

## AFTER ENRON: THE NEW REFORM DEBATE

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### I INTRODUCTION

In 1776, Adam Smith, the intellectual father of modern market capitalism, wrote that:

By pursuing his own interest [an individual] frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good.<sup>1</sup>

It is impossible, of course, to know what Smith would have made of the corporate scandals and collapses of the first years of the 21<sup>st</sup> century, but it would appear the pursuit of individual interest through the 1990s has produced outcomes that are clearly contrary to, and destructive of, the 'public good'.

The pursuit of individual interest, which in its more intense and less palatable form might be termed simply as greed, has over the centuries produced periods of excess and consequent attempts to regulate that behaviour.<sup>2</sup> After the South Sea bubble in 1720, the formation of new companies was prohibited, in the absence of specific legislative authority, for more than a century. After the 'Great Crash' of 1929 in the United States, the Securities and Exchange Commission ('SEC') was formed to regulate companies and markets, the Glass-Steagall Act<sup>3</sup> which separated banks from investment banks was passed, along with a raft of other legislation designed to prevent such excessive behaviour recurring.

In this jurisdiction, the Poseidon Boom of the late 1960s led, initially in NSW, to new laws aimed at regulating securities market activity. After the 1987 share market crash following a decade of increasingly speculative activity by the 'entrepreneurs' of the 1980s, there was wholesale reform, which included new corporations and securities laws, more stringent accounting standards, a new emphasis (with force of law) on continuous disclosure by the Australian Stock Exchange and a new consensus between regulators, companies, investors and

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1 Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (first published 1776, 1952 ed) 194.

2 For a general discussion of the history of corporate regulation, see, eg, Harold Ford, Robert Austin and Ian Ramsay, *Ford's Principles of Corporations Law* (2001) ch 2.

3 *Banking Act of 1933*, Pub L No 73-66, 48 Stat 162 (1933).

other interested parties on the constituents of good governance. The evolution of that consensus, and indeed the progressive updating of corporate law, continues.

None of these reforms, of course, is designed to prevent corporate failure. It is an integral if brutal element of market capitalism, and one essential to the efficient allocation of capital, that it provides both opportunities to succeed and to fail. The legal framework governing corporate behaviour and regulating securities markets ought, however, to protect investors and creditors from dishonest behaviour by boards, management and other participants in the public markets for capital. Most importantly, it ought to ensure that they have sufficient information, of sufficient integrity and with sufficient timeliness, to protect themselves from either dishonesty or recklessness.

The string of large and high-profile local corporate failures in 2001 — HIH Insurance, One.Tel, Ansett and Harris Scarfe — raises the question of regulatory failure, as well as serious issues about the effectiveness and/or integrity of the governance of these companies. With one possible exception, however, there are no obvious commonalities in the causes of their failure. One.Tel's collapse was due to a fundamentally flawed business model. Ansett failed because it was not efficient enough, or sufficiently well-managed or capitalised, to withstand the effects of a vicious price war sparked by new industry entrants. Harris Scarfe's demise was due to longstanding and ultimately unsustainable fraudulent accounting. Until the Royal Commission inquiring into the circumstances of HIH's collapse concludes, it is not appropriate to reach absolute conclusions about the causes of its demise other than to say it would appear that it had, for some time, consistently and significantly underestimated its liabilities, and under-reserved and under-priced for risk.

One possible issue of systemic importance posed by the collapses — most substantially by HIH's demise — is whether there was audit failure. This is a critical question, which is as yet unanswered. We know there was some regulatory failure in the HIH collapse because the Australian Prudential and Regulation Authority ('APRA') has conceded it. Graeme Thompson, chief executive of APRA, said that with the benefit of hindsight, 'APRA could have been more aggressive with HIH and dug more into its financial condition once we had identified concerns with its operation in the middle of 2000'.<sup>4</sup> Subsequently the federal government has accelerated the introduction, from 1 July this year, of a new capital adequacy, solvency and prudential framework for general insurers.<sup>5</sup> The stable door has been shut, but only after HIH and more than three billion dollars of other general insurance losses bolted through it.

