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Corporate regulation in Australia: Fact or fiction

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CORPORATE REGULATION IN AUSTRALIA: Fact or Fiction

by

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ABSTRACT

This paper recognises and takes as given that there is a recurring cycle of regulatory failure, regulatory reform. It also accepts the arguments of a small number of authors that there are flaws within the regulatory mechanism which contribute to the perpetuation of the regulatory failure, regulatory reform cycle. However, this paper argues that these flaws are but a symptom of more deeply seated problems.

The regulatory framework is weak in very fundamental and strategic areas including the nature of legislation and accounting standards, enforcement and overall administration. The fact that these weaknesses are not adequately addressed or rectified suggests that regulatory failure is by design. It is, therefore, contended that until the rhetoric is replaced with a commitment to genuinely enforceable regulatory measures, the regulatory failure, regulatory reform cycle will continue.

Key words: regulatory failure; fraud; corporations law; legislation; accounting standards; financial information

It appears there is a growing perception that Australia's corporate sector is characterised by a recurring cycle of regulatory failure, regulatory reform. For example, according to Sykes, corporate collapses in Australia are " . . . a recurrent malaise and endemic to the private enterprise system as it presently functions" (1988, p.x). McQueen has also noted recurrent instances of corporate and regulatory failure in Australia from as early as the 1870s (1991, pp.22-23). Similarly, Andrew Rogers, former Justice of the New South Wales Supreme Court, has characterised the Australian economy as a "recurring cycle of booms and collapses" arising from the regulatory system's inability to institute effective measures to halt the cycle (1991, p1). Rogers has attributed the recurring cycle to the nature of the regulatory system and its lack of clear, short and sharp laws and prompt imposition of penalties (p.1).

Often in the wake of corporate failure, much of the blame for those failures which are unexpected is laid at the door of accountants and auditors and the part they have played in the preparation and publication of misleading financial statements. For example, Michael Cannon's study of the Victorian land boom and subsequent economic collapse late last century revealed

> The falsifying of balance sheets, the payment of dividends from non-existent profits and the publication of misleadingly optimistic forecasts were among the shocking features of the crash (1972, p.28).

A century later, Sykes suggests that little has changed

> As receivers and investigators gradually strip bare the recent corporate scandals in Australia, one factor becoming apparent is that the accounts of the companies concerned have been unsatisfactory, to say the least (1990, p.43).

Chambers has argued, in a fashion similar to Rogers, that the fault lies in the fact that the accounting practices adopted were permissible and that the laws, regulations and rules were " . . . vague, toothless and often self-contradictory" (1973, Preface, Securities and Obscurities [no pagination]). Almost twenty years later, Clarke and Dean concluded that misleading financial statements have been as much the result of compliance with accounting standards as non-compliance (1992, p.186).

While the above represents the views of only a handful of authors, their views have the support of historical evidence. This evidence also supports the view that progressive improvement or reform of corporate regulation, for example, the introduction of corporate legislation and attempts to refine it over more than a century; the successive implementation of first the National Co-operative Scheme and the creation of the National Companies and Securities Commission (NCSC) followed by federal corporations law including a national body to administer it, the Australian Securities Commission (ASC); the voluntary promulgation of accounting standards by the accountancy profession; and the creation of the Accounting Standards Review Board (ASRB) and its successor, the Australian Accounting Standards Board (AASB) coupled with statutory backing of approved accounting standards have been to little or no avail in the battle to curb corporate malfeasance. The regulatory failure, regulatory reform cycle persists because, as investigations in the wake of corporate collapses invariably reveal, the measures initiated in the past have proved inadequate.

The purpose of this paper is to identify and outline some of the factors that contribute to regulatory failure. The focus, however, is not on particular aspects of regulation such as specified legislative provisions or accounting standards. It is the contention of this paper that these are the outcome of fundamental inadequacies in the regulatory system. Furthermore, these inadequacies appear to exist almost by design because, as McCraw has observed " . . . regulation is best understood as an institution capable of serving diverse, even contradictory, ends, some economic, some political, some cultural" (1975, p.180). In other words, regulation is political and it cannot be assumed that reality will be consistent with the rhetoric. The specific weaknesses identified for the purposes of this paper revolve around the uncertainty inherent in corporate legislation, including accounting standards, and its enforcement. It should be made very clear at this point that this paper in no way represents an argument for the replacement of regulation with market forces. The paper is intended to highlight problems with existing and past regulation with a view to making certain that future regulation will be enforceable.

The following sections of the paper will identify and describe some of the weaknesses in corporate regulation and their potential impact on the successful administration of regulatory measures. The specific weaknesses to be discussed in order are: frequent changes in legislation/legislators; lack of authority of regulatory bodies; lack of funding; and ambiguous and flexible legislation and accounting standards. The paper will then offer some concluding comments by way of a prognosis of the likelihood of effective regulatory reform in the future.

