1992, CE Heath International Holdings was publicly traded on the Australian Stock Exchange with the codename HIH. In 1995 the name of the company was changed to HIH Winterthur as the result of a merger between HIH Insurance and a large Swiss Company, Winterthur Insurance. Due to increasing concerns about the company's operations in 1998, Winterthur sold its holding in the company and HIH Insurance Limited was established (Mirshekary et al, 2005).

**Table 1: HIH History**

<b>Date</b>	<b>Event</b>
Jun 4 1992	British insurance broker CE Heath floats off 45 per cent of its under-performing subsidiary CE Heath International Holdings Ltd (HIH) on the stock exchange. HIH in 1991 had net assets of \$A39.7 million.
April 1995	HIH Insurance Ltd acquires CIC Insurance
Jun 6 1996	HIH acquires Utilities Insurance
Jan 8 1997	HIH becomes Australia's largest underwriter of bank assurance business after acquiring Colonial Mutual General Insurance.
Sep 1998	HIH blacklists stockbroking analysts who disputed its assessment of the company
January 1999	HIH wins a \$300-million takeover bid for FAI Insurance
3 March 1999	HIH posts a 39 per cent fall in 1998 net profit to \$37.6 million, blaming damage claims

19 November 1999	HIH admits it paid more than it expected for FAI.
March 2000	HIH returns to profitability in first half of 1999/2000.
June 2000	Analysts are concerned about HIH after the Australian Prudential Regulatory Authority's (APRA) proposes to increase capital adequacy requirements for insurers
13 September 2000	HIH sells part of its domestic personal lines business to German insurance giant Allianz for nearly \$500 million
14 September 2000	HIH shares tumble to an all-time low after a lower-than-expected profit result and criticism of the Allianz deal
12 October 2000	HIH chief executive Ray Williams announces his retirement
15 December 2000	HIH shareholders call for resignation of former FAI chief Rodney Adler from the HIH board
26 February 2001	Rodney Adler resigns from HIH board
14 March 2001	NRMA Insurance buys HIH's workers' compensation portfolio.
15 March 2001	HIH Insurance goes into provisional liquidation with losses of \$800 million
16 March 2001	APRA says HIH's woes stem largely from a reassessment of claims liabilities
11 April 2001	Provisional liquidator warns it could take up to 10 years before some creditors are paid.
16 May 2001	Australian Securities and Investments Commission launches its biggest ever investigation, seizing HIH documents
18 May 2001	Former HIH chief Ray Williams hands in his passport and says he has nothing to hide
21 May 2001	The federal government announces a royal commission into what is Australia's biggest corporate collapse.

Adapted from [www.apf.gov.au](http://www.apf.gov.au)

At the time of liquidation the HIH group consisted of over 250 subsidiaries in a highly complex structure. Their operations were worldwide with businesses functioning in numerous countries such as Hong Kong, the United Kingdom, the United States and New Zealand. The HIH group was comprised of three separate government-licensed insurance companies including HIH Casualty and General Insurance Ltd, FAI General Insurance Company Ltd and CIC Insurance Ltd.

HIH's business strategy, as stated in the 2000 annual report was to secure a major market share position in the Australian general insurance industry and to diversify distribution channels (Buchanan et al, 2003). HIH achieved this through acquiring other players within the insurance industry. The first big acquisition occurred in 1993 and was with CIC Insurance Group for \$154.2 million. Five years later in 1998, HIH



initiated a takeover of FAI Insurance for \$300 million. The strategy had the effect of increasing HIH's size by many times in the course of a decade and resulted in premium growth of 26 percent per annum in insurance markets that were already overcrowded and competitive (Cagan, 2001).

Early indications that a collapse was imminent can be observed through significantly reduced profits, a downgraded credit quality and a sharp fall in the share price in the mid-to-late 1990s. On the 15<sup>th</sup> March 2001, HIH was placed into provisional liquidation with estimates of a half year loss of \$800 million. Formal liquidation occurred on the 27<sup>th</sup> August 2001. A Royal Commission, lead by Justice Owen was appointed to lead inquiries into the collapse as there were argued to be significant ramifications for the insurance industry, governments and policy holders as a result of the failure.

### **3.2 Fraudulent Misconduct**

The Royal Commission's investigation into the collapse of HIH found that both business and accounting (and the auditors) contributed to the failure. The business factors included over-priced corporate acquisitions and corporate extravagance. The latter appeared to be based on a corporate culture that held that money was for spending and the fact that the HIH group was not operating according to the minimum solvency requirements set by the prudential regulator, APRA and the Insurance Act 1973 (Clarke & Dean, 2001).

The accounting failures included inadequate provision made for insurance claims and improperly-priced past claims on policies. The latter led to an under-estimation of present and future insurance premiums for any given industry class and claim category. Unfortunately, the corporate audit committee failed to assess the risk of these actions (Clarke & Dean, 2001). The adoption of aggressive accounting practices, a takeover without due diligence, the presence of management fraud and, it would seem, poor audit practices together ultimately led to the HIH collapse. Each of these points will be considered in turn in the sections to follow.