The question mark over the quality of the audit functions associated with the corporate failures is of greater consequence because it links what has happened in Australia directly to what has transpired overseas, most particularly in the US, where debate over reforms to the audit function are raging in the wake of a series of accounting scandals and corporate collapses. The importance of the US

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4 Evidence to Senate Economics Legislation Committee, Parliament of Australia, Canberra, 5 June 2001, 237.

5 *General Insurance Reform Act 2001* (Cth).

economy and market, and the roles they play in the global economy and financial markets, ensures that any major reforms in the US will flow through to Australia, despite the fact that the causes of corporate stress and failure appear to have been quite different here.

The remainder of this article examines recent developments in the US, focusing on the Enron and WorldCom collapses. It captures aspects of the current regulatory debate in the US, and its implications for Australia. In the aftermath of the corporate failures, two areas requiring reform are the audit function and the current financial reporting model.

## II THE SITUATION IN THE UNITED STATES

The US is experiencing systemic failure in its regulatory framework, which calls for radical and painful change. The situation is not quite so severe in Australia. Two important factors underlying the differing experiences of these two markets are the role each played in the speculative bubbles of the late 1990s, and the extent of performance-based compensation used in each country.

### A The Twin Booms

The dot-com bubble of the 1990s had the classical ingredients for a speculative bubble: the emergence of a radical new technology/opportunity at a time of loose monetary policy (and therefore easy and cheap credit) which captured the popular imagination with its promise of both a different future and the opportunity for fabulous wealth.

Less remarked upon, but of larger dimensions than the dot-com bubble, was an associated boom in the telecommunications sector as 'telcos' and telecommunications equipment suppliers scrambled to build the infrastructure to meet the promised insatiable appetite of the Internet era for bandwidth. The telecommunications boom coincided with the privatisation and deregulation of national carriers and markets around the world.

The dot-com bubble started to lose momentum early in 2000 and burst in March that year. A few months later the telecommunications boom started to follow suit. Geoffrey Colvin, a *Fortune* magazine columnist, calculated that the decline in the market value of the dot-com sector amounted to US\$1 trillion, while the market value of US telecommunications companies fell by US\$2.5 trillion.<sup>6</sup> That decline is continuing and, given the level of debt-financed telecommunications over-capacity being experienced around the world, the effects could take a decade to work through.

The epicentre of the dot-com and telecommunication booms was the US. Deflation of the twin booms has exposed a level of ugliness in the US corporate system, and failings in its governance and regulatory structures, which have shocked investors, regulators and legislators and has had global ramifications. In

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6 Geoffrey Colvin, 'When Scandal isn't Sexy', *Fortune* (Chicago), 10 June 2002, 56.

contrast, Australia was a peripheral player in the dot-com and telecommunications bubbles.

## B Executive Remuneration

Performance-based compensation has long been a feature of executive remuneration in the US. Over the past decade or so, as growth-hungry investors have demanded better performance, the concept of 'aligning' the interests of executives and shareholders emerged. This alignment was created by the increased use of executive options and performance incentives as substantial, sometimes dominant, elements of senior executive remuneration packages. The notion was that the increased focus of executives on 'shareholder value' and returns would create mutual benefit.

The popularity of options increased massively during the dot-com era, as the technology start-ups substituted equity and the promise of eventual wealth for the cash salaries their business models did not allow. The competition for executive talent between the 'old economy' and 'new economy' companies inevitably forced established companies to match the type and scale of remuneration on offer. Additionally in the US, options are an attractive way to pay executives, as the accounting standards do not require them to be expensed but, when exercised, their value is a deduction against corporate tax.<sup>7</sup> Issuing them, as opposed to paying cash salaries, boosts reported earnings. Alan Greenspan, chairman of the US Federal Reserve Board, said that the substitution of unexpensed option grants for cash compensation had added an estimated 2.5 percentage points to the reported annual earnings growth of the Standard & Poor's 500 companies between 1995 and 2000.<sup>8</sup>