AREAS OF REGULATORY WEAKNESS

Legislation is one of the most obvious sources of regulatory weakness. The fact that company legislation has been in existence for well over 100 years makes one wonder how the examples of grossly misleading financial statements referred to by Sykes could have occurred. One contributory factor may be the motives behind the legislation. For example, the dominant force behind the original companies legislation in the UK was to facilitate incorporation. Hence, it was clearly in the interests of business. In return for the privileges of incorporation, companies were required to adhere to certain rules or guidelines including the disclosure of financial information. Australian corporate legislation was adapted from the UK model and was expanded upon in the wake of the Victorian land boom of the late nineteenth century to provide further protection to investors and creditors (Victoria, 1895, p3338). However, given that fraud and misrepresentation still prevail in spite of legislation, it could be asked if the disclosure requirements of company legislation are little more than a sham or a symbolic gesture to quell the fear engendered by previous corporate collapses and fraud. As Cranston states:

> Often it is fallacious to assume that the forces dominant in formulating business regulation really intended to make any dent on commercial practices. Business regulation may be characterised as symbolic, since from the outset the purpose may simply have been to assuage public opinion or to divert its attention (1982, p3).

Legislative initiatives can be both intentionally and unintentionally weakened in a number of ways with the result that those who wish to avoid the consequences of the legislation may do so with relative impunity. This paper argues that one of the major sources of weakness in company legislation is uncertainty. The areas of uncertainty to be examined here are: frequent changes in legislation/legislators, lack of authority vested in regulatory agencies, lack of funding and ambiguous or flexible statutes and standards.

1. Frequent Changes in Legislation/Legislators

According to Doyle, frequent changes in legislation can have an adverse impact on compliance with laws:

> Where laws relating to a subject-matter are frequently altered . . . it becomes difficult to persuade those who are ruled that "regulation" ie. technical, neutral implementation of a law, is possible . . . the law is in "disrepute" because parties know that the values are not settled and the "law" is as temporary as the present configuration of law-makers (1981, p98).

Parliamentary debates of both the Senate and House of Representatives indicate that frequent changes to company legislation under the Co-operative Scheme were indeed a problem. For example, in November 1983, Senator Durack commented on the number of amendments to the legislation, approximately one hundred, before the Senate at that time as well as the magnitude and complexity of what was relatively new legislation (Australia, 1983, p2680). The Co-Operative Scheme was initiated in December 1978.

Parliamentary debates some nine years later reveal that nothing has changed. In discussing the report of the Joint Committee on Corporations and Securities presented to the Senate in June 1992, reference was made to evidence given to the Committee by the business and professional communities. This evidence maintained that further amendment to the corporations law was not necessary and that company directors were having a difficult time coming to grips with changes to the law brought about by the newly introduced national regulatory scheme and the creation of the ASC. Further amendments, therefore, should be delayed (Australia, 1992b, p4109).

The extensiveness of changes to the corporations law since 1989 was raised in the Senate in the following December. The Corporations Bill 1989 contained almost 1,000 pages. Amendments required in the aftermath of the constitutional challenge to the Federal Government's bid to introduce federal corporations legislation (New South Wales v Commonwealth of Australia (1990) 1 ACSR 137) contained some 300 pages. A series of other amendments followed. These included the Corporations Legislation Amendment Act 1991, the Corporations Legislation Amendment Bill (No 2) 1991, the Corporations (Unlisted Property Trusts) Amendment Bill 1991, the Corporations Legislation (Evidence) Amendment Bill 1992 and the Corporate Law Reform Bill (No 2) 1992 (Australia, 1992e, p5296). These amendments were described in the Senate as complex and directed towards achieving a national regulatory scheme (p4109).

It appears the business and professional communities had valid grounds for complaint. Such frequent amendments also raise doubts about the purpose of the legislation. The business and professional communities' claims to be having difficulty in coming to grips with existing legislation would tend to give them an excuse not to apply it particularly when it is likely to be changed at any time. In turn, frequent and complex changes in legislation can make enforcement difficult. This point was also raised in the Senate (p4109). As will be discussed below, difficulties of enforcement may result because the regulators themselves lack expertise. With an ever changing set of rules, gaining expertise is unlikely to be an easy task. This point was raised in evidence before the Joint Committee on Corporations and Securities in August 1992. Tony Hartnell, then chairman of the ASC, stated that problems were encountered by the ASC in training staff because the complexities of the corporations law made training a very long, slow process (Australia, 1992c, p13). Inexperience was also suggested as a reason for the ASC's preference for civil remedies as opposed to criminal proceedings during the years that Tony Hartnell was chairman. It was claimed in the financial press that Hartnell had a commercial background and had both a distaste for and lack of familiarity with criminal law (Gray, 1992, p12).

The question of enforcement was also raised in the Senate with regard to the progress of the ASC and prosecutions arising out of the corporate failures of the 1980's. Early in its existence, the ASC identified 16 "big" cases which were to be investigated. By June 1992, some $4.7 million had been spent on these investigations but only two convictions had resulted. Even though there were a number of matters pending, progress cannot be said to be apparent. The Commonwealth Director of Public Prosecutions (DPP) complained that the ASC was not referring matters to it for prosecution and, as a result, it had underspent its corporate prosecutions budget by $1.5 million (Australia, 1992d, p5289).