### 3.2.1 *Aggressive Accounting Practices*

Evidence suggests that HIH engaged in aggressive accounting practices as early as 1992. In a due diligence report by Ernst and Young performed for CIC Holdings while in merger talks with CE Heath International (an earlier version of HIH), Heath was found to have understated liabilities by \$18 million and under-reserved by \$41 million.

Much of this sum constitutes a *prudential margin*. Requirement for a prudential margin is vital for the ongoing operations of an insurance company. A common and prudent insurance company practice would entail reserving approximately 20% more capital beyond what is necessary to cover expected liabilities (Skyes, 2002). Ray Williams, who was the CEO of Heath, disagreed with the need for a prudential margin and a second report by an independent expert was drafted and recommended that the merger still take place. Notably, the independent expert on this matter was a Mr Alan Davies of Arthur Anderson. Davies later became HIH's lead auditor in 1996 when the former auditor, Dominic Fodera, became HIH's finance director (Buchanan et al, 2003).

The merger also led to an accounting treatment of *reserves* which resulted in distortions in the asset amounts in the balance sheet. The auditors were aware of this practice but failed to raise their concerns with management. It was suggested that a culture now dominant within HIH may have discouraged a questioning of authority.

There was also \$288 million in government securities that HIH pledged as *security* for Westpac Bank letters of credit being used as capital for the insurer's four Cotesworth syndicates at Lloyds. The Australian Prudential Regulation Authority (APRA) insists that once assets are pledged for specific facilities such as these letters of credit they cannot be used as assets or reserves for the insurer generally (Westfield, 2003). However, HIH used the assets committed to Westpac in solvency calculations in its quarterly report to APRA to hide its insolvency. APRA was questioned with regard to their involvement in the failure, while it was found not to have contributed to HIH's collapse it did fall short in the way it exercised its responsibilities with regard to the insurer.

### *3.2.2 Takeover and Due Diligence*

Many of HIH's difficulties may be related to its aggressive acquisition strategy and the creation of no less than 250 subsidiaries (Cagan, 2001). The acquisition of FAI Insurance in 1998 was the most controversial takeover. Rodney Alder, who later became a member of HIH's board of directors, sold his own majority-owned insurance company FAI for \$300 million to HIH. HIH's cash flow required that the company borrow heavily to support the purchase. The purchase was based on the assurances given by Alder and neither board consultation nor a due diligence was completed; instead reliance on FAI's recently completed accounts was used. APRA approved the deal.

The assets of FAI were grossly overvalued which resulted in a premium well in excess of the real value being paid to gain control (Mirshekary et al, 2005). In fact, over a matter of weeks in 1998 and without telling HIH, Goldman Sachs, who was FAI's advisor, revised sharply downwards its valuation of the insurer from \$200 million to \$20 million (Anonymous, 2002). This move seriously affected the financial position of HIH and triggered a continuing sharp decline in the value of the shares. As a consequence, HIH was forced to write off its investment in FAI to the value of \$400 million in September 2000 (Mirshekary, 2005). The FAI acquisition put additional pressure on HIH's financial viability at a time when HIH's reserving and pricing strategies were already compromised (Cagan, 2001).

### *3.2.3 Management Excesses*

Finally, and even as HIH headed towards collapse, its management was accused of using company funds to enjoy lavish lifestyles. Personal expenses were charged to corporate credit cards, excessive tipping at restaurants, generous corporate gifts and extravagant travel expenses were found as evidence to inappropriate activities (Bradford, 2003).

## **3.3 The Role of the Auditors**

Arthur Anderson completed the external audits for HIH from 1971 until its collapse in 2001. They may have played a part in its collapse or at least in its costly delay. Their contribution to the situation is considered in the following sections as to relating

either to their conduct on the audit, their independence, and the extent to which management and board practices may have contributed to the failure.

### *3.3.1 Audit Practices*

It would have seemed that a prudent and competent audit would have revealed a number of the aggressive practices referred to above. For example, prudential margin calculations should have revealed a weak reserve situation in an area crucial to an insurance organization. Being observant as to senior management lifestyle and examining samples of company 'expenditures' may well have revealed the questionable appropriations carried out in the company's name. Finally, examining the client's correspondence -- including their letters of credit -- should have revealed the pledged securities later used in the APRA report (although we note that the APRA report may not have been integral to the audit engagement). Even were the implications of these actions all missed, the major takeover of FAI Insurance, with obvious and overt related party implications, should have been a red flag to auditors concerned with financial position.

The 'planning' process also seemed bereft of the care due to the engagement. As part of the audit process a risk assessment is to be carried out by the auditors to determine the structure and plan of the audit. Arthur Anderson assessed the riskiness of HIH and deemed it a maximum risk client due in part to its aggressive accounting practices and the difficulty experienced in the past with regard to resolving issues with HIH management. Despite this finding, Anderson retained HIH as an audit client. Even though HIH was considered to be a maximum risk client, there was no risk management plan that had been prepared by the engagement team and therefore not reviewed or approved by the senior management team at Arthur Anderson (Cooper & Deo, 2006).