Against the backdrop of one of the longer and stronger bull markets in history, there was an extraordinary escalation in executive remuneration. A Bloomberg analysis of corporate filings between 31 May 1999 and 31 May 2000 showed eight chief executives received remuneration of more than US\$100 million. The mostly highly paid, Charles Wang of Computer Associates International Inc, received US\$511 million! Bloomberg found that the average total pay of the 505 chief executives it monitored was US\$12.5 million.<sup>9</sup>

While share prices kept rising there was little discontent about this largesse, because corporate executive interests and those of their investors coincided. The historically high share prices relative to earnings, however, meant that companies were under extreme pressure to provide superior and consistent earnings growth. As CEO remuneration increased, their tenure decreased. In Australia, the average tenure of the Business Council of Australia's ('BCA') 90

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7 Financial Accounting Standards Board, *Statement of Financial Accounting Standards (SFAS) 123: Accounting for Stock-Based Compensation* (1995).

8 Alan Greenspan, 'Corporate Governance' (Speech delivered at the Stern School of Business, New York University, New York, 26 March 2002).

9 Graef Crystal, 'Eight CEOs Make the \$100 Million Club: Bloomberg Pay Survey' *Bloomberg News* wire service, 22 June 2000.

chief executives has, according to the BCA, fallen from almost eight years a decade ago to 4.2 years.<sup>10</sup>

The combination of option-provided incentives, pressure from institutions for earnings growth and the higher CEO turnover provided, with hindsight, a destructive combination. It encouraged companies to push the boundaries in their reporting and the quality of reported earnings fell. A 2001 study by the Financial Executives International ('FEI') Research Foundation found that between 1998 and 2000 there were 464 restatements of corporate earnings, or an average of more than 154 a year, compared with an average of 46 per year for the previous decade.<sup>11</sup> The most frequent cause of restatements was improper recognition of revenues. The push to 'align' the interests of executives and shareholders had a fairly predictable, and quite unhealthy, effect on corporate ethics and practices. An excess of greed had been introduced, largely unchecked, to the US system.

### C Early Moves for Reform

The SEC, concerned about the increasing use of 'pro forma' earnings and aggressive accounting treatments, increased its enforcement efforts towards the end of the 1990s. However, despite the growing concern about the quality of reported earnings and deteriorating corporate ethics, until the Enron collapse there was no great understanding of the extent of the problem, nor of its implications.

Arthur Levitt, then chairman of the SEC, campaigned unsuccessfully for better and tighter reporting standards, the expensing of options, more independent auditors and more independent sharebroking analysts. The business and accounting lobbies in the US successfully resisted most of his agenda, although the major accounting firms reluctantly began spinning off their lucrative consulting businesses to distance their audit functions from the biggest and most obvious source of conflicts. Then Enron collapsed and the nature and urgency of the debate about governance and regulatory structures changed overnight.

## III ENRON

### A Background<sup>12</sup>

Enron was created in 1985 from the merger of Houston Natural Gas and InterNorth, a Nebraska gas company. Enron rode, and evolved with, the deregulation of the US energy markets through the late 1980s and 1990s. It became the largest trader of gas and electricity in North America and the United

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10 Hugh Morgan (Speech delivered at the Melbourne Mining Club lunch, Grand Hyatt Hotel, Melbourne, 13 June 2002). This speech was reported in Ian Howarth, 'Life Too Short For Mining Chiefs', *Australian Financial Review* (Sydney), 14 June 2002, 64.

11 Financial Executives Research Foundation, *Quantitative Measures of the Quality of Financial Reporting* (2001), <<http://www.fei.org/download/QualFinRep-6-7-2k1.ppt>> at 16 August 2002.

12 See generally, Enron <<http://www.enron.com/corp/pressroom>> at 16 August 2002.

Kingdom, dominating the markets. It progressively shed its physical assets to focus on trading and the development of complex derivative products. Over time it extended its trading activities to create markets for derivative products, including paper, coal, metals, telecommunications bandwidth and even weather. It was regarded as the model of a 'virtual', new-age company and in 2001 was named 'The Most Innovative Company in America' for the sixth consecutive year in *Fortune* magazine's annual survey of directors, executives and analysts.<sup>13</sup> Over its 15 year history as Enron, its market capitalisation grew from US\$2 billion to US\$70 billion. In 2000 it reported operating profits of US\$1.3 billion. It was the seventh largest company in the US.