Dissension between the DPP and the ASC became very public during 1992 with a series of articles appearing in the press (eg. Gray, 1992, p12; Pheasant, 1992, p4; Spiers, 1992a, p1-2; 1992b, p1-2). As a result of the dispute becoming public, hearings were held with both parties before the Joint Statutory Committee on Corporations and Securities in October 1992. The report of this committee dealt with apparent conflicts between the ASC and the DPP. In defence of the ASC's failure to conclude investigations into alleged serious criminal corporate activity and initiate prosecutions, the report made reference to the backlog of complex investigations - "an inherited mess not of its own making" - and the inexperience of the newly created ASC's investigators - "many of whom were new to the task" (Australia, 1992d, pp.3-4).

In an accounting context, Walker also lends support to Doyle's view. In an evaluation of the ASRB and accounting regulation policies that affected its progress, Walker stated that between 1978 and 1985, the formative years of the Co-operative Scheme, the NCSC and the ASRB, the Ministerial Council had undergone some thirty changes in composition (1987, p281). Furthermore, there had been changes in a number of "key players" since the establishment of the ASRB. The "key players" identified by Walker included NSW Attorney-General, Frank Walker, Commonwealth Attorney-General, Gareth Evans, NCSC foundation chairman, Leigh Masel and senior public servants. Changes in the positions held by these individuals and the introduction of new "players" influenced the policies affecting company regulation. According to Walker these changes in players worked to the profession's advantage which, in contrast to the regulators, had a relatively stable leadership:

> The reshuffling of portfolios in both State and Commonwealth arenas, the retirement of Masel, and the reassignment of public servants led to a lack of continuity of involvement by leading participants in the government sector, and accordingly some volatility in policies. On the other hand, there was a high level of continuity in the leadership and staffing of the two accountancy bodies. In this environment, the profession found that when lobbying about the ASRB or the future of Schedule 7, it did not need to take 'no' for an answer (pp.284-285).

2. Lack of Authority of Regulatory Bodies

Legislation may also be deficient in that it fails to provide a regulatory body with sufficient powers to effectively carry out its duties. Alternatively, the powers and duties may not be clearly defined leaving the regulatory body open to challenge on its right to undertake certain activities. The experiences of the NCSC and its successor, the ASC, particularly their relationship with the DPP provide evidence of this.

Under the Co-operative Scheme, the role of the NCSC was to administer company legislation in Australia. The State and Australian Capital Territory Corporate Affairs Commissions were to act as delegates of the NCSC. However, as Grabosky and Braithwaite have noted, the NCSC was to "have regard to the principle of maximum development of a decentralized capacity to interpret and promulgate the uniform policy and administration of the scheme" (1986a, p12). As a consequence, the NCSC had no control over the allocation of resources within the scheme and while it was able to provide guidelines and refer cases to its delegates, it could not initiate prosecutions or interfere in enforcement policies at State level (1986a, p12). Grabosky and Braithwaite describe the relationship between the NCSC and its State delegates as poor and co-operative in name only:

> We send what we think are good cases to the states because we don't have the resources to do them ourselves. In fact, most time is spent on sending good stuff we've picked up and two or three years later we're still writing letters begging them to reply as to what they've done.
>
> In very few cases we have resources to go in and say look . . . give us a report on that. We want a report. The report then comes over and they say there is no case to answer . . . and you could go through this report and their interviews and there was a *prima facie* case there. You could go in and prosecute them on the documents (1986a, p13, interview with senior NCSC official. Emphasis in original).

The administration and functions of both the Co-operative Scheme and the NCSC are characterised by what Grabosky and Braithwaite term "layering", that is, the delegation of enforcement of regulation to various administrative layers (1986b, p88). The purpose being that the more layers a prosecution must transit, the less likelihood of it ever being completed. While the extension of this process to legislation under the Co-operative Scheme may be beyond the scope that Grabosky and Braithwaite saw for the term "layering", it clearly has the same impact as indicated by the frequent changes in legislation under the Scheme as well as the magnitude and complexity of the legislation (Australia, 1983, p.2680).

Further evidence of layering within the area of corporate regulation is the relationship between the NCSC's successor, the ASC, and the DPP. The ASC has authority under section 49 of the Australian Securities Commission Act 1989 to initiate prosecutions for offences against the Corporations Law. Given the experience of the NCSC in terms of the delegation of prosecutions to State Corporate Affairs Commissions, the decision to delegate prosecutions to the DPP appears at first to be somewhat puzzling. However, a review of the evidence given by Tony Hartnell to the Joint Committee on Corporations and Securities in 1992 provides the answer to this riddle. Apparently, the legislation which created the DPP contains a provision stating that the DPP can undertake corporate prosecutions. According to Hartnell, the DPP informed the ASC that if it did not willingly send prosecutions to the DPP, the legislation would be invoked and the DPP would undertake the prosecutions whether the ASC liked it or not (Australia, 1992c, p18). On the basis that the difficulties inherent in the splitting of the regulatory function in this way were known, the inclusion of such a provision in the DPP legislation is questionable.

Grabosky and Braithwaite found that regulatory agencies that used the State Crown Law Offices or the DPP in the case of Commonwealth agencies, often experienced delay and other problems in the conduct of prosecutions:

> The most common complaints were the failure of prosecutors to understand technical problems, according low priority to regulatory work compared to 'cops and robbers' cases, entering into plea bargains without consulting the agency, delays, and failure to come to grips with the regulatory strategy of the agency (1986a, p200).