Finally, auditors simply came to the wrong conclusions. HIH's annual report for the 30<sup>th</sup> June 2000 was signed off by Arthur Anderson stating that it was a going concern with net assets of \$939 million. Nine months later HIH collapsed with debts of \$5.3 billion. Anderson used HIH management reports and forecasts and did not gain sufficient evidence to draw the conclusions they did. The liquidator could not find the documentation outlining the reasons for establishing HIH as a going concern. This

indicates that Anderson failed to produce adequate working papers which prove that the audit actually took place.

### *3.3.2 Auditor Independence?*

Andersen's own relationship with the client was hardly commendable. By the time of liquidation, three former Arthur Anderson partners who had carried out work on the HIH financial audit held positions on the HIH board of directors. Geoffrey Cohen was the Chairman, Dominic Fodera was the Chief Operation Officer and Justin Gardner was a non-executive director. The HIH Royal Commission claimed that significant evidence exists to ascertain that a close personal relationship developed between the parties and that this relationship developed to the stage that it could be a threat to the independence of the assurance team and/or a particular auditor (Mirshekary et al, 2005). Such relationships would now normally be in serious breach of most codes of conduct such as Professional Statement F1 which is applicable to all Chartered Accountants in Australia.

This apparent lack of independence between the board of directors and the auditors indicates that the best interests of HIH may not always have been a priority. Andersen's apparent failure to produce sufficient working papers or to gather sufficient evidence to support their findings raise serious concerns about the quality of the audit they conducted.

There has also been evidence to suggest that Anderson's independence was absent when it came to the high-pressure relationship between HIH's directors and the Arthur Anderson audit team. A statement by Mr Martin, who was counsel to the HIH Royal Commission, suggests that the audit concepts of competence, judgement and independence may have been compromised as they endeavoured to complete their work under time and fiscal constraints. He stated that "Since HIH management were reluctant to increase the amount of audit fees paid to Arthur Anderson, Anderson sought to reduce the amount of work performed on the HIH audit," (Mirshekary et al, 2005).

A significant independence issue also appeared in the form of Arthur Anderson's payment to HIH Chairman, Geoffrey Cohen for consultancy fees. Over a period of nine years these fees totalled \$190,887 and also included the use of an Arthur

Anderson office and secretary. Adding to suspicions of wilful wrongdoing, these fees were not disclosed to the remaining board members in the annual general meetings. The Auditing Practice Statements (AUP) provide direction on this matter and AUP 32 states, “no officer of the company to be audited shall receive any remuneration from the firm acting in an advisory capacity to it on accounting or auditing matters.” The close and complex financial relationship between the auditors and the HIH chairman raise further questions of influence in this case.

Finally, it should be noted that Arthur Anderson provided both audit and non-audit services to HIH. Providing both audit and non-audit services to clients is allowed under certain circumstances. There are however ethical constraints to help ensure that auditor independence is retained. It becomes a question of how can an auditor provide an independent opinion on the financial statements when he or she may have had a role – however indirect – in guiding the client towards preparing those statements? (Van Peurseem & Pratt, 2003). Clearly the issue is whether the provision of non-audit services was ethical on Arthur Anderson’s behalf while still acting in the best interests of the shareholders to whom they owe a duty of care.

The Royal Commission has found that the largest corporate collapse in Australia was not due to fraud or embezzlement but the result of attempts to paper over the cracks caused by overpriced acquisitions (Owen, 2003). While management and the misstatements they created led the charge toward the disastrous corporate collapse, Arthur Anderson’s role in it appeared to be substantial.

### **3.4 A Note on Corporate Governance**

We add that the Board of HIH cannot escape blame. Corporate procedures were amiss, particularly with respect to appropriate corporate governance practices (Pass, 2004). While HIH established an audit committee for example; they appeared to fail to use it effectively. There was an apparent breach of independence within the committee as Geoffrey Cohen was the chairman of HIH and the chairman of the audit committee. The members of the audit engagement team did not meet with the HIH audit committee without management present which makes it difficult to be reasonably independent of management. In this case, it may have made it more difficult to discuss management’s questionable choices.

Mardjono (2005) studied the collapses of both Enron and HIH and drew parallels between the failures. He concluded that Enron and HIH did not fail because they were in an unprofitable business; they failed because they assaulted the key principles of good corporate governance.

### **3.5 Closing Comments**

Arthur Anderson's independence ultimately fell under public scrutiny and the Association of Institutional Shareholders in Australia, probably sharing the wider concerns that prevailed (Cooper & Deo, 2006). It would appear that the auditors failed to display either independence of mind or in appearance with regard to their largest Australian client HIH, and succumbed to their own pressures of the bottom line in carrying out the statutory audit of this significant client.

The collapse of HIH led to major losses for its policy holders, creditors, shareholders, employees, governments, auditors and regulators. The policy holders were largely affected because the provisional liquidators made it clear that there would be long delays for claims to be honoured and even then, it was unlikely that they would be paid in full (Owen, 2003). Other industries were also affected. For example, HIH was one of Australia's biggest home-building market insurers and its collapse left the building industry in turmoil. Governments were required to intervene to resolve issues and did so by creating a Federal HIH Claims Support Scheme.