Last year, however, the US financial media started to focus on the existence of thousands of complex, off-balance sheet vehicles, largely managed by former Enron chief financial officer Andrew Fastow. In October last year, Enron announced a US\$618 million third quarter loss and a write-down in shareholders' funds of US\$1.2 billion related to the off-balance sheet partnerships. The vehicles, it appears, were used to hide debt and losses and manipulate profits. As many of the derivative markets Enron developed were opaque and illiquid, it was also able to use transactions with the vehicles to establish and inflate the value at which it would mark-to-market the value of contracts it held. Enron's auditors, Andersen, were aware of the partnerships and indeed provided advice on their establishment. In desperation, Enron sought to merge with a competitor, Dynergy, but the deal fell through and, last December, it was forced to file for Chapter 11 in the biggest bankruptcy in history.

The revelation of the long-term deception Enron's executives had practiced on US investors and regulators ignited an extraordinary wave of recriminations and finger-pointing because it said, in embarrassingly visible fashion, that all the checks and balances that were supposed to be so robust within the US system had failed spectacularly. There was audit failure of the gravest magnitude; regulatory failure; cheerleading for Enron by broking analysts who failed to question accounts which they acknowledged they did not understand; the involvement of investment bankers, lawyers and institutional investors in establishing and investing in the Enron partnerships; and the failure of the credit rating agencies. Enron's investors and employees — many of whom held Enron stocks through the company's pension fund schemes — lost massively, while the senior executives kept hundreds of millions of dollars. Former CEO Jeff Skilling cashed out US\$112 million of options in the three years before Enron failed.

Within weeks of Enron's collapse its auditor, Andersen, was also in trouble as it emerged that its staff had shredded tonnes of Enron-related documents. Andersen, founded by Arthur Andersen in the wake of the 1929 crash with the ambition of restoring some credibility to company reporting, was one of the 'Big Five' global accounting firms which dominate international accounting services. Even before its grand jury indictment for obstruction of justice in March this year, Andersen was in trouble, with its corporate clients fleeing and its international business fragmenting as partnerships bailed out. The indictment,

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13 Ahmad Diba and Lisa Munoz, 'Who's Up, Who's Down', *Fortune* (Chicago), 19 February 2001, 64.

which resulted in a conviction in June, was effectively a death warrant for the firm. More than 600 of its US clients, representing billings of about US\$1.4 billion, have changed auditors since Enron made its Chapter 11 filing.

## B Implications

Post-Enron, much of the focus of the discussion about reforms to the US system has been on the role of the auditor and on accounting standards. The Enron experience highlighted the conflicts that have developed within the big accounting firms as their non-audit income streams have grown. In 2000, Andersen billed Enron US\$25 million for audit services and US\$27 million for non-audit services. With current and former Andersen staff filling most of the key financial positions within the company, including the CFO and chief accountant positions, it also highlighted an unhealthy closeness of auditor and client. It also undermined the US conviction that, in the US Generally Accepted Accounting Principles ('GAAP'), it had the best accounting standards in the world.

As some of the emotion in the immediate aftermath of Enron's collapse started to subside, initial calls for a draconian response to the shortcomings it had revealed were displaced (with considerable pressure from the accounting and business lobbies) by a less intrusive consensus. The chairman of the SEC, Harvey Pitt (who had successfully helped lead the opposition to Arthur Levitt's attempted reforms as a lobbyist for the accountants) advocated the view of the profession and big business that reforms that led to more regulatory intrusion into the affairs of companies could lead to loss of efficiency and competitiveness.