The DPP criticised the ASC's preference for seeking civil remedies instead of criminal prosecutions even in instances of serious corporate wrongdoing (Australia, 1992d, p6-7, 1.17-1.20). This, of course, could be the ASC's back lash to the DPP's demand to undertake criminal prosecutions rather than allowing the ASC to follow through on its investigations. However, there is no evidence to support this. There is, however, evidence to suggest that flexibility and uncertainty in legislation and other forms of regulation act as a deterrent to criminal prosecution. This evidence will be presented later in the paper. Furthermore, in response to the DPP's criticisms, the ASC argued that evidence arising from civil proceedings may give rise to criminal charges (p5, 1.14, 1.15). Even if such evidence emerges, it may prejudice subsequent criminal prosecutions. The prejudice problem was identified by Rogers J in one of the many Cambridge Credit hearings

> . . . it is an affront to the usual concepts of justice that, 13 years after the events in question, factual material should be denied to the Court and to the parties because the possibility remains of criminal charges being laid at some future date. . . . I have . . . attempted to refrain from expressing any view on the propriety of the conduct of the directors in order to

> ensure that, if they should be brought to trial on some criminal charge, nothing I say should hinder them from getting a fair trial (Cambridge Credit Corp Ltd & Another v Hutcheson & Others (1985) 3 ACLC 263 at 268).

The ASC further argued that the DPP wasted resources by pursuing only a small number of charges arising from ASC investigations and/or requiring additional evidence before proceeding with prosecutions (1992d, pp.10-11, 1.29-1.34). The investigation into the collapse of the Bond group in 1989 provides an example of the difficulties inherent in Australian corporate regulation. A Ministerial Council appointed enquiry was established in March 1990. In 1991, the enquiry was taken over by the ASC and a management committee comprising members drawn from the ASC, the Federal Police and the DPP.

In 1992, Tony Hartnell announced that a 600 page interim report had been produced and that it was likely to result in criminal prosecutions of a number of Bond office bearers. The ASC also sent a prosecution brief to the Commonwealth DPP. While the brief included some twenty boxes of documents relating to the case, it was not considered sufficient to lay charges. The DPP demanded further information (Australian Financial Review, 1994, p.15).

Some months later, a similar impasse occurred within the management committee conducting the investigation. The investigating team working with the Federal Police representative to the committee attempted to narrow the focus of the investigation in order to bring it to a, hopefully, successful conclusion. The balance of the management committee disagreed arguing that the investigation should focus on all aspects of the case rather than a selection. The argument that speed was desirable was apparently not acceptable. The following year, similar attempts to narrow the investigation were also rejected by the ASC management committee (Williams, 1994, p15). Given this scenario, it is not surprising that the case did not come to court until late 1995.

Matters involving the long delay in the Bond case were aired in hearings in 1992 before the Joint Statutory Committee on Corporations. The Committee recognised that the problem here was the separation of investigators and prosecutors particularly when there was no liaison between the two until the investigation was completed (Australia, 1992d, p.12, 1.35-1.36). The desirability of both investigators and prosecutors working together from the outset of an investigation was recognised. However, the separation of the two bodies, in effect, layering, provided "a check on over-enthusiastic investigators and prosecutors and protected the rights of the individual . . ." (pp.12-13, 1.36). The stalemate in the Bond investigation highlights the difficulties of separating investigators and prosecutors even if there is liaison between the two.

The Federal Attorney-General's solution to problems of this nature was the establishment of yet another layer in the regulatory process. A National Steering Committee on Corporate Wrongdoing was established to, inter alia, resolve disputes between the ASC and the DPP (1992d, Appendix II). The problem with this is that it will add to the time taken to complete investigations which now has legislative and judicial complications.

Under section 1316 of the Corporations Law, prosecutions for criminal offences identified within the Act must be undertaken within five years of the relevant event taking place. At the current rate of progress, it appears unlikely that prosecutions will eventuate regardless of the findings of the investigation unless the consent of the Minister responsible for administration of the Act (section 80A(2) provides this definition of "the Minister") is obtained. In other words, even if sufficient evidence is gathered to support a prosecution, this must be achieved within five years or yet another layer of the regulatory system must be negotiated to even bring the matter to court. Even if the five year statute of limitations is waived, the courts may not be prepared to accept prosecution on the basis of natural justice. As already indicated, the Cambridge Credit case provides evidence of this.

3. Lack of Funding

While not directly related to legislation, funding is also an example where the government may, either intentionally or inadvertently, circumvent its own legislation. If insufficient funds are provided to monitor compliance with or enforcement of legislation, it becomes little more than an exercise in public relations or deception. The government can point to the legislation and claim that it has provided the necessary measures to protect the public. As has been pointed out by Charles Williams, as deputy chairman of the NCSC, legislation is cheap but enforcing it is another matter (cited by Bowerman, 1990, p1).

The question of resources available to enforce legislation was raised in the 1991 report of the House of Representatives Standing Committee on Legal and Constitutional

Affairs (Australia, 1991c, pp.32-33). During the course of hearings giving rise to the report, evidence of a lack of resources for the administration and enforcement of corporate legislation was presented to the Committee by the Attorney-General's Department and the former chairman of the NCSC, Henry Bosch (pp.32-33). Details of the evidence was not provided in the report. However, the financial press published part of Bosch's evidence in August 1990 (Sculley, 1990, p.25). Bosch told the Committee that during 1987, the NCSC received a constant stream of complaints from shareholders about the activities of certain companies. The media and the Commission itself also detected a number of matters worthy of attention by the NCSC. However, due to a lack of resources, the Commission had only been able to consider about one-tenth of the matters brought to its attention (p.25).