The report completed by the Royal Commission has revealed the need for changes in corporate governance, insurance regulation, financial reporting and other insurance-related activities. There have been a number of repercussions for the auditing profession with attention directed towards the Ramsay Report into auditor independence and Professional Statement F1. The report has also called for increased regulation of the audit profession and recommended that the Corporations Act 2001 and the Australian Stock Exchange listing rules be amended (Mirshekary et al, 2005)..

Justice Owen presented his findings in the report to the Royal Commission regarding the breach of independence and concluded that the combined effect of the features of the relationship between Anderson and HIH gave rise (or would give rise to those

aware of the relevant facts) to a perception that Anderson was not independent of HIH. While a close analysis of the conduct of the 1999 and 2000 audits reveals no reason to conclude that Anderson's independence was in fact compromised (Owen, 2003), their *apparent* lack may have affected the quality of the work performed on the audit of HIH. This may have also contributed to HIH's ability to carry out aggressive accounting practices which lead to its demise.



#### **4. THE RISE AND DEMISE OF ALAN BOND**

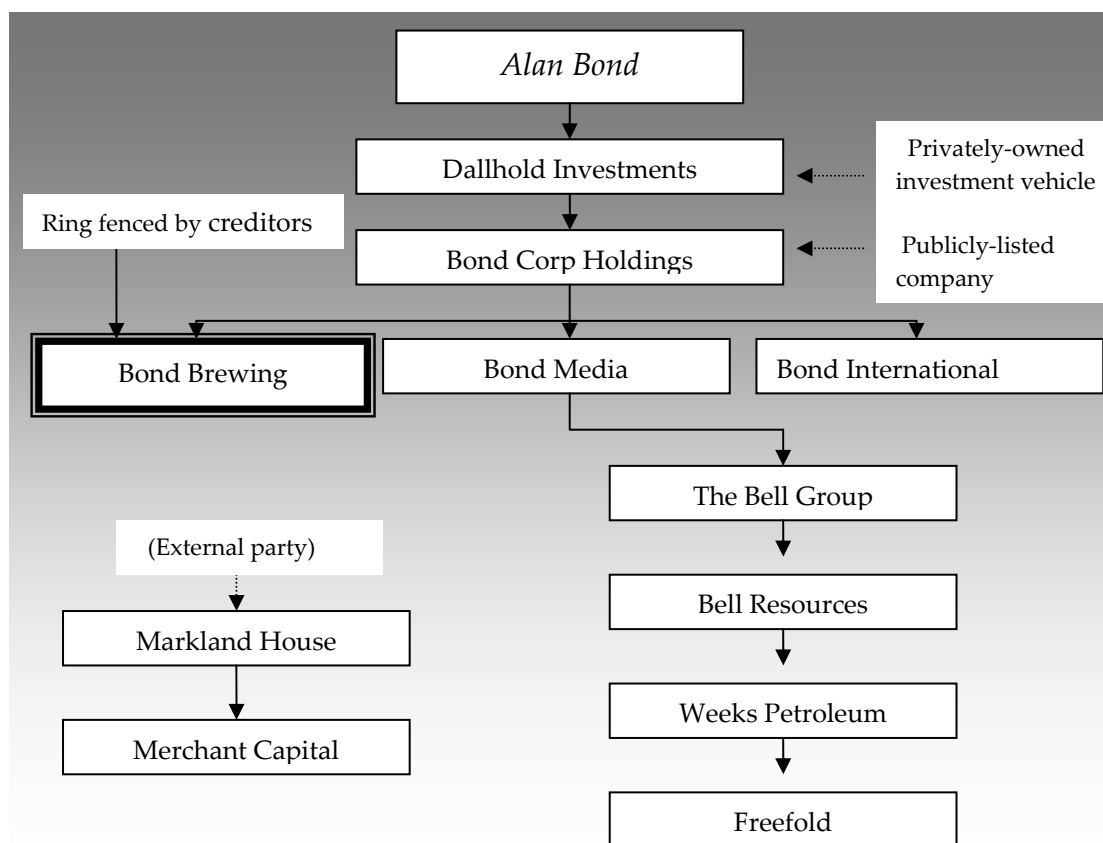
It was said that nobody took Australia so high nor brought it as low as Alan Bond whose name became synonymous with the excesses of Australia's 1980s share market (Sykes, 1996). While not alone in stretching the bounds of directorship, he may have been one of the most spectacular of the time. The 1980s was a period of unsustainable spending which produced dozens of rags-to-riches-to-receivership entrepreneurs (In Bondage, 1990), ending with Australian banks forced to write off A\$28 billion in bad debts between 1989 and 1993 once these events became publicly known (Sykes, 1996).

Bond was born to a poor English family who immigrated to Australia in 1950 to escape poverty. A school dropout, Bond began his working life with no money or connections, but quickly built an empire which included the world's fifth largest brewery, Australia's largest media company, and significant worldwide interests in property and mining (ABC Television, 2003). Bond was named 'Australian of the Year' in 1978, successfully bid for the America's Cup in 1983, and founded Bond University in 1987, Australia's first private university. The Australian Prime Minister called him a 'great Australian' (New York Times, 2002).