Among Pitt's suggested reforms was a new private sector oversight body, the Public Accountability Board, to review accounting firms' quality controls and auditing practices. The Public Accountability Board would include representation from the firms. Pitt did not propose to restrict the non-audit services firms could supply their audit clients, nor did he support the rotation of auditors. The emphasis of his agenda was on improved corporate disclosure, including a US version of the Australian continuous disclosure regime, and a direction that CEOs and CFOs should personally sign, and be accountable (liable) for, their companies' annual and quarterly filings. He also advocated a more 'principles-based' approach to setting accounting standards.<sup>14</sup>

In Australia, contemporaneously with the aftermath of Enron, the findings of a review of auditor independence were released. Written by Ian Ramsay, a director of the Centre for Corporate Law and Securities Regulation, the review (the 'Ramsay report') was commissioned by the federal government after the HIH collapse.<sup>15</sup> Among Ramsay's recommendations were that former audit partners

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14 See below Part V(B) for a discussion of the principles-based approach.

15 Ian Ramsay, *Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform — Report to the Minister for Financial Services and Regulation* (2001), <<http://www.treasury.gov.au/contentlist.asp?classification=14&titl=Publications>> 23 July 2002.

should be prohibited from becoming a director of a company they had audited within two years of leaving the audit firm; that companies should be prevented from having as directors an immediate relative of their auditor; that auditors be required to disclose the dollar value of non-audit work; that they should rotate audit partners at least every eight years; that Australian Stock Exchange rules should force all listed companies to have an audit committee and make auditors available to annual general meetings of shareholders and that a new Auditor Independence Supervisory Board be created to monitor and enforce ethical standards. The recommendations emphasised the role of the audit committee and the relationship it should have with the auditors, as well as self-regulation by the profession. The Ramsay report was consistent with the evolving, moderating tone of the debate in the US. Then, however, came WorldCom.

## IV WORLDCOM

### A Background<sup>16</sup>

WorldCom, based in Mississippi, was a telecommunications company that emerged from obscurity during the frenzy of corporate activity in the sector unleashed by deregulation of the US telecommunications industry. Through a frenetic series of takeovers — 72 over 17 years — the company emerged as the second largest US long-distance carrier and developed the world's largest Internet protocol network. At its peak it was valued at about US\$180 billion. On 25 June WorldCom shocked financial markets by announcing that an internal audit had uncovered what the SEC described in a press statement issued a day later as 'accounting improprieties of unprecedented magnitude'.<sup>17</sup> The 'improprieties' involved treating items that should have been expensed as capital items, inflating the company's reported earnings and cash flows by at least US\$3.9 billion over the five quarters to the end of March 2002. Had the items been expensed, WorldCom would have reported losses for that period rather than the US\$2 billion of profits it claimed to have earned. The timing of the disclosure may have been a coincidence but WorldCom's auditor, Andersen, was replaced by KPMG in May 2002.

### B Implications

If Enron's collapse and the circumstances surrounding it raised suspicions about the integrity of the US financial reporting framework, WorldCom seemed to confirm them. Its disclosures galvanised and changed the debate over reform. Where previously the business and accounting lobbies appeared to be succeeding in their effort to minimise the extent of the reforms and their impact, after WorldCom the prospect of substantial reform strengthened sharply. President

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16 See generally, WorldCom <<http://www1.worldcom.com>> at 16 August 2002.

17 Securities and Exchange Commission, 'SEC Statement Concerning WorldCom' (Press Release, 26 June 2002), <<http://www.sec.gov/news/press/2002-94.htm>> at 18 July 2002.



George Bush said that he was 'deeply concerned' about accounting practices in the US and said the administration would fully investigate the issue and 'hold people accountable'.<sup>18</sup> In the US, a reform bill sponsored by the chairman of the Senate Banking Committee, Paul Sarbanes, had been floundering. The *Public Company Accounting Reform and Investor Protection Act of 2002*,<sup>19</sup> introduced to the Senate on 25 June, had met fierce opposition from business and Republicans. It proposed the creation of an independent regulatory board, with a majority of members from outside the accounting profession, to oversee auditors and audit standards; it would prohibit auditors from offering consulting services to audit clients; it would insist that audit committees, comprised of independent directors, would become responsible for selecting and overseeing auditors; it would force executives to disgorge bonuses and other incentive payments if there was subsequent disclosure of audit error; it would make it an offence for an executive or a director to mislead or coerce an auditor and it would direct the SEC to devise rules to address conflicts of interests faced by stockbroking analysts.