The lack of activity by the NCSC was also raised by Tony Hartnell before the Joint Committee on Corporations and Securities in 1992. Hartnell claims that when the ASC took over from the NCSC, the press and Australians, in general, thought the NCSC was actually pursuing a number of "notorious" matters. According to Hartnell, virtually nothing, in fact, was being done and in some cases, files had not even been opened (Australia, 1992c p7).

Funding was also a problem for the State Corporate Affairs Commissions. It has been disclosed that lack of resources meant that only one third of 1,168 cases referred to the New South Wales Corporate Affairs Commission in 1975 were pursued. Many of these cases were subsequently dropped. Corporate Affairs Commissions in Victoria, South Australia, Western Australia and the Australian Capital Territory have also complained that lack of resources had forced them to either drop cases or accumulate substantial backlogs of cases with little prospect of catching up (Grabosky & Braithwaite, 1986a, pp.24-25). The issue of funding was also raised before the Joint Statutory Committee on Corporations and Securities in the dispute between the ASC and the DPP. The ASC is required to fund both the cost of investigation and prosecution. This situation was described by the Committee as "almost designed to produce hostility" (Australia, 1992d, p11, 1.31). This is evident in the complaints by the ASC that the DPP often rejects the evidence gathered or requires more extensive investigations. On the other hand, the DPP complained that it was hampered in its prosecution function by decisions made by the ASC as to the amount of resources to commit to a particular investigation and prosecution (pp.10-11, 1.29-1.32).

Lack of resources was identified as an element in the long delay between the collapse of Cambridge Credit Corporation and the laying of criminal charges against the auditor and three directors of the company (Whitbread & Others Cooke & Others; Purcell v Cooke & Others (No 2) (1987) 5 ACLC 305 p318). Maxwell J provided explicit details of the resources required but not supplied to facilitate completion of the investigation (pp.318-321). These included lack of supervision by senior legal staff of the Corporate Affairs Commission, lack of legal officers, investigators and clerical staff to conduct the investigation and equipment such as computer and photocopying facilities. Maxwell J concluded that the delay in commencing criminal proceedings was unjustified and further stated

> . . . the relevant evidence of the team's activities is . . . that of an ill-equipped, rudderless ship sailing without a competent master. . . . The team's problems were compounded by the lack of adequate facilities and the failure of the Commission and the Government to provide the means

> by which the preparation of the Commission's prosecution could have proceeded with due expedition (p323).

It would appear that funding is a political tool. Research by Grabosky and Braithwaite supports this view. As evidence, they cite comments from Ministers to requests by Corporate Affairs Commissions for additional resources such as "[t]he more resources you have, the more matters you will find to investigate" (1986a, p25) and refusals of State treasuries to provide additional funding to support new staff appointments (p13).

In 1990, the Federal Budget provided for an increase in regulatory funding of $210 million over the next four years. This represented a 50 per cent increase in funding (Boyd, 1990, p3). The new Australian Securities Commission was to receive $107 million for the first 6 months of operations and $123 million and $137 million respectively for the following two years. In contrast, Government funding of the NCSC and State Corporate Affairs Commissions amounted to some $70 million per annum. These bodies, of course, also generated revenue but this was not necessarily available for regulatory activities (Shanahan, 1990, p86). Given that the collapse of a single company, Cambridge Credit in 1974, resulted in the loss of between $75 million and $100 million of investors funds, one wonders whether the increase in funding, which is supposedly aimed at protecting shareholders, is little more than a "drop in the bucket". This question becomes very pertinent given the statement made by Gavin Campbell, group managing director of the Australian Stock Exchange:

> The financial difficulties of some well-known individuals and their associated companies have caused the loss of at least $5 billion of shareholders' funds during the past year (1990, p20).

Consideration also needs to be given to the plight of creditors. The collapse of the National Safety Council of Australia (NSCA) is a case in point. It was recently announced that unsecured creditors of the NSCA were told that they could expect minimal return on the $276 million owed to them (Porter, 1990, p25).

As Bosch has also pointed out, the amount of regulatory funding available from the government should be compared with the cost of special investigations into companies activities. For example, it was reported in 1990, the investigations into the Bond Group and Rothwells had to that time cost approximately $1 million and $2 million respectively (Sculley, 1990, p25). Both investigations continued for some years and are only now before the courts. The Rothwells case is anticipated to last for some eighteen months (Dixon, 1995, p.6).

Following the announcement of the increase in funding to the ASC, its chairman, Tony Hartnell, stated that enforcement of the law and litigation arising from investigations into recent instances of contravention of company law would be the first items on the agenda for the ASC. However, as was indicated above, progress on these investigations has been slow due to the inexperience of some members of the ASC and the conflicts with the DPP. A further problem has been the wording of relevant statutes and accounting standards which may be so ambiguous or flexible that prosecutions may not be initiated or proceeded with due to fear of losing them anyway.