On the back of this success, Bond launched a global spending spree, borrowing heavily to grow his empire and pay for his extravagant lifestyle. In the five years leading up to 1989, Bond Corp's 'revenue' grew from A\$365 million to A\$7.7 billion (In Bondage, 1990). Bond purchased Vincent van Gogh's 1889 masterpiece 'Irises' in 1987 for a record price for any painting to-date of A\$53.9 million (Delilkhan, 1990). Despite this, he would soon announce Australia's largest corporate loss and it would be revealed how he plundered public companies, paid himself huge fees, took huge private profits from public deals and sold assets to related companies at wildly inflated prices (Williams, 1999).

This study examines, in particular, the related party business decisions (Figure 2) that contributed to the spectacular nature of this failure, and considers the auditor's role in detecting and reporting (or failing to detect and report) these events earlier.

**Figure 2: Bond Corp and Related Parties<sup>1</sup>**



#### 4.1 Debt Patterns

Bond consistently loaded his companies with debt to fund the next purchase (Sykes, 1996). This strategy facilitated massive growth, but left his empire in a precarious position. The stock market crash of 1987 saw the Australian Stock Exchange shed 25% on October 20, losing 50% of its value by November 11 (ketupa.net, 2006). It was at this point that Bond’s businesses were starting to reveal themselves as weak. Following the 1987 share market crash, Bond Corp had debts of A\$7.2 billion and A\$3 billion in equity (Anonymous, 1989). Considering the optimistic view Bond traditionally took when valuing his assets, the real gearing was significantly higher and shareholders’ funds may have actually been negative (Sykes, 1996). In hindsight, many analysts believe Bond Corp was insolvent following the crash; however, no one seemed to be aware of this at the time. Bond continued to borrow as if his companies were performing better than ever (Williams, 1999).

<sup>1</sup> This figure represents only a small portion of the companies under Bond Corp control.

In a very short time frame Bond had radically enlarged his empire; but the components of his conglomerate were operating poorly. The breweries were the only division producing positive cash flows, though sales were falling and it was so heavily indebted that its creditors ‘ring-fenced’ its cash flows, forbidding funds from being further siphoned off to other businesses (Anonymous, 1989). By 1988 Bond faced a severe liquidity and cash flow problem. No one would lend him money and his empire was sinking under the weight of debt created by his frenzied acquisitions (AAP, 2005).

#### *4.1.1 Back-to-Back Loans*

To solve the liquidity crisis Bond acquired a majority interest in the “Bell Group (TBG), inserted himself as Chairman, and fellow Bond Corp executives as directors. The target of this acquisition was a prized TBG asset, a 39% (controlling) stake in Bell Resources (Bell). Bell controlled A\$2 billion in cash and liquid assets following a flurry of asset sales by the group’s previous majority shareholder, Robert Holmes a Court. Holmes a Court had interpreted the recent stock market crash as a sign the investment environment had fundamentally changed, and had rapidly (and wisely) liquidated the assets of TBG. He thereby ensured the company was on a sound financial footing to continue into the future (Williams, 1999). Unfortunately, Bond siphoned off much of this cash from Bell through a series of back-to-back loans. Bell would advance funds to a subsidiary of Markland House (Markland) (a small Sydney based merchant bank where Bond was a director. Markland, acting as an intermediary, would on-lend to Bond Corp directly or through a subsidiary, adding a small markup for the service.

TBG’s established practice was to deposit money with a prudent spread of reputable finance companies (R v Bond, 1997). Merchant – the target -- did not meet this standard. With shareholders funds of just A\$16 million, no director could justify providing it with a loan of any size (Sykes, 1996). Since Bond controlled Bell’s board, Merchant was added to the list, allowing the first of the funds to be transferred on 29 August 1988 (R v Bond, 1997). By 3 November 1988, A\$447.5 million had been transferred to Bond Corp, with a further A\$55 million to Dallhold, Bond’s private investment vehicle. No security was provided for these transfers, nor could they be apparently justified on any reasonable commercial basis (R v Bond, 1997).

#### *4.1.2 Freefold Debt Facility*

Following a tipoff by Holmes a Court, still a director on TBG's board, the executive director of the National Companies and Securities Commission (NCSC) enquired whether any of Bell's funds had been lent directly or via back-to-back (circular) loans to Bond Corp or Dallhold (*R v Bond*, 1997). To sidestep this enquiry, Bond established a debt facility with Freefold, a company further down the ownership chain. Freefold had recently divested a A\$500 million stake in BHP, the Australian mining giant, therefore had sufficient funds to reverse the Bond loans. A response was issued stating none of Bell's funds had been loaned to Bond Corp or Dallhold.