That latter proposal relates to charges that analysts' recommendations have been influenced by the investment banking relationships their firms had with corporate clients. A leading US investment bank and broking firm, Merrill Lynch, paid a US\$100 million fine and undertook to introduce policies to insulate its analysts from the influence of its investment banking division in May after an unprecedented inquiry and legal action by the New York State Attorney-General's office. That office is investigating at least five other big investment banks. Securities analysts have been blamed for not questioning Enron's accounting before its collapse and for the absence of objectivity during the dot-com boom, where their firms generated massive fees from arranging the initial public offerings of shares in companies they promoted through their research.

## V THE AFTERMATH: CONSEQUENCES FOR AUSTRALIA

In Australia, as in the US, the most intense focus of the debate post-Enron, WorldCom and the local corporate failures has been on corporate disclosure and the role of auditors. It is evident that regulators around the world have concluded that the critical issue raised by the Enron and WorldCom episodes is the failure of the current financial reporting model and, in particular, a lapse in audit standards. Modern capitalism has spawned massive, international corporations operating in ever more complex environments and accessing increasingly sophisticated capital markets. To safeguard the interests of investors, a complex framework of regulation and oversight has been developed: a system which relies on the veracity and quality of financial reporting and, in particular, the

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18 Office of the Media Affairs, 'President Promises WorldCom Investigation' (Press Release, 26 June 2002), <<http://www.whitehouse.gov/news/releases/2002/06/20020626-2.html>> at 16 August 2002.

19 S 2673, 107<sup>th</sup> Congress (2002). This was enacted on 30 July 2002: *Sarbanes-Oxley Act of 2002*, Pub L No 107-204, 116 Stat 745 (2002).

assurance provided by the audit process. Confidence in corporate accounts is the most important prerequisite for the economic system to function. That confidence was undermined by Enron, WorldCom and the host of restatements of corporate earnings flowing out of the US. Not surprisingly, therefore, the largest part of the reform effort is directed at the accounting profession. Most of the measures mooted are aimed at reinforcing the independence of auditors from corporate management and ensuring the integrity of the audits.

### A. The Role of Auditors

Best practice before Enron was a governance structure which gave an audit committee comprised of independent directors the power to hire, fire and monitor auditors. That will now become common practice, perhaps legislated or imposed by stock exchange listing rules. In June 2002, the New York Stock Exchange ('NYSE') issued a report on corporate accountability and listed standards which proposed changes, and new standards, for corporate governance and disclosure practices by companies listed on the exchange.<sup>20</sup> Among the key recommendations were that the role and authority of independent directors should be increased, and that the definition of independence should be tightened. Audit, nomination and compensation committees should consist solely of independent directors. Further, the audit committee should have sole authority to hire and fire auditors and approve any non-audit work by the auditors. In addition, the chief executives of the companies should have to attest to the accuracy, completeness and understandability of information presented to investors. The NYSE recommendations reflect a broader consensus that allowing auditors to be chosen by, and report to, the management who also pay them is asking for trouble.

A more contentious issue is the extent to which provision of non-audit services by auditors should be limited. According to an Australian Securities and Investment Commission study, non-audit fees account for about 50 per cent of the total fees paid to auditors.<sup>21</sup> The accounting profession says, with some justification, that completely prohibiting auditors from providing non-audit services will not only damage the firms financially and reduce their appeal to potential employees, but also reduce the level of technical expertise within firms and therefore their competence to conduct audits. On 23 May, the two major Australian accounting professional bodies — the Institute of Chartered Accountants in Australia and CPA Australia — released a 'New Australian Standard for Audit Independence'.<sup>22</sup> The standard, which will become mandatory on 31 December 2003, bans the provision of non-audit services where, in conducting an audit, a firm could be required to check its own work.

20 New York Stock Exchange, *Report of the New York Stock Exchange Corporate Accountability and Listing Standards Committee* (2002), <[http://www.nyse.com/pdfs/corp\\_govreport.pdf](http://www.nyse.com/pdfs/corp_govreport.pdf)> at 22 July 2002.

21 Australian Securities and Investments Commission, 'ASIC Announces Findings of Auditor Independence Survey' (Press Release 02/13, 16 January 2002), <<http://www.asic.gov.au>> at 18 July 2002.