4. Ambiguous & Flexible Legislation & Standards

Legislation and accounting standards may be specifically designed to permit non-compliance by making provisions ambiguous or flexible. Of course it is also possible that the drafters of the legislation were not able to foresee difficulties with the provisions or lengths to which the regulated might go to avoid the legislation.

a. Legislation

Prime examples of ambiguous and flexible statutory provisions are the accounts, audit and related provisions in the former Companies Act (Codes) and the Corporate Law. The provisions of the Companies Act (Codes) required, inter alia, directors to have prepared for each financial year a profit and loss account and balance sheet giving a true and fair view of the company's profit or loss and state of affairs (section 269(1), (2) & (3)) and for auditors to express an opinion as to the truth and fairness of the accounts and other matters covered by section 269 (section 285(3)). The Act required compliance with the provisions of the Act, Schedule 7 (now replaced by Schedule 5) and applicable approved accounting standards (section 269(8),(8A)) unless compliance would not show a true and fair view(section 269(8B)). In other words, true and fair was a statutory over-ride in that non-compliance with both standards and the provisions of the Act was permitted if this meant the accounts provided a true and fair view.

The term "true and fair view" or similar versions such as "true and correct" and "full and fair", have a long history in terms of application to financial reports. The origin of these terms is usually taken to be the UK Joint Stock Companies Acts of 1844 and 1856. However, Chambers has traced the history to the beginning of the 18th century where similar terminology was employed in Acts governing both publicly and privately owned ventures (1989, pp.-3).

In spite of its relatively long history, the term has never been given a statutory definition. This has generated considerable uncertainty and apparently precluded the prosecution of some instances of suspected or alleged corporate misconduct. Bosch and at least one other member of the NCSC alluded to the difficulties "true and fair" presented when regulators contemplated a prosecution for non-compliance with company legislation and/or accounting standards. Henry Bosch, as chairman of the NCSC, publicly announced the Commission's intention of finding a suitable case of creative accounting and bringing legal action against the perpetrators (Bartholomeusz, 1987, p25). Such a case was found. Bosch described the company's accounts as being so creative as to be outrageous. However, on seeking legal advice, the response was very negative and the case was not pursued. Part of the problem was apparently the fact that the company auditors were one of the then Big Eight accounting firms. True and fair comes down to a matter of professional judgment and advisers indicated that it would be very difficult to first find expert witnesses who would be prepared to testify that accounts signed as "true and fair" by a member of the Big Eight did not, in fact, show a "true and fair view". Second, even if such witnesses were forthcoming, it may be difficult to prove to the court that the opinion expressed by the NCSC witnesses were superior to those of the auditor of the accounts (Bosch, 1987a, pp.18-19). The nature of this problem was identified by Salmon LJ in Odeon Associated Theatres Ltd v Jones (1971) 2 WLR 331:

> . . . sometimes there is evidence of two parallel but conflicting principles of commercial accounting. In such cases the courts must do the best

> they can without evidence, or choose between the conflicting evidence, or decide which is the most appropriate principle of commercial accounting to adopt (pp.336, 337).

Similarly, in CAC v A. & T. Barton (1977) ACLC 40-343, a case dealing with charges brought under the Securities Industry Act 1970 and section 176 of the Crimes Act which, inter alia, makes it an offence for any person to knowingly make a statement that is false or misleading in a material particular. The court held that a prima facie case had not been made out under section 176 because

> . . . the difficulties and the honest differences of opinion inherent in the concepts of 'profit', 'true and fair', and 'ordinarily accepted accountancy principles'

meant

> . . . there was not sufficient cogent evidence to establish that the profit statement was false (p129.466)

A former member of the NCSC research staff, Ian Langfield-Smith, has also suggested that the uncertainty surrounding the interpretation of "true and fair" has led regulators, on legal advice, to institute prosecutions under the general criminal law rather than the companies legislation because of the relatively greater certainty of the outcome (1990, p25). On the other hand, as Bosch has indicated, the standard of proof under the criminal law is "beyond reasonable doubt" and when the outcome of a prosecution is likely to turn on the conflicting evidence of expert witnesses, this standard may be difficult to achieve (Bosch, 1987a, pp.18-19).

In a bid to overcome the problems outlined above, the Corporations Legislation Amendment Bill 1991 amended the "true and fair view" requirement. In essence, the amendment requires the preparers of financial statements to comply with requirements of the Corporations Law and approved accounting standards and if it is considered that a true and fair view will not result, additional information is to be provided in the notes to the accounts (section 297(1), section 298(1) and section 299(1) respectively). The purpose of this amendment is to reduce

> . . . the scope for some companies to use some dubious accounting treatments in reliance on the more general, and vaguer, true and fair test, rather than comply with a relevant appropriate accounting standard (Australia, 1991b, pp.4214-4215).

In the inevitable debate over this amendment, it was not surprising to find that the director of the AARF, Warren McGregor, was in favour of the amendment. As the research arm of the AASB, and therefore an integral part of the standard setting machinery, the AARF would have much to gain from what amounts to the legislation of accounting standards. Previously, mere compliance with accepted accounting practices was not sufficient to constitute a true and fair view. As Craig and Clarke have observed "*[p]rofessionalism* was traded for *protection*" (1993, p56, emphasis in original). Furthermore, if Chambers (1973) and Clarke and Dean (1992) are correct, enforcing compliance with flexible, vague and even contradictory accounting standards is not likely to be any more appropriate than requiring the accounts to show a true and fair view.