Thus while this statement may have been 'technically' correct, it was seriously misleading. Bond's response failed to mention the A\$105 million of back-to-back loans that had not been unwound, it failed to state the financing position in place when the letter was received, and failed to mention the Freefold debt facility which was effectively still Bell's money (*R v Bond*, 1997). Bond appeared to have a fondness for treating corporate laws with contempt; following the response A\$170 million was transferred via new back-to-back loans (ABC Television, 2000)

The Freefold debt was due for repayment in March 1989, however Bond Corp's financial position had continued to deteriorate and its credit rating was reduced to 'B' and then to 'CCC'. Not only is this rating at the lower end of the scale, a company with this rating is defined as being 'vulnerable to nonpayment' (Standard & Poor's, 2006). Traditionally, less credit-worthy borrowers are required to provide more collateral than usual for a loan (Chan & Kanatas, 1985). Bond Corp's credit rating had plummeted, ensuring that it was not able to repay the debt however, defying logic, the Freefold board voted to extend the repayment date to September 1989, still without requiring any security (*R v Bond*, 1997).

This extension was not in the interests of TBG's shareholders, nor the minority shareholders in Bell or Freefold, but bought Bond time to develop a new strategy. Bell's status as a publicly listed company required the Freefold facility to be tided up to portray the appearance of a legitimate commercial transaction. This was because the accounts of Bell had to be audited and published on a regular basis, which would reveal both the size and nature of the inter-company debt. It was decided to

consolidate all of the loans into the Freefold facility and issue a security over the debt. The current authorization for A\$700 million would need to be extended. ‘Kindly’, the Freefold board offered to increase the value of the facility to A\$1 billion and defer the repayment date (R v. Bond, 1997). While, in general, larger loans are positively correlated to increased interest rates, more collateral, and a stronger credit rating of the borrower (Melnik & Plaut, 1986), these factors were not evident here.

In a typical commercial loan arrangement, equipment, real estate, accounts receivable or inventories are normally offered as collateral (Chan & Kanatas, 1985). Due to the covenants already in place with Bond’s heavily indebted assets, efforts to secure the Freefold debt resulted in the creation of an unconventional security package which would never have been acceptable in a prudent arms’ length deal (R v. Bond, 1997). Bond provided no collateral. The company also had a poor credit rating, and Freefold was effectively offering a very cheap loan. It appeared that in reaching the decision to increase borrowing capacity, the Bond Corp-dominated TBG board failed to act in the best interests of its shareholders.

A third mortgage was offered over the brewing assets. Not only did this mortgage contravene existing covenants, the breweries were barely able to service the debt they already carried as a result of losing significant market share (Sykes, 1996). The third mortgage on the brewery assets provided no incentive for repayment as this security was effectively worthless. The decision to increase the debt facility and defer repayment was approved by Freefold only five days after a national current affairs program broadcast an expose on Bond Corp, claiming the company significantly inflated its profits in 1988 (Sykes, 1996). Given Bond Corp’s shaky financial position, its low credit rating, and the deteriorating performance of its main assets; given the recent spate of corporate collapses following the stock market crash, given the expose on Bond Corp inflating its profit, and given the worthless security provided for the debt, shouldn’t the directors of Freefold have wanted to urgently recover this money rather than offer significantly more?

On May 30<sup>th</sup> 1989 Bond chaired Bell’s Annual General Meeting (AGM). Following the revelation of the inter-company debts, he set about reassuring shareholders that

their funds had not been placed at risk as the loans were secured and met the best investment criteria. He also assured shareholders that no funds had been lent to Dallhold. This information was later said to have been an intentional effort to deceive as to the nature and extent of what had occurred (R v. Bond, 1997).

Following the AGM, Bond lost control of Bell when he and his fellow Bond Corp executives were threatened with legal action from a major shareholder (New York Times, 1990). Without access to Freefold's cash, Bond Corp's companies started to fall dramatically.

## **4.2 The Court Judgement**

Bond was charged with nine matters arising from these transactions. By pleading guilty to two counts of contravening s229 of the Companies Code, the rest were dropped. The prosecution alleged s229 was breached as a result of Bond's intent to defraud; therefore, he failed to act honestly as a director (R v. Bond, 1997). The first offence related to the initial time extension of the Freefold facility, the second related to the increase of the facility from A\$700 million to A\$1 billion. Bond had clearly obtained substantial personal benefits from these offenses at the expense of minority shareholders (R v. Bond, 1997).

In sentencing Bond, the Judge had to consider whether the offences were of the worst possible sort and the method by which the fraud was achieved. A\$994 million was transferred from companies where Bond was a director to companies where he was a director and held a substantial interest. The judge concluded the fraud was in the worst category as Bond was in a position of trust, had misleadingly responded to the NCSC in November 1988, and misled shareholders' at Bell's AGM (R v. Bond, 1997). Bond was jailed for four years, less than half the maximum sentence available.

This punishment was received with public outrage, criticized as being insufficient and disproportionate to the seriousness of the crime (Williams, 1999). Bond's actions had cost thousands of shareholders billions of dollars. While it is not mentioned whether Bond was a member of the Institute of Directors, his actions broke numerous sections

of their code of ethics, including their core values: absolute integrity, openness and transparency, and respect for others (Institute of Directors, 2004).