22 The Institute of Chartered Accountants in Australia and CPA Australia, *Professional Statement F1: Professional Independence* (2002), <[http://www.cpaaustralia.com.au/01\\_information\\_centre/10\\_audit/1\\_10\\_0\\_f1\\_draft.asp](http://www.cpaaustralia.com.au/01_information_centre/10_audit/1_10_0_f1_draft.asp)> at 10 September 2002.

The new standard also requires the rotation of audit partners for listed companies every seven years, and a two year waiting period before a retired auditor can become a director of a company they audited. In common with the Ramsay report, the accounting bodies shied away from proposals that would introduce mandatory rotation of audit firms, as opposed to audit partners. Rotation of firms was off the agenda in the US until WorldCom but is now again being seriously discussed. Accounting firms argue that the first two years of an audit are a learning experience for the auditor after which the audit process becomes increasingly valuable to the client and its stakeholders. Mandatory rotation would reduce the quality of audits and increase their cost, particularly as not all firms have the same level of expertise in all sectors of corporate activity. There is sufficient validity to this argument to ensure that, if mandatory rotation were introduced in any of the major jurisdictions, the period of incumbency would be quite lengthy.

There are two obvious benefits from mandatory rotation of firms: without unlimited tenure firms would be less vulnerable to influence or corruption by their clients and they would work in the knowledge, shared by their corporate clients, that the quality of their audits would eventually be reviewed by their successor. It may not be possible to legislate against bad audits but it ought to be possible to reduce the risk of audits being corrupted by a firm's commercial ambitions or its relationship with management. Tougher rules on conflicts, distancing of auditors from management through a strengthened role for the audit committee and some form of firm rotation would strengthen the audit regime.

The Treasurer, Peter Costello, in June announced a review of audit regulation and corporate disclosure which will incorporate the findings on auditor independence indicated in the Ramsay report.<sup>23</sup> These issues will be addressed in the next phase of the government's Corporate Law Economic Reform Program ('CLERP').

## B Accounting Standards

If the role of auditors is under severe scrutiny, so too are the accounting standards on which their work is based. Ordinary investors may believe that an auditor's role is to attest to some form of objective truth about a company's financial position. In reality, and in law, it is to confirm that the accounts are drawn up in compliance with the accounting standards of the jurisdiction.

Until Enron, the US GAAP were regarded as the most stringent and robust accounting framework in the globe, at least by US regulators and investors. US standards have, over the years as companies and auditors have sought greater certainty, developed into a complex, highly prescriptive, black-letter set of rules. In Australia and the UK, accounting standards, while still detailed and sometimes extremely complicated, tend to more akin to statements of principle and rely on a philosophy of substance over form. Black letter rules, as Australian investors and legislators discovered in the 1980s, invite loopholing.

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23 Peter Costello, 'Review of Audit Regulation and Corporate Disclosure' (Press Release, 27 June 2002), <<http://www.treasurer.gov.au/tsr/content/pressreleases/2002/034.asp>> at 18 July 2002.

Former US Federal Reserve Board chairman, Paul Volcker, said that while most of the accounting profession in the US still believed the US had the best and most comprehensive standards, 'everything is on the table', including 'the style [in] which accounting standards are set out — whether the emphasis is on matters of principle or detail'.<sup>24</sup> Volcker is chairman of the trustees of the International Accounting Standards Committee Foundation. With the International Accounting Standards Board ('IASB'), the Foundation was created last year to include the UK and US in the attempt to create international standards acceptable to all the major capital markets. Australia announced in 1996 that it would 'harmonise' its standards with the international standards produced by the IASB's predecessor organization, the International Accounting Standards Committee.<sup>25</sup> It is ironic that the collapse of one of America's corporate icons has produced the greatest opportunity to convince the US to embrace the concept of international accounting standards. The European Commission last year proposed legislation that would see the European Union adopt the IASB standards from 2005.<sup>26</sup> There are obvious benefits for companies and financial markets, and probably regulators, if there is consistency between accounting standards within the major markets.