Clearly, any flexibility inherent in both accounting standards set by the profession and approved accounting standards promulgated by the AASB will only serve to diminish any gains made by the legislative attempts to overcome the difficulties posed by the lack of definition of true and fair. In this regard, Flint's comments regarding accounting standards and statutory requirements are particularly pertinent

> Compliance with statutory requirements of disclosure and presentation and with accounting principles or accounting standards will not of itself ensure achievement of a true and fair view unless these requirements, principles or standards have been well conceived within the context of what are understood to be the criteria of a true and fair view.
>
> [These requirements, principles or standards] are the means to the end and not the end itself (1978, p488).

b. Accounting Standards

The majority of accounting standards contain what Henderson calls "weasel words" which allow accountants to avoid compliance with a standard (1985, p.52). Weasel words such as "should", "beyond reasonable doubt" and "reasonable assessment" are justified by the profession on the grounds that not all companies are the same and therefore accountants must be able to use their "professional judgment" (pp.52-53). While the different accounting methods for different circumstances argument may be valid, the lack of guidelines or precise selection criteria for the appropriate method compounds the problem because it fosters the exercise of almost unbridled "professional judgment". This, in turn, would appear to have led to the situation identified by Clarke and Dean that compliance with accounting standards does not necessarily mean that financial statements are not misleading (1992, p.186). Further support for this view is available from Henry Bosch. In an article in the May 1987 edition of *The Chartered Accountant in Australia*, Bosch is reported to have stated:

> . . . there are too few (accounting standards) and those that there are, have too many loopholes and . . . these loopholes are capitalised upon by the personal interpretation of the accountant (The Chartered Accountant in Australia, 1987, p46).

In a similar vein, in a study of major Australian corporate collapses, Sykes came to the conclusion that poor accounting systems and practices were among the dangers facing top management because they meant that management may provide misleading information (1988, pp.549-550). From the perspective of investors, the accounts of some of Australia's companies, particularly those giving rise to corporate scandals in recent times, have proved to be unsatisfactory (1990, p.43). Investigations into corporate scandals such as Reid Murray Holdings (Victoria, 1963; 1966-67), Cambridge Credit Corporation (New South Wales, 1977; 1979) and Rothwells (Australia, undated) provide evidence of this as well as suggesting that some accountants appear to use their professional judgment somewhat capriciously. While this obviously brings the profession into disrepute and creates an aura of uncertainty, it also makes it difficult for regulators to "mount a successful prosecution" (Langfield-Smith, 1990, p25).

Flexibility in accounting standards can also lead to what has been termed "creative accounting". Creative accounting allows a variety of treatments of substantially the same transaction and thereby allows management to manipulate results to suit particular purposes. It follows that creative accounting extends not only to failure to comply with accounting standards but also in their application (Clarke, 1988, p64; English, 1989, p15; Clarke and Dean, 1992, p186). As indicated above, the practice is clearly evident in Australia. This is supported by a research report issued in 1990 by the Australian Bankers Association which sets forth the proposition that among the factors contributing to corporate failures, inadequate accounting standards and low corporate morality figured prominently (1990, p15).

As indicated above, Henry Bosch, while chairman of the NCSC, launched a campaign for eradication of creative accounting but with variable success due to the difficulties inherent in the true and fair view concept. The potential for this difficulty to arise is still present due to the scope for professional judgment in accounting standards. One of the examples highlighted by Bosch was AAS 20 *Foreign Currency Translation:*

> Despite the existence of an accounting standard on the subject, there are considerable differences in the way in which companies are treating this matter and substantial sums are involved . . .
>
> The effect of all this is to make the concept of profit elastic (1987a, pp.-6).

The following examples taken from actual financial reports were used to illustrate the point:

> Company H . . . wrote off the bulk of its unrealized foreign currency losses of $170M. Company I appeared to ignore, for the purposes of comment, large unfavourable movements which occurred after the balance date but before the directors signed the accounts. Company J amortized both 'realized and unrealized gains and losses on long term borrowings'. Company K used the 'defer and amortize' approach recommended by the standard and proudly lists as assets deferred foreign currency losses. This is surely a perverse use of terminology (p.6).

In September 1987, AASB 1012 (formerly ASRB 1012): *Foreign Currency Translation*, was introduced. AASB 1012 requires foreign exchange gains and losses to be accounted for as part of operating profit in the period in which the exchange rates change. The deferral option is no longer available except in the case of costs incurred on assets under construction (qualifying assets) and hedge transactions dealing with the purchase or sale of specific goods or services. AAS 20 was subsequently amended to conform with approved accounting standard AASB 1012. However, there is still flexibility within both standards which may allow holding companies to manipulate consolidated results. The standards prescribe two methods for the incorporation of foreign-based operations into the accounts of the holding company - the temporal method and the current rate method. Considerable differences in financial results can occur between these methods. The appropriate method depends on whether the subsidiary is a self-sustaining operation or an integrated operation. While guidelines are provided for purposes of identifying self-sustaining operations, there is scope for differences of opinion. As Langfield-Smith has stated

> . . . the presence of foreign exchange gains and losses can only be determined once the benchmark question of integrated or self-sustaining has been answered, a test which seems to allow a considerable degree of latitude (1987, p12).