### **4.3 Audit Issues**

Numerous audit issues arise from this case. While the extent to which back-to-back loans were utilized would have been difficult to uncover, this case illustrates that it would be important to be on the lookout for them! An earlier 'signalling' of problems by the auditor may have led to better outcomes in terms of lower minority shareholder losses or even business recovery. Where were the auditors?

Upon the discovery of the Freefold debt facility, TBG's auditor -- Coopers & Lybrand -- conducted an investigation which included examining Bond Corp's accounts and consulting the auditor (Arthur Andersen). This led Coopers & Lybrand to conclude that it was unnecessary for a provision to be created against the full recovery of the loans on the 1988 report, despite the debt not being covered by adequate security. The stock market crash occurred by the time this report came out. Many other companies which had taken a similar approach had simply disappeared. The auditors new Bond Corp faced a severe liquidity crisis and restrictions had been placed on the brewing assets. How was it possible that a provision was not deemed necessary?

Arthur Andersen had actions to answer for as well. A television documentary accused Bond Corp of significantly inflating its 1988 profit, yet this failed to deter the Freefold board from increasing the debt facility offered to Bond. One would think that the auditors might have identified this transaction as questionable in their statutory audit of Bond Corp accounts and tagged the report months earlier. In addition, a quarter of the A\$402 million profit for the 1988 year was derived from the incomplete sale of two international properties (Sykes, 1996). Since the contracts were not signed off, it would seem to contravene the concept of prudence if they were recognised in the accounts at that point. Despite the material nature of this transaction (increasing profits by A\$100 million), the accounts were not qualified by Arthur Andersen. These properties were eventually sold two years later at a substantially reduced price (Sykes, 1996).

In contrast to the 1988 report, the 1989 annual report contained one of the longest audit opinion qualifications ever seen. Stretching three-and-one-half pages of very small type, the auditors had a massive list of concerns. They included overly optimistic asset valuations, questionable revenues, negative net assets and A\$3.6 billion in debt repayable within 12 months (Sykes, 1996). Was it possible for the operations of Bond Corp to deteriorate so significantly in one year? Is it possible that 1989 was the first and only year executives at Bond Corp had participated in creative accounting techniques? The deteriorating financial position of Bond Corp had become apparent, but we suggest there may also have been numerous signs in preceding years that the situation was out of control. Ultimately, we ask how it may have been possible to avoid discovering these events in the previous year's audit.

It appears neither of the audit firms uncovered the back-to-back loans which existed prior to the creation of the Freefold debt facility. While these may have been hard to identify, it does raise doubts as to whether the auditors had a thorough knowledge of the organizations they were auditing. Auditors have a responsibility to investigate and report irregularities when suspicions are, or ought to be aroused, by evidence which comes to light in the course of an audit (Johnson, 2000). Should 'suspicions' have been raised here? Back-to-back loans, through one or more intermediaries external to the group, can pose significant problems for the auditor as the intermediary can conceal the fact that it is one between related parties. In a normal audit, a confirmation letter would be obtained from the 'external' party. Unless the auditor had reason to suspect interference, the letter from that outside lender is likely to be considered a strong form of evidence as to the quality of the loan (Van Peurseem and Pratt, 2004).

There are however established 'red flags' associated with back-to-back loans which a knowledgeable auditor can use to increase the likelihood of the loans being discovered. These are listed by Johnson (2000):

- Restrictions on a company in the group lending funds to other members;
- A member of the group is in need of funds; and
- There are corresponding inflows and outflows of funds in the two companies involved in the transaction.



In the case of Bond Corp, the first two red flags were visible. The breweries were the only division achieving positive cashflows; however, they were so heavily indebted that creditors had placed restrictions on the funds generated. Bond Corp as a whole was also in desperate need of cash, urgently requiring funds to meet day to day requirements. Not only was the company heavily indebted, its business were performing poorly and generating significantly negative cashflows.

The final red flag would have been more difficult, but perhaps possible, to detect. The ownership chart of Bond Corp was a labyrinth of over 100 related businesses. They had numerous origins, and there were outside intermediaries. While in hindsight the existence of back-to-back loans are of course visible to the pedestrian view, it seems a problem might have been *suspected* by the presence of such seeming unnecessary complexity. We acknowledge however that, it would be difficult to unravel the full detail of this web of deceit.

#### **4.4 Closing Comments**

The American Institute of Certified Public Accountants (AICPA) has developed a number of mechanisms to help the auditor identify potential fraud. One of these is the 'fraud triangle' in which fraud opportunity, rationalization of unethical actions and socio-economic pressures combine to create a lethal mixture. The Alan Bond case appears to be an illustration of the AICPA fraud triangle at work. Pressure was exerted on Bond and his fellow executives as a result of the corporation's desperate need for cash. Bell provided the opportunity for a short-term fix to this problem thanks to its significant cash reserves. The auditors did not appear to be a significant deterrent in carrying these actions out. Finally, and throughout his colourful corporate career, Bond showed nothing but contempt for corporate rules and regulations, and treated shareholders' assets as if they were his own. The rise and demise of Alan Bond provides lessons for auditors and regulators alike. As stated by Mahar (2000), the importance of Alan Bond to corporate regulation and shareholder protection is making sure he, or someone like him, does not have the power to damage the small shareholder in the way they did again.