An advocate for overhauling US standards is Joe Berardino, former CEO of Andersen. Berardino's view is that US accounting rules and literature have

grown in volume and complexity as we have attempted to turn an art into a science. In the process, we have fostered a technical, legalistic mindset that is sometimes more concerned with form rather than the substance of what is reported.<sup>27</sup>

He describes the current financial reporting system as having been created in the 1930s for the industrial age, at a time when assets were tangible and investors sophisticated and few, and highlights the need to move to 'a more dynamic and richer reporting model'.<sup>28</sup> This appears to be occurring in the US, with the SEC mandating more frequent disclosure of material events and better explanation of critical accounting policies.

### C Options for Reform

In striving for a more effective reporting model, a more radical approach than that of the SEC could involve eliminating audits altogether, and making boards and management solely responsible (and liable) for their company's reporting. Alternatively, it could be worthwhile reconsidering the role and the approach of auditors. In today's environment of global markets and global companies, it seems perverse that we place such reliance on an annual statement of assurance from an auditor which says nothing more than that the accounts concerned —

24 Paul Volcker, 'Accounting in Crisis' (Speech delivered at the European Commission, 6 March 2002), <<http://www.iasc.org.uk/docs/speeches/020306-pav.pdf>> at 30 August 2002.

25 Australian Accounting Standards Board, Policy Statement 6, *International Harmonisation Policy* (1996).

26 *Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the Application of International Accounting Standards* [2002] OJ L 243, 1.

27 Joe Berardino, 'Enron: A Wake-Up Call', *Wall Street Journal*, 4 December 2001, A32.

28 *Ibid.*

themselves simply a snapshot of a moment in the company's year — comply with accounting standards. Given Australia's concept of continuous disclosure (one the US is introducing), the auditor could be involved in a continuous audit, *providing some level of assurance that the basis of any disclosure is sound.*

If that were too radical or costly, it would be a relatively straightforward matter to require auditors to produce more meaningful audit statements. These could identify the key accounting issues within the financial statements, particularly any which have provoked significant discussion with the board and/or management, and discuss the implications of using a different treatment. A similar requirement could be made of the audit committee.

Additional possibilities for reform include a positive obligation on auditors, and perhaps company officers, to inform the audit committee and the authorities of any suspect or unusual transaction. Auditors should also be available to their real employers — the client company's shareholders — to answer questions about the accounts at annual meetings. That might require granting them some qualified form of privilege.

## VI CONCLUSION

Periods of excess stress test the integrity of markets, their participants and the safeguards that are supposed to discipline their behaviour. They make the points of vulnerability within those safeguards more visible. Enron, WorldCom, HIH and the other corporate scandals that have emerged over the past year are not novel — every lengthy speculative boom is eventually characterised by a level of unsustainable optimism and greed that encourages recklessness and chicanery. No doubt that will be as true for the next boom as the last.

The recent US experience has, however, caused questioning of the practice of aligning the interest of management and shareholders and the structure and quantum of the rewards available. The architecture of the so called 'shareholder value' model of governance appears badly flawed and almost designed to produce Enron-style disasters. It would appear that the pressure to perform in the near term, when coupled with massive incentives for short-term performance, produces a destructive mix. Investors, particularly institutional investors, may have had unrealistic expectations of the ability of companies to deliver superior growth continuously, creating an environment where executives were almost encouraged to find ways to make it appear they were achieving the unachievable. It will not be easy to withdraw from executives the largesse of the form and scale they have become so accustomed to.

Redirecting incentives towards more reasonable and productive outcomes is a priority of any post-Enron reform. Another is upgrading the quality and credibility of corporate disclosure. Had the audit function performed better under pressure; had securities analysts, funds managers, ratings agencies and other professional market participants been more diligent or less complicit; perhaps we would have seen less damage inflicted on investors, employees, market confidence and the US brand of market capitalism.

In any event, Enron and subsequent disasters — and HIH in Australia — have indicated that the current reporting model and the audit function associated with it are, if not broken, then malfunctioning. There is an opportunity to think more creatively and laterally about how to devise a model better suited to the demands of this century and the needs of this century's users of company accounts.