Furthermore, even if the distinction between self-sustaining and integrated operations is correctly applied, not all gains or losses resulting from foreign currency translation will be recognised in the accounts since " . . . the temporal method . . . excludes the recognition of potentially significant foreign exchange gains and losses" (p.12).

Langfield-Smith identified three other areas of the standard which allows options which may provide scope for "creative" accounting or "abuse" of the relevant provisions. Briefly, these areas deal with

> *qualifying assets* whereby gains or losses associated with these assets may be used to adjust the cost of the assets;

> *hedging transactions* The standard permits the netting of gains or losses arising from 'hedging transactions'. To the extent that gains and losses on hedged transactions and hedging transactions cancel each other out,

full disclosure of the impact and possible risk associated with foreign trade are not made;

branch or subsidiary operations The definition of "foreign operations" implies that only those reporting entities required to prepare accounts or groups accounts would be classified as "foreign operations". Furthermore, the accounts or group accounts must be prepared in a foreign currency. If these criteria are not met, it could be argued that translation differences need not be accounted for (1987, pp.12-15).

Given the lack of certainty surrounding the meaning of true and fair view and the flexibility inherent in accounting standards, it is not unusual to find a lack of judicial precedent on these matters or on the accounts provisions of the Companies Act (Codes). A search of company law cases found no entries dealing with the accounts provisions, including true and fair view, of the Companies Act (Codes) 1981 and very few with the legislation's predecessor, the Uniform Companies Act 1961/62. Some eight cases between 1967 and 1982 made mention of true and fair but not necessarily within the context of the relevant accounts provisions of the legislation. One such case was the previously cited CAC v A and T Barton in which it was stated that the accepted differences of opinion within the accountancy profession made it impossible to establish whether or not a particular profit statement was misleading ((1977) ACLC 40.343 at p29,466).

In light of this decision, even from a Magistrates Court, it is not surprising that advice to members of the NCSC was to pursue prosecutions under the general criminal law rather than the Companies Legislation which relies upon the true and fair view concept. The lack of criminal prosecutions in such cases also provides evidence of the difficulties inherent in such prosecutions. These difficulties may also help explain the ASC's reluctance to seek prosecution under the criminal law.

Further evidence is provided by Craig and Clarke who argue that the variations permitted in approved accounting standards give rise to a staggering number of "acceptable" permutations (1993, p59). In support of this contention, Craig and Clarke use as an example, a company which must apply twenty approved accounting standards. The example further assumes, conservatively, that each standard permits two alternative treatments of particular accounting items. On this basis, the number of acceptable accounting outcomes is 1,048,576 (pp.59-60). This result is patently inconsistent with the sentiments expressed by Vic Prosser as executive director of the Institute of Chartered Accountants in Australia:

> The Accounting Standards Board of the AARF is aware of and committed to the need for a base of consistent logical and effective accounting standards to aid the standard and uniformity of financial reporting and the public understanding and use of financial statements (1983, p91).

This appears to be a prime example of the rhetoric which flies in the face of the inherent flexibility and scope for choice in many accounting standards.

PROGNOSIS

The foregoing has attempted to identify some of the problems inherent in company regulation in Australia. The question that must now be addressed is why, after almost 100 years of company regulation of some sort, do these problems still exist? For example, "true and fair" has had an even longer life-span than company legislation but its meaning is no closer to being clarified than it was 100 years ago. Flexible accounting standards or practices have been used to distort or manipulate profits and other accounting numbers with the result that the accounting profession in Australia has been discredited since the turn of the century. Why is there uncertainty, flexibility and ambiguity in corporate regulation?

The answers to questions such as these are not readily discernible. However, what is apparent is that the problems extend beyond flaws in legislation and accounting standards. It is quite clear that these are nothing more than symptoms of more deeply seated problems. The answer also cannot be to lay the blame for regulatory failure at the door of corporate transgressors and highfliers and their lawyers, accountants and auditors as suggested by Bosch and cited in Senate Parliamentary debates in 1992 (Australia, 1992a, p2205). Recurring regulatory failure arising from inadequacies in the form and structure of corporate regulation and the bodies established to enforce it, raise questions about the commitment of those behind corporate regulation. Do they really want things to change or is it all a sham?

Research by Grabosky and Braithwaite suggest that corporate regulation in Australia is characterised by what they term, 'manners gentle' (1986, p.1). This is not because Australian regulatory agencies lack power but that they are reluctant to use it (p.2). However, the evidence produced in this paper indicates that this reluctance arises for a number of reasons including direct and indirect pressure from members of parliament to stall investigations, lack of funding and other resources, rivalry between regulatory bodies and legal advice that flexibility and ambiguity inherent in relevant forms of regulation will preclude a successful prosecution. The failure to address these problem areas and arrive at lasting solutions does not appear to be accidental or for lack of evidence that problems exist. Rather, inadequate regulation resulting in regulatory failure would seem to be by design. With this in mind, the solution to the recurring cycle of regulatory failure, regulatory reform in Australia appears to lie in replacing the rhetoric and concomitant 'smoke screen' of regulatory reform with commitment by all relevant parties to the integrity and viability of corporate regulation.

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