UNEXPECTED CORPORATE FAILURES IN AUSTRALIA THROUGH THE DECADES - COMMONALITY OF CAUSES

Thesis submitted by

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STATEMENT OF SOURCES

DECLARATION

I declare that this thesis is original and my own work and has not been submitted in any form for another degree or diploma at any university or institution of tertiary education. Information derived from the published work of others has been acknowledged in the text and list of references given.

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Signed: **Richard John Lane**

8 September, 2016

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Date

ABSTRACT

Unexpected corporate failures have been happening ever since there have been companies and continue to happen notwithstanding that, at the present time, there is the strongest governance and corporate law ever. Although individual corporate failures have been analysed in the literature by academics and practitioners there is a lack of research identifying the fundamental causes of unexpected corporate failures over many decades and analysing the commonality of causes evident across the corporate failures. This research gap is addressed in this thesis.

The first aim of this thesis is to analyse the fundamental causes of unexpected corporate failures in Australia over the 50 year period ended 2010. The second aim is to identify whether commonality of causes exists across the collapses.

To achieve the first aim, the methodology for analysing the unexpected corporate failures across the decades is case study analysis, analysing major corporate failures from each decade. The case study methodology of analysis was chosen because it provides a consistent structured framework approach in the form of a template so that common factors across the case studies can be tabulated into a summary table of causes of each case study. This approach allows the researcher to consistently assess and evaluate information across five decades. The thesis includes discussion relating to the theory relevant to this research, agency theory. Agency theory has been used as a consistent lens through which to view and interpret each case study. The causes of the unexpected failure were determined from the results of investigations by court-appointed inspectors, receivers and managers, liquidators, administrators and also from the research and professional literature. At the end of each chapter

including a case study, the causes are presented with brief detail and referencing.

The methodology used to achieve the second aim, was to amalgamate the summary of the common causes of all case studies in order to produce a master comparison list in the form of a matrix for analysis and evaluation.

The findings show that there is commonality of causes throughout the eight case studies. The matrix revealed nine common causes of unexpected corporate failure extracted from the eight case studies. Five of the nine main causes identified were common to all eight case studies covering the five decades thus clearly demonstrating that although legislation, regulation and standards strengthened over the 50 years covered by the case studies, the five main causes continued to occur.

From further analysis of the matrix, the causes were categorised into two groups. The first group includes causes which demonstrate a lack of strategy and management expertise. The second group includes causes which can be clearly identified as relating to one or more points of the fraud triangle.

Therefore, the principal conclusion of this thesis is that commonality of causes exists across the unexpected corporate failures analysed in this thesis. Notwithstanding amending legislation, changes to regulations, adoption of accounting and auditing standards that have the force of law, corporations continue to fail unexpectedly and the causes of the failures in many cases are unchanged.

This information will be useful to investors and regulators because it draws together the common threads underlying each corporate collapse analysed in the case studies to examine what factors are associated with unexpected corporate failure over time.

This thesis takes one step forward in providing an holistic approach to understanding the factors that led to unexpected corporate failures of the past so that they may, possibly, be prevented in the future.

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Glossary

ABC	ABC Learning Centres Ltd
AIM	Australian Institute of Management
Allianz	Allianz Australia Limited
AMP	AMP Society
ASA	Australian Society of Accountants
ASIC	Australian Securities and Investments Commission
Atkinson	Sallyanne Atkinson Chairman of ABC Learning Ltd
BCH	Bond Corporation Holdings Ltd
Black	James Black CFO of ABC Learning Ltd
Bond Corporation	Bond Corporation Pty Limited
BRL	Bell Resources Ltd
CAANZ	Chartered Accountants Australia and New Zealand
CAC	Corporate Affairs Commission
Cambridge	Cambridge Credit Corporation Limited
CCB	Child Care Benefit
CDO	Collateralized Debt Obligations
CDPP	Commonwealth Department of Public Prosecutions
CE Heath	CE Heath International Holdings Ltd
CEO	Chief Executive Officer
CF	Conceptual Framework
CFO	Chief Financial Officer

Chevron	Chevron Sydney Limited
CIC	CIC Insurance Group
CIC Holding	CIC Holdings Limited
CLERP 9	Corporate Law Economic Reform Program
Cowdroy	Cowdroy Investments Proprietary Limited
CPA	Certified Public Accountant
CRT	Classic Radio and Television
DMH	David Murray Holdings Ltd
EU	Enforceable Undertaking
EY	Ernst and Young Chartered Accountants
Factors	Factors Limited
FAGIF	First Australian Growth and Income Fund
FAI	FAI Insurance Ltd
FASB	Financial Accounting Standards Board
GAAP	Generally Accepted Accounting Principles
GC	General Council of the Australian Society of Accountants
GFC	Global Financial Crisis
GID	General Investments and Discounts Pty Ltd
GRB	Rough Draft General Revision Bill
Green	Simon Andrew Peter Green
Groves	Eddy Groves Founder of ABC Learning Ltd
Heileman	G. Heileman & Co

HIH	HIH Insurance Ltd
HIH Winterthur	HIH Winterthur International Holdings Limited
Hunter	Hunter Purchases Proprietary Limited
IAS	International Accounting Standards
IAS 36	International Accounting Standard 36
ICAA	Institute of Chartered Accountants in Australia
ICAC	Interstate Corporate Affairs Commission
IFRS	International Financial Reporting Standards
Kemp	Martin Kemp Director of ABC Learning Ltd
Kitool	Kitool Pty Ltd
Minsec	Mineral Securities Limited
MLC	MLC Ltd
Moloney	Gregory Moloney Partner of Ferrier Hodgson Chartered Accountants
Mort	R.E.M. (Mort) Hutcheson CEO of Cambridge Credit Corporation Ltd
NCSC	National Companies and Securities Commission
Northumberland	Northumberland Insurance Company Limited
OECD	Organisation for Economic Co-operation and Development's
Owen	Commissioner Mr. Justice Owen of HIH Royal Commission
Packer	Kerry Packer Chairman of Nine Network
Palmer	Herbert (Herbie) George Palmer Chairman of H.G. Palmers Limited
Palmers	H.G. Palmers Limited
Payne	M. W. Payne Underwriting Agency Pty Ltd.

PBM	Payne’s Bon Marche Pty Ltd
PICL	Connell Petrochemical Industries Corporation Ltd
Pitcher	Pitcher and Partners
PPL	Payne’s Properties Pty. Ltd.
QMS	Queensland Maintenance Services
RBA	Reserve Bank of Australia
Report	HIH Royal Commissioner’s Report
RMA	Reid Murray Acceptance Ltd
RMDWA	Reid Murray Developments (W.A.) Pty Ltd.
RMH	Reid Murray Holdings Ltd
Rothwells	Rothwells Bank
Rowland	Tiny Rowland Chairman of Lonrho
RR	Robert Reid & Co Limited
Ryan	David Ryan Director of ABC Learning
SAGIF	Second Australian Growth and Income Fund
SCL	Stanhill Consolidated Limited
SDF	Stanhill Development Finance Ltd
SEC	U.S. Securities and Exchange Commission
SGIOWA	State Government Insurance Office of Western Australia
SPL	Stanhill Pty Limited
TCLT	Transitional Control Loss Theory
TFV	True and Fair View

Walker	Peter Walker Partner Ferrier Hodgson Chartered Accountants
Wellington	Wellington Court Holdings Proprietary Limited
Williams	Ray Williams
WMC	Western Mining Corporation Ltd
Zullo	Frank Zullo Brother-in-law of Eddie Groves CEO of ABC Learning Limited

1. CHAPTER 1 – Introduction

1.1. Research Question

The focus of this thesis is the research question: What are the fundamental causes of unexpected corporate failures in Australia over the 50 year period ended 2010 and what commonality of causes are evident? This information is useful to investors and regulators because it draws together the common threads underlying each corporate collapse analysed in the case studies to examine what factors are associated with unexpected corporate failure over time.

While this topic has broad application across a number of disciplines, the primary focus is the discipline of accounting. A detailed examination of the issues from a legal or corporate governance perspective is beyond the scope of this thesis.

1.2. Definition of Unexpected Corporate Failure

The definition of unexpected corporate failure that is used throughout this thesis is: The financial collapse of a company following profitable financial reports and financial statements that showed that the company was considered a going concern for the subsequent twelve month period. This definition was developed by the researcher in discussions with an expert in the field Professor J.J. Staunton in 2010. For the purposes of this research the words 'failure' and 'collapse' are interchangeable.

1.3. Context and Scope of the Study

In the period covered by this thesis there have been many government inquiries, Inspectors' Investigations of corporate collapses and, in more recent times, actions from the corporate watchdog the Australian Securities Investments Commission (ASIC). However, unexpected corporate failures in Australia continue to occur. The aim of this thesis is, therefore, to analyse the fundamental causes of unexpected corporate failures in Australia over the 50 year period ended 2010. In addition, to identify whether commonality of causes exists across the collapses and, if so, what these causes were and to make recommendations for future actions and/or reforms to be carried out by regulators and the profession.

The scope of this thesis includes the analysis of a selection of case studies of unexpected Australian corporate failures from each decade from 1960 to 2010. The analysis documents the common causes associated with corporate failures, thus providing evidence for regulators to consider reforms across all Australian States and Territories. The thesis also includes discussion relating to the theories relevant to this research, particularly agency theory, and suggests that a specific part of agency theory be termed Transitional Control Loss (TCL). The discussion also reviews the implications of the fraud triangle in relation to unexpected corporate collapses.

1.4. Contribution to the Literature and Practice

Although individual corporate failures have been analysed in the literature by academics and practitioners (see, for example, Clarke, Dean, & Oliver, 2003; Sykes, 1996) there appears to be a lack of research identifying the fundamental causes of unexpected corporate failures over many decades and the commonality of causes evident across the corporate failures. This research gap is addressed in this thesis.

1.5. Significance of the Study

This thesis provides an holistic view of unexpected corporate failures over five decades from 1960 to 2010. The significance of this study is that it will analyse case studies providing a table of common causes over the decades, and contribute to theory development under the umbrella of agency theory. The thesis will also contribute to both the academic and professional literature. This thesis found that a commonality of causes exists across the case studies analysed covering the five decades and a matrix presenting the common causes is Table 12, section 9.2. This information will be of use to a range of stakeholders including, but not limited to, governments, regulators, professional bodies, academics, potential investors, company directors and senior management.

1.6. Methodology

The methodology for analysing the unexpected corporate failures across the decades is case study analysis, analysing major corporate failures from each decade. The case study methodology of analysis was chosen because it provides a consistent framework approach so that common factors across the case studies can be drawn out. This approach allows the researcher to consistently assess and evaluate information across a number of decades. According to (Cooper & Morgan, 2008):

> *Case studies are a research approach, a systematic and organized way to produce information about a topic,*
>
> *… case study research is an in-depth and contextually informed examination of specific organizations or events that explicitly address theory.*
>
> *Case studies focus on bounded and particular organizations, events, or phenomena, and scrutinize the activities and experiences of those involved, as well as the context in which these activities and experiences occur* (p.160).

There were many corporate failures during the period covered by this thesis, however the companies critically examined in the case studies in this research were selected on the basis that they were public companies listed on the stock exchange, the public lost large amounts of money as a result of the collapse, and their collapses were unexpected.

The companies selected by decade and the chapters in which they are discussed are:

- 1960s - Chapter 4

  Case Study 1: Reid Murray Holdings Ltd,

  Case Study 2: Stanhill Development Group,

  Case Study 3: H.G.Palmers Ltd:

- 1970s - Chapter 5

  Case Study 4: Mineral Securities Limited,

  Case Study 5: Cambridge Credit Corporation Ltd:

- 1980s - Chapter 6

  Case Study 6: Bond Corporation Holdings Ltd:

- 1990s - Chapter 7

  Case Study 7: HIH Insurance Group Ltd:

- 2000s - Chapter 8

  Case Study 8: ABC Learning Centres Ltd.

Wherever possible in the case studies, primary data has been sourced from government appointed inspectors' and investigators' reports of the unexpected corporate failures. Also reports from liquidators, administrators and receivers have been accessed. Where information from these sources is not available, there is reliance upon material sourced from scholarly writings and historical research published by a limited number of professional, semi-professional, academic and popular sources (i.e. mass media). Judgements and statutes are referred to only in examining prosecutions following the investigations that lead to the various reports.

1.7. Overview of the Study (i.e., Structure of the Thesis)

This thesis is structured in the following way.

Chapter 2 outlines the theory that provides the theoretical and scholarly base for the analysis of the eight case studies in this thesis. The theory that provides a base for analysis of the case studies is agency theory. In many of the case studies TCL circumstances arise which is consistent with the agency view. TCL is not used as a basis for analysis, but the TCL circumstances are found to be common across many of the cases. This approach provides a consistent framework within which to conduct the analysis of the different case studies and will best highlight the common causes in different factual situations and different regulatory and economic environments over time.

The results of this research can be used as a reference to develop common solutions to deep-rooted problems of corporate management. This information can better protect investors and creditors and promote greater integrity and effectiveness in the administration of corporate regulations.

Chapter 3 introduces the Pyramid Enforcement Model and also the loose and undefined concept ‘full and fair’, ‘true and correct’ and ‘true and fair’ qualitative standard. This discussion underpinned much of the presentation of financial accounts until The Corporations Act (2001) was introduced. The accounting standards now take precedence with regard to the true and fair requirement (see section 3.3).

Chapters 4, 5, 6, 7 and 8 each cover one of the five decades from 1960 to 2010 and the analysis of case studies of unexpected corporate failures within each decade. At the beginning of each case study, a Table of Events specifies the order of the analysis; and a colour indicator informs the reader of the progress of the analysis. For instance, the main headings of the chapter and case study for Chapter 5 are shown as per this example:

EXAMPLE: Table of Events

Table of Events Chapter 5

Introduction
Economic Conditions 1970
Economic Event 1970
Case Study 4
Case Study 5
Summary and Conclusions

The structure and contents of each section are as follows:

Introduction: The introduction will set the scene for the period of the analysis, a decade.

Economic Conditions: Under this heading, the economic conditions prevailing at the time of the study are discussed and may include relevant factors such as the strength of the economy at the time, unemployment percentages and monetary pressures.

Economic Event: During each of the decades in the study an event occurred that hastened the unexpected collapse of a number of companies that were not properly managed and thus were unable to cope with changes, for example, the stringent credit restrictions resulting from an economic event.

The case study

Each case study will be examined using a consistent structure and approach. For example, in Chapter 5 the structure is as follows:

EXAMPLE: Table of Events

Table of Events Chapter 5

Introduction
Economic Conditions 1970
Economic Event 1970
Case Study 4 Mineral Securities Limited **Background** Collapse Investigation Prosecution
Case Study 5 (structured as per Case Study 4)
Summary and Conclusions

Background: The background of the company that is the subject of the analysis is discussed regarding its formation, personnel and type of business.

Collapse: Events that led to the unexpected failure of the company including causes and possible involvement of company officers and directors, and the appointment of investigators and/or administrators, receivers and liquidators.

Investigation: Examination of the inspectors' reports and their findings.

Prosecutions: Following findings and recommendations by the inspectors, where court action took place, the resultant penalties are discussed as to their severity and whether appropriate signals were sent to the business sector as a deterrent.

At the end of the chapter the case studies as a whole will be examined under the following headings (again, Chapter 5 is used as an example):

End of the chapter

At the conclusion of the Chapter after the case study analysis a Summary and Conclusions section is provided which includes a review of relevant governmental inquiries, and a discussion of regulatory and professional outcomes as per the example shown below. The chapter concludes with a summary of the major causes for the collapses analysed and discussion linking the findings to the theories outlined in Chapter 2.

EXAMPLE: Table of Events

Table of Events Chapter 5

Introduction
Economic Conditions 1970
Economic Event 1970
Case Study 4
Case Study 5
Summary and Conclusions **Government Inquiry** Regulation and Legislation change Profession Action Summary of Major Causes

Government Inquiry: Government actions such as formal inquiries will be critically analysed, incorporating many criticisms detailed in the literature of the method that governments pursued to rectify the ongoing saga of unexpected corporate failures.

Regulation and Legislation Change: In this section secondary sources such as the inspectors' recommendations and complaints are examined to see if they were included in the relevant government inquiries that may have followed and to identify any changes that were made to the regulations or legislation, i.e. primary sources, as a result.

Profession Action: This section deals with the action by the professional accounting bodies following criticism as a result of corporate failures. There have been two main professional accounting bodies during the period of fifty years covered by the thesis. They are CPA Australia (formerly the Australian Society of Accountants) (ASA) and Chartered Accountants Australia and New Zealand (CAANZ) (formerly The Institute of Chartered Accountants in Australia (ICAA)).

Summary of Major Causes: The commonality of causes of corporate failures is summarised at the end of each chapter and represented by a table with the causes and details tabulated in vertical columns.

In the final chapter (Chapter 9 – Discussion and Conclusion) the tables of causes of unexpected corporate failure from each case study will be displayed in a matrix (Table 12) and then analysed for commonality of causes found across the decades. These are then summarised and the major findings highlighted. The analysis includes categorising the commonality of causes into two groups, those which exhibited lack of strategy and management expertise, and those which could be related to points of the fraud triangle. As each case study is to be analysed within a consistent framework specific causes can be identified rather than economy wide factors.

2. CHAPTER 2 - Theoretical Frameworks

2.1. Introduction

This Chapter outlines the theories that provide the theoretical and scholarly base for the analysis of the eight case studies. The theoretical frameworks used in this thesis in order to provide a consistent lens through which to view and interpret each case study will be agency theory and the conceptual framework of the fraud triangle.

2.2. Agency Theory

Previous research in 2009 (Lane & O'Connell, 2009, p. 122) asserted:

> *…that any study that utilises listed public company financial statements and reports as a primary data source should not draw conclusions from them without considering the theoretical environment which surrounds such corporations.*

Accordingly in this research, agency theory is drawn on, *inter alia*, to inform this analysis.

Jensen and Meckling (1976) defined an agency relationship:

> *…as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the*

> *agent. If both parties to the relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interests of the principal* (p.5).

So both parties to the relationship, through human motivation and behaviour, are potentially self- interested, rational wealth maximizers[1]. Agency theory, more simply stated:

> *…explains how to best organize relationships in which one party determines the work while another party does the work. In this relationship, the principal hires an agent to do the work, or to perform a task the principal is unable or unwilling to do* (Moritz-Rabson, 2015, p. 1).

In the corporate context the principals are the shareholders and the agents the senior management and board of directors.

Agency theory is relevant to this thesis as a consistent lens through which to analyse the actions of the management of the corporations in the case studies and to help explain and predict why managers in each case act in a particular way given that agency theory asserts that, in general, everyone is a self-interested, rational, utility maximiser. Agency theory predicts that managers will make decisions that maximise their own wealth rather than that of shareholders in the absence of incentives to do otherwise. For example, managers are more risk averse than shareholders because they cannot diversify their human capital investment in the firm in the same way that shareholders can diversify their

[1] Economics concept that, when making a purchase decision, a consumer attempts to get the greatest value possible from expenditure of least amount of money. His or her objective is to maximize the total value derived from the available money.

investment. Therefore, unless other incentives are provided, a rational manager will prefer projects that protect his/her fixed cash salary as long as possible but these may be low risk when shareholders (and firm value) would be maximised if higher risk projects were selected (Jensen & Meckling, 1976; Moritz-Rabson, 2015).

2.2.1. Transitional Control Loss

This is proposed as a distinct instance of agency theory, in that it suggests that a specific part of agency theory be termed Transitional Control Loss which highlights and emphasizes the unilateral behavior by the founder of a corporation. In the cases analysed in this thesis, the person who most often demonstrates this pattern of behavior is the owner of the original (privately owned) business, who has conceived, founded and made a success of the business. He/she is then in the position of floating this business on the stock exchange, thus placing the business into public ownership. The founder/owner, often in the new position of CEO or chairman of the board of directors of the newly listed company, has difficulty accepting the loss of control as a result of transitioning from a private company to a public company, and therefore frequently makes decisions in their own best interest and not in the interests of the new owners, the shareholders.

Researchers and authors have commented on directors and/or chief executives who are domineering and therefore difficult to deal with, particularly from the auditor's point of view. For example:

> *Another explanation…of audit failure is to be found in the effect of a domineering chief executive, especially where that person is also the founder of the audited company. An important factor in deterring auditors from taking a forthright stand in the audit process is the existence of a domineering chief executive in the company being audited* (Tomasic R, 1991, p. 17).

There are similar examples in the USA:

> *We also find that firms manipulating earnings are: (i) more likely to have boards of directors dominated by management; (ii) more likely to have a Chief Executive Officer who simultaneously serves as Chairman of the Board; (iii) more likely to have a Chief Executive Officer who is also the firm's founder; (iv) less likely to have an audit committee; and (v) less likely to have an outside block holder*[2] (Dechow, 1996, p. 1).

Agency theory depicts individuals as rational, self-interested and utility maximisers. The particular instance of agency theory, Transitional Control Loss (TCL) is where a founder CEO struggles with the loss of unilateral decision making. Founder CEOs are a common factor associated with corporate collapses in these case studies. Many of the founder CEOs analysed in the case studies in this thesis were unable to transition from a private company governance structure to the rigors of public company accountability.

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[2] **Blockholder** The owner of a large proportion of ownership shares of a company (The Free Dictionary, 2015)

2.3. The Fraud Triangle

The fraud triangle is used in this thesis as a conceptual framework through which to apply a consistent lens to the facts of the case studies. It does not seek to address legal issues of whether a fraud has been committed in a legal sense.

The original fraud triangle was conceived by criminologist, Donald R. Cressey, to explain why people commit fraud. There are three components of Cressey's fraud triangle. The first component is *Pressure or Motivation* where an individual has some financial problem that is unable to be solved through legitimate means. The second component is *Perceived Opportunity* where the individual perceives there is a low risk of getting caught abusing their position of trust. The third component is *Rationalisation* involving a person reconciling his/her behaviour with the commonly accepted notions of decency and trust (LACPA, 2009).

The fraud triangle was revised in 2007 to show specific relevance to corporate rather than individual fraud in an article describing the collapse of management controls in Enron. The three components of the Free et al. variant, shown in Figure 1, are similar to Cressey's original model and will be applied to the analysis of the actions of the directors of the failed companies. While a particular cause of the failure can be related to a particular point of the triangle, it should be noted that the three points of the fraud triangle are linked therefore provide solutions for prevention of fraudulent actions across the corporate structure.

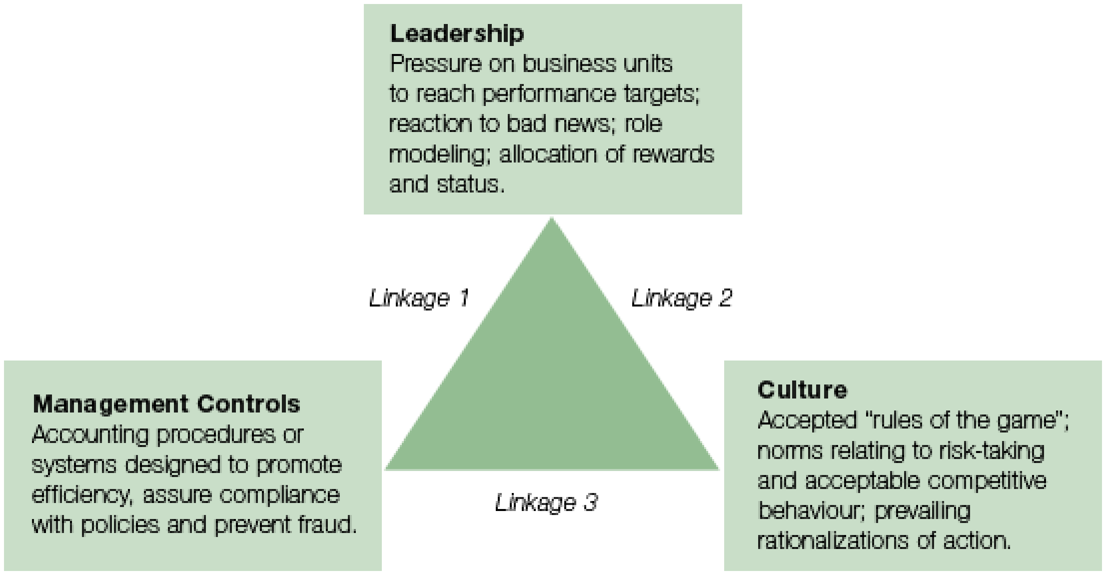

Figure 1: The Organisational Fraud Triangle (Free, Stein, & Macintosh, 2007, p. 4)

3. CHAPTER 3 – The Pyramid Enforcement Model and the True and Fair Qualitative Standard

3.1. Introduction

The purpose of Chapter 3 is to introduce the Pyramid Enforcement Model and also the qualitative standard ‘true and fair’ which are the constraints facing management at various points in time and are included as part of the regulatory background.

The introduction of the Pyramid Enforcement Model in 1992 provided a vehicle for graduated enforcement of regulatory compliance which was not available prior to 1992. The pyramid enforcement model is mentioned here because it shows that the regulators eventually had an alternative compliance tool that provided for civil penalties where criminality might have been difficult to prove. The model is not used in the analysis of the case studies in this thesis, as it is a legal process, which is outside the parameters of this thesis.

The qualitative standard ‘true and fair’ is a legislative theme stating that the published financial accounts of a company were ‘true and fair’ representations of the company’s financial state of affairs. There have been several changes to the qualitative standard, ‘true and fair’, over the five decades covered by this research. This section has outlined the major changes to the qualitative standard over the relevant study period.

3.2. The Pyramid Enforcement Model

In 1992 Ayres and Braithwaite created the pyramid enforcement model (Figure 2) when they suggested that the ideal regulatory approach to enforcing compliance with regulation is through the adoption of an explicit enforcement pyramid. Under this model, if 'soft' measures, such as those shown at the base of the pyramid shown in Figure 2, fail to produce compliance, then sanctions of greater severity are used (Australian Law Reform Commission 50, 2008).