## 5. CONCLUSION

Each case is unique. Adelpia is a story of a private cable company whose directors, despite going public to raise funds, continued to treat its finances as a personal piggy bank for its founding family. It also tells the story of a market gone mad, placing perhaps unrealistic expectations on continued growth and profit-making that – like the famous Enron and WorldCom of similar times – could not reasonably be met. Australia’s largest insurance failure – HIH -- informs us how company failure affects not only its shareholders, but also society – its employees, insurance beneficiaries and others. In Bond Corp, with the infamous Alan Bond at its helm, we see how an individual who commands the wide respect of society also has the capacity to bring a company down due to the trust others have in him.

Despite distinctions, these three situations share some common features which may be informative to researchers, auditors and governing bodies. One might find a common thread in some characteristics of the human condition, and perhaps those means and opportunities that expose its darker sides. These cases also tell a story of how seniors in industry are held – or not held -- to account for public actions.

One of our authors – Maiqing Zhou – points to a theory which captures one aspect of the corporate problems observed here. Birchfield (2004) suggests how, when certain factors combine in a ‘perfect storm’, that we find real problems emerge. The so-called ‘perfect storm’ of fraud is most likely to occur when, according to Birchfield (2004):

- There is external pressure to perform (and fraud can be the response);
- There are opportunities to deceive; and
- Those perpetrating the frauds find a way to continue doing so through a rationalization of their own behaviour.

How does the ‘perfect storm’ play out in the events set out in these three cases of corporate fraud? (Table 2).

**Table 2: ‘Perfect Storms’?**

	<i>External Pressure to ‘Perform’</i>	<i>Opportunities to Deceive</i>	<i>Rationalization</i>
Adelphia	Booming Wall Street profit and share price expectations	Corporate culture of moral decay, family led the board	Defense in court evidenced entitlement mentality
HIH Insurance	Economic boom; growing need for credit and cash; collapse imminent	Interlocking directorships, aggressive accounting policies	Extravagance and management’s entitlement lifestyle noted in court
Bond Corp	Public expectations of Bond enterprises high; awards and accolades to Alan Bond well-known	Interlocking companies and directorships, aggressive accounting policies allowed	Alan Bond noted for entitlement attitude

It seems that, despite their different settings and industries, these cases share a combination of opportunities via, for example, powerful positions on governing boards, pressures to perform sometimes unrealistic feats of enterprise, and a false confidence in their ‘rightness’ in performing fraudulent acts. They appear to paint a common picture of a lethal-to-the-public combination of opportunity and greed so damaging to those who come into contact with them.

Also noted is a pattern in the nature of transactions that led to the largest and most damaging levels of fraud. The process of raising ‘capital’ appears as a frequent element of this game. Through the existence of compliant banks and lenders, with the support of complacent or powerless boards, or in particular through the use of inter-company relationships and financial gamesmanship we see the company and public defrauded on a massive scale.

So if it is all so predictable, then why didn’t the auditors discover and reveal these problems? We can observe a pattern here in which, at least in these cases, the auditor did not provide the quality of analysis that the public might have expected. The reasons for such problems seem to range from a simple failure to ‘identify’ the fraud to what appears to be a failure to act upon their (likely) knowledge of it when it became known.

In most cases, and given incomplete access to information, we cannot and will never be able to fully know the balance that may have occurred between the two, or where the primary fault may have lain. Nonetheless, there does seem to be some pattern: a

failure to pick up the ‘warning signals’, a struggle to sort through convoluted equity structures and, sadly in some cases, less attention to ‘independence’ than should have occurred. There are lessons for many in this selection of corporate fraud disasters.

## **6. FUTURE RESEARCH**

Overall there are a number of directions which can be pursued for further research, many of which could contribute significantly to both our understanding of corporate fraud and to the auditor’s role within a corporate fraud environment. An extended study of other cases in which corporate fraudsters have been brought before the courts is a fruitful avenue for research, as through court action much of their behaviour is publicly revealed. Doing so could begin to reveal yet further similarities and differences, and also test the conceptual frameworks used to explain their presence.

The role of the auditor should not escape further examination either. If by analysing ethical practices and promulgations, accounting standards and auditing guidance, one can come to a better understanding of how they benefit (or fail to benefit) practice; then it may also be possible to see how the auditor is either enabled or restrained by their regulatory environment. It would be worthwhile to explore further the auditor’s own formal (and informal) role in detecting and reporting corporate fraud in a timely manner.

An economic perspective on the issue is also important. The auditor operates in a competitive market to provide ‘assurance’ services at less cost than its competitors. If it can be demonstrated that such incentives do or do not operate well, then much may be achieved in terms of identifying market interventions that should occur.

Corporate fraud is shown to be significant in size and material in affecting the lives of investors, employees and whole communities. It would seem that any efforts to better understand or address these issues would form part of an important and long-lasting contribution.

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