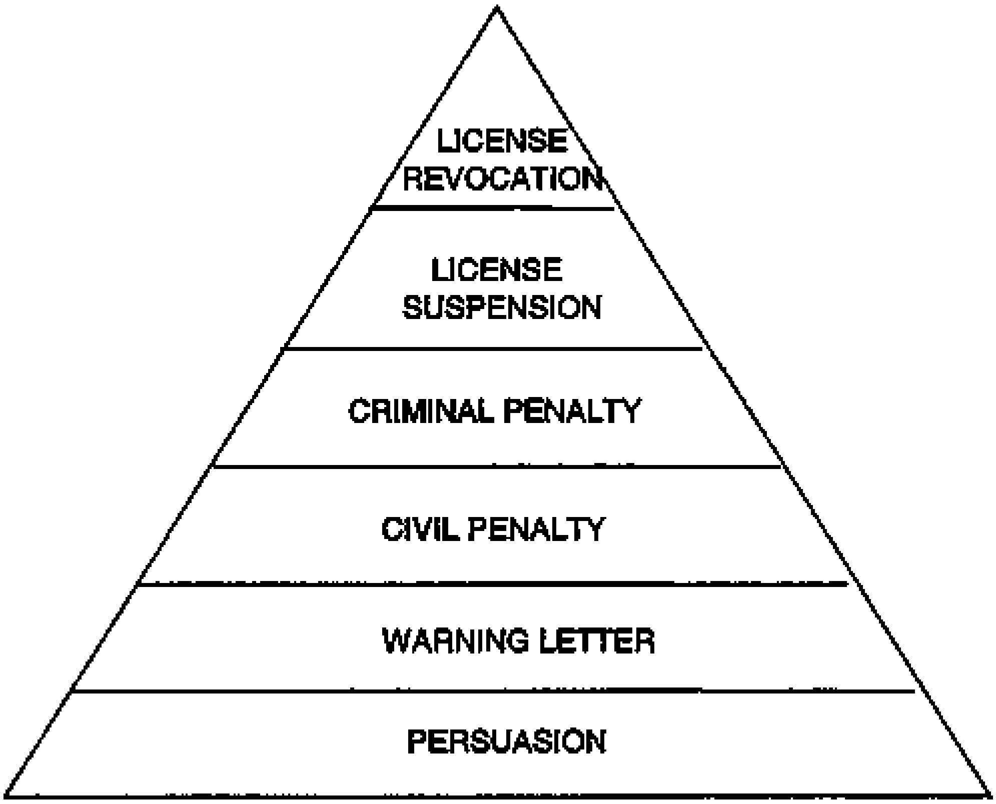

Figure 2: The Pyramid Enforcement Model (Ayres & Braithwaite, 1992).

Until 1993, the enforcement of Australian corporate law was prosecuted through the criminal jurisdiction. The National Companies and Securities Commission (NCSC) 1981-89, the Australian Securities Commission (ASC) 1989-98 and currently the Australian Securities and Investments Commission (ASIC) 1998 –

current period, experienced problems in enforcing the directors' duty provisions because in using criminal law a higher standard of proof was required than for civil matters. The need to satisfy the criminal rules of evidence, beyond a reasonable doubt, made it difficult to provide an effective enforcement regime (Comino, 2009).

Ayres and Braithwaite (1992) in their book, *Responsive Regulation: Transcending the Deregulation Debate* argued that:

> *Pyramids of increasingly stringent enforcement measures are needed to respond to the diverse objectives of regulated firms. An enforcement pyramid subjects regulated firms to escalating forms of regulatory intervention if they continually refuse to respond to regulatory demands* (Ayres & Braithwaite, 1992, p. 20).

The suggested modified form of the Pyramid Enforcement Model for corporation law is shown in Figure 3. At the base of the pyramid, persuasion and a warning letter from ASIC, the corporate watchdog, represents an administrative or non-judicial approach promoting a timely and cost effective enforcement of the law. Naturally ASIC attempts to concentrate their efforts at the base of the pyramid as this is a quick and low cost option.

The next level of the pyramid involves civil proceedings which were not generally available during the decades covered by the case studies in Chapters 4 to 6.[3] Civil proceedings did involve court proceedings and lawyers, and were

[3] Even before the introduction of civil penalties, there was always the option for compensation orders under the old corporations law for breach of directors' duties (2001 Act s 1317H perhaps former s 1317HA –, also the option of civil action such as an injunction under s 1324 to prevent breaches of duty, and as a last resort, winding up under just and equitable ground in s 461(1)(k) for repeated breaches of duties, also winding up for insolvency etc. Also former corporations legislation (and now s 179) also preserved general law civil action for breach of fiduciary or common law duties of directors

therefore far more costly than the non-judicial proceedings on the lower rungs of the pyramid. Outcomes for creditors may have also been very different if the regulator prior to ASIC had the powers that ASIC, which came into being in 1998, has available today to seek asset preservation orders, freezing of corporate assets and surrendering of the passports of those under investigation. There were no civil penalties to provide some ‘middle-ground’ enforcement option/punishment.

The next level of the pyramid contains the criminal proceedings and these are used as a last resort. The brief is prepared by ASIC but the prosecution of the case is carried out by the Commonwealth Department of Public Prosecutions (CDPP).

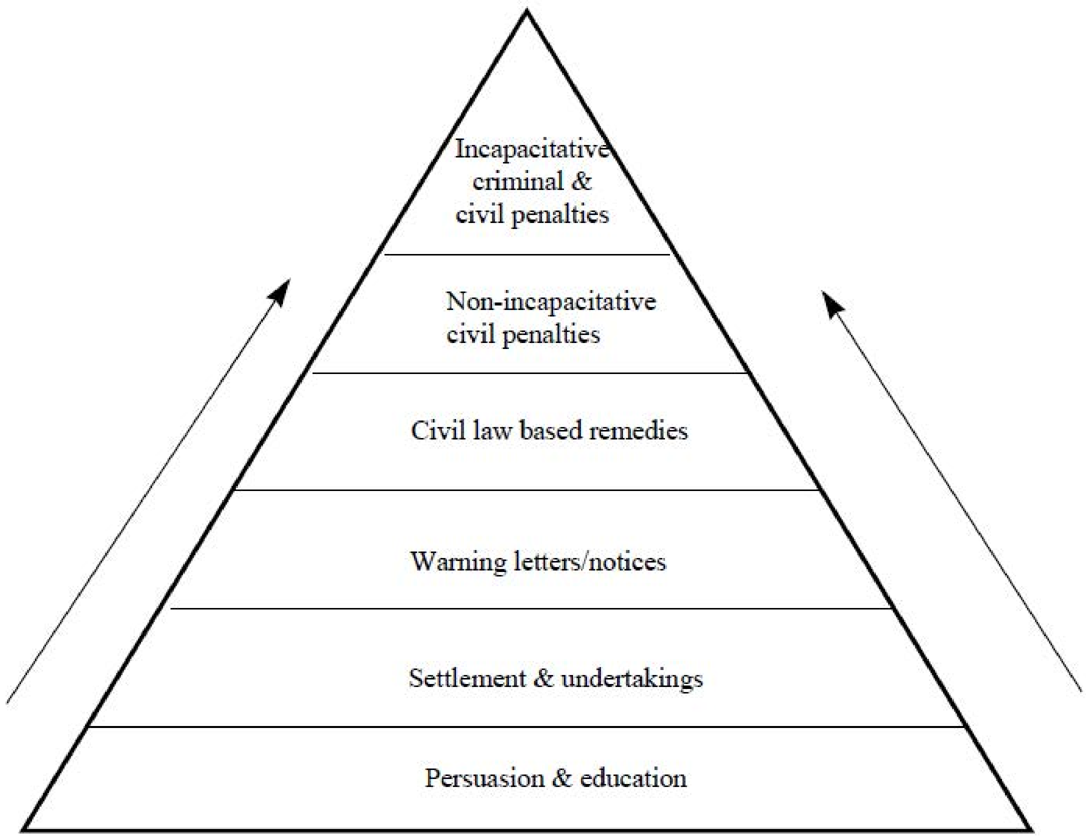

Figure 3: Enforcement Pyramid (Gilligan, Bird, & Ramsay, 2006, p. 10)

The report by the Senate Standing Committee on Legal and Constitutional Affairs (also known as the Cooney Committee) regarding Company Directors' Duties, known as the Cooney Report, presented the findings of the committee in November 1989. It was not until 1993 that the findings and recommendations of the committee were introduced into the legislation by the parliament. The committee addressed the problem of lack of successful prosecutions of company directors by recommending that the cases be dealt with utilising civil remedies instead of the criminal sanctions provisions of the Corporations Act 1989 (Cth).

In 1993 the Cooney Committee recommended major reforms to the corporation law relating to enforcement of the statutory duties of company officers. These recommendations were introduced into legislation in 1993 by the introduction of civil penalties found in Part 9.4B----Civil Consequences of Contravening Civil Penalty Provisions of the Corporations Act 1989 (Cth). However, in reality over the five decades of this thesis including the period since these recommendations were introduced into legislation, penalties for individuals were almost non-existent, the likelihood of discovery was small and the penalties were not heavy.

3.3. The ‘full and fair’, ‘true and correct’ and ‘true and fair’ qualitative standard.

Ever since the accounting provisions were first contained in the Joint Stock Companies Act 1844 (UK), the legislative theme has been that published financial information in the form of a company balance sheet and subsequently the income statement were to be ‘full and fair’ representations of the company’s financial state of affairs and changes that had taken place (British Govt, 1844). In fact the explicit direction emanating from the Gladstone Committee of Enquiry, which preceded the 1844 Act, was that those interested in a company’s financial affairs were to be accurately informed through the financial statements being made public (Hunt, 1936).

The concept ‘true and fair’ began its life in the United Kingdom, courtesy of the Joint Stock Companies Act of 1844 where companies were required to prepare a ‘full and fair’ balance sheet until a change in the law in 1900 where the balance sheets were to show ‘true and correct view’ of the state of the company's affairs, and the obligation to apply the standard had been shifted to auditors, but the notion remained largely intact (McGregor, 1992).

The concept was introduced to Australian legislators around the turn of the 20th century; however it was not until Australia adopted the United Kingdom's Companies Act of 1948 as a basis of modern Australian companies' legislation that the requirement was that:

> *Every balance sheet of a company (to) give a true and fair view of the state of affairs of the company as at the end of its financial year, and every profit and loss account of a company (to) give a true and fair view of the profit or loss for the financial year (section 149) However under that legislation the concept of 'true and fair' was an override in that it placed an obligation on directors to not only comply with specific reporting requirements but to go beyond and ensure that enough additional information was provided to give a true and fair view of relevant matters* (McGregor, 1992, p. 68).

When the Accounting Standards Review Board was formed in Australia in 1983 the Companies Act and relevant Codes were amended to give the force of law to accounting standards that were drawn up and approved by the Board. The new legislation Balance Sheets and Profit and Loss Accounts were to be drawn up in accordance with applicable approved accounting standards. The 1983 Companies Act retained the 'true and fair' concept but contained a fundamental deviation from the way in which the concept had been applied in previous Companies Acts. McGregor (1992) noted:

> *Rather than requiring compliance with the accounting standards and with the then Schedule 7 to the Act and Codes and the provision of any additional information necessary to give a true and fair view, the new legislation permitted directors not to apply an approved accounting standard if, in their opinion, such application would not give a true and fair view* (McGregor, 1992, p. 68).

Chambers and Wolnizer (1991) in their study of the historical background of ‘true and fair view’ stated:

> *…recourse to earlier legislation and to the constitutive documents of partnerships and companies in the early years of the nineteenth century suggests that the 'true and correct view' of the states of affairs expected in the companies legislation of 1844 and 1856 was to be given by the valuation of assets at up-to-date prices, and specifically at selling prices in the ordinary course of business* (Chambers & Wolnizer, 1991, p. 197).

Chambers and Wolnizer further observed that since the commencement of the UK Companies acts in 1844:

> *…there has been an overriding statutory provision to the effect that every balance sheet and profit and loss account of a registered company shall give true and correct (later, true and fair) views of its dated state of affairs and dated profit or loss respectively* (Chambers & Wolnizer, 1991, p. 197).

In effect, for 150 years, the requirement of the various Companies Acts has been for financial accounts to be presented showing a ‘true and fair’, ‘full and fair', or 'true and correct' view of the result. In the *Corporations Act 2001 (*Cth) the accounting standards now take precedence with regard to the true and fair requirement, i.e.:

> *Section 296 Compliance with accounting standards and regulations*
>
> *(1) The financial report for a financial year must comply with the accounting standards*
>
> and:
>
> *Section 297 True and fair view*
>
> *The financial statements and notes for a financial year must give a true and fair view of:*
>
> *(a) the financial position and performance of the company, registered scheme or disclosing entity; and*
>
> *(b) if consolidated financial statements are required—the financial position and performance of the consolidated entity.*
>
> *This section does not affect the obligation under section 296 for a financial report to comply with accounting standards.*
>
> *Note: If the financial statements and notes prepared in compliance with the accounting standards would not give a true and fair view, additional information must be included in the notes to the financial statements under paragraph 295(3)(c)*

The note at the end of Section 297 reduces the overriding statutory provision of the true and fair requirement, stated above, to an additional

> note to the financial statements. No definition of ‘true and correct’ or ‘full and fair’ was given and in fact to this day where the words ‘true and fair’ are embodied in the *Corporations Act 2001* (Cth) there remains a lack of any definitive guideline for such a qualitative standard.

Chambers and Wolnizer concluded:

> *(a) that 'true and correct' and 'true and fair' and like terms are simply expressions in the vernacular of the intent that financial accounts and summaries shall be false to the dated financial facts of companies in no significant respect; (b) that in respect of property and other assets, the use of market selling prices, as in the ordinary course of business, and not cost prices, would give the required view of a dated state of affairs and dated profits or results* (Chambers & Wolnizer, 1991, p. 211).

Over the years, there has been constant criticism of true and fair:

> *Is it not time to get rid of the notion that accounts should be 'true and fair'? These imprecise adjectives have become increasingly meaningless in an era of intense corporate activity. Perhaps what is needed is a move towards rules which can be made to stick* (Waller, 1990, p. 53*).*

In Australia, as part of the Corporate Law Economic Reform Program (CLERP 9 enacted in 2004) compliance with Australian Auditing Standards became mandatory and the true and fair view requirement is only satisfied through the notes to the financial accounts, only if the directors are of the opinion that the accounts prepared in accordance with the accounting standards do not show a true and fair view.

Leibler (2003) says that:

> *In an ideal world, and with just a little imagination, accounting standards would always produce a true and fair result. But this is not necessarily so in the real world. In recognition of the fact that this laudable objective is unlikely to be attained in practice, in 1998 the commonwealth parliament once again re-affirmed that there was a need to retain, quite independently of compliance with accounting standards, a 'true and fair view' requirement (p.61).*

There are opposing views of the meaning and use of true and fair view (TFV). According to Ram (2002) the legal view of a TFV that has traditionally favoured conservatism in financial reporting has probably been shaped by the late 19th and early 20th century views of the courts on the function of audits and the purpose of a balance sheet. In Re London and General Bank (No.2), for example (a case concerning, *inter alia*, whether shareholders had been deceived as to the condition of the company), the purpose of the statutory audit was described as:

> *…securing to shareholders independent and reliable information respecting the true financial position of the company at the time of the audit* (Ram, 2002, p. 3).

Ram also states that the accounting view is that if the accounts are compliant with the generally accepted accounting principles (standards) then *prima facie* that is evidence that the accounts are true and fair (Ram, 2002).

Over the five decades covered by the case studies in this thesis, true and fair and the corporations law are mentioned in the analysis of the cases, but in reality penalties for individuals were almost non-existent until recent changes were introduced to secure successful prosecution of company directors.

4. CHAPTER 4 - Case Studies of a Number of Unexpected Corporate Collapses 1960 to 1969

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4.1. Introduction

The purpose of this chapter is to analyse three case studies of corporate failures which occurred between the years 1960 to 1969. The regulatory framework in place at the time of each failure and the subsequent changes if any to regulation and legislation as a result of the failures is also briefly discussed. The case studies for this chapter are:

Case Study 1, Reid Murray Holdings Ltd (RMH),

Case Study 2, Stanhill Development Group (SCL), and

Case Study 3, H.G Palmers Ltd (Palmers).

These three case studies are representative of the unexpected corporate failures that occurred in the 1960s. All of these companies were heavily involved in the retail boom following the end of World War II. The case studies will be assessed using agency theory as a consistent lens through which to analyse the actions of the management of the corporations (see section 2.2).

The chapter concludes with a table for each case study of the major causes underlying these corporate failures during this decade, any relevant

Government Inquiry and the regulatory changes made in response to the relevant Government Inquiry's recommendations.

The regulatory framework in place at the time of each failure in this chapter was the *Companies Act 1961*. It should be noted that the three case studies in this chapter refer to matters from at least fifty years ago and in some cases information was scarce and primary data generally not available with the exception of reports by the government appointed inspectors sourced by the researcher in respect of Case Studies 1 and 2. Each case study concludes with a summary of the prosecutions emanating from the results of the respective investigation.

There were many corporate collapses during the period, however the companies analysed here and in later chapters have been selected on the basis that their collapse was unexpected. The collapses were not predicted as all indications from reading directors' and auditors' reports attached to financial statements and press releases issued by the directors immediately prior to the collapses were positive as to the prospects of each company as a going concern.

The definition of unexpected corporate failure used in this study is, the financial collapse of a company following profitable financial reports and financial statements that showed that the company was considered a going concern for the subsequent twelve month period (see section 1.2).

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4.2. Economic Conditions

At the beginning of the 1959-60 financial year, the economic conditions in Australia found unemployment which had been between 1.1% during World War II, was just below 3% by 1959-60 (Australian Bureau of Statistics, 2001).

According to the monetary authorities (the Reserve Bank of Australia) it became clear in January 1960 that the growth rate of aggregate demand was faster than aggregate supply. In other words, households were demanding more goods and services and satisfying that demand by borrowing from banks and finance companies (Henderson, 1965).

In the final stages of 1959-60, a strong rise in outstanding advances caused the Reserve Bank to request the trading banks to *achieve an early and significant reduction in the rate of new lending* (Henderson, 1965, p. 57). This request was generally ignored by the banks.

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4.3. Economic Event

The Economic Event for the first three case studies, RMH, SCL and Palmers, is the Credit Squeeze of 1960-61 and therefore the following discussion applies to all three cases. The federal treasurer, Harold Holt, when delivering the Budget in August 1960, issued a warning that the country was over-reaching its resources and the government would be required to act to curb over - optimistic expectations (Sykes, 1998). The Government decided that credit needed to be tightened and on 15 November 1960 Treasurer Holt announced a package of economic measures. The range of measures was severe.

The main corporate lenders in the late 1950s and early 1960s were life insurance offices and superannuation funds. Under the new measures they were required to hold at least 30% of their assets in government and semi – government securities.[4] This move greatly reduced the capacity of the life offices and superannuation funds to make loans to the corporate sector.

In addition to the tightening of credit, overdraft interest rates rose from 6% to 7% and the tax deductibility of certain interest payments, such as interest paid on the popular investment, convertible notes, was revoked (Sykes, 1998). Sales

[4] Government Bonds are issued by the Commonwealth Government and are usually referred to as risk- free bonds because the government can either raise taxes or print money to redeem them. Semi-government securities are bonds issued by state or local governments and are issued to fund infrastructure projects and other ongoing financial commitments.

tax on cars and trucks was increased from 30% to 40% (Dyster & Meredith, 1990).

As a result of the credit squeeze, there was an increase in unemployment as companies were forced to place restrictions on their activities. The share market had its largest fall in 9 years when it fell 20% in the December quarter to December 1960 (Sykes, 1998). The 1960 credit squeeze affected many companies that were over extended and poorly managed. The first three case studies in this chapter were so affected.

4.4. Case Study 1 - Reid Murray Holdings Ltd

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4.4.1. Background

The South Australian retail company David Murray Holdings Limited (DMH) group merged with the old established wholesale business Robert Reid & Co Ltd (RR) in 1957. RR had branches in Sydney, Brisbane, Melbourne, Adelaide, Perth and Tasmania and the merged group's new parent company was named

Reid Murray Holdings Ltd (RMH). By store numbers the RMH group was one of the largest retail groups in Australia, with a total of 72 stores (Sykes, 1998).

The relevant holding entity, RMH, after the merger consisted of a group of companies the most important of which were Reid Murray Acceptance Ltd (RMA), and Payne's Properties Pty Ltd (PPL). The former CEO of DMH, Oswald O'Grady, became the CEO of the holding company, RMH, and Raymond Borg became manager of PPL.

The RMH group entered the early 1960s as one of the largest retailers in the country. The RMH group had interests in wholesaling, general retailing, specialty retailing (principally electrical goods), financing and land development. The company was borrowing very heavily at the rate of £3 million every two months.

That success in the capital market:

> *…was against a background of RMH enjoying a glowing financial press in recognition of its reported outstanding financial performance…and the appearance in its accounts of going from financial strength to strength…*(Clarke, et al., 2003, p. 57).

By the end of 1960, the group had £7 million invested in land. Although glowing financial reports were issued in subsequent years, it was placed unexpectedly into receivership in May 1963 (Clarke, et al., 2003).

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4.4.2. Collapse

Following the emergence of RMA as virtual 'banker' for RMH, the nature of the transactions between the two companies meant that effectively RMA was a branch of RMH. In 1959 and early 1960 RMA was borrowing at a rate of nearly £3 million every 2 months from subscribers to Prospectuses for Debentures and Unsecured Notes. Prospectuses were issued for a nominated sum, but with the proviso that the company reserved the right to accept oversubscriptions (Clarke, et al., 2003).

In the first trust deed (July 1958) the Equity Trustees Executors and Agency Co. Limited were required to monitor RMA borrowings limited to five times the shareholders' funds as shown in the audited accounts (Murray & Shaw, 1963). As RMA was the banker for the RMG any increase in RMA shareholders' funds had to be financed by a loan from RMA to RMH. However Section 56 of the Companies Act 1958 provides:

> *(1) Subject to this Act it shall not be lawful for a company to give, whether directly or indirectly and whether by means of a loan guarantee or the provision of security, or otherwise, any financial*

assistance for the purpose of or in connexion with a purchase or subscription made or to be made by any person of or for any shares in the company

Provided that nothing in this section shall prohibit

(a) Where the lending of money is part of the ordinary business of a company, the lending of money by the company in the ordinary course of its business (Murray & Shaw, 1963, p. 42).

RMH sought legal advice from the company solicitors as to whether the scheme would be in contravention of the provisions of Section 56. The legal advice was positive that the scheme could go ahead.

However, after the collapse, the inspectors had a contrary view stating:

> *It appears to us that this advice was misconceived, for under the proviso to section 56 lettered (a) it is not enough that the lending of money be part of the ordinary business of the company but it is also necessary that the lending of the particular money by the company be made in the ordinary course of its business.*
>
> *We do not think that it could ever properly be said that a loan made by a company to another company specifically for the purpose of enabling the second company to take up shares in the first company with that money could be said to be a lending made in the ordinary course of the business of the first company. However this may be, the advice tendered by the solicitors was accepted and the scheme was implemented. Thereafter the maintenance of the paid up capital of RMA was a matter of no difficulty at all, because as soon as funds representing capital were paid to RMA by RMH, RMA at once paid back those funds to RMH and each*

> *of the transactions amounted to nothing more than a simple exchange of cheques* (Murray & Shaw, 1963, p. 42).

With the financial press writing favourable reports about the group and the capital market in a very liquid state, oversubscriptions provided a surplus of cash that the company had to invest in profit making enterprises. The company invested in vacant land for development, purchased at the top of the market and when the credit squeeze was imposed, the value of the land fell, and could only be sold at 'giveaway' prices.

As mentioned in Section 4.3, the credit squeeze initiated by the government in November 1960 had an immediate effect on companies that were poorly managed and over extended with borrowings from both banks and depositors in the form of bank overdraft, debentures and unsecured notes. RMA normally relied upon a net inflow of debenture funds with most existing investors converting their existing certificates into new loans and new investors exceeding those investors cashing in their debenture certificates. However one month after the announcement of the credit squeeze the net inflow turned into a net outflow for December 1960 of £500,000 and the overdraft with the National Bank rose to £3.5 million from its agreed limit of £3.25 million (Sykes, 1998).

In May 1962 RMA issued a prospectus for £250,000 with a right to receive oversubscriptions of £1.65 million. Debenture issues from finance companies are normally divided into two components. The first component is the amount sought to be raised by the issue which is underwritten and the second component is the amount of oversubscriptions which are not underwritten. The 1962 prospectus, the last ever issued by RMA, raised a further £920,000 excluding conversions i.e. investors reinvesting their expired certificates.

Debenture surpluses (the amount of inflow exceeding the outflow) for June and July were small and in August and September net deficiencies of £110,067 and £158,079 respectively were recorded (Sykes, 1998). As a result of the net outflow of debenture raising from the May prospectus, in the August-September period, the National Bank became very alarmed as both the creditors and overdue creditors had considerably increased. Future debenture raisings would be put under a great strain if the accounts for the year to August 1962 showed a loss.

RMH announced on 19 November 1962 it had lost more than £1.5 million in 1961-2 on trading operations, and would write several million pounds off the amount of its retail debtors and development land. It also applied to the courts for approval for a scheme of arrangement. However, it is not clear whether the Scheme was granted.[5]

The trustees for the debenture holders, Equity Trustees, were granted the right to appoint a receiver to RMA. The receivers appointed on 10 January 1963 were two Chartered Accountants, C.J.Waugh and E.H. Niemann, from Hungerford Spooner and Kirkhope Chartered Accountants, an experienced firm of liquidators. They were also appointed official liquidators of RMH on the same date (Sykes, 1998). In April 1963, the Attorney-General of Victoria appointed senior Queen's Counsel, B.L.Murray and B.J.Shaw, inspectors to conduct an investigation into RMH and certain of its subsidiary companies including RMA. The companies had been declared in April 1963 under Division 4 of Part VI of the Companies Act 1961. When a company is 'declared', inspectors are

[5] Schemes of Arrangement are a flexible form of court approved corporate reconstruction and/or amalgamation as per Part 5.1 of the *Companies Act 2001*.

appointed. The details of this process are explained in the Companies Act of 1961 which states:

> *A declaration shall not be made in respect of a company or foreign company in pursuance of this section unless—(a) the Governor in Council is satisfied that a prima facie case has been established that, for the protection of the public, the holders of interests to which the provisions of Division 5 of Part IV apply or the shareholders or creditors of the company or foreign company, it is desirable that the affairs of the company or foreign company should be investigated under this Division; and* Section 173 (1) states;
>
> *The Governor in Council may appoint one or more inspectors to investigate the affairs of any company to which this Division applies and to report thereon in such manner as the Governor in Council directs* (Victorian Government, 1961, p. 589).

While, in the case of RMH the inspectors claimed not to be accountants, they did acknowledge that they received *every assistance …from various members of the firm of Fuller King & Co…from the liquidators, and from the various receivers and managers now in control of subsidiaries (*Murray & Shaw, 1963, p. 109).

Fuller King & Co, Chartered Accountants, were the RMH auditors.

In a final parting comment, the inspectors stated that:

> *In the course of our investigation we consulted executives of several*

finance companies and a number of independent practising accountants for instruction in their special mysteries. We do not name them and we have not always agreed with their views but we derived much assistance from our discussions and we express our gratitude (Murray & Shaw, 1963, p. 110).

Mr. B.L.Murray QC was subsequently appointed Solicitor-General of Victoria and presented a paper to the Western Australian Law Society's Summer School in February 1966. The paper was entitled 'Conflict within Companies'. The paper was printed and circulated to ICAA members and the Victorian ICAA Committee invited Mr. Murray to present the paper to the members at the 14th Annual Victorian Congress on 18 March 1967.

At the commencement of the speech Mr. Murray made reference to the unexpected nature of the corporate collapses stating:

Perhaps the most disturbing feature of the spectacular company failures which have occurred in Australia during the last half decade is that in most cases the public continued to invest money in the companies until a relatively short time before the collapse occurred… (Murray, 1967, p. 828).

Further, in a strong criticism of stockbrokers, solicitors, bankers and accountants, he said that:

It therefore follows that many of these advisers were unable, by a perusal of the published accounts and prospectuses, to see any indication of the failure which was to occur (Murray, 1967, p. 828).

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4.4.3. Investigation

The inspectors decided to split the investigation of RMH into two parts. The first part was to look at the companies as a group. There were more than two hundred and twenty subsidiaries:

> *As our investigation proceeded we became conscious that the affairs of the companies had two aspects each of which required separate examination before such affairs could be properly understood. The first aspect was that in which each company or group of companies is seen as a single and distinct entity. This view directs attention to the details of the particular business and to the individual transactions and dealings of each company or group of companies* (Murray & Shaw, 1963, p. 3).

The second aspect referred to by the inspectors was to look at the affairs of some of the subsidiaries on an individual basis. After proceeding for some time in their investigation the inspectors took the view that although each company or group of companies in the group had its own individual story, vital factors in that story were common throughout the group:

> *For these reasons we decided to report separately on the group as a whole on the one hand and on the individual companies on the other, subject to this, that our report on the group as a whole would necessarily involve a report also on the affairs of Reid Murray Holdings Limited and Reid Murray Acceptance Limited, since the affairs of these companies are inextricably involved in the affairs of the group* (Murray & Shaw, 1963, p. 3).

The management of the company and its subsidiaries were criticised in the investigator's report: *The best of the group's executives were second class. The others were worse* (Shaw, 1966, p. 93). Inspector Shaw stated that *RMH failed to provide overall management for the group. CEO O'Grady's theory was that managers of companies acquired by RMH could be relied upon to manage their companies efficiently* (Shaw, 1966, p. 92).

The first prospectus of nine issued by RMA during the period July 1958 to May 1962 stated that the chief function of RMA was acting as financier for RMH although it would *seek any sound finance business available outside the group* (Clarke, et al., 2003, p. 56). The amount sought by most prospectuses was £1million, but as previously noted, oversubscriptions were accepted.

Two of the main factors affecting the solvency and thus the wealth of RMH were first the lack of proper assessment of bad debts and lack of a correct Provision for Doubtful Debts, and, second the lack of a meaningful valuation of the considerable land holdings held in a subsidiary company which were displayed as a current asset in the financial accounts.

Looking back on this, as a Current Asset the land was treated as trading stock instead of a fixed asset for long term development. Therefore costs associated with the retention of the land for development such as interest were added to the historical cost, reducing the interest expense in the Profit and Loss Account and increasing the value of the land treated as stock. The land value in the books of account was inflated over historical cost with no adjustment made for a reduction in the market value of the land, which was valued by professional valuers at £750,000 less than the value in the books of account.

The investigators concluded with the comment:

> *We believe that it follows that the accounts of the group must have fallen short of their supposed objective- namely that of presenting a true and fair view of the state of the affairs of the group and of the results of its operations* (Murray & Shaw, 1963, p. 107).

The investigators stated that their criticism of the financial accounts and records of RMH would not be accepted by the accounting profession generally, however, they added that:

> …*common sense has compelled us to reject a number of the accounting practices used in the group and, apparently, regarded as acceptable by accountants* (Murray & Shaw, 1963, p. 107).

Subsequent Companies Acts also referred to the 'full and fair', 'true and correct' and 'true and fair' qualitative standard. In this case study the RMH group was subject to the *Companies Act of 1961* and the true and fair qualitative standard is imposed in many sections and paragraphs of the Act. Part VI of the act refers to accounts and audit and in Section 161(1):

> *Every company and the directors and managers thereof shall cause to be kept in the English language such accounting and other records as will sufficiently explain the transactions and financial position of the company and enable true and fair profit and loss accounts and balance-sheets and any documents required to be attached thereto to be prepared from time to time, and shall cause those records to be kept in such manner as to enable them to be conveniently and properly audited* (Victorian Government, 1961, p. 576).

4.4.3.1. The First Interim Report

Reid Murray Holdings Limited and certain subsidiaries including Reid Murray Acceptance Limited

The first report by the inspectors was an interim report into the affairs of RMH and certain subsidiaries including RMA. The inspectors criticised what they termed *the complete lack of reality shown* (Murray & Shaw, 1963, p. 107) in the 1961 accounts published by the group.

The directors' report attached to the 1961 financial accounts was favourable and was accompanied by the supportive directors' and auditors' certificates. However, the inspectors found that the true position was very different. In the absence of a cash flow statement there was no disclosure that the group had been desperately short of liquid funds for over a year and had been delaying payment of their trade creditors.

The group's bankers, the National Bank of Australia, had been exerting strong pressure on the group throughout the year to reduce its overdraft. Instead RMH actually arranged and used an additional stand-by overdraft with the Commonwealth Bank.

The directors of RMH referred to the group's credit retailers as the *backbone of the business of the group* however the inspectors referred to the results of those retailers for the 1961 year as *catastrophic* (Murray & Shaw, 1963, p. 107).

This assessment, by the inspectors, ignored the changed method of accounting during the year from normal simple interest calculation where the interest portion of the loan is spread over the entire loan to the Rule of 78. See explanation below:

> *Rule of 78*
>
> *A practice in which lenders amortise repayment of short-term loans in a way that the borrower pays most of the interest earlier. For example, in a 12-month loan, the borrower will pay nearly all of the interest over the first, say, six or seven months before his/her payments cover any principal at all. The Rule of 78 guarantees that the lender will still make a profit if the borrower repays the loan early. However, it does not do anything to protect the borrower and it is illegal to use for loans with a term longer than 61 months* (Farlex Financial Dictionary, 2012).

Fuller King & Co, the auditors for RMH referred to the change to the Rule of 78 in a letter to the directors regarding the financial accounts for the year ended 30 June 1961. While considering the Rule of 78 a reasonable basis of calculating income yet to mature they issued a strong message about the way the method should be used correctly:

> *… but we draw attention to the fact that the accuracy of this accounting concept is dependent upon instalments being collected when due. If instalments are in arrears the 78ths method will bring into account an excess of income for the year, unless an adequate provision for doubtful debts is charged against earnings for the period to provide for instalments not yet received and which might ultimately prove to be uncollectible. We defer a further consideration of this point as it is relative to our comments later in this report upon provisions for doubtful debts* (Murray & Shaw, 1963, p. 114*).*

The change from the simple interest calculation to the Rule of 78 method of accounting for the year ended 30 June 1961 was voluntarily decided by the directors on 29 June 1961. Table 3 shows the immediate benefit to the bottom line for that year. However, as shown by the changes made to the 1961 accounts after the collapse of the RMH group, the directors did not heed the warning from the auditors and provide adequately for doubtful debts in relation to the retail debtors repaying their loans under the Rule of 78 method.

Table 1: Profit increase Rule of 78

The following table summarizes the effect on the group's consolidated profit for the year resulting from the change in the method of computing income yet to mature:

Group of Companies.	Effect on Profit. Increase.	Decrease.
	£	£
Paynes Bon Marche	403,868	..
Ron Shaw	..	121,750
Reid Murray Acceptance	106,641	..
John Allan	..	54,040
Saverys	17,000	..
David Murray—finance companies	15,301	..
Lavis	6,417	..
Hicks Atkinson	6,386	..
Shillidays	2,784	..
	558,397	175,790

giving a net increase in profits of £382,607.

(Murray & Shaw, 1963, p. 114)

In addition to the capital raised from the issue of shares, RMH raised substantial amounts of cash from the issue of first mortgage debentures. The debentures were usually issued for a short term, from one to three years and were secured by a mortgage over the assets of the company and subject to monitoring by independent trustees.

The amount of debentures due to mature in 1963/64/65 totalled £19 million and, as the group collapsed in April 1963, there was no hope of borrowing further funds to meet the maturities. By April 1963 the large sum borrowed meant the quarterly interest bill was in excess of £500,000 (Murray & Shaw, 1963). In reality this meant a type of Ponzi[6] scheme had been in place whereby the new inflow of funds from debentures were relied upon and used to repay interest

[6] The term Ponzi scheme is used in this thesis where existing claim holders were repaid from new investors that were promised high returns.

and principal of debentures maturing (U.S.Securities and Exchange Commission) (SEC).

A Ponzi scheme is defined by the SEC as:

> *…an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors. Ponzi scheme organizers often solicit new investors by promising to invest funds in opportunities claimed to generate high returns with little or no risk. In many Ponzi schemes, the fraudsters focus on attracting new money to make promised payments to earlier-stage investors to create the false appearance that investors are profiting from a legitimate business* (U.S.Securities and Exchange Commission, p. 1).

The inspectors made the observation that none of the matters subject to their criticism were disclosed adequately in the financial accounts and recommended that the published accounts of the group should have reported more information than the consolidation of the results by the subsidiaries. They suggested that the results of the subsidiaries that made a net trading loss during the year and the extent of the loss should have been disclosed in a more explicit fashion.

The inspectors were generally critical of the lack of disclosure in financial reporting and the lack of disclosure of subsidiary companies information that was facilitated by consolidated accounting methods and intercompany adjustments (Murray & Shaw, 1963).

The two largest investments by the group were in land and debtors. Fluctuations in the economic cycle in Australia have always impacted on the valuation of land holdings and because the RMH group purchased during the escalation of prices in the 1959 period the group was vulnerable to any major variation in price of land. As the group had in excess of £7 million invested in land it had *rendered itself startlingly sensitive to variations in economic conditions* (Murray & Shaw, 1963, p. 108). The large investment by the group in land meant that if there was a demand for readily available cash in the group, the funds invested in land were out of reach.

Analysing this in the current day, it would appear that land purchased for development would not be expected to be sold within the next twelve months and classifying it as a current asset was incorrect and presented a misleading statement of the value of current assets. Also capitalizing interest paid in connection with land development transactions is a common occurrence providing that such addition to the book value of the asset does not ultimately have the effect of increasing the book value beyond current market value(cite source). The auditors Fuller King & Co went further:

> *Because every allotment of land is different it is very difficult to evaluate whether the cost carried in the books is above or below the market value at balance date, and it is important that such an assessment be made in order that the balance-sheet may present a true and fair view of the state of the company's affairs. The responsibility for making this appraisal must rest with the directors who, if in doubt as to values at which certain*

> *projects are being carried, should take such steps as are necessary to have independent valuations made* (Murray & Shaw, 1963, p. 114).

The other main asset of the group was retail debtors. The debtors were retail customers who had purchased goods from the group and usually had an arrangement to repay the debt on a time payment plan. The amount owing by the end of 1960 by debtors exceeded £30 million.

There were significant amounts of cash coming into the group from debenture issues, without proper strategic planning as to how the funds were to be spent. Credit was extended to debtors with poor credit ratings and other debtors were given credit on amounts far beyond their ability to repay (Murray & Shaw, 1963). This strategy has contributed to many corporate failures over the last 50 years and was one of the main causes of the GFC in the US and Australia (Sykes, 2010).

However, when the credit squeeze was introduced in November 1960 and the debenture cash inflow started to dry up the RMH group was lacking in self-funded working capital which meant that the debtors had been funded by borrowed money. Any bad debts would thus reduce the capacity of the group to repay the borrowed funds used for credit transactions. In the first Interim Report, the inspectors came to the conclusion that the failure of the Reid Murray Group was not caused by large scale fraud and dishonesty but simply: … *the business of the group was badly run. It borrowed without thought and invested without wisdom* (Murray & Shaw, 1963, p. 109).

4.4.3.2. The Second Interim Report

Reid Murray Holdings Limited and certain other Companies and Final Report – Payne's Properties Pty Ltd and certain Subsidiary and Associated Companies

The second interim report dealt with the relationship between the Board of Reid Murray Holdings and the Payne's group consisting of the holding company and some 21 subsidiaries.

The inspectors were critical of the accounting principles and practices used by the Payne's group which lead to misleading accounts and fictitious profits. For example, RMA would lend funds to PPL to acquire land. If the land was held for several years RMA would record as income the interest PPL was charged for the advance, but PPL would then capitalise the interest thus excluding the expense from the PPL profit and loss account. In some cases the inspectors found specific instances of fraud.

In what one commentator described as *Reid Murray's largest single disaster area* (Sykes, 1998, p. 306), the land subsidiary PPL stepped up its property activity by undertaking development of a 2,500 acre satellite town at Sunbury west of Melbourne. The plan for Sunbury was to develop a planned town for a population of 40,000 people. (Sykes, 1998) adds that: *the receivers were still selling plots, with houses on them, in 1986* (p.306) some 20 years after the collapse. RMH simply did not have the resources to develop the planned town.

The inspectors concluded that:

The management of Reid Murray Holdings and the directors of Payne's permitted Mr. Borg, who was a Director of Payne's and later a Director of Reid Murray Holdings, so to entangle the business and affairs of his family and himself at the Sunbury land deal with the business and affairs of the Group that he and his family virtually became partners with and in some cases competitors of Payne's in the project, so far as profits were concerned at any rate (Murray & Shaw, 1965, p. 165).

4.4.3.3. Final Report

Reid Murray Holdings Limited, Reid Murray Acceptance Limited and Certain Other Companies

The inspector responsible for the final report, B.J.Shaw QC, revisited some matters raised in the First Interim Report he co-authored with B.L.Murray QC and arrived at conclusions which revealed serious deficiencies in conventional accounting:

…and in summary, we also conclude there are deficiencies in penalties for breaches of the Companies Act 1961. The inspector attributed causes of the losses by the companies under investigation to, inter alia, borrowing for fixed capital as well as working capital, lack of any planning of expenditure and repayment of debenture funds and the management theory failings of the managing director of RMH, Mr O'Grady. O'Grady's theory was that Reid Murray Holdings should not interfere in the management of the group's operating subsidiaries but should leave them to their original managers to control (Shaw, 1966, p. 93).

The inspector, in his conclusions to his final report, made very pertinent comments about matters which he felt, notwithstanding three extensive reports, were left unanswered. These concerns were:

> *Even though it is true that the huge sums lost by the Reid Murray group did not simply disappear into the pockets of its management, but were lost because the group was badly run, and, in any case, was engaged in enterprises of dubious profitability, this does not answer all the questions raised by the Reid Murray failure: other questions, and important questions, remain to be answered* (Shaw, 1966, p. 93).
>
> This final report was presented by B.J.Shaw who went on to summarise his concerns:
>
> *In my view the most important of these questions are the following:*
>
> - *If the group was badly run and was engaged in unprofitable enterprises and suffered its losses for these reasons, how was it that the group appeared for so long to be both well and profitably run?*
> - *How did it come about that in 1961 the group published cheerful accounts showing substantial profits and the directors made a cautiously optimistic report to shareholders when by the time the 1962 accounts came to be published it was clear that disaster had befallen the group?*
> - *How was it, that in May, 1962, Reid Murray Acceptance was able to put out an equally cheerful prospectus, and how was it that that prospectus should have been kept open to public subscription*

until mid-October, 1962, when in November and December, 1962, it became clear that the group had collapsed.

- *These are, in my view, some of the most serious and important questions raised by the Reid Murray collapse* (Shaw, 1966, p. 93).

The major causes of the failure of RMG are summarised in Table 2.

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4.4.4. Prosecutions

In March 1965, Borg a director of RMH and PP was convicted on four fraud offences and sentenced to nine years jail. O'Grady, Wilkinson and Wolstenholme were fined £300 each for making loans to finance share issues while they were directors. Wilkinson and O'Grady were also fined £200 each for having issued a prospectus in 1959 which contained untrue statements. O'Grady again faced court on another prospectus charge in relation to the last prospectus issued by RMA in May 1962. He was fined £400 for having made untrue statements in the document. After decimal currency was introduced in

February 1966, Wolstenholme was fined $400 in a later hearing for the same offence (Sykes, 1998).

In addition to the prosecutions of the holding company directors, there were several prosecutions of directors of certain subsidiaries that were not included in the companies investigated by the inspectors. The Queensland Government appointed Mr. P. D. Connolly QC to investigate the affairs of Reid Murray Developments (QLD) Pty Ltd. His report was presented to the Queensland Legislative Assembly and the Justice Minister Hon. P .R. Delamonthe told the House that:

> *… a copy of the report will be forwarded today to the chief investigator of the Reid Murray group of companies, Mr. B. L. Murray, Q.C., of Melbourne* (Legislative Assembly Queensland Government, 1964, p. 2523*).*

Mr. Connolly reported that the Queensland Subsidiary had declared profits in years when it was actually making losses and that the books of account were inadequate and inaccurate (Sykes, 1998). [7]

In Western Australia, two directors of Reid Murray Developments (WA) Pty Ltd (RMDWA) Peter Charles Sullivan and John Lawrence Simpson were sentenced to jail by Mr. Justice Hale for twelve months and nine months respectively for:

… *with intent to defraud, they caused false entries to be made in the books of three companies* (Anon, 1964a, p. 3).

The other companies involved were two subsidiary companies of RMDWA Brenton Buildings Pty Ltd and Capitol Constructions Pty Ltd. In a classic

[7] Mr. B .L .Murray nor Mr. B. J. Shaw do not appear to mention the document in their reports.

example of the second component of the fraud triangle, perceived opportunity, where the individual perceives there is a low risk of getting caught abusing their position of trust, the two directors stole from the subsidiary Benton Buildings Pty Ltd 821 Joywoth bricks and a quantity of electrical fittings which were used in the construction of a swimming pool in the backyard of Sullivan's home. (Anon, 1964a) Further analysis and application of the theoretical frame work in this thesis is discussed at the end of this chapter.

4.5. Case Study 2 – Stanhill Development Group

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4.5.1. Background

The Korman brothers, Stanley and Hilel, incorporated Stanhill Pty Limited (SPL) in 1945 and set up their own textile manufacturing business. The company was a private company and the major corporate vehicle for the Korman family, who held all its share capital. The Stanhill-controlled business often involved related-party transactions that were *full of intrigue – complex almost beyond description* (Clarke, Dean, & Oliver, 1997, p. 55). SPL was the forerunner of a string of companies named Stanhill, some of which would be public and some private:

Investors in the public companies would see much of their money disappear into the private ones owned by the Korman family (Sykes, 1998, p. 326).

As an example of complex related party transactions, as early as 1953 the Kormans acquired all the shares in a listed company Chevron Ltd. Early in 1955 Korman refloated Chevron Ltd, a listed company that ran a private hotel in St Kilda Road, Melbourne, under the name of Stanhill Consolidated Limited (SCL) (Sykes, 1998).

In 1955 SCL issued a prospectus for Debenture Stock and Shares. The funds were to be used to pay the balance of £285,000 owing to a Korman family company, Park Lake Pty Ltd for SCL's purchase of a property called the 'Town House' one of three properties which made up the assets of SCL. The corporate legislation in effect at that time was the Companies Act 1938.

A total lack of disclosure of the conflict of interest in this transaction later brought condemnation from the Inspector, Mr. Peter Murphy, Q.C., who was appointed in August 1963 to investigate the Stanhill Group of Companies. In his final report Mr. Murphy referred to the transaction:

Chevron Pty Ltd was a wholly owned subsidiary of SCL, clause 8 of the Fourth Schedule of the Companies Act 1938 required that the name and address of the vendor of any property purchased . . .by any subsidiary company . . . which is to be paid for wholly or partly out of the proceeds of the issue offered for subscription by the prospectus must be set out. Moreover, the amount payable in cash, shares or debentures to the vendor must be stated, and in the case of real property, as was the case

> *here, full particulars of the nature and extent of the interest (if any) of every director of the company . . . . in any sale or purchase within the two preceding years of such real property , must be set out in the prospectus* (Murphy, 1967, p. 14).

The Inspector concluded by stating; *it was reprehensible that this statutory information was not given.* (Murphy, 1967, p. 14).

An examination of paragraph (c) of part 1 of the 5th schedule of the 1961 Companies Act, discloses a similar responsibility for disclosure of information:

> *Short particulars of any transaction relating to the property completed within the two preceding years in which any vendor of the property to the company or any person who is, or was at the time of the transaction, a promoter or a director or proposed director of the company had any interest direct or indirect* (Victorian Government, 1961, p. 747*).*

Another company brought into the SCL group was Factors Limited (Factors). Factors was originally incorporated in the year 1923 under the name The Automobile Finance Company of Australia Limited. The Company engaged mainly in the business of hire purchase which financed the purchase of used motor cars. It was in October 1957 that Stanley Korman successfully completed negotiations with Factors which gave him a majority representation on its Board. The consequent control of its affairs gained by him was later to enable SCL to channel some £2 million of Factors' money into various enterprises with which Stanley Korman was associated. Twenty five years later Alan Bond from Bond Corporation Holdings Ltd behaved in a similar fashion channelling some $1.2 billion from the Bell Resources Group of companies to various companies with which Alan Bond was associated, such action led him to be charged with fraud.

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4.5.2. Collapse

The story of the collapse of the Stanhill/Korman group centres on the corporate behaviour of the co-founder of the group, Stanley Korman.

Mr. Murphy in his third and final report said:

> *It cannot be said that the collapse of the Korman Group was wholly caused by the disregard of the provisions of the Companies Act or of the principles underlying those provisions. But it seems clear that this collapse would have caused far less harm to the public if these provisions had been complied with* (Murphy, 1967, p. 169).

The inspector also noted:

> *The facts set out in this report make it abundantly clear that Stanley Korman was first and foremost interested in the financial welfare of his family companies and of his family. When the public interest conflicted with his own interest, the public interest was forsaken* (Murphy, 1967, p. 168*).*

An example of the conflict between a public company that Korman controlled and Korman's family companies was the money raised by Factors between 6 February 1958 and 31 July 1960 and its dispersal to Korman family interests via a Factor's subsidiary General Investments and Discounts Pty Ltd (GID):

- The total sum raised by Factors from the public was £4,537,857:
- Loans by Factors to its subsidiary GID £2,927,293: and
- Loans by GID to Korman family companies £1,088,972 (Murphy, 1965-66).

As the funds borrowed by Factors from the public were costing between 8.5% and 9% interest, inspector Murphy referring to accepting over-subscriptions totalling approximately £500,000, concluded:

> *I have seen no evidence to show that there was any budgeting or planning by the Directors before such over-subscriptions were accepted, but if there was, it could hardly have been contemplated that advances to the family companies for five years at seven and a half per cent or nine per cent interest would be a justifiable use of these moneys* (Murphy, 1965-66, p. 116*)*.

Therefore, 24% of every pound raised by Factors over the three years was siphoned into the Korman family companies (Sykes, 1998).

It is generally acknowledged that the primary duty of a director is of a fiduciary nature. The director must act honestly, with trust, in good faith and in the best interests of the company (Clarke, et al., 1997). This certainly was not the case with the directors of companies in the Stanhill Group. The following is an example of one of the many ways the directors acted contrary to their fiduciary duties.

Stanhill Development Finance Ltd (SDF) was incorporated in 1959 to acquire properties from Stanhill Consolidated Limited (SCL) and issued a prospectus in July 1960 offering £750,000 in 5 shilling shares and £2 million in Registered Unsecured Notes. The issue was heavily oversubscribed. The funds were to be used, according to the prospectus, for:

- providing finance for industrial undertakings to purchase properties:
- acquiring sites and erecting buildings on a lease-purchase arrangement:
- acquiring sites for subdivision:
- acquiring sites for development:
- financing unit developmental projects:
- financing suitable development projects such as regional centres:
- lending funds on mortgage: and
- underwriting development finance.

In a total breach of trust, the actual disposition of the funds was completely different to the aims set out in the prospectus. Almost the entire funds of the company were diverted into other related companies that needed a cash injection (Clarke, et al., 1997).

Inspector Murphy commented that the 1960/61 credit squeeze was a shock which most well administered and income earning companies were able to withstand (Murphy, 1965-66).

According to the Inspector, the Stanhill and Factors group were certainly not well administered. For example, a subsidiary of Factors, Rockmans Limited, collapsed and, as a result, the creditors of Rockmans and Factors debenture holders lost a total of £4 million (Murphy, 1965-66).

The affairs of the Stanhill Group were complex and confusing. Another set of transactions in which the Korman family companies were enriched at the expense of the public companies, were a group of land transactions. Late in 1957, two Korman family companies, Stanhill and Dominion, purchased land for £227,250 as part of Korman's plan to develop a satellite township to be named Woodlands Estate and then sold it only months later to Stanhill Estates, a subsidiary of SCL, for £515,010, a profit of £287,760 to Stanhill and Dominion (Murphy, 1967).

The effect of the November 1960 credit squeeze meant the Stanhill group were in financial trouble. A quick fix was needed for companies in the group that had large debt obligations as a result of property purchases bought at inflated prices and a cheque 'round robin' came to the rescue. The inflated prices were then used as a means of refinancing.

Inspector Murphy explained:

> *In my opinion the Round Robin is the most telling transaction in which S.C.L engaged. It is not difficult to see why it was negotiated by Stanley Korman in a furtive manner. It was, in effect, a refined arrangement whereby money was taken from the public company, S.C.L., and paid to Stanhill. This unjust enrichment of the Korman family was effected at the*

> *expense of the public company, S.C.L., and indirectly at the expense of the public company S.D.F.*(Murphy, 1965-66, p. 149).

He went on further to say, *inter alia*, that the actions taken in executing the Round Robin:

> *…stamp the Round Robin as a fraud on the public companies (Murphy, 1965-66, p. 150).*

A diagram of the Round Robin is provided in Figure 4:

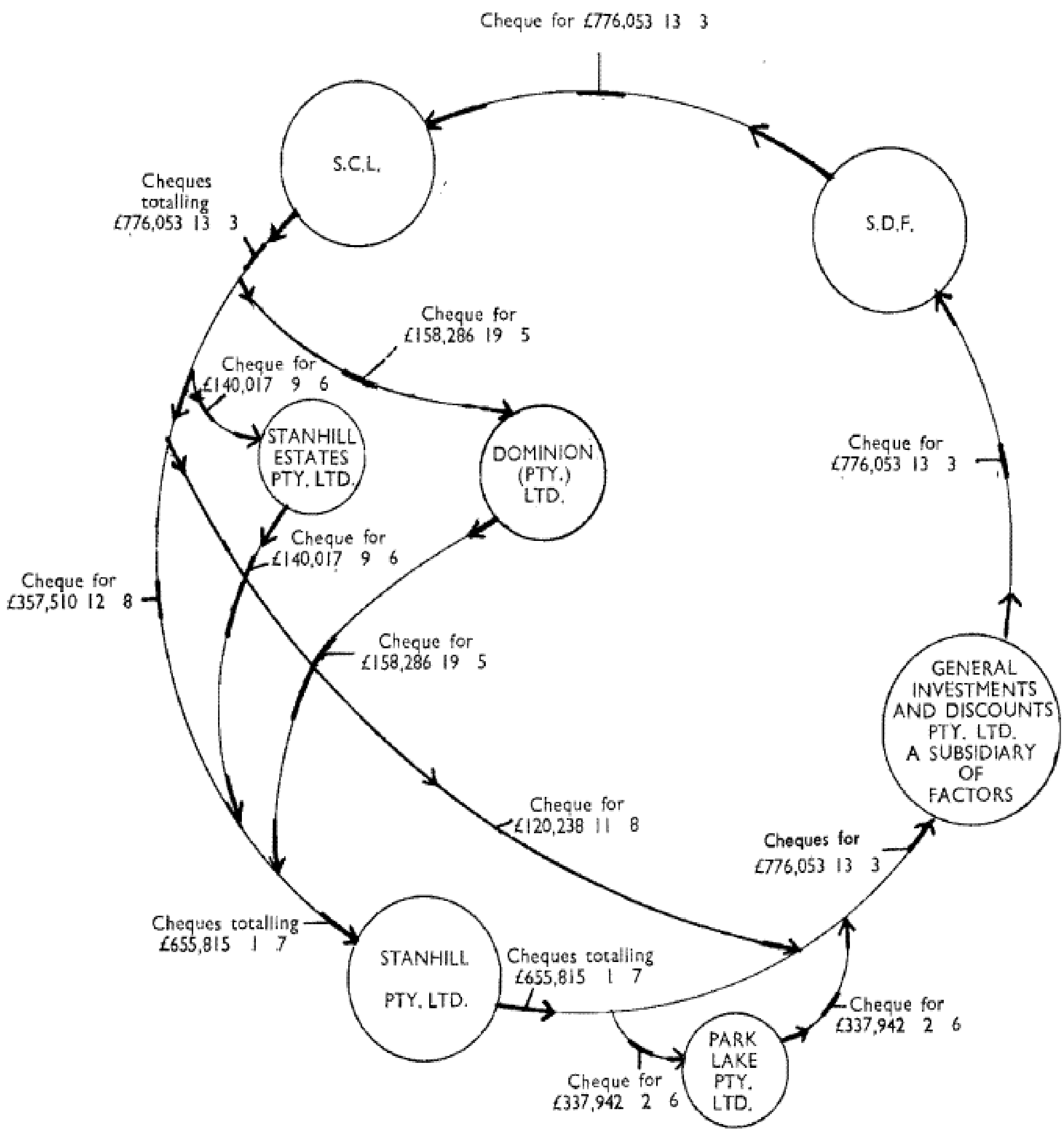

Figure 4: Stanhill Round Robin of cheques (Murphy, 1964, p. 41)

A Round Robin is a transaction which depends upon simultaneous passing of cheques from one company to a second company to a third company, then back to the first company. No money changes hands. In Figure 4 above the overall effect of the complex cheque transactions was to eliminate the debts owing to SDF from the Factors Group and substitute SCL as the debtor.

The collapse of the Stanhill Group was due to many reasons. The loans from the public companies to the Korman family companies were a major cause of cash flow problems in the listed companies. The creation of artificial valuations on land purchased by the public companies at inflated prices from the Korman family companies were transactions not at arm's length where the parties to the transactions were not independent of each other.

The main concerns of the Stanhill Group included large sums which were owing by family companies which would not, or could not, repay. The management of the group was disorganized and the operating listed public companies were starved of working capital and they replied on borrowed funds for survival. The major cause of the group's collapse was the building of the Chevron Sydney.

Summarising the cost overruns on the building the secretary of the company advised the Sydney Stock Exchange the cost of the first stage of the two stage project to build the hotel would be about £1.25 million and the total project would be about £3.5 million. It actually cost £5.5 million just to complete the first stage and the second would never be completed. Failure to build the hotel within the estimated cost also destroyed the earning rate, which turned out to be negative (Sykes, 1998).

On 14 February 1963, following a debtor's judgement for £2,113,219, a receiver was appointed to SDF. Finally the financial facts were being publicly revealed. The public arm of the Stanhill Group had collapsed. SCL and its subsidiaries, Stanhill Estates and Dominion, ended in liquidation (Clarke, et al., 1997).

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4.5.3.Investigation

The Government appointed Peter Murphy QC as inspector in August 1963. The affairs of the SCL group were examined by the inspector and he produced three reports. As sole inspector he outlined in his final report the assistance he had received from accountants and in fact acknowledges that without certain help it would not have been possible to do the job,

Mr. Murphy's action in engaging an accountancy firm and his expression of appreciation to them for assistance is a stark contrast to the approach of Mr. B.L.Murray in the Reid Murray collapse who openly displayed an apparent antipathy towards the accountancy profession. There would undoubtedly be value in having a suitably qualified accountant as a member of any panel of inspectors for future investigations of unexpected corporate failures. It would appear a logical step to take as the majority of the inspectors' tasks involve matters of an accounting nature.

The inspector estimated the losses of the Stanhill group to be approximately £24 million. As there was no national corporate legislation it was necessary to appoint inspectors in each separate State according to the State Legislation in force at the time. As a result Inspector Murphy was also appointed an Inspector in New South Wales in October 1963 and also appointed an Inspector in Queensland in December 1963. The group of eleven companies was declared under Division 4 of Part VI of the Companies Act 1961 under the corresponding divisions of the companies acts of those states (Murphy, 1964).[8] All companies were related to the Korman family and four of them were public companies listed on the Stock Exchanges. The public companies were Stanhill Development Finance Limited (S.D.F.), Stanhill Consolidated Limited (S.C.L.), Factors Limited (Factors), and Chevron Sydney Limited (Chevron).

4.5.3.1. The First Interim Report

Stanhill Development Finance Ltd

The inspector chose to report first upon the affairs of SDF and the reasons given were that:

> *This Company was the last of the public companies to commence its operations, it was without any subsidiaries, and its activities, I believe, may fairly be taken as characteristic of the more complex activities of the other public companies upon which I shall report as soon as possible* (Murphy, 1964, p. (i)).

It is important to note that the inspector states that Korman and the directors of SDF considered in their minds the other companies controlled by them as a 'Group' notwithstanding in the eyes of the law each company had a separate

[8] An explanation of the meaning of being 'declared' is located in case study no.1 at 4.4.2.

legal entity. The companies were SCL, Factors, Chevron, and several private companies owned by the Korman family, Stanhill Pty Ltd, Park Lake Pty Ltd. Stanhill Estates Pty Ltd and Dominion (Pty.) Ltd (Murphy, 1964).

It was the intermingling of the public and private companies and the concept of the group, together with the large number of subsidiaries, that created the opportunity for manipulation of the affairs of all companies under the control of Korman. Stanhill Development Finance Ltd acted in a similar way to Reid Murray Acceptance Limited in Case Study No.1. Both companies were used as 'cash cows' (bankers) for the respective group of companies although when making representations to the public when issuing a prospectus, no mention was made of any prospective deviation of the subscribed funds to uses other than those uses listed in the prospectus. In the case of SDF the prospectus issued on 27 July 1960 raising £2.75 million the page titled Objects of the Issue states *inter alia:*

> *In particular the company will:-*
>
> *(a) Provide finance for industrial undertakings to purchase properties.*
>
> *(b) Acquire sites and erect buildings on a lease-purchase arrangement.*
>
> *(c) Acquire sites for subdivision for sale as house building allotments.*
>
> *(d) Acquire sites for development on the unit principle as homes, medical suites and offices.*
>
> *(e) Finance unit developmental projects on a profit participation basis and/or underwrite such projects.*
>
> *(f) Finance suitable development projects such as regional centres, housing schemes, &c., on a profit participation basis.*

(g) Lend funds on mortgage.

(h) Underwrite wholesale development finance (Murphy, 1964, p. 18).

In fact, it would appear that none of the particular objectives listed were actually achieved. Although not illegal, the act of not carrying out intended objectives brought a scathing attack on the directors by the Inspector who said, in his concluding remarks:

> *It is my opinion that the directors paid no regard to the representations contained in the prospectus, when using the funds of the issue. They simply used the moneys available when and if financial assistance was needed by another company regarded by the directors as part of the Group* (Murphy, 1964, p. 72).

The directors' actions were in complete disregard of the fact that SDF was a separate entity and as such had its own separate legal obligations under the Companies Act. All of the funds raised by the prospectus, i.e. £2.75 million were dispersed by lending to other companies, both private and public in which Korman was interested (Murphy, 1964). Apart from ignoring stated intentions for the use of funds made in the prospectus, the directors did not make any attempt to obtain security for the advances made to companies within the group. Debenture holders were usually comforted by the Debentures being secured by mortgage over the assets of the company. The actions by the directors meant that if the Korman group company that received unsecured loan funds failed, there could be no recourse for the debenture holders because of the lack of security. Consequently, when the company failed the shareholders and noteholders lost the sum of £2.76 million.

Further criticism of the directors by the inspector was in relation to the conflict of interest when advances were made from SDF to other companies within the group. In almost every case the directors of SDF were also directors of the borrowing company. The inspector formed the view that such loans were considered by SDF's directors from the point of view of the borrower and not the lender. Normal prudence and due diligence, see (a) to (f) below, when assessing a borrowers' application for loan funds were completely ignored by the directors of SDF Inspector Murphy stated:

> *If the borrower accepted the rate of interest offered, the directors appear to have given no thought to:-*
>
> *(a) what security was to be provided;*
>
> *(b) the value of any such security;*
>
> *(c) the actual production of the security;*
>
> *(d) the solvency of the borrower;*
>
> *(e) the use to which the advance was to be put by the borrower;*
>
> *(f) the general wisdom from SDF's point of view, of making the advance in all the circumstances prevailing* (Murphy, 1964, p. 73).

The inspector found that those in charge of the investment of the cash raised by the company had little or no regard for their duties as officers of a public company. He also found that it was difficult to find any occasion where the directors considered solely the interests of the shareholders and noteholders of SDF (Murphy, 1964). This attitude is explained by agency theory (see section 2.2).

4.5.3.2. The Second Interim Report

Factors Ltd.

The second interim report by the inspector Peter Murphy QC (the inspector) deals entirely with Factors Limited (Factors), part of the Stanhill Group of Companies, and its 80 subsidiaries. In the report the inspector examined the period from December 1957 when Stanley Korman was appointed a director of Factors up to April 1963 when a receiver was appointed.

In April 1963 receivers were appointed by the Bank of New Zealand (a secured creditor) and The National Trustees, Executors and Agency Company of Australasia Limited (the Trustee for noteholders and debenture holders).

The report also has a wide ranging review of the company from April 1963 until the date of the finalization and lodgment of the report with the Attorney General in May 1966. There was a sense of urgency from the investigator to lodge the report with the Attorney General at the earliest moment due to the facts revealed during his investigation when he said:

> *It appears to me that many investors and shareholders would be assisted in making their assessment of the future prospects of the company if they were able to consider its past history, and the apparent reasons for the huge losses sustained (*Murphy, 1965-66, p. ii*).*

Factors was in business as a Hire Purchase Company without subsidiaries for more than 30 years until 1957 when Korman became a director. In similar ways to Stanhill Consolidated Limited under Korman's aggressive management style, Factors rapidly expanded and diversified its activities.

Holeproof Industries Limited and Rockmans Limited

Funds for the expansion were subscribed by the public and mainly used to takeover well-established businesses and form a multitude of subsidiaries. The main well-established businesses acquired by Factors were Holeproof Industries Limited in Australia, Holeproof Industries Limited in New Zealand both clothing manufacturers, and Rockmans Limited (Rockmans). Rockmans had been a public company since 1950 and under the management of the Rockman family it had built a chain of 81 drapery stores and was represented in all states except Western Australia (Sykes, 1998).

The Holeproof companies and Rockmans were trading profitably at the time of acquisition and, with the exception of Rockmans, continued to trade profitably until the Stanhill Group collapsed.. The inspector goes on to state that, following the takeover, Holeproof (N.Z.) and Holeproof (Australia), continued to operate under the same management as before and therefore appeared to have received little or no interference from the Stanhill Directors of Factors. Both companies continued to prosper. However there was harsh criticism from the Inspector regarding the administration of Rockmans:

> *On the other hand, Rockmans was, as I have already set out, administered by Mr Korman and his new policies wrecked it* (Murphy, 1965-66, p. 176).

The financial results of Factors and its newly formed subsidiaries after Korman became a director in 1957 showed it earned a profit of £10,000 in 1959 and thereafter incurred losses. The Credit Squeeze in November 1960 had little to do with the collapse of Factors according to the opinion expressed by the inspector (Murphy, 1965-66).

The major criticisms by the inspector were directed at Korman and parts of the Companies Act. The inspector's final words of the whole report were directed at Korman:

> *…what the evidence does show is that, whatever accounting should now be demanded of Stanley Korman, he has shown himself to be wholly unfit to direct any company in which the public may be induced to repose its trust or invest its money* (Murphy, 1965-66, p. 186).

The criticism of the Companies Act was mainly directed at the provisions of the 9th Schedule of the Companies Act 1961 relating to Consolidated Accounts. The inspector noted that this criticism was one *on which all witnesses were in accord* (Murphy, 1965-66, p. 175). He went on to suggest that amendments and additions to the statutory provisions relating to consolidated accounts should be considered. One of the aspects of the criticism he addressed was the Group concept that enabled the non-disclosure of subsidiary companies' profits or losses. Therefore with so many subsidiaries it was possible to show a consolidated profit for the group and conceal substantial losses incurred by unprofitable subsidiaries (Murphy, 1965-66). Clause 4 of the 9th Schedule Of the Companies Act 1961 provided that where a company has a subsidiary or subsidiaries in which it holds more than 50% of the share capital, then apart from publishing its own profit and loss account and balance sheet the holding company has two alternatives. It must annex to its balance sheet and profit and loss account either:

(a) a balance sheet and profit and loss account consolidating the accounts of

all such subsidiaries with its own, after eliminating all inter-company balances and transactions ;

or

(b) separate balance sheets and profit and loss accounts for each such subsidiary (Murphy, 1965-66, p. 177).

4.5.3.3. The Third and Final Report

Stanhill Development Finance Limited and other Companies.

On 20 November 1967 the Stanhill Group Inspector Peter Murphy QC delivered to the New South Wales Attorney-General his third and final report of the investigation into the Stanhill Consolidated Group. While mentioning that the investigation had taken more than three years, the inspector deemed it unnecessary to conduct a detailed investigation of all the subsidiaries of Stanhill Consolidated Limited (S.C.L.):

To have done so would have made this investigation even more lengthy than it has been, and I doubt whether anything more would have been revealed than already appears. The activities of each company which I have investigated fall into a similar pattern (Murphy, 1967, p. i).

Delivering his first report in September 1964 on the affairs of Stanhill Development Finance Limited (S.D.F) the inspector commented that the activities of S.D.F.:

…might fairly be taken as characteristic of the more complex activities of the other public companies which I was appointed to investigate. Almost

> *three years have passed, and in delivering this final report, I can say that this opinion has been confirmed by my subsequent investigation* (Murphy, 1967, p. i).

The inspector stated that the third and final report contains numerous instances of the wrongful exercise of lawful authority and breaches of trust. He felt it was necessary to single out the actions of the directors of various Korman companies as to their corporate behaviour:

> *…it is nevertheless appropriate to remark that the directors of S.C.L. and Chevron Sydney acted in an unorthodox and irresponsible manner, seldom considering the individual interests of the companies. They certainly did not consider them in the way that one would expect a reasonably prudent businessman to consider the matter in hand, if his own interests were involved* (Murphy, 1967, p. 167).

Further comments were made by the inspector on the directors' failure to act as required in exercising due diligence and acting honestly in performing the duties of the office of a company director. He stated that *instances of failure to measure up to the standard were legion* (Murphy, 1967, p. 168).

A significant example of misfeasance by the directors of Stanhill Consolidated Limited (SCL) was the involvement of the company with a company known as Australia House Inc. The company was incorporated in New York in 1958 and according to the inspector's findings the company was not part of the Korman 'Group'. It was formed with the express purpose of buying a fourteen story New York building and leasing part of the space to the Australian Government as another 'Australia House'. It was clear from the Inspector that the main two directors of Australia House Inc. were Stanley Korman and Robert J. Eliasberg (Murphy, 1967). Because of the unorthodox conduct of the directors of the Stanhill Group, there was no certainty whether a transaction was being conducted on behalf of a director personally or on behalf of one or other of the public or private companies of which he was a director. However, in the case of Australia House Inc., money advanced by SCL to Australia House Inc. was clearly minuted as being a loan thus SCL was an unsecured creditor. An excerpt from the minutes of an August 1960 board meeting of SCL confirmed this:

> *It was noted that the Company (SCL) only had an interest in this building by way of a loan to Australia House Inc. of New York* (Murphy, 1967, p. 166).

Therefore, a creditor/debtor relationship between SCL and Australia House Inc. was established in the Minutes of SCL.

The auditors Price Waterhouse & Co received confirmation from the Director Robert Eliasberg of the amount owing, £201,830, as a loan from SCL and the balance sheet of SCL included an asset advance to Australia House Inc. £201,830.

Board minutes in September 1960 state the Chairman reported to the board that the Commonwealth of Australia was not interested in taking space. Immediately discussion regarding disposal of the building became an important subject. However on the basis of the August 1960 board meeting minutes, the only interest SCL could have in the disposal of the building would be as a creditor interested in being paid back the total principal of its unsecured loan.

The directors of SCL did not challenge the treatment by Price Waterhouse in the published accounts of the £201,830 as a loan and not as an investment. In the financial year ended 31 July 1961 the financial accounts of Australia House Inc. recorded a loss on the sale of the building of £54,373.

Minutes of 25 and 26 August 1961 of SCL record that the matter of Australia House Inc. was detailed by the Secretary and:-

> *It was moved by Mr. I. K. Redpath, seconded by Mr. D. Korman and carried unanimously that it has always been known to the Board that Mr. S. Korman and Mr. R.J. Eliasberg were acting on behalf of Stanhill Consolidated Limited in this matter and any profit or loss was to the account of the company and neither Mr. S. Korman nor Mr. R. J. Eliasberg had any financial interest in the matter* (Murphy, 1967, p. 166).

Having regard to the August 1960 minute that stated SCL:

> *…only had an interest in this building by way of a loan to Australia House Inc. of New York…* the inspector also said that …*the only reasonable conclusion to draw is that this latter resolution was passed in order to relieve Stanley Korman from an embarrassing position* (Murphy, 1967, p. 167).

SCL incurred a total loss on the transaction of £54,373. Apart from the minute of 25 – 26 August 1961 all other documentation pointed to a company owned by Stanley Korman and Robert Eliasberg. However at a meeting of directors of SCL held over three days, 30 November, 1 and 2 December 1961 the following motion was passed:-

> *It was moved by Sir John McCauley seconded by Mr. I. K. Redpath and carried unanimously that Stanhill Consolidated Limited accept the loss in question (£54,373) and that same be included in the profit and loss account of Stanhill Consolidated Limited for the year ended 31st July, 1961. It was reaffirmed that Mr. S. Korman and Mr. R. J. Eliasberg were acting on behalf of the company in this matter and that any profit or loss associated with the project would be to or against Stanhill Consolidated Limited* (Murphy, 1967, p. 167).

As a final cogent remark, Australia House Inc. was not listed as a subsidiary of SCL in that company's accounts for the year ended 31 July 1961 nor was the operating loss of Australia House Inc. included in the consolidated profit and loss account. It is therefore incredible that all the entries in SCL's balance sheets for the financial years 1959 and 1960 include the advances made by SCL to Australia House Inc. as current assets and are not shown as freehold property or as advances to or shares in a subsidiary company. The attached note to the balance sheet that refers to the asset clearly implies a loan to a separate company. When the plan came to nothing, SCL bore the loss not Stanley Korman (Murphy, 1967).

The major causes of the failure of SDG are summarized in Table 3.

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4.5.4. Prosecutions

The inspector Peter Murphy QC in his second report of May 1966 was very critical of SCL, Factors and Korman and his two sons, David and Leon, stating:

> *One finds at every turn that both SCL and Factors misrepresented their true financial position to the public, to auditors, to shareholders, to banks, to a court, and to creditors. Stanley Korman's aims were certainly not altruistic. They appear to have stemmed from his ambition for power and money. His sons, Leon and David, were advanced by him into positions of authority in Factors and Rockmans, which positions they were ill-equipped to fill. They were paid salaries which, to men in their twenties, should have appeared huge. They were both failures (Murphy, 1965-66, p. 185).*

Mr. Murphy then concluded his report with a direct attack on Korman:

> *Mr. Korman's defects as an administrator outweighed his qualities as a negotiator. He was, moreover, unprincipled and untrustworthy. Whatever view one may take of others who were involved in the affairs of Factors, there can be no doubt that Stanley Korman has shown that he is lacking*

> *in the sense of responsibility which is necessary in a public company Director. What the evidence does show is that, whatever accounting should now be demanded of Stanley Korman, he has shown himself to be wholly unfit to direct any company in which the public may be induced to repose its trust or invest its money* (Murphy, 1965-66, p. 186).

As a result of Mr Murphy's scathing report, Korman stood trial in October 1966 on a charge of having issued a prospectus containing false statements. The case was based on the non-disclosure of a land deal called the Willowbank Deal in the Factors' debenture prospectus of December 1958, two years before the start of this case study and the 1960s decade (Sykes, 1998). Despite the frequent suggestions by the inspector Mr. Murphy QC that there was fraud committed on many occasions when financial accounts were misleading and company minutes treated with contempt, only one person in the whole Stanhill case was charged, the founder Stanley Korman.

Magistrate Mr. R. K. Hudspeth found the statements in the prospectus false and misleading and sentenced Korman to six months jail. Korman's appeal against the sentence was heard in the Supreme Court the following August before Mr. Justice Nelson. In disallowing the appeal His Honour said the twelve months maximum penalty for a prospectus offence was lenient, confirming the six month sentence imposed could not be described as excessive. There were no more charges against any other officer or director of any of the Stanhill Group.

4.6. Case Study 3 - H.G.Palmers Ltd

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4.6.1. Background

The founder of the H.G. Palmers Group, Herbert (Herbie) George Palmer (Palmer), was a door-to-door salesman during the 1930s depression selling radio sets. He opened a retail establishment in 1933 in rented shop space in the Sydney suburb of Bankstown and expanded his sales of radio and electrical equipment. He opened a branch in Wollongong on the south coast of NSW in 1947 and Herbie's brother Norman was put in charge of the Wollongong side of the business.

There were four directors appointed and they remained as the board of the parent company H.G.Palmer (Consolidated) Ltd. throughout its public career. The chairman was Sir Norman Nock, a former Lord Mayor of Sydney and chairman of the well-known hardware company Nock and Kirby. Other directors were Palmer, his brother Norman and Cecil Trenam (Sykes, 1998).

The second World War restricted the amount of new goods being manufactured and available and Palmer's stores were mainly restricted to repair work. The inevitable boom in demand for electrical goods, including white goods, after the war provided an outstanding opportunity for a switched-on entrepreneur like Palmer (Clarke, et al., 1997).

The demand for white goods eased in the late 1950s and was replaced by the introduction to Australia of black and white television sets. The growth of the H.G. Palmer group was phenomenal. By 1960 it comprised approximately 150 retail outlets in New South Wales, Victoria, Queensland and South Australia. Like the two previous case studies, growth by acquisition was the order of the day. Thus the addition of corporate value was minimal. It seemed that if an electrical retailer was for sale then H.G.Palmer bought it (Clarke, et al., 2003).

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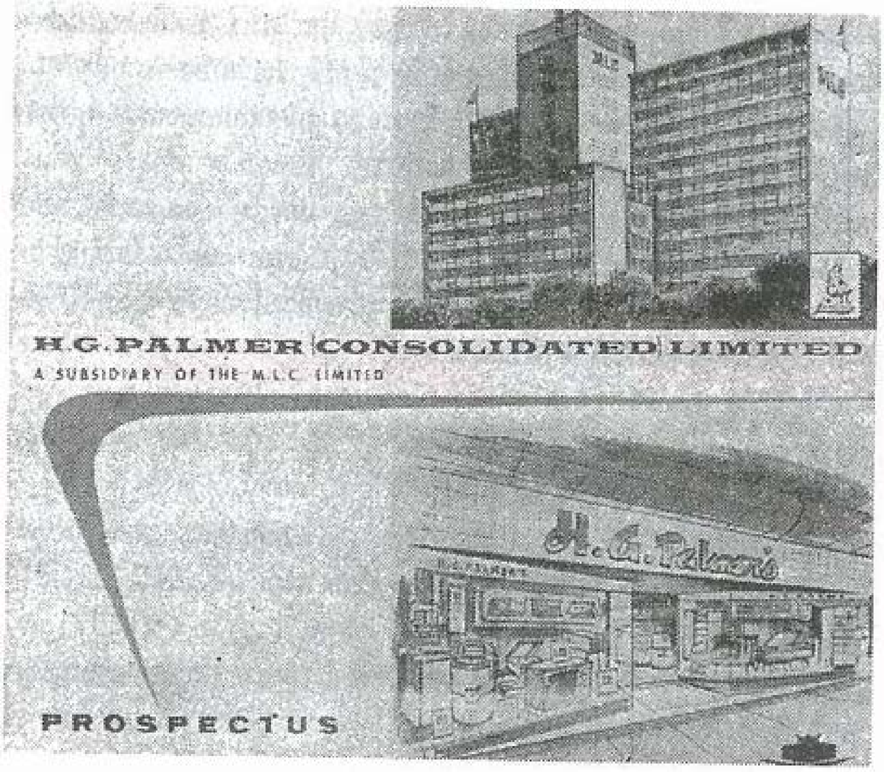
4.6.2. Collapse

H.G.Palmers Ltd (Palmers) during the 1950s and early 1960s was the shining light of the retail world reporting nearly fifteen years of consecutive growth in sales and reported profit. Palmers certainly received extremely positive press especially in the Australian Financial Review. On 21 March 1963 under the heading A Matter of Gearing a very bullish article stated:

> *Of the success stories of Australian retailing, that of H.G.Palmer, the Sydney-based electrical retailer which yesterday announced a further increase in profit for the six months to December, must be one of the most heartening* (Anon, 1963b, p. 20).

Just eighteen days later on 8 April 1963 the insurance giant MLC Ltd. made a bid for the ordinary share capital of Palmers. The Australian Financial Review reported the bid under the headline: *Bolt from the Blue bid by MLC for Palmer* (Anon, 1963a, p. 20). The writer waxed lyrical about what a great investment the MLC was making stating, *inter alia*: *The acquisition, if approved, promises to be a profitable one for the MLC* (Anon, 1963a, p. 20). The takeover by the MLC in 1963 changed the attitude of many investors towards retaining an investment in Palmers by way of first mortgage Debenture Stock and Unsecured Notes. Brokers' advising clients were giving them comfort by enforcing the idea that with the MLC behind Palmers the stock was a secure investment. Palmers also reinforced the connection by printing a photo of the MLC building at North Sydney on the cover of the Prospectus issued on the 31 July 1964 (Clarke, et al., 2003).



An example of an H.G. Palmer prospectus cover dated 31 July 1964

Source: Sydney Morning Herald, 20 November 1965. Reproduced with approval from John Fairfax & Sons Ltd.

Figure 5: MLC building at North Sydney on the cover of the Prospectus issued on the 31 July 1964 (Clarke, et al., 2003).

Professional investment advisors were strongly recommending investors to stay with Palmers as they were a ‘good buy’, stressing the connection of the company with the MLC. Again the Australian Financial Review published an article where its advisor answered a question from a small investor who was thinking of investing in Palmer Debentures. Part of the answer to the enquirer said, *inter alia: In making the investment it is comforting to know the MLC Insurance Group owns the ordinary capital of Palmer* (Anon, 1964b, p. 18). Many large listed public companies previously with a small or nil investment in

Palmers invested large amounts because the MLC owned the ordinary capital of Palmers.

On 25 October 1965 Palmers released their preliminary results. It was also announced that the MLC had written off its entire investment in the business and that the Permanent Trustees had appointed a receiver and manager of the troubled group. Many small investors had relied upon their broker's or financial advisor's recommendation to stay with or renew maturing debentures and unsecured deposits (Sykes, 1998). The financial editor of the Sydney Morning Herald, Tom Fitzgerald, criticized the exploitation by Palmers' publicity of using the MLC's ownership of Palmers for public borrowing purposes for over two years and also criticised the actions of the MLC in just walking away from the perceived responsibility of honouring the debts of its subsidiary company. He wrote that the publicity was used not only to sustain the flow of funds from the public but also to borrow the funds at a cheaper rate because of the MLC's involvement. This was at a time when other borrowing company debacles, such as the collapse of Reid Murray Holdings Limited and Stanhill Consolidated Limited (See case studies 1 and 2) created a difficult borrowing market (Sykes, 1998).

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4.6.3. Investigation

There appears to have been no investigators appointed to inquire into the affairs of the Palmers Group. Mr. C.H.R. Jackson, a chartered accountant, was appointed receiver and manager and there were hearings in the Magistrate's Court and the Supreme Court when certain of the officers of the company were sent for trial. (4.6.4). As these matters were dealt with nearly fifty years ago it is difficult to locate details of these cases and also archived newspaper coverage from that era.

The main cause of the collapse of Palmers was the failure to write off bad debts and adequately provide for doubtful debts as required by Section 162 (6) (d) of Part VI Division 1 of the Companies Act 1961. One of the main reasons for large amounts of bad and doubtful debts was Palmer's policy of setting the level of credit refusals. Raymond Guy, a former acting secretary of the company, testified that when he was Brisbane office manager, Palmer used to visit the branch and check the credit refusals. Palmer told him that Brisbane's credit refusal rate of 10.6% was too high. Later Guy was told the refusals had to be reduced to 2.5% (Sykes, 1998).

The setting of the level of credit refusals had the effect of falsely qualifying applicants as credit worthy when they obviously were not. The refusal by the officers of the company to monitor the outstanding debtors more closely and take action to recover or write off bad debts as and when required caused an overstatement of current assets and operating profits of the group.

The company was spending more than it was receiving for example:

> *Late in May 1964 during a discussion with Palmer, the chief accountant, Williams had produced figures showing the company was living at the rate of £70,000 a week above the capital inflow* (Sykes, 1998, p. 380).

According to the trial judge, Mr Justice Lee's comments, the auditor, John McBlane (McBlane), a chartered accountant, could have been more concerned about the debts of the companies. Mr. Justice Lee presiding at his trial said McBlane, from as early as 1962, had ignored warnings from his agents that all was not well with the group. Lee went on to say to McBlane:

> *Once you had formed the opinion that you did, your duty was clear; namely to disclose the position to the full board of the consolidated company, and it was then their worry* (Sykes, 1998, p. 383).

Instead McBlane although well aware of the staggering bad debts of the company, concealed the facts apparently hoping by some miracle the company could trade out of its difficulties. Justice Lee said that: *the auditor's report in a prospectus stood between the public and unscrupulous, dishonest directors of large organisations* (Sykes, 1998, p. 383).

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4.6.4. Prosecution

Following the issue of the January prospectus fraud squad detectives served summonses on Palmer, the group's former secretary William Rose (Rose), and auditor McBlane. The summonses alleged Palmer had concurred in the issue of a prospectus in January 1965 in which the net profit of Palmers had been falsely stated. Two months later, six former directors of Palmers were charged with having authorised a false prospectus. Norman Hector Palmer was committed for trial on the Companies Act charge alone. Dr Pollard was committed for trial on only the Companies Act charge, but the crown agreed not to proceed with the case. All charges against the remaining four directors, Cecil Trenam, Sir Norman Nock, Robert Cadwallader and Brian Page were dropped. Charges against Rose and Norman H Palmer were also dropped (Sykes, 1998).

At the committal hearing of the three remaining directors charged the magistrate Mr. Scarlett SM commented on the profits disclosed by Palmers over the 15 years to 1964 and said:

> *If bad debts had been written off there would not have been any profit for the company for many years* (Sykes, 1998, p. 381).

This matter was also succinctly stated:

> *The reality was that H.G.Palmer had not made an actual profit in any year since incorporation, let alone the record profit levels for 1963 and 1964* (Clarke, et al., 2003, p. 84).

Issuing a false prospectus brought criminal charges of fraud to three of the executives and a prison sentence for two of them. The three executives were charged under the Crimes Act not the Companies Act and that is the reason the jail terms were longer than the one year maximum under the Companies Act. The presiding judge, Mr Justice Lee, sentenced the founder of the group, Palmer, to four years jail and the auditor, McBlane, was sentenced to three years jail. Former company secretary Rose was acquitted (Sykes, 1998).

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4.7. Chapter 4 Summary and Conclusions

4.7.1. Government Inquiry

In August 1967, the Company Law Advisory Committee was established led by Sir Richard Eggleston.

The terms of reference were:

> *To enquire into and report on the extent of the protection afforded to the investing public by the existing provisions of the 1961/62 Uniform Companies Acts and to recommend what additional provisions (if any) are reasonably necessary to increase that protection* (Interim Report 1 Eggleston Committee, 1970, p. 3).

The committee produced seven interim reports each dealing with separate aspects of Corporate Law (Company Law Advisory Committee, 1969-70). The references to this committee's findings also apply to all three case studies in this chapter.

The main interim reports issued by the Eggleston committee relevant to this research are the 1st Interim Report – Accounts and Audit (1970) (Interim Report 1 Eggleston Committee, 1970) and the 5th Interim Report – On Control of Fund Raising, Share Capital and Debentures (Interim Report 5 Eggleston Committee, 1970).

The Standing Committee of the Attorneys-General produced a Rough Draft General Revision Bill (GRB) of 20 February 1968 which they had prepared by the Victorian draughtsman for the Eggleston Committee to comment upon and approve or suggest amendments. So in effect the government inquiry consisted of two parts, the Draft GRB and the Eggleston Committee's input to that draft by way of approval, suggested change or rejection of the draft legislation.

The Accounts and Audit report, the Committees first, was printed in March 1970. The committee noted that:

> *Undoubtedly one of the most potent weapons available for the protection of investors is the compulsory disclosure of information as to the past performance of the company, coupled with the safeguard against mis-statement provided by audit requirements* (Interim Report 1 Eggleston Committee, 1970, p. 4).

In this section of the research, the researcher will analyse the changes, if any, to the Companies Act 1961 following recommendations by the Committee after identifying the two protections for investors in the above paragraph. Lack of adequate disclosure was certainly one of the most important findings of the inspectors' of the RMH (Murray & Shaw, 1963) and SDC (Murphy, 1965-66) case studies in this chapter.

This first interim report concentrated on the Disclosure of Information in Accounts, Reports of Directors, the Powers, Duties, and Responsibilities of Auditors and the complete revision of the 9th Schedule of the Companies Act 1961.The report describes that the function of the annual accounts:

> …*should be to present a complete picture of the result of the year's operations and the state of affairs at the end of the year* (Interim Report 1 Eggleston Committee, 1970, p. 7).

The Eggleston Committee therefore had to comment on and suggest amendments to the GRB which when completed formed the Companies Act 1971 which was an amending act to the Companies Act 1961. Attempts to locate a copy of the draft of the GRB were unsuccessful. The Committee's first Interim report is a 144-page document with approvals for many sections of the GRB and suggestions for redrafting sections wherever the advisory committee thought appropriate. In this research, analysis will be of the inspector's recommendations as to changes to the Companies Act 1961 and the relevant changes suggested in the GRB and approved by the Advisory Committee and enacted in the Companies Act 1971.

One of the main criticisms made by the inspectors in all three case studies in this chapter was the lack of adequate bad debt write offs and lack of adequate Provision for doubtful debts. The inspectors were quite clear on this point in the H.G. Palmer debacle (see section 4.6.3) and RMH (see section 4.4.3.1).

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4.7.2. Regulation and Legislation Change

The Legislation in effect for the decade 1960-1969 was the Companies Act 1961 (1961 Act). The changes to the GRB suggested by the Eggleston Committee when enacted became the Companies Act 1971 (1971 Act) which was an amending act with the 1961 Act still referred to as the Principal Act (Victorian Government, 1971). The uniformity produced by political agreement between the states in the form of the Uniform Acts (1.9) was not matched by administrative uniformity. Different state bureaucracies administered the Uniform Acts according to their pattern of administrative practice and quality. In addition, the legislative uniformity was gradually eroded during the decade of the 1960s as the various states commenced amending the uniform companies legislation in response to different developments in the companies and securities field.

This Chapter deals with three major spectacular unexpected corporate collapses which in some cases revealed that management skills and practices had not adjusted to the economic prosperity of the 1950s and 1960s (Tomasic, Bottomley, & McQueen, 2002).

4.7.2.1. Matters raised by Inspectors as recommendations to change the Companies Act. 1961.

As discussed in the introduction to this chapter (see section 4.1), this section examines various complaints by the inspectors of the companies in the three case studies in this chapter. The section analyses whether the matter was considered by the Government Inquiry, the Eggleston Committee, what action, if any, was suggested by the Committee and whether the legislation was subsequently changed as a result. However, although changes were made to regulations and legislation as discussed in the following analysis, case studies in chapters 5 to 8 demonstrate that unexpected corporate failures continued across the decades.

The matters to be examined are:

- 4.7.2.2 Certification of Consolidated Accounts:
- 4.7.2.3 Bad Debts and Provision for Doubtful Debts:
- 4.7.2.4 Misleading statements in a Prospectus:
- 4.7.2.5 Greater disclosure in financial accounts:
- 4.7.2.6 Changes to Consolidated Accounts Presentation:
- 4.7.2.7 Auditors extended powers: and
- 4.7.2.8 Creation of a Companies Commission.

The above matters will be analysed under the headings:

The Inspector’s Recommendations and Complaints:

The GRB and Committee's Response: and

New amendments to the Companies Act 1971.

4.7.2.2. Certification of Consolidated Accounts

The Inspectors' Recommendations and Complaints

Consolidated accounts prepared in accordance with the 9th Schedule of the Companies Act 1961 did not require the signature of the Directors' or Secretary of the Company. The accounts were only reported on by the auditors. The inspector of the Stanhill Group (Case Study 2) Mr. P. Murphy Q.C. stated:

> *Even the necessity for the auditors' report is not to be found in the substantive provisions of the Act itself, but only enters by way of a side wind in clause 4 (4) of the 9th Schedule.*
>
> *Consolidated accounts are in most cases more important to shareholders than the holding company's own accounts, and they are not the auditor's but the Directors' accounts.*
>
> *It would accordingly seem to be advisable that an amendment to the Act be considered in order to remedy this omission, and to require that both the Directors of the holding company and its Secretary certify to the consolidated accounts as such* (Murphy, 1965-66, p. 179).

The GRB and Committee's Response

The GRB before the Committee had already proposed that the directors of a holding company should be required to vouch for the group accounts and also deal in their report with the affairs of the group (Interim Report 1 Eggleston Committee, 1970).

The Committee regarded this suggestion as a desirable reform but suggested safeguards for directors to ensure that they have the machinery available to enable them:

> *…to obtain the information required for their preparation, nor without some protection where they rely on such information and have no reason to suspect its accuracy* (Interim Report 1 Eggleston Committee, 1970, p. 8).

New amendments to the Companies Act 1971

As a result of the Committees recommendations the new Section 162 (11) of the Companies Act 1971 dealt with the certification of the group accounts by the directors:

> *There shall be attached to group accounts of a holding company to be laid before the company at its annual general meeting, before the auditor reports on the group accounts under this Part, a statement made in accordance with a resolution of the directors of the company and signed by not less than two directors stating whether in the opinion of the directors the group accounts are drawn up so as to give a true and fair view of—*
>
> *(a) the profit or loss of the company and its subsidiaries for their respective last financial years ; and*
>
> *(b) the state of affairs of the company and its subsidiaries as at the end of their respective last financial years—so far as they concern members of the holding company* (Victorian Government, 1971, p. 565*).*

The Legislators' went further than the Committee's recommendation and added an extra paragraph to section 162, paragraph 12:

> *The directors of a company shall cause to be attached to any accounts of the company and, if it is a holding company, group accounts to be laid before the company at its annual general meeting, before the auditor reports on the accounts or group accounts under this Part, a statement signed by the principal accounting officer of the company or other person in charge of the preparation of the company's accounts or of the group accounts, stating whether to the best of his knowledge and belief the accounts or group accounts as the case may be give a true and fair view of the matters required by this section to be dealt with in the accounts or group accounts as the case may be* (Victorian Government, 1971, p. 566).

The only difference in the legislation between the recommendation from Mr. Murphy Q.C. and the new Act was the change from the company secretary to the principal accounting officer of the company or other person in charge of the preparation of the company's accounts or of the group accounts, as the additional signatory before the auditor reported on the accounts.

4.7.2.3. Bad Debts and provision for Doubtful Debts

The Inspectors' Recommendations and Complaints

Mr. B.L. Murray Q.C. and Mr. B.J.Shaw Q.C., the inspectors' of the Reid Murray Group Case Study (see section 4.4.2), were critical of the lack of control over and adequate disclosure of Bad Debts and Provision for Doubtful Debts. In their first Interim Report they stated:

> *The major asset of the group was its terms debts. These debts had commenced to rot away and the rot had already progressed a startling distance. There was already a considerable bad debt element in these debts and it was increasing daily* (Murray & Shaw, 1963, p. 108).

In the Palmers' case study (see section 4.6.4) the prosecutor at the Central Criminal Court trial of the Palmers' Directors and Auditor, Mr. C Shannon Q.C., said that the January 1965 prospectus issued by Palmers had been false in material particulars. He continued:

> *A reader would have formed the impression that there was no bad-debt problem. The auditor's report had given no consideration to a vast body of bad and doubtful debts* (Sykes, 1998, p. 379).

<u>The GRB and Committee's Response.</u>

The Companies Act 1961 did not single out bad debts or doubtful debts for special treatment but they were included with all Current Assets in Section 162 (6) (d) of the 1961 Act:

> *Where the directors are of the opinion that any current assets would not at least realize the value at which they are shown in the accounts of the company their opinion as to the amount that those current assets might reasonably be expected to realize in the ordinary course of business of the company* (Victorian Government, 1961, p. 577).

The Committee examining the GRB's Section B on disclosure and completeness of information in the accounts and directors' reports came to the conclusion that mere verbal changes to the existing 1961 Act were not sufficient (Interim Report 1 Eggleston Committee, 1970).

New amendments to the Companies Act 1971

In the 1971 Act, bad and doubtful debts were singled out for special attention at Section 162 (7):

> *The directors shall (before the profit and loss account and balance-sheet referred to in sub-sections (1) and (3) are made out) take reasonable steps— (a) to ascertain what action has been taken in relation to the writing off of bad debts and the making of provisions for doubtful debts and to cause all known bad debts to be written off and adequate provision to be made for doubtful debts* (Victorian Government, 1971, p. 564).

The rest of the Current Assets were then included in sub section (b) that followed.

4.7.2.4. Misleading Statements in a Prospectus

The Inspectors' Recommendations and Complaints

In the three case studies in this chapter the inspectors found prospectuses issued by each company contained untrue statements: refer to separate comments under the heading of prosecutions at the end of each case study. Section 47 (1) of the Companies Act 1961 refers to untrue statements in a prospectus and states:

> *Where in a prospectus there is any untrue statement or wilful non-disclosure any person who authorized or caused the issue of the prospectus shall be guilty of an offence against this Act unless he proves either that the statement or non-disclosure was immaterial or that he had*

reasonable ground to believe and did, up to the time of the issue of the prospectus, believe the statement was true or the non-disclosure immaterial.

Penalty: Imprisonment for one year or one thousand pounds or both (Victorian Government, 1961, p. 491).

Penalties imposed upon the founders of RMH, SDC and Palmers varied. O'Grady from RMH received a £400 fine, Korman from SDC was sentenced to six months jail (both civil cases) and Palmer from Palmers was sentenced to four years jail (a criminal prosecution): refer to Prosecution section of each case study. Through their actions, the public had lost close to £80 million in the collapses of the 1960s and many thousands of investors small and large ended up losing everything they had invested in some of the largest and most famous companies in Australia (Sykes, 1998).

The GRB and Committee's Response

The Committee's Interim Report No 5, titled '*on the control of fund raising, share capital and debentures'* considered in detail the matter of untrue statements in a prospectus but did not recommend any change to the penalty:

> *Where there is false or misleading matter in a prospectus or any material matter is omitted from a prospectus, a person to whom this section applies is, subject to this section, guilty of an offence against this Act.*
>
> *Penalty: $2,000 or imprisonment for one year, or both* (Interim Report 5 Eggleston Committee, 1970, p. 42).

4.7.2.5. Greater disclosure in financial accounts

The Inspectors' Recommendations and Complaints

The inspectors' in the first two cases, RMH and SDG, complained strongly about the lack of disclosure in the financial accounts. In the final report of the inspectors' into the affairs of RMH and RMA, the 1961 financial accounts were criticised by Mr. B. J. Shaw Q.C as combining what was plain dishonesty with misleading exploitations of recognised accounting practices (Shaw, 1966) Shaw went on to say:

> *This was only possible because at the time it was widely accepted that company accounts could properly be presented without explanation of the methods used in their preparation. In my opinion the investigation has shown that the practices accepted by accountants in 1961 in the preparation of company accounts were inadequate to prevent the presentation of misleading accounts and has shown further that the whole question of how company accounts ought to be prepared and presented requires urgent and critical examination* (Shaw, 1966, p. 94).

The directors' of SDF made certain representations in the 27 July 1960 prospectus as to how the funds raised were to be used (see section 4.5.3.1). There was no disclosure as to how these representations were not honoured and how the total funds raised from the issue, £2.75 million were advanced within three months to other companies, both public and private, in which Korman had financial interest (Murphy, 1964).

The GRB and Committees' Response

The Committee made it quite clear that disclosure of information in accounts and directors' reports was most important:

> *Undoubtedly one of the most potent weapons available for the protection of investors is the compulsory disclosure of information as to the past performance of the company, coupled with the safeguard against mis-statement provided by audit requirements* (Interim Report 1 Eggleston Committee, 1970, p. 6).

New Amendments to the Companies Act 1971

There were many changes to the 1961 principal act by the amendments in the 1971 Act. The 9th Schedule of the Companies Act 1961 was completely redrafted by the 1971 amending legislation with at least 22 paragraphs amended. The main theme of the amendments was greater disclosure. Some of the more important amendments were:

> *Paragraph 2: Pursuant to sub-paras. 1(a), (b) and (c), a separate statement is now required as to the amounts of dividends and interest received or paid in respect of each subsidiary company, and in respect of associated and other corporations.*
>
> *Paragraph 2(1) (c) and (f): Particulars as to where there has been a sale or revaluation of assets, the amount of any profit and the extent to which it has been brought into account in determining profit or loss of the company or of the group must be shown.*
>
> *Paragraph 2(1)(l): Particulars of the emoluments of directors of the companies engaged in the full time employment of the company and*

related Corporations other than full time salaries as employees and of emoluments of other directors of the company are to be stated.

Paragraph 2(l)(m): Particulars of the amounts paid to or receivable by the auditors with separate amounts in respect of auditing and other services must be shown.

Paragraph 5(1)(i): Requires the amounts of any provisions for doubtful debts to be shown as a deduction from the respective items.

Paragraph 5(2) (a) and (b): Requires additional disclosure with respect to intercompany debts.

Paragraph 5(3): Provides for an estimate to be given of the maximum amount for which the company and its subsidiaries could become liable in respect of contingent liabilities.

Paragraph 5(4)(e) and (f): Requires additional disclosure in relation to the holding of shares in or debentures of subsidiaries and related corporations.

Paragraph 5(4) (i): Requires disclosure of loans made to directors of the company or related corporations or corporations in which a director owns a controlling interest.

Paragraph 6(2): Requires current liabilities and current assets to be clearly distinguished from other liabilities and assets.

Paragraph 7: Deals with the method of valuation of assets and requires particulars to be given as to the date of valuation, and whether the valuation was made by an officer of the company or a related corporation. A separate provision is contained in this paragraph with respect to assets comprising land or interest in land held for sale or

> *resale and requires disclosure as to the capitalisation of development costs* (CCH Australia Limited, 1972, pp. 9153-9154).

Most of the above amendments to the Act were mentioned by the inspectors in their reports as a necessary mechanism for improvement to the Act and disclosure in reporting of the financial accounts. The amendments, although reactive, closed many of the loopholes in the reporting of financial accounts previously exploited by company directors and management.

4.7.2.6. Changes to Consolidated Accounts Presentation.

The Inspectors' Recommendations and Complaints

The inspector of the SCG, Mr. P. Murphy Q.C., was critical of the inflexibility of clause 4 of the 9th Schedule of the Companies Act 1961. He made several recommendations for amendments, in particular the publishing of a statement to be included with the consolidated accounts showing the profit or loss of each of the subsidiaries of the holding company. His reasoning was that it:

> …*would also have the effect of making it more difficult for a holding company to draw a veil over unprofitable ventures* (Murphy, 1965-66, p. 176).

The GRB and Committee's Response and New Amendments to the Companies Act 1971

The responses from both the GRB and the Committee was to draft a new section 161 in the 1971 Amending Act defining group accounts in relation to a holding company as:

> *(a) a set of consolidated accounts for the group of companies of that holding company ;*
>
> *(b) two or more sets of consolidated accounts together covering that group ;*
>
> *(c) separate accounts for each corporation in that group ; or*
>
> *(d) a combination of one or more sets of consolidated accounts and one or more separate accounts together covering that group* (Victorian Government, 1971, p. 559).

There were additional responsibilities for directors if the group accounts were prepared other than as one set of consolidated accounts covering the group. They had to certify on, or in a certificate attached to the accounts:

> *(a) that the preparation of one such set of consolidated accounts is impracticable or that it is preferable, in the interests of the shareholders, that the accounts be prepared in the form in which they are prepared (as the case may be), for reasons to be stated in the certificate ; and*
>
> *(b) that, in the opinion of the directors, the accounts so prepared are not significantly affected by transactions and balances between the corporations covered by the accounts, except to the extent stated in any notes forming part of the accounts (Victorian Government, 1971, p. 604).*

The changes in the legislation permitted the directors, subject to certification, publishing separately the accounts of a substantial loss-making subsidiary the investment in which has been written off completely by the holding company. SCG inspector Murphy made this recommendation because of the collapse of Rockmans, a subsidiary of Factors (Murphy, 1965-66).

4.7.2.7. Auditors’ Extended Powers

<u>The Inspectors’ Recommendations and Complaints</u>

In the final report into the affairs of the Reid Murray Group the inspector Mr. B. J. Shaw Q.C. was very critical of the 1961 accounts which he said:

> *…combined what was plain dishonesty with misleading exploitations of recognized accounting practices* (Shaw, 1966, p. 94).

Although the inspectors’ had made such an observation in the first report, Shaw felt the need to repeat them because:

> *…that in the circumstances in which the 1961 accounts were prepared many of the devices which I have called misleading exploitations of recognized accounting practices received the imprimatur of the various accountants who were auditing the accounts involved. Now it is true that some of the auditors of the companies whose affairs I have investigated were supine and gullible but most were not and I do not think that any were dishonest and yet the accounts were approved* (Shaw, 1966, p. 94).

Shaw said that the reason this occurred was through lack of disclosure of the methods used in the preparation of the accounts. He urged that to prevent the presentation of misleading accounts the whole question of how company accounts were prepared and presented required urgent and critical examination (Shaw, 1966).

<u>The GRB and Committee’s Response</u>

There is a special section in the committee’s No. 1 report dealing with the powers, duties, and responsibilities of auditors. Reference is made to the company failures of the 1960s and the inspectors’ comments in relation to the failures which the committee felt revealed a necessity for strengthening the position of auditors which may help to ameliorate, even if it cannot entirely remove, the weaknesses disclosed in the system as a whole. The committee noted that occasions have arisen in which fears have been expressed as to the risk of actions for defamation in respect of adverse comments in the auditor's report. The committee's response was that there was no doubt that an auditor exercising the statutory function has a qualified privilege in respect of statements which are made in the course of the performance of the auditor's duty (Interim Report 1 Eggleston Committee, 1970).

The committee felt that the position of auditor could be strengthened:

> *…by a provision placing the auditor under a duty, in certain cases, to report breaches of the Act to the Registrar. We believe that one of the weaknesses of the present system is that an auditor, who discovers some infringement of the Act during the financial year, has, in effect, no means of dealing with the situation, in the last resort, until the time comes for him to make his report on the accounts* (Interim Report 1 Eggleston Committee, 1970, p. 19).

<u>New Amendments to the Companies Act 1971</u>

The Companies Act of 1971 had an additional clause entered strengthening the powers of auditors in Section 167 (8):

> *If an auditor, in the course of the performance of his duties as auditor of a company, is satisfied that—*
>
> *(a) there has been a breach or non-observance of any of the provisions of this Act ; and*

(b) the circumstances are such that in his opinion the matter has not been or will not be adequately dealt with by comment in his report on the accounts or group accounts or by bringing the matter to the notice of the directors of the company or, if the company is a subsidiary, of the directors of its holding company—he shall forthwith report the matter in writing to the Registrar

(Victorian Government, 1971, p. 590).

4.7.2.8. Companies Commission

In the Committee's two Interim Reports which are relevant to this research (numbers 1 and 5) there was a proposal put forward by the Committee for the establishment of a Companies Commission with powers including, giving companies of a defined class power to omit specified information required by the act, or to present their accounts in a different form from that required. Also power to alter or add to the requirements as to accounts and the director's report, to perform the duties at present carried out by the Companies Auditors Boards, and to undertake tasks at present carried out by the Registrars in cases where they could more conveniently be performed by a single body (Interim Report 1 Eggleston Committee, 1970).

These recommendations for the establishment of a Companies Commission were partly realised when individual states created their own Corporate Affairs Commission (CAC) in early 1971. The committee had called for the establishment of a national companies commission and this came into being in July 1974 as the Interstate Corporate Affairs Commission (ICAC) (Mees & Ramsay, 2008).

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4.7.3. Profession Action

When unexpected corporate failures occurred in the 1960s both the Australian Society of Accountants (ASA) and the Institute of Chartered Accountants in Australia (ICAA) became defensive and seemed more concerned with protecting their public image than responding in a positive way to attack from investigators of the unexpected corporate failures (Australian Society of Accountants, 1966; Irish, 1963). The Investigators' Reports into the Affairs of the RMH group were critical of published financial statements that contained, as Shaw stated, *misleading exploitations of recognised accounting practices* and *received the imprimatur of the various accountants who were auditing the accounts involved* (Shaw, 1966, p. 94).

In a scathing attack on the Accounting Profession, the inspectors of RMG stated:

> *We believe that it follows that the accounts of the group must have fallen short of their supposed objective namely that of presenting a true and fair*

> *view of the state of the affairs of the group and of the results of its operations* (Murray & Shaw, 1963, p. 107).

The inspectors of RMG (both of whom were Queen's Counsel) continued their criticism:

> *Accordingly we have examined the accounts of the group and have found what we believe to be defects in them. We now say that neither of us is skilled in accountancy and we are aware that much of what we have said will not be accepted by the accounting profession generally* (Murray & Shaw, 1963, p. 107).

This assumption later proved to be correct when the General Council (GC) of the Australian Society of Accountants published a 47 page report entitled Accounting Principles and Practices Discussed in Reports on Company Failures (Australian Society of Accountants, 1966). In this report the GC in response to the various pointed criticisms by the inspectors stated:

> *General Council considers that accountants must make much greater efforts to provide more informative financial statements* (Australian Society of Accountants General Council, 1966, p. 42).

The GC in the report distinguishes between problems of accounting measurement and problems of financial policy and it concludes by stating:

> *General Council believes that it would be unfortunate if the publicity …given to the company failures…, many of which were associated with over-statement of profits and asset valuations, were to result in renewed emphasis on conservatism and a distortion of accounting*

> *measurement*… and finally… *the inspectors' reports should be construed as showing a need, not for more conservatism in accounting, but rather more disclosure in accounting, accompanied, if the circumstances should require it, by prudent financial policies, the effects of which should be fully disclosed* (Australian Society of Accountants General Council, 1966, p. 42).

The Institute of Chartered Accountants also published articles about the subject submitted by senior members of the profession in the monthly journal, The Chartered Accountant in Australia. The President of the Institute of Chartered Accountants in Australia (ICAA) in 1963 presented a paper entitled 'Should We Blame the Auditing Profession?' (Irish, 1963). This was presented five months after the Reid Murray Group was placed into liquidation and was presented at the eleventh Annual Congress of the ICAA Research Society (N.S.W. Division). Irish started the address by stating that for the years 1960, 1961 and 1962 the losses by listed companies on the Sydney Stock Exchange were £32 million posing the questions, *How could these things happen and so suddenly?* Irish goes on to ask: W*ho is to blame?* and *Should we blame the Auditing Profession?* (Irish, 1963, p. 79).

Also attending the Congress were a panel of financial writers who evidently thought that the Auditing Profession should shoulder a greater part of the blame. Irish intentionally refrained from naming the sources, companies or auditors. Comments from the writers quoted by Irish included:

> *After what has happened in 1962, auditors, as a body, must do some soul- searching and examine their public image. They must become*

> *more vocal in explaining their duties and responsibilities. They cannot be blamed for the past year's crop of failures, but shareholders are asking why they could not have given some indication sooner that certain companies were in difficulties. They cannot hide behind professional reticence (Irish, 1963, p. 79).*

There were many more comments quoted by Irish but the general criticism by the financial writers was that the financial accounts presented were accounts that chartered accountants regarded as giving the public a true and fair view of the state of the company's finances. Irish then looked at the criticisms and arrived at two scenarios:

> *…if the comments were justified, the profession needed to do something about it,- if they were not justified, then the profession should heed the advice of one of the writers …to be more vocal in explaining our duties and responsibilities* (Irish, 1963, p. 80*).*

He chose the latter scenario and went on for a further 16 pages of explanations as to what a balance sheet is and is not, and the duties of an auditor et al. Looking back it was a pity that he did not address the first scenario as well. Inspectors of the three case studies in this chapter were very critical of the auditors. The auditor of Palmers was sent to jail for three years therefore the comments by the panel of financial writers would appear to have been justified. It must be remembered that in the 1960s the accounting profession was virtually self-regulated and criticism levelled at the profession generally and Generally Accepted Accounting Principles (GAAP) in particular, by the inspectors, was not received kindly by the profession. In fact it appeared that the profession felt threatened:

> *General Council is opposed to any external control of professional standards on the following grounds:*
>
> *(a) Complete understanding of the problems of the profession of the kind which can only be gained by practitioners in the profession is necessary for its adequate control;*
>
> *(b) Statutory control by an outside authority may tend to restrict new thought and progress;*
>
> *(c) Whilst statutory control by an outside authority might be able to deal with disciplinary aspects of the profession, it would be less competent to deal with the ethical and remedial aspects, particularly educational, that might arise from unfavourable occurrences, or revealed weaknesses in professional standards* (Australian Society of Accountants, 1966, p. 29).

The ICAA formed a Public Relations Committee in 1965 to improve the image of the Institute. Referring to widespread criticism and jokes about chartered accountants in general and auditors in particular the committee was alarmed that the *…ignorance and misconception … extends to opinion leaders in the community* (Public Relations Committee, 1965, p. 674). The committee indignantly continued;

> *How many of us shuddered at the implications to be drawn from some of the woolly thinking that underlay criticism of auditors over company failures in recent years? There is no doubt that, as a profession, we are misunderstood, that the 'average person' has no clear appreciation of where the responsibilities of the chartered*

accountant start and finish. Ignorance breeds distrust and we, *of all the professions need public confidence in large measure* (Public Relations Committee, 1965, p. 674/675).

The final barb from the inspectors of Case Study 1, Reid Murray Holdings Group, should have encouraged a deeper study by the profession as to why a company allegedly following GAAP should fail in such an unexpected fashion when they stated:

On the other hand we believe that we are accustomed to the use of common sense, and common sense has compelled us to reject a number of the accounting practices used in the group and, apparently, regarded as acceptable by accountants (Murray & Shaw, 1963, p. 107).

The ICAA issued new 'Recommendations on Accounting Principles' in January 1964 and they were published in the Chartered Accountant Journal in February 1964. The new recommendations replaced corresponding recommendations issued by the Institute in 1946. There were two items covered by the new recommendations – presentation of balance sheet and profit and loss account and the treatment of stock-in-trade and work in progress. The recommendations were not mandatory for members and the document allowed for alternative approaches to the recommendations:

In recommending what is regarded as the best practice the Institute recognises the variety and complexity of business enterprises which make absolute standardisation of practice impossible. The elements of skilled judgment which are necessary can only be guided by these *recommendations, and circumstances may arise where departure from them is justifiable.*

It should not therefore be assumed that what the Institute regards as the best practice necessarily means that an alternative approach is unacceptable or open to question in particular circumstances (Institute of Chartered Accountants in Australia, 1964, p. 493*).*

While the 21 page document will not be examined in this research it is worth noting the aspirations of the ICAA as to the effect of members implementing the recommendations, looking back, were extremely optimistic. The editorial stated, *inter alia:*

It is clear that these recommendations, apart from aiding the Chartered Accountant in the day-to-day performance of his duties, will give the investing public greater assurance that their interests are being safeguarded against the actions of incompetent or unscrupulous management (Institute of Chartered Accountants in Australia, 1964).

The case studies of Chapters 4, 5, 6, 7 and 8 demonstrate that investors, rather than having their interests safeguarded, were again subjected to the actions of unscrupulous and incompetent management.

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4.7.4. Summary of major causes underlying the corporate failures

Tables 2, 3 and 4 summarise the causes from each case study in this chapter.

Table 2: Case Study 1 Reid Murray Holdings Ltd

Cause	Detail
Lack of Provision for Doubtful Debts and Bad Debt write-offs	Main asset of group was retail debtors yet no adequate provision for bad and doubtful debts (Murray & Shaw, 1963).
Misleading statements in Prospectus/Financial Statements Report	Three directors fined for untrue statements in prospectuses (see section 4.4.4).
Excessive borrowings & lack of repayment strategy	No planned usage of excessive borrowed funds (Shaw, 1966).
Related party transactions/conflict of interest	Related party transactions led to gross conflicts of interest (Murray & Shaw, 1965).
Borrowing short, investing long	Relying on borrowing short term and investing in long term fixed capital expenditure (Shaw, 1966).
Incorrect valuation and allocation of assets	Erosion of land value listed as current assets not brought to account (Murray & Shaw, 1963).
Ponzi scheme	Debentures 1963-5 totalling £19,000 could only be repaid from further borrowing (Murray & Shaw, 1963).
Lack of disclosure	Lack of full disclosure of financial results of subsidiary companies (Murray & Shaw, 1963).
Unstructured rapid expansion	Exploiting physical asset valuation without regard for other limitations on growth (Clarke, et al., 2003).

Table 3: Case Study 2 Stanhill Development Group

Cause	Detail
Lack of Provision for Doubtful Debts and Bad Debt write-offs	Moneys owing by family group.
Misleading statements in Prospectus/Financial Statements Report	*Korman stood trial in Melbourne's City Court in October 1966 on a charge of having issued a prospectus containing false statements. The case was based on the non-disclosure of the Willowbank deal in Factors' debenture prospectus of December 1958* (Sykes, 1998, p. 357)
Excessive borrowings & lack of repayment and planning strategy	Factors public money raising including over-subscriptions partly dispersed to Korman family interests at lesser interest than commercial rate (Murphy, 1965-66).
Related party transactions/conflict of interest	Multiple related party transactions contrary to objects of prospectus issue (Murphy, 1964). Conflicts of interest when directors of lending company are also directors of borrowing company. Such loans were considered from the borrowers point of view, not the lenders (Murphy, 1964).
Borrowing short, investing long	Not applicable
Incorrect valuation and allocation of assets	Selling assets to related company at a profit then using inflated selling price as new historical cost for borrowing purposes (Murphy, 1967).
Ponzi scheme	Not applicable
Lack of disclosure	Non-disclosure of subsidiary companies' profits or losses (Murphy, 1965-66). Non-disclosure of conflict of interest re sale of Town House to SCL from Korman's Park Lake Pty Ltd.
Unstructured rapid expansion	The expansion and collapse of the Korman empire occurred in the space of three years (Sykes, 1998).

Table 4: Case Study 3 – H.G.Palmer Ltd.

Causes	Details
Lack of Provision for Doubtful Debts and Bad Debt write-offs	Enforced reduction by founder H.G.Palmer of credit refusal rate caused massive bad debts which were never written off. When finally written off- main cause of collapse of company (Sykes, 1998).
Misleading statements in Prospectus/Financial Statements Report	Overstatement of assets and profit because of failure to write off bad debts and make provision for doubtful debts (Sykes, 1998).
Excessive borrowings & lack of repayment strategy	Interest bearing debt was far in excess of main asset trade debtors (Sykes, 1998).
Related party transactions/conflict of interest	Sale of family companies at more than favourable terms (Clarke, et al., 2003).
Borrowing short, investing long	Not applicable
Incorrect valuation and allocation of assets	Continuous failure to write off bad debts meant the group hadn't made a profit for years if at all (Sykes, 1998) (Clarke, et al., 2003).
Ponzi scheme	From 1956 to 1965 fifteen capital raisings were made with great reliance on incoming debenture and note subscriptions to pay investors not renewing for a further period (Clarke, et al., 2003).
Lack of disclosure	Lack of disclosure re correct state of debtors when January 1964 prospectus issued (Sykes, 1998).
Unstructured rapid expansion	Growth by expansion not adding corporate value but acquiring value that already existed (Clarke, et al., 2003).

There was a similarity in the first two case studies in this chapter in that the management of the companies were both criticized by the inspectors and investigators for similar reasons. In Case Study 1, Reid Murray Group, the inspector said that the best of the group's executives were second class and the others were worse. In other words, he was placing an emphasis on the incompetence of the management (Shaw, 1966). In Case Study 2, Stanhill Development Corporation, the inspector’s criticism of the founding director and CEO, Stanley Korman, was that he showed himself to be wholly unfit to direct any company in which the public may be induced to invest its money (Murphy, 1965-66). However, in Case Study 3, H.G. Palmers Ltd, there was a difference from the first two case studies in that no inspectors or investigators were appointed. A receiver and manager was appointed. The founder and CEO, H.G. Palmer’s policy of setting the level of credit refusals at an unreasonably low level contributed to the large amount of bad and doubtful debts which was one of the main reasons for the collapse of the company. A similarity between the three case studies was that, in each case, a director of each company was charged with fraud and sentenced to a term of imprisonment.

The extent of the poor management (as described by the inspector) in the Reid Murray Group is demonstrated by the findings in the matrix (Table 12) which shows that all nine causes were found in the analysis of this group.

In Chapter 9 the commonality and causes of unexpected corporate failure for all the case studies in this thesis are compared in a matrix (Table 12).

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4.7.5. Theoretical Applications to Case Studies in this Chapter.

The Fraud Triangle (see section 2.3) concept was applied to all three case studies in this chapter. The tables of factors associated with multiple corporate collapses (see section 4.7.4) each have detailed fraud allegations by the inspectors and/or convictions for fraud as per court proceedings. Looking at the three linkages of the Fraud Triangle, there were no efficient management controls, the rules of the game were dictated by domineering CEOs and the pressure to resolve bad news events created opportunities for fraud to take place. However, the actions of the agents were constrained by the probability of detection and punishment.

This study depicts the actions of individuals in each of the three case studies in this chapter using agency theory, whereby individuals are assumed to be rational, self-interested and utility-maximising. These characteristics, in combination with the Fraud Triangle, enable the identification of particular factors associated with all three of the unexpected corporate collapses. In Case

Study 1, incompetent management and lack of controls were the main causes of the unexpected collapse. In Case Study 2, lack of proper disclosure of related party transactions was a major cause of the collapse and in Case Study 3, the main cause of the collapse was failure to make provision for bad and doubtful debts.

5. CHAPTER 5 - Case Studies of a Number of Unexpected Corporate Collapses 1971-1980

<u>Table of Events Chapter 5</u>

5.1. Introduction

The purpose of this chapter is to analyse two further case studies of unexpected corporate failures that occurred between the years 1970 to 1979, the regulatory framework in place at the time of each failure and the subsequent changes if any to the regulations and legislation as a result of the failures. The case studies in this chapter are Case Study 4, Mineral Securities Ltd, and Case Study 5, Cambridge Credit Corporation Ltd.

It should be noted that the two case studies in this chapter refer to matters up to 44 years ago, and as with the cases analysed in Chapter 4, information is scarce with primary data generally not available therefore there is heavy reliance on literature from Sykes (1998) Clarke and Dean (2003) and the Senate Select Committee Report known as the Rae Report (1974). However this researcher obtained copies of the reports by the government appointed inspectors for Case Study 5. The chapter concludes with a table of the major causes underlying these corporate failures during this decade.

The case studies will be assessed using agency theory as a consistent lens through which to analyse the actions of the management of the corporations.

The investing public did not receive the greater assurance guaranteed by the ICAA journal editorial (see section 4.7.3) in the years 1970 to 1979 as corporate failures continued throughout the decade. This chapter will analyse two of the failures that occurred in the 1970s, selected, as for the previous chapter, on the basis that they were unexpected.

The first, Case Study 4, the Mineral Securities Group (Minsec), includes an analysis of the highs and lows of the mineral securities boom of the late 1960s and early 1970s. The second, Case Study 5, the Cambridge Credit Corporation Group (Cambridge), is a further example of the type of failed strategy seen in the RMG failure with regard to development of large tracts of vacant land. The strategy of borrowing short and investing in long term projects proved to be vulnerable to the volatility of the financial markets.

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5.2. Economic Conditions

Apart from the credit squeeze in 1961 and the troubles of the retailers analysed in Chapter 4, the late 1960s were:

> *…halcyon days for the Australian economy. Disposable income was rising and unemployment was negligible. Economists occasionally voiced*

concern about inflation, but by later standards it was too negligible (Sykes, 1998, p. 385).

Towards the later end of the mining securities boom (1969/70) there were a number of market corrections. Concerns about manipulation of share prices and insider trading moved the Government to appoint a Senate Select Committee in 1970 (Tomasic, et al., 2002).

The Senate Select Committees' (Rae Report) findings and suggestions will be dealt with in section 5.6.1.

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5.3. Economic Event

There were three economic events that occurred during the 1970s. The first, the mining securities boom, was a carryover event from the late 1960s nickel boom. The second was the oil embargo 1973-4. There were several reasons for the oil embargo. First the USA terminating the Gold/Dollar convertibility:

The USA President Richard Nixon's August 1971 decision to suspend the convertibility of dollars into gold was one of the most important chapters in modern economic history. Nixon's move, which was precipitated by rising U.S. balance of payments deficits, ended the *system of fixed exchange rates that had been established at the Bretton Woods conference of 1944 and ushered in a regime of floating rates* (Regional Oral History Office & University of California Berkley, 2011).

The oil embargo occurred between October 1973 and January 1974, when world oil prices quadrupled due mainly to the U.S. removing the gold standard. At the same time the Arab members of OPEC raised the posted price of crude by 70% in response to the Yom Kippur War, and placed an embargo on exports to the U.S. and other nations allied with Israel. The third was the credit squeeze of 1974 brought about by the adverse consequences of high inflation (Battellino, 2010)

The events most relevant to this study are the mining securities boom and the credit squeeze, both of which are discussed in this research.

The Mining Securities (Nickel) Boom

While the retailers had been lurching from one disaster to another (see Chapter 4 case studies) the mining sector, dormant since the 1930s, was emerging as the powerhouse of the Australian economy and becoming the next boom. The main event that triggered the mining boom was the discovery of nickel at Kambalda in Western Australia on 28 January 1966 by Western Mining Corporation Ltd (WMC) (Sykes, 1998). There were three main nickel producers in the world at that time, two from Canada and one from France. The largest by far was International Nickel (Inco) of Canada, producing about half the world's supply. In the latter years of the 1960s the supply of nickel tightened dramatically due to two large strikes by the employees of Inco's main mine while negotiating for higher wages (Sykes, 1998).

WMC took advantage of the shortage of supply due to the industrial action at Inco. WMC had a major underground mine producing within nineteen months from discovery on a virgin site, a record breaking achievement. The mine shipped its first consignment of concentrate overseas in August 1967 (Sykes, 1998). Another aspect of the mining boom were the sharp increases in mining of coal and iron ore, and the development of oil and bauxite discoveries. This boom slowed down during the early to mid-1970s due to very high inflation in Australia and globally (Battellino, 2010).

<u>The credit squeeze of 1974</u>

A combination of the OPEC oil shock (which damaged almost all Western economies) and using the public service as a pace setter in an attempt to increase wages, had further boosted an already rising inflation rate and depressed economic activity, giving rise to 'stagflation'[9].

In mid-1974 Treasury presented a grave economic prognosis to senior ministers and advocated a policy of deflationary measures that became known as the 'short, sharp shock' (Hawkins, 2007).

High inflation was prevalent in Australia and the Whitlam government introduced a dear-money[10] policy as an anti-inflation measure. The government long bond rate had increased to 8.5% and Prime Minister Whitlam announced that:

[9] *A condition of slow economic growth and relatively high unemployment - a time of stagnation - accompanied by a rise in prices, or inflation* (Investopedia).

[10] Dear Money is when it is expensive to borrow money because of high real interest rates. For example, if bank rates are 10% and inflation is 6%. The effective real interest rate is 4%.

> *Substantial increases in other interest rates will follow as effects of the operations (on bond rates) spread throughout other markets for funds. If as a consequence, the high interest rates have the effect of curbing the speculative rush into land and property, that will be all to the good* (Sykes, 1998, p. 437).

As the mineral securities boom started to wind down, companies that continued to enter the market started to incur heavy losses as the volume of buyers dwindled. The first case study in this Chapter, Case Study 4, Mineral Securities Limited, was a prime example.

Companies that relied upon continual inflows of borrowed funds to continue their expansionary strategies were the first to suffer from the higher interest rates and tightening of liquidity from the 1974 credit squeeze. Case Study 5 in this Chapter, Cambridge Credit Corporation, was one such case.

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5.4. Case Study 4 - Mineral Securities Limited

5.4.1. Background

Mineral Securities Limited (Minsec) was formed in 1965 as a non-listed public investment and share trading company by mining engineer Kenneth McMahon (McMahon). Minsec became a listed company in 1967 with no staff, as management services were provided by the partnership, Kenneth McMahon and partners, a separate entity formed by the founder of Minsec specifically for the purpose of providing management services.

Minsec's ambitious plan was to trade on the share market with subsequent profits used to acquire control of selected mining companies. This strategy was initially extremely successful because the listing of Minsec took place at the start of the share market boom of the late 1960s.

> *In five years of existence Minsec had achieved the most remarkable success of any company in Australia's history. The company's initial issued capital was $308,000 and by the end of 1970 it had acquired assets worth more than $100 million* (Sykes, 1995, p. 236).

The growth and expansion of Minsec's share trading activities was evident as for the last 18 months of its life it was the heaviest share trader Australia had known. To make an adequate comparison, the Rae Committee sought evidence from the AMP Society (AMP). The AMP was the largest life office in Australia being as large as its next three competitors combined:

> *The rate of the AMP's share purchases per annum at that time was $40 million and sales of about $8 million. By contrast, in the calendar year 1970 Minsec bought $107 million worth of shares and sold $47 million (not counting a $6 million transaction on both sides which came to be known as the 'Robe shuffle')* (Sykes, 1995, p. 240).

The successful share trading activities continued up until the early months of 1970 when the market slowed because of the flood of new exploration floats where the companies' only assets were unproven pegged claims. For the financial year ending 30 June 1970 conditions in the market were very buoyant and the company produced a net profit from share trading of $9,059,927 (Rath, Cox, & Collum, 1973).

Minsec had become a mining house with 13 listed subsidiaries. Minsec also established two mutual funds, the First Australian Growth and Income Fund (FAGIF) and the Second Australian Growth and Income Fund (SAGIF). In the Rae Report it was noted that in the prospectus of each fund it was confirmed that the fund:

> *will be of a 'general' investment type…Minsec has now substantially reduced its long-term investments in companies in which it does not have management control… it is intended that the Fund will direct its activities*

> *to long- term portfolio investment not associated with management control…*(Rae Report Part 1 volume 1, 1974, p. 14.63).

Despite those assurances, the Rae Report concluded that the funds concentrated the majority of their long-term investment funds in the Minsec group and associated companies (Rae Report Part 1 volume 1, 1974).

Minsec and the stock broking firm Patrick Partners were the two great success stories of the late 1960’s. Both owe their success to the mining boom. However the mining boom subsequently destroyed both of them (Sykes, 1998):

> *The architect of their destruction – apart from their own follies – was Ernest Roy Hudson (Hudson), the Chairman of Kathleen Investments Ltd* (Sykes, 1998, p. 411).

Kathleen Investments Ltd was formed in the 1950s by Ric Dowling a partner of stock brokers Patrick Partners with the objective of retaining an Australian stake in the Mary Kathleen uranium deposit between the Queensland towns of Mt. Isa and Cloncurry

These comments are discussed in the next section, Collapse.

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5.4.2. Collapse

The collapse of Minsec will be considered under the following headings:

1. Backdating the loss on sale of Poseidon shares:

2a First Australian Growth and Income Fund (FAGIF):

2b Second Australian Growth and Income Fund (SAGIF):

3 Reinvesting heavily in a falling market: and

4 Shuffling of shares in Robe River Ltd.

1. Backdating the loss on sale of Poseidon shares

The share market started to fall from about March 1970 as a spate of new exploration floats flooded the market. Floats were becoming harder to take seriously when the only assets were unproven claims (Sykes, 1998). In fact Minsec's share trading team in mid-February 1970 decided that the boom was ending and promptly sold most of their stock but retained shares in Poseidon. Poseidon was a speculative nickel mining stock whose share price was driven by, what turned out to be, over optimistic reports of geological surveys of nickel reserves. Poseidon was the most notable stock of the nickel boom in which

Minsec had invested heavily. The selloff produced small losses but the selling strategy appeared sound. When Poseidon's share price began to slide in the latter half of 1970 Minsec was the largest victim (Sykes, 1998).

When Minsec was preparing to report its results for the year ended 30 June 1970, the directors realised that the company had sustained a loss of about $2.8 million on Poseidon shares since that date which was in the next financial year. As there was a substantial profit for the year ended June 1970 the directors decided to backdate the loss on the sale of the Poseidon shares and deduct an amount of approximately the size of the loss from the profits to be declared for the 1969-70 year.

However, in the Rae Report it was disclosed that:

> *Not only had all the Poseidon shares been sold in the following, 1970-71 year, but rather more than half of them had also been bought after the end of June 1970, according to the information supplied by the receiver Mr Jamison. No indication of any abnormal deduction having been made from the 1969-70 declared profit was given in the profit-and-loss statements in the annual accounts for that year* (Rae Report Part 1 volume 1, 1974, p. 14.42).

The only note in small print attached to the Balance Sheet as at 30 June1970 was a short sentence saying that:

> *Market value of the investments of the group has been calculated on the basis of the last sale price of each stock on 30th June 1970~ with the exception of one stock which has been further written down in the light of*

> *post-balance date events to the realised value* (Rae Report Part 1 volume 1, 1974, p. 14.42).

If this was referring to the Poseidon share transactions it was misleading or uninformative in several ways through lack of proper disclosure. It gave no indication of the amount involved and what effect the adjustment had on the declared profit. Readers of the report would naturally think that the note referred to shares on hand at 30 June 1970 and certainly not to stock purchased after 30 June and subsequently sold at a loss.

The auditors, Bowie Wilson, Miles & Co., gave unqualified endorsement to the manner of the presentation of the accounts certifying that the balance sheet and profit and loss account of the holding company and subsidiaries were:

> *…properly drawn up ... so as to give a true and fair view of the state of the company's affairs as at 30th June 1970, and of the results of the company and the group for the year ended on that date* (Rae Report Part 1 volume 1, 1974, p. 14.43).

The auditors therefore gave an unqualified report on the directors' action of backdating a purchase and sale of shares in a subsequent financial year. The resulting loss from the transaction had the effect of reducing the large profit for the preceding year and reducing the losses in the subsequent year. The Rae Committee stated:

> *We have been astonished that auditors should have said that the profit and loss account for Minsec for the year ended June 1970*

was 'true and fair'. In our view, the accounts were not 'true', and we cannot see how, in the circumstances, the auditors were properly fulfilling their role as the guardians of the shareholders and the public (Rae Report Part 1 volume 1, 1974, p. 14.43).

It is another matter whether auditors are in fact guardians of the public as suggested by the Rae Committee. However it is a well-recognised fact that their role traditionally is in the capacity as guardians of the shareholders (Baxt, 1974). As such the auditors provide a watching brief as to the actions of the participants consistent with agency theory, especially as the agents (the board and senior management) were acting in their own best interests.

Prior to the Poseidon losses, Minsec had been making substantial profits. The distortion of the 1969-70 accounts by concealing the losses of a subsequent year enabled the directors to continue making positive statements that substantial profits were still being earned and there had been no change in the company’s share trading experience (Rae Report Part 1 volume 1, 1974).

2a. First Australian Growth and Income Fund (FAGIF)

2b. Second Australian Growth and Income Fund (SAGIF

The two mutual funds (FAGIF) and (SAGIF) had invested in Poseidon shares concurrently with Minsec. In the period from June to August 1970 the combined losses of the two funds amounted to $530,539 which represented approximately fifteen per cent, an appreciable part of their total resources. In a classic case of conflict of interest, three of the directors of these mutual funds were also directors of Minsec. This was a clear case of the agents looking after their own self-interest instead of the principal's interest and further demonstrates the effect of agency theory. It is therefore hard to understand that, after the Poseidon losses suffered by the mutual funds and Minsec and the further evidence that there were unprofitable trading conditions for Minsec, FAGIF and SAGIF were made by Minsec to invest another $1.3 million in shares of Minsec in September-October 1970 (Rae Report Part 1 volume 1, 1974).

3 Reinvesting heavily in a falling market

In June 1970 Minsec made its first big mistake by deciding to re-enter the market and buy again even though the market was falling. The question that appears to have not been asked was how Minsec's share price and borrowing ability would be affected by the market possessing the knowledge that it was having an unprofitable experience in its share trading activities.

As the Rae Report stated:

> *Instead of preparing for the disclosure of its lean experience,(losing money in a falling market), Mineral Securities set about distorting the public picture of its profit trend and plunging into the short-term money market to a depth that no Australian company had done in order to make massive purchases of shares in mineral prospects* (Rae Report Part 1 volume 1, 1974, p. 14.41).

The massive purchases of shares by Minsec referred to above included $16.6 million buying shares in Queensland Mines Ltd, nearly $11 million buying shares in Kathleen Investments Ltd, and $2.5 million buying shares in Thiess, a total of $30.1 million all purchased prior to the end of 1970. By the end of the year the market value of these holdings had fallen to $24.6 million.(see table 5 below) showing an unrealised loss of $5.5 million (Sykes, 1998).

Table 5: Mineral Securities Ltd, Share Prices (Sykes, 1998, p. 422)

Share	1970 peak	31.12.70
Kathleen Investments	$17.50	$11.80
Queensland Mines	$46.00	$30.00
Robe River	2.70	2.35
Thiess	$5.60	$4.65
Mineral Securities	$23.00	$10.00

The damning condemnation of Hudson, noted earlier (see section 5.4.1), had its genesis when Queensland Mines Ltd (a 51% owned subsidiary of Kathleen Investments Ltd) released a statement on 1 September 1970 of its exploration work for uranium being carried out at Nabarlek 170 miles east of Darwin.

The seven paragraph statement was issued by Hudson as chairman and managing director of Queensland Mines Ltd. The final paragraph stunned the investment community and said:

> *Drilling and costeaning (a form of geochemical sampling where a shallow trench is dug then the exposed rock mapped analysed and sampled (NSW Mining, 2013)) of the first lens (hand held magnification device to see small details more closely) gives indicated reserves of 55,000 tons of U308 (a compound of uranium) of an average grade of 540lb per ton of ore* (Sykes, 1998, p. 416).

This immediately gave the impression that Nabarlek was a highly profitable uranium deposit. The share market reacted positively and Kathleen Investments' share price rose from $4.80 to $8.10. The shares peaked in October 1970 at $17.50.

The Government inquiry section of this chapter (see section 5.7) will deal with the effects of the announcement, which the Rae Committee would later describe as a *grievous misrepresentation* (Rae Report Part 1 Volume 3, 1975, p. 17). The fall in the share price of Kathleen Investments Ltd and Queensland Mines Ltd was because of the Nabarlek statement which grossly overstated the possible reserves of uranium.

4 Shuffling shares in Robe River Ltd

When the Minsec financial accounts for the year ended 30 June 1970 appeared with the concealed profit adjustment due to the loss on the Poseidon shares, the directors were well advanced in an attempt to sustain the façade of continued share trading success. The process aimed at selling about 6,000,000 shares in Robe River Ltd (Robe River) so that Minsec could declare a profit on them while still retaining the shares in a wholly owned subsidiary.

Initially the chairman of Minsec, McMahon, said Minsec wanted to sell substantial quantities of Robe River shares so the ultimate trading profit from the sales would be used to offset trading losses which the company was experiencing in the market, however when the company learned of the plans for expanded output and greatly enhanced profits from Robe River this policy was changed.

The revised action involved the collaboration of an intermediary, a stockbroking firm Hattersley & Maxwell from Sydney (Rae Report Part 1 volume 1, 1974). Minsec therefore produced a profit by shuffling the sale of the Robe River shares via Hattersley & Maxwell to a related company Minsec Investments Pty.

Ltd. in order to circumvent the elimination of the related party transaction[11] which occurs in the consolidation process. It is claimed that it was imperative that the profit from the sale of the Robe River shares to the subsidiary had to be included otherwise Minsec's six monthly accounts to the 31 December 1970 would show a loss (Clarke, et al., 2003).

On 25 January 1971, Minsec announced:

> *The consolidated net profit, subject to audit, from both mining operations and share trading of Minsec and its subsidiaries for the six months ended 31 December,1970, was in excess of $3.5 million after deducting the minority shareholders' interests, provision for tax and writing down the share trading portfolio to the lower of cost or market value* (Rath, et al., 1973 para 131).

There was disagreement about the accounting treatment of the profit from the sale of Robe River shares to a wholly owned subsidiary company via a third party and the effect of that transaction on to the bottom line of Minsec. The real issue was whether a consolidated profit could be reported under conventional consolidated accounting. The conventional treatment, then and currently, where a subsidiary generates profits from group transactions would be to eliminate those profits. Minsec's legal counsel advised the company on 2 February, 1971 that the profit on the Robe River share transactions should be excluded from the calculation of income for the six months ended 31 December, 1970.

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[11] *'Related-Party Transaction' is a business deal or arrangement between two parties who are joined by a special relationship prior to the deal. For example, a business transaction between a major shareholder and the corporation, such as a contract for the shareholder's company to perform renovations to the corporation's offices, would be deemed a related-party transaction.* (Investopedia, p. 1).

The next day, 4 February, directors of Minsec issued this statement to the Sydney Stock Exchange:

> *The directors wish to withdraw the statement made in the company's circular of 25 January 1971…directors were advised by senior counsel that 5,193,400 of the Robe River shares purchased by Minsec Investment P/L must be treated as having been purchased from the Company. Accepted accountancy practice requires that profits derived from a sale by a parent company to its subsidiary should be eliminated from consolidated profit and loss accounts… the profit of $6.63 million earned by the Company on the sale of these shares is to be eliminated from the consolidated profit and loss account so that the results for the six months will appear as a loss of approximately $3.283 million* (Rath, et al., 1973, p. 119).

Following those announcement events moved very rapidly. Minsec's demise matched its rise. Five weeks after the 4 February 1971 announcement the shares were suspended from trading.

The Rae Committee summed it up in their report:

> *"No company in Australia has had a more spectacular rise and fall than Mineral Securities Australia Ltd. Formed in 1965 as an unlisted company with an initial paid capital of $170,500, and listed on the stock exchanges in 1967 after a comparatively small public issue of $137,500, the company had acquired assets in excess of $100 million by the end of 1970.The market valuation of its issued capital was then about $70million. Five weeks later, the shares were suddenly suspended from*

trading on the exchanges, preliminary to their formal removal from the lists forever as being worthless (Rae Report Part 1 volume 1, 1974, p. 14.10)**.**

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5.4.3.Investigation

Although government inquiries into the companies analysed in these case studies are found later in this chapter (see section 5.6.1) it is prudent to mention in this section the formation of the Senate Select Committee and its findings known as the Rae Report. While the purpose of the Select Committee was to report on Australian securities markets and their regulation, the trading activities of Mineral Securities Ltd (Minsec) in the share market were so voluminous, the Committee's report part 1 volume 1 released in 1974 devoted 149 pages of its report to the activities of Minsec.

Appointment of Inspectors and Scope of Investigation

Inspectors were appointed on 9 February 1971 and stated that:

> *Our appointment, in the first instance, followed an announcement on 4th February, 1971, to The Sydney Stock Exchange Limited that the directors (of Mineral Securities Australia Limited) wish to withdraw a statement made in the Company's circular of 25th January, 1971…*(Rath, et al., 1973, p. 8).

Many changes to the Companies Act 1961 were made when the Amending 1971 Act was passed, including the repeal of the Investigations section in Part VI of the 1961 Act. The appointed date of the commencement of the new Part VIA of the Companies (Amendment) Act, 1971 was 1 January 1972 with the repeal of Part VI of the Companies Act 1961 coming into effect on 31 December 1971 (see Appendix 2).

The section of the Act under which the inspectors' appointment was made therefore had changed and to remove any possible legal challenge to their appointment because of the change they were reappointed this time under the amended Act.

The inspectors' stated:

> *… To remove any doubt which may have existed concerning the continuance of the investigation and for more abundant caution, on 18th January, 1972, in pursuance of the powers conferred by subsection (1) of section 170 of the Act we were appointed to investigate all the affairs of Mineral Securities Australia Limited from the date of its incorporation until 18th January, 1972* (Rath, et al., 1973, p. 7).

On 3 February 1971 Minsec requested The Sydney Stock Exchange to suspend trading in the securities of the Company until further notice on all exchanges, local and overseas. On the same day there had also been redemptions by Minsec of shares it held in FAGIF and SAGIF. Both these actions on 3 February 1971 preceded the announcement by Minsec on 4 February 1971 to The Sydney Stock Exchange withdrawing their profit statement made on 25 January 1971. The action of redeeming the shares was clearly an act of insider trading as there were common directors on the Minsec, FAGIF and SAGIF boards.

There was a further appointment for the Minsec inspectors:

> *On 14th December, 1972, we were appointed inspectors to investigate such affairs of First Australian Growth and Income Fund and Second Australian Growth and Income Fund as relate to all the circumstances surrounding applications for redemptions, and redemptions, of shares in those companies by Mineral Securities Australia Limited, in respect of the period from 4th January, 1971 to 31st March,1971* (Rath, et al., 1973, p. 8).

The three inspectors of the Minsec group at the end of their written report produced a Summary of Opinions. The first 14 relevant paragraphs numbered 723 -737 deal with the inspectors' opinions of the company personnel and whether there is enough evidence to form an opinion as to offences committed by each individual. There were two major questions that were investigated.

All of the paragraphs in the summary of opinions above dealt with the first major question, the validity of the profit made on the sale of Robe River shares by Minsec to its wholly owned subsidiary. The second major question was the redemption of Minsec shares from the FAGIF and SAGIF. The directors were clearly not aware of or ignored their fiduciary responsibilities in relationship to both entities. The decision to redeem the Minsec shares from the two funds was a clear case of insider trading as there were common directors on the boards of Minsec and the funds. There was also insider trading on a grand scale by Hudson the managing director of both Queensland Mines Ltd and Kathleen Investments Ltd.

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5.4.4. Prosecution

The Companies Act of 1971 brought up to date the Companies Act of 1961. The changes mainly increased the monetary penalty for breaching Section 124 of both the 1961 and the amending 1971 Companies Act which dealt with insider trading.

The Rae Report was very critical of the insider trading by Hudson, the Chairman and Managing Director of Queensland Mines and Kathleen Investments. Hudson had an extreme conflict of interest being aware at all times of the overstated grades and reserves of the Nabarlek site whilst selling down his holdings in those companies at higher prices than otherwise obtainable had the public been aware of the downgrade. The reports stated:

On each of these selling occasions, therefore, Mr Hudson was privately aware of developments which widened the glaring discrepancy between the ascertained geological facts and the state of confident belief in the market to which he sold the shares. Each of the selling transactions coincided with an advance in his personal understanding of the discrepancy. Mr Hudson's explanation of the sales does not alter the grave impropriety of the share dealings. This is a case of 'insider trading' with a peculiarly objectionable twist. The person who made profits from his possession of information that made a mockery of the market's belief in his company's shares was also one of the persons responsible for misleading that market for a period of nearly a year (Rae Report Part 1 Volume 3, 1975, p. 83).

Mr Hudson, by the tenor of his evidence, sought to imply that the practical significance of the profits he made from the share dealings was minor. The figures can be left to speak for themselves. In mid-April 1970, when the first aerial surveys of the Nabarlek area were under way, Mr Hudson's family company Talbot Investments had bought 4,500 additional shares in Queensland Mines and 5,500 in Kathleen Investments at a total apparent cost of less than $45,000. In the two-and-half months following his public announcement of 1 September 1970 Mr Hudson and his family company sold 9,000 shares in Queensland Mines and 3,000 in Kathleen Investments. The proceeds from those sales amounted to $347,000 (Rae Report Part 1 Volume 3, 1975, p. 84).

The relevant paragraphs of the Summary of Opinions by the inspectors referred to the Robe River transactions and the redemption of shares from the two trusts FAGIF and SAGIF. The inspectors were very critical of the board and suggested there were possible grounds for charges to be laid for insider trading.

However, the penalty for insider trading was negligible as seen in the relevant section 124 of both the 1961 Companies Act and the amending 1971 Companies Act.

The only major differences between the original section and the amending section appear to be in paragraph 2 where the word improper has been moved from 'improper advantage' 1961 Act, to 'Improper use' 1971 Amending Act and the penalty for breaching the section increased from £500 in the 1961 Act to $2,000 in the 1971 Amending Act.

Section 124 of the 1961 Act:

> *(1) A director shall at all times act honestly and use reasonable diligence in the discharge of the duties of his office.*
>
> *(2) An officer of a company shall not make use of any information acquired by virtue of his position as an officer to gain directly or indirectly an improper advantage for himself or to cause detriment to the company.*
>
> *(3) An officer who commits a breach of any of the provisions of this section shall be—(a) liable to the company for any profit made by him or for any damage suffered by the company as a result of the breach of any of those provisions; and*
>
> *(b) guilty of an offence against this Act*
>
> *Penalty: Five hundred pounds* (Victorian Government, 1961, p. 547).

Section 124 of the 1971 Act:

> *(1) A director shall at all times act honestly and use reasonable diligence in the discharge of the duties of his office.*
>
> *(2) An officer of a corporation shall not make improper use of information acquired by virtue of his position as such an officer to gain directly or indirectly an advantage for himself or for any other person or to cause detriment to the corporation.*
>
> *(3) An officer of a corporation who commits a breach of a provision of this section is—(a) liable to the corporation for— (i) profit made by him ; and (ii) damage suffered by the corporation— as a result of the breach ; and*
>
> *(b) guilty of an offence against this Act*
>
> *Penalty : $2,000.*(Victorian Government, 1971, p. 548).

The NSW Corporate Affairs Commission considered prosecution of Hudson but ultimately took no action. According to (Sykes, 1998):

> *…one possibility was that he be prosecuted under the then Section 124 of the Companies Act, which requires a director to act honestly and diligently in the discharge of his duties. However, Queensland Mines was registered in the ACT and as all relevant acts and events occurred outside the ACT there was no chance of a successful prosecution under the ACT Companies Ordinance. (*p.429*).*

The directors McMahon, Nestel and other directors of Minsec were charged with having published a false statement when they announced a profit of more than $3.5 million for the 1970-1 half year (Sykes, 1995). They were prosecuted under section 176 of the Crimes Act, section 73 of the Securities Industry Act and under section 47 of the Companies Act (Clarke, et al., 2003).

After a long trial the jury were ordered by the trial judge Mr. Justice Taylor to find the directors not guilty. One of the main reasons for this decision was that while the Crown alleged the profit was false, they had not stated what the true profit was for the six months.

In his book 'The Money Miners', Trevor Sykes referring to this Minsec judgement states:

> *The judgement had disturbing implications. His Honor's judgement could be reduced to the proposition that a charge of announcing a false profit cannot succeed unless the prosecution can establish what the true profit was* (Sykes, 1995, p. 370).

According to (Sykes, 1995) the profit of a company is the end product of a number of assumptions made when preparing the balance sheet. A variation in any one of a number of items will produce a variation in the profit. (p. 370).

He goes on to cite various assumptions, some valid even today:

> *…the value of stocks on hand, depreciation rates, revaluation of assets, estimate of bad debts and provision for doubtful debts valid in accounting terms but will produce a variation in the profit* (Sykes, 1995, p. 370).

In the end nobody was convicted as a consequence of the Minsec collapse.

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5.5. Case Study 5 - Cambridge Credit Corporation

5.5.1. Background

In March 1950 a qualified accountant (not in practice) R.E.M. Hutcheson joined his father R.E.B. Hutcheson, a practicing accountant in Newcastle, New South Wales, with the objective of starting a finance company. They incorporated Newcastle Acceptance Company in the same year and in 1955 changed its name to Cambridge Credit Corporation Limited (Sykes, 1998).

The Hutcheson family company, Unilateral Services Pty Ltd, managed 100 private and public companies including Cambridge Credit Corporation Limited (Cambridge). The companies were financing hire-purchase agreements managed by the Hutchesons. Following official listing on the Newcastle and Sydney Stock Exchanges in November 1957, expansion was rapid. Cambridge operated primarily as financier and principal engaged in property trading, land subdivision and lease rental (Clarke, et al., 2003).

There were four other companies which were controlled by Cambridge either through majority shareholding or voting control. Although they were not subsidiaries they were considered as Hutcheson family companies by the inspectors. They were, Northumberland Insurance Company Limited (Northumberland), Wellington Court Holdings Pty Ltd (Wellington), Cowdroy Investments Pty Ltd (Cowdroy) and Hunter Purchases Pty Ltd (Hunter). These companies were referred to in the Inspector's First Report as 'Hutcheson Conglomerate'. The appointed inspector Mr F.J.O. Ryan, NSW Commissioner of Corporate Affairs, (see section 5.5.3 for the appointment details) in his second report stated:

> *In reality all of these companies were managed and operated as one group which, for convenience, has been termed the Hutcheson Conglomerate in the Second Report* (Ryan, 1979, p. 3).

The auditors of Cambridge since 1 July 1966 had been Fell & Starkey, Chartered Accountants, an Australia-wide partnership with offices in Brisbane, Newcastle, Sydney, Canberra, Melbourne, Adelaide, Perth and Darwin (Ryan, 1977). Prior to that date the audit had been conducted by various firms which amalgamated with others who subsequently acted in that position. Fell & Starkey also acted as auditors or accountants for each of the Hutcheson family companies and most of the joint ventures. The partner in charge of the audit since 1956 had at all times been Daniel Michal Purcell, whose office has always been located in Newcastle, New South Wales (Ryan, 1977).

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5.5.2. Collapse

The reasons that Cambridge Credit Corporation Limited collapsed has been summarised in three paragraphs in the inspectors' conclusions to their 585 page first report delivered to the NSW Parliament in 1975. The reasons given are:

> *From about 1966, Cambridge advanced its available funds substantially by way of investment in large tracts of undeveloped land for long-term sub-division and sale. These assets were described in the Cambridge group accounts as 'Mortgages and Other Receivables' and were included therein at full value although Cambridge's interest in the land ranked behind those of outside mortgagees and unpaid vendors, whose interests were not disclosed in the accounts* (Ryan, 1977, p. 12.12).
>
> *The nature of the investment in real estate was such that it was incapable of producing a cash flow sufficient to service the projects themselves and existing borrowings from the public, resulting in Cambridge having to rely increasingly on further borrowings. To attract such borrowings, Cambridge became dependent on being able to report*

> *as trading profits internally generated "profits" derived from front end transactions and capitalised interest on loans. As a result of its borrowing and investment policies, Cambridge became increasingly vulnerable to changes in the economic climate* (Ryan, 1977, p. 12.13).
>
> *The severe escalation of interest rates in 1973/74 caused a significant tightening in liquidity in the finance industry and money markets generally which had dire consequences for Cambridge. In 1974, the company was unable to increase its new debenture borrowings to the extent required and its financial partners (banks and associated companies) showed an unwillingness or inability to enter into new commitments and/or to roll over existing loans* (Ryan, 1977, p. 12.14*).*

In an article written in 2007, The Sydney Morning Herald's finance reporter Leonie Wood shed further light on the cause of the collapse:

> *It had acquired swathes of vacant land beyond the fringes of metropolitan areas in the late 1960s and early '70s, subdivided them, installed sewerage, kerbing and lighting. Its plan was to sell the blocks for suburban housing. But in 1974, as interest rates rose sharply, property prices slumped and new housing activity stalled, Cambridge was unable to raise fresh funds* (Wood, 2007, p. 1)*.*

All of the Cambridge directors attended a board meeting held on the 13 September, 1974 and authorised the issue of a press release reporting the year ended 30 June, 1974 financial results.

The press release was issued on the 16 September 1974 with the following headline:

Cambridge profit up by 33.2 per cent (Ryan, 1977, p. 2.2).This statement was in keeping with the directors of Cambridge acting in their own best interest and not the shareholders or principle's best interest which conforms to agency theory.

This headline and press release followed one issued six months earlier on or about 12 March, 1974:

> ***Cambridge credit profit up by 99.8% for half year***

(Ryan, 1977, p. 2.4).

These headlines would no doubt have instilled confidence in the investing public and institutional investors. The 16 September 1974 press release went on to state, *inter alia*,

> *The directors said that in the year under review, the corporation had met continued success in its debenture and unsecured note issues. The rate of renewals in maturing debentures and notes remained high.*
>
> *As at June 30, 1974 the corporation's tangible assets stood at $213,054,343 compared with $170,549,671 as at June 30, 1973* (Ryan, 1977, p. 2.2).

After the March 1974 announcement of the 99.8% increase in profit for the half year Cambridge suffered a liquidity problem which increased in intensity until August,1974, when it reached crisis proportions and culminated in the advice given to the Trustee on 30 September, 1974 (Ryan, 1977, p. 2.5 0009). The directors knew in August that the lack of liquidity had reached crisis proportions yet still issued the bullish press release on 16 September, 1974 that the

Cambridge profit had risen by 33.2% for the financial year. Notwithstanding the cash flow crisis, on the 15th September, 1974 a 4 ½% dividend amounting to $126,000 was paid on the 9% cumulative preference shares

(Ryan, 1977, p. 2.3).

In a perfect example of the definition of *'unexpected corporate failure'* (see section 1.2) 14 days after the record profit press release of the 16 September 1974, the directors of Cambridge on 30 September 1974 gave written advice to the Trustee for the Debenture and Noteholders, Permanent Nominees Limited, that the company was not able to make payment of interest due to Debenture and Noteholders on that date. The Trustee forthwith gave notice to Cambridge and all its guaranteeing subsidiaries that the security under the debenture trust deed had become enforceable (that property given as security under the Trust Deed would have to be realised) and certified that in its opinion:

> *…delay in the exercise of the powers reserved under the Debenture Trust Deed would imperil the interests of the debenture stockholders* (Ryan, 1977, p. 2.1).

Mr. C.H.R. Jackson, Chartered Accountant was appointed Receiver of Cambridge and Messrs. J.G.A. Tucker, G.F. Warhurst and C.H. Niemann were appointed receivers of the guaranteeing subsidiaries in Queensland, New South Wales and Victoria respectively (Ryan, 1977).

Looking back, the statement by the directors in the 16 September 1974 press release that the rate of renewals in maturing debentures and notes was high was obviously false. As events unfolded the cumulative preference dividend of

4.5% was paid out of capital which action was ultra vires the Companies Act of 1961.

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5.5.3. Investigation

On 10 February, 1975 pursuant to Section 170(1) of the Companies Act, 1961 the New South Wales Attorney General appointed the Corporate Affairs Commission as inspector to investigate and report on the affairs of Cambridge Credit Corporation Limited and related corporations. The Commissioner, Mr. F.J.O. Ryan, delegated the task to Messrs. K.M.B. Wright, Chartered Accountant, P.R Callaghan, Barrister-at-Law, H.A. Collum, Deputy Chief Inspector, and J. H. Renneberg, Assistant Senior Inspector of the Commission (Ryan, 1977).

The inspectors produced two lengthy reports, the first in 1977 and the second in 1979. The first report deals principally with Cambridge's involvement in real estate development whereas the Second Interim Report deals principally with the involvement of those other companies in Cambridge's affairs (Ryan, 1979).

The conclusions in Section 6 at the end of the second report contained startling comments from the inspectors:

> *We are of the opinion that statements of Cambridge's net profits before tax for the year ended 30th June, 1966, and for each subsequent six months ended 31st December and year ended 30th June, and Shareholders' Funds as at those dates as contained in the Auditors' Reports included in prospectuses dated after 30th June, 1966, and before 6th may, 1974, issued by Cambridge are false* (Ryan, 1979, p. 277).

The inspectors are in effect saying that every set of financial accounts produced in prospectuses over an eight year period and approved by the auditors were false. This implied that both the directors and the auditors either did not understand or ignored the accounting standards and provisions of the Companies Act 1961. Similar comments were made by the court in Case Study 3, H.G.Palmers Limited (see section 4.6.4). The main reason given for the inspector's comments was the overstatement of Cambridge's net profits before tax and Cambridge's Shareholders' Funds, due, in part to:

1. *The failure to recognise the subsidiary trustee or agency status of Wellington and Hunter and the subsidiary status of Northumberland,*
2. *The failure to recognise and make adequate provision for bad or doubtful debts,*
3. *The failure to provide for diminution in value of investments in subsidiaries and other companies,*

4. *The bringing to account of unrealised profits on front end land transactions and*
5. *The overstatement of the cost of assets acquired* (Ryan, 1979, p. 277).

These five points are now analysed in greater detail.

1. **<u>The failure to recognise the subsidiary trustee or agency status of Wellington and Hunter and the subsidiary status of Northumberland</u>**

Neither Cambridge management nor Fell & Starkey, the auditors, ever considered the financial implications of the interlocking nature of the Hutcheson Conglomerate or the assets position or the trading results of the Hutcheson Conglomerate as a whole. Both management and auditors always chose to believe that a parent-subsidiary relationship could only exist when one could be traced as owning more than *50%* of the voting shares in the other. The reality of common ownership and control was ignored (Ryan, 1979).

The Companies Act 1961 was very clear as to the definitions of a subsidiary and yet this was ignored by both management and auditors. Part 1 Section 6 states:

> *(1) For the purposes of this Act, a corporation shall, subject to the provisions of sub-section (3) of this section, be deemed to be a subsidiary of another corporation, if—*
>
> *(a) that other corporation—*
>
> *(i) controls the composition of the board of directors of the first-mentioned corporation;*

(ii) controls more than half of the voting power of the first-mentioned corporation; or

(iii) holds more than half of the issued share capital of the first-mentioned corporation (excluding any part thereof which carries no right to participate beyond a specified amount in a distribution of either profits or capital); or

(b) the first-mentioned corporation is a. subsidiary of any corporation which is that other corporation's subsidiary (Victorian Government, 1961, p. 448).

The inspectors found that Cambridge management used nominees extensively to hold shares in companies that did not wish to be recognised as subsidiaries, by the falsification and backdating of statutory and accounting records, sometimes after audit, and the absence of or incomplete documentation (Ryan, 1979).

The inspectors went on to state:

> *The Hutcheson Conglomerate for many years had been suffering large cash losses and had survived only by reason of public borrowing through Cambridge. These losses and the links between the Cambridge Group and other Conglomerate members had never been disclosed by Cambridge, although when regard is had to them, Cambridge's situation must have been precarious, if the company was not insolvent, since before 1966* (Ryan, 1979, p. 3*).*

2. <u>The failure to recognise and make adequate provision for bad or doubtful debts</u>

There were many companies controlled by Cambridge that came within the definition of a device to be used by Cambridge to hide losses and escape the obligations of consolidation as a subsidiary. One illustrative example examined here is Hunter Purchases Pty Limited (Hunter). Hunter was incorporated on 19 December 1955 and was originally used as the vehicle for a joint venture between another Hutcheson family company and an outside partner financed by Cambridge (Ryan, 1977).

The joint venture terminated in June 1961. Hunter was reactivated in April 1966 and was financed by Cambridge and used to acquire seemingly irrecoverable debts at full face value from Cambridge's Brisbane Branch, recourse claims against a group of customers engaged in electrical goods, retail and hire-purchase business, totalling $1,037,013 as at 30 June 1966. The total of advances by Cambridge to Hunter exceeded the asset backing for such advances in Hunter's books by more than $1 million. This meant Cambridge lent more than $2 million to Hunter to acquire $1,037,013 worth of highly doubtful debts and recourse claims, the difference allocated to goodwill, an intangible asset (Ryan, 1977).

In a strange use of creative accounting Cambridge's management took the view that this discrepancy represented a goodwill element which Hunter could ultimately repay out of future earnings (Ryan, 1977).

The next three years ended June 1969 proved disastrous for Hunter when continuing in the hire-purchase and retail fields and branching out into the leasing of television sets and the marketing of soft goods. The balance of advances from Cambridge by this date was $5.7 million and the net deficiency of assets in Hunter's books was over $3.4 million. The book value of the Hunter debt to Cambridge as at 30 June 1971 was an enormous $9,013,137. The provision for bad debts was $500,000 (Ryan, 1977).

The inspectors concluded in their second report that:

> *Hunter was managed and wholly financed by Cambridge and was no more than a device for holding undisclosed Cambridge losses and conducting undisclosed Cambridge business. It was passed off as an independent Hutcheson company and whilst it is difficult to trace the beneficial ownership of its issued shares, it would be to our mind idle to suggest that they were held other than for Cambridge beneficially; in any event, we are of the opinion that if Hunter was not a subsidiary of Cambridge it was nothing more than an agent of Cambridge or a bare trustee for Cambridge* (Ryan, 1979, p. 6.31 281).

A bare trustee is defined as follows:

> *The trustee of a bare trust; a trust that has been reduced to holding the trust property at the absolute disposal and benefit of the beneficiaries* (Duhaime, 2014, p. 1).

In general the inspectors summing up the position of the Hutcheson Group stated that:

> *Each of Northumberland, Wellington, Cowdroy and Hunter, was financially dependent on Cambridge and at all times they collectively owed Cambridge millions of dollars. Since at least 1969, Northumberland was reporting losses on operations and was suffering large cash losses.*

Wellington had no source of income, Cowdroy's only significant income came from dividends on Cambridge shares and Hunter was always hopelessly insolvent (Ryan, 1979, p. 282)

The inspectors then reinforced their findings about the relationship of some of the Hutcheson Group with Cambridge:

At all times since their respective reactivations Wellington and Hunter were subsidiaries of Cambridge and should have been consolidated in the Cambridge Groups financial statements; in any event they were agents or trustees for Cambridge, and their assets and liabilities should have been included, on a line by line basis, in Cambridge's accounts. At least from 1st April 1971, Northumberland was also a subsidiary of Cambridge and should have been so treated in the Cambridge Group accounts. At all times, Cambridge's financial support to Northumberland and Cowdroy should have been disclosed in the accounts (Ryan, 1979, p. 282).

3. **<u>The failure to provide for diminution in value of investments in subsidiaries and other companies</u>**

A typical example of the above in Hunter was the way that share trading was conducted and the accounting process used for profits and losses on sale. In the case of Hunter's dealings in 1970 in ordinary shares in Land Planning and Development Ltd in which sales were made in a falling market:

Purchased 30 January 1970 22,000 shares @ 60 cents

$13,840.40

March 1970 21,000 shares sold @ 42 cents

$8,841.54

30 June 1970 1,000 shares carried forward at 'cost' ($4.63 per share) $4,638.86

At 30 June 1970 the market price per share was 23 cents and the market value of the balance of the shares held at that date was $230 as compared with the cost carried forward of $4,638.86 noted above. The value in the accounts was therefore grossly overstated. This method of accounting for share trading is only acceptable if coupled with the procedure of valuing stocks at balance date at the lower of cost or market value (Ryan, 1979, p. 4.250/251*).*

Current accounting practice is to value the shares at the lower of cost or net realisable value.

4. The bringing to account of unrealised profits on front end land transactions

As Cambridge became involved in long term rural type acreage real estate developments there was an ever increasing problem of lack of liquidity. Similar to Reid Murray Holdings Limited in the 1960s it was a case of large capital outlays using short term borrowed money for no likelihood of a return for many years.

Cambridge in the meantime experienced realised losses from other activities, including share trading, hire purchase operations, and investment in film production. All this was compounded by the takeover at the beginning of 1973 of one of its real estate development partners; Intercapital Investments Limited

(Intercapital) and the consequent diversification of its activities into hotel management and aerial photographic servicing companies.

Cambridge needed to continue showing profits to enable it to raise additional borrowings from debentures. In an attempt to alleviate the problem inherent in increased borrowings, a method of enabling the company to report regular profits by bringing into accounts profits at an early stage of the development of projects, was introduced. These profits were termed ‘front end’ profits (Ryan, 1977, p. 2.6). While there is no official definition for front end profits, in the Cambridge case it referred to the accounting for full profit on sale of land notwithstanding Cambridge as vendor retaining a significant interest in the purchaser either as a venturer or shareholder (as noted below). Front-end sales of undeveloped land provided a significant proportion of the reported trading profits of Cambridge from 1970 onwards.

The inspectors were particularly concerned with what they termed as the essential ingredient of front-end transactions, the fact that Cambridge, as vendor, or having a significant equity interest in the vendor, retained an interest in the subject property by virtue of its holding a significant equity interest as a venturer or shareholder in the purchaser. It was the practice in the Cambridge published accounts for Cambridge’s full share of vendor’s profits from front end sales to be included without allowance or disclosure of the proportion attributable to Cambridge’s interest in the purchaser. If professional best practice had been applied a controlling interest in the purchaser by Cambridge would ensure profits would be eliminated on consolidation. In all other cases where there was significant equity but not a controlling interest full disclosure should be made of the proportion attributable to the vendor.

In the inspectors' first report there are thousands of words written about the many transactions involving front end profits from land sales.

To summarise the treatment of profits arising from front end sales generally the inspectors stated:

> *The Cambridge group results for the years ended 30 June 1973 and 1974 included profits before tax of over $4.48 million and $3.29 million, respectively, from front end sales of land to joint venture companies, excluding Group Housing, in which Cambridge had an equity interest. Those profits included over $2.68 million and $1.64 million respectively, applicable to Cambridge's retained interest in the land subject to sale as a result of the company holding a significant equity interest in both the vendor and the purchaser. The practice of including the whole of such profits without allowance for, or disclosure of, the proportion attributable to Cambridge's interest in the purchaser had been the subject of considerable discussion by the auditors amongst themselves and with Cambridge* (Ryan, 1977, p. 3.2 0077).

5. <u>The overstatement of the cost of assets acquired</u>

Cambridge treated all members of the Hutcheson Group in a similar way to Hunter, that is as a repository for debt or, as they were not subsidiaries, receiving cash from Cambridge to buy shares in Cambridge and assist the propping up of the share price.

Hunter's operations, managed and wholly financed by Cambridge, were unsuccessful from the start and by June 1971 its recognised accumulated losses were $2,533,090, although its assets were grossly overvalued and its indebtedness to Cambridge had reached $9,013,137. After Cambridge decided to take action to wind down Hunter's activities in 1972-3, cash rebates, dubious 'commissions' and other profits from Cambridge totalling about $4.7 million were diverted to Hunter and over $2.7 million was written off without disclosure in the Cambridge accounts in reduction in the company's indebtedness to Cambridge (Ryan, 1979).

The auditors' failure to recognise that Hunter's debt at 30 June 1971 was bad or extremely doubtful led to legal proceedings for breach of contract by the liquidator and dealt with in the prosecutions section of this case study. The inspectors quantified the overstatement of Cambridge's net profits before tax and Shareholders' Funds contained in the Auditors' Report in prospectuses issued after 30 June 1966, which were based on accounts for a full financial year, in the following table:

Table 6: Overstatement of Cambridge net profits (Ryan, 1979, p. 277).

Prospectus No. and date	Profits	Shareholders' Funds	Cumulative Overstatement of Profits and Shareholders' funds
	(As disclosed in Auditors' Reports)		
	$	$	$
15—21 Sept 1966	413,920	4,132,028	1,037,009
17---02 Oct 1967	434,067	4,619,387	1,365,273
19---11 Oct 1968	661,345	5,682,660	3,053,271
21---10 Oct 1969	750,670	7,591,784	4,617,819
24---06 Nov 1970	674,121	10,195,509	6,066,366
26---01 Nov 1971	1,534,614	12,270,104	9,223,651
28---20 Nov 1972	2,387,688	13,650,797	9,425,044
30---12 Nov 1973	1,864,837	15,548,634	9,291,942

Criticism of Auditors

The Audit firm of Fell & Starkey received heavy criticism from the inspectors. In respect of the audit report for the Prospectus dated 6 May 1974 the inspectors' said:

> *In our opinion, the amount of 'Liquid Assets' as certified by the auditors was overstated by at least $49,050,277…* (Ryan, 1977, p. 581).

Subsequent legal action against the auditors is dealt with in the Table of Events - Prosecutions.

5.5.4. Prosecutions

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The inspectors of the Hutcheson Group, during the course of writing their reports, made similar complaints and accusations to those in previous case studies in this thesis regarding the actions of the directors and auditors of the companies including:

> *Director Mr. Davis-Raiss had little regard for truth in his documentation of transactions and maintenance of accounting records. Whilst, however, he may have been the instigator of much of the falsification referred to in*

this report, his inspiration, if not direction, came from Mr. Hucheson (Ryan, 1979, p. 282).

We have expressed detailed conclusions concerning the auditors in section 5 (of this report). To those, we add the opinion that had the auditors adopted a competent, critical and independent approach in their work, the conglomerate set up and the disastrous situations of Cambridge and Northumberland could never have developed (Ryan, 1979, p. 282).

At the conclusion of the first Cambridge report the inspectors made the following comment:

We propose to deal with our conclusions as to the questions of possible criminal and civil proceedings arising from the matters dealt with in this Report in a supplementary Report (Ryan, 1977, p. 12.19 584).

Two years later when the second report was printed a similar last paragraph was included alluding to the fact that there would be a third report:

We propose to deal with our conclusions as to the questions of possible criminal and civil proceedings arising from the matters dealt with in this Report in a supplementary report. We also propose to deal briefly with other matters which have come to our attention relating to affairs of Cambridge in a further report (Ryan, 1979, p. 6.40 283).

After a wide search no evidence could be found that a third report was in fact produced.

Cambridge closed its doors on 30 September 1974 when C.H.R Jackson was appointed receiver. He warned on his first day in the job that the receivership would take many years. This was an understatement. Cambridge held a huge property portfolio and the realization of the real estate in fact took 36 years finally wrapping up in 2010.

There were two court cases where the auditors Fell & Starkey and some of the directors were sued. Cambridge failed in 1974 and it is unclear as to why there was a delay of three years before the receiver sued Fell & Starkey, and it was not until seven years after the failure that the receivers were ready to bring the case before a judge (Sykes, 1998).

When the case had still not been resolved by 1984, the presiding judge Mr. Justice Rogers made a special statement in the Supreme Court saying:

> *Never has the proposition that justice delayed is justice denied come nearer to realisation… It is particularly important for the orderly conduct of commerce that those engaged in it should feel it safe to enter into obligations secure in the knowledge that should there arise some dispute it can be litigated and determined with despatch* (Sykes, 1998, p. 466).

There were two issues that the receivers pursued separately in the courts against the auditors. The first was in relation to the Hunter debt owing to Cambridge. The second was in regard to the overstatement of related and subsidiary company assets in Cambridge's balance sheet for the year ended 30 June 1971 in the sum of $9,661,190 (Rogers, ACLR, & 545, 1985).

The borrowing capacity of Cambridge from debenture issues was restricted by the debenture trust deed's provisions which contained constraints on Cambridge's ability to create or issue debenture stock and to make unsecured borrowings, and limited borrowings to three-quarters of the value of liquid assets of the company or five times the value of shareholders' funds whichever was the lesser amount (Ryan, 1977, p. 2.23).

Cambridge issued debentures on 30 June 1971. In the prospectus there was no mention of a provision for bad or doubtful debt relating to the Hunter debt which at that stage was $4.6 million. The receiver sued the auditors over this matter because in the words of Mr Justice Rogers the trial judge:

> *The plaintiffs' case on the separate issue took substantially the following form:*
>
> *1. In the audit of the company's accounts for the year ended 30 June 1971 the defendants should have required the directors of the company either to write off as a bad debt or to make provision against the whole or part of the Hunter debt being irrecoverable. In either event there would have been a breach of the provisions of the debenture trust deed requirements for a prescribed ratio to be maintained between assets and debentures on issue.*
>
> *2. Failing the directors of the company taking some action to avoid a breach of the trust deed ratio, the trustee for the debenture holders should have appointed a receiver in September 1971.*
>
> *3. A receiver appointed in September 1971 would have been able to realise the assets of the company so as to throw up a surplus in shareholders' funds of some $1.3 million.*

4. The failure of the defendants to act as in (1) above, conformably to their contractual obligations, allowed the company's business to be carried on until the appointment of a receiver in September 1974.

5. The receivership, instead of throwing up a surplus of shareholders' funds of $1.3 million, resulted in a large deficiency of assets over liabilities which together with interest quantified the plaintiffs' loss in the region of $200 million (Rogers, et al., 1985 9 ACLR 545).

In March 1985 Mr. Justice Rogers awarded the receivers $145 million special damages against Fell & Starkey. The judge held that the main audit partner Purcell should in 1971 have been conscious of the need to scrutinize Cambridge with considerable care. He found that breaches of duty by Fell & Starkey were a substantial cause of its collapse in 1974. In essence the size of the damages was the estimated size of the shrinkage of Cambridge's net worth since 1971 (Sykes, 1998, p. 466).

The Rogers' verdict was overturned on appeal in June 1987 and eventually an out of court settlement, while officially confidential, is believed to be approximately $20 million was paid to the receivers by the insurers of Cambridge (Clarke, et al., 2003). The ruling given in the two-to-one majority for the auditors found that there was no causal connection between the auditors' breach of contract in 1971 and the losses suffered since then. Mr. Justice McHugh said he found that the sole cause of the loss or damage was the economic downturn in 1972-74, coupled with the decisions to expand Cambridge's borrowings and investments in real estate (Sykes, 1998).

Looking back it is hard to agree with the appeal judge's sole cause of the loss given that the second inspectors report was printed in 1979 six years before Mr. Justice Rogers' verdict. One of their key findings was the financial reports in every prospectus from 1966 to 1974 were false and that the overstatement of the profits and shareholders' funds between November 1970 and November 1971 was between $6,066,366 and $9,223,651 (Ryan, 1979, p. 277). That meant that Cambridge was insolvent long before the June 1971 accounts referred to in the court proceedings.

The charges against three of the directors, Hutcheson, Whitbread, Davis -Raiss and the original lead auditor Purcell were made in March 1985 more than 10 years after the collapse. They were charged with conspiring to cheat and defraud Cambridge investors. In December 1986 the charges were quashed by Mr. Justice Maxwell who ruled that the delay was harsh, oppressive and an abuse of procedure. He criticized the NSW Corporate Affairs Commission (See Appendix 1) as *an ill-equipped rudderless ship sailing without a competent master* (Sykes, 1998, p. 466).

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5.6. Chapter 5 Summary and Conclusions

5.6.1. Government Inquiry

The government inquiry mentioned in Chapter 4, the Eggleston Committee, had called for the establishment of a national companies commission. It came into being in a weak form in 1974 called the Interstate Corporate Affairs Commission (ICAC). However, in approximately 1971 the states of NSW, Victoria, Queensland and, later, Western Australia had abolished their state companies' office and created their own Corporate Affairs Commission (CAC).

Importantly, after the creation of ICAC, no longer would companies need to incorporate in one of participating ICAC states (see Appendix 2). It was the perception that ICAC was only a temporary creation, the first publication of ICAC was only eight pages long. Under the ICAC agreement all power remained invested in the individual state's CAC. In five years ICAC was replaced in 1979 by the National Companies and Securities Commission (NCSC) (Mees & Ramsay, 2008).

The Senate Select Committee on Securities and Exchange (Rae Report) was the dominant government inquiry for the 1970s. The main term of reference was to:

> *…inquire into and report upon the desirability and feasibility of establishing a securities and exchange commission by the Commonwealth either alone or in co-operation with the States…*(Rae Report Part 1 volume 1, 1974, p. v).

The Committee recommended the establishment of a national securities commission with full regulatory and investigative powers of a federal statutory body, modelled on the US Securities and Exchange Commission. Arguing strongly for a national regulatory body for the national securities market, the Rae Report stated:

> *A major purpose of federation was to create a national economy. The growth of a strong securities market in which funds can be raised nationally to finance capital formation must be regarded as a logical, and presumably, expected result of that objective. It would, therefore, appear that the regulatory system should facilitate and encourage the development of a national securities market. Separate or duplicated laws of the States and Territories regulating the securities market are obviously required when there is no national legislation. Nevertheless, one of the effects of having separate laws rather than national legislation has been to obstruct and burden unnecessarily the development of the national market. For example, a company should be able to raise capital nationally without having to register a prospectus in every State and Territory. It should be required to keep the public market informed, but*

> *not by the filing of accounts in every State and Territory in which it carries on business. It should be able to operate through subsidiaries incorporated in different States and Territories without having to cope with diverse accounting requirements.*(Rae Report Part 1 volume 1, 1974, p. 16.12).

The Eggleston Committee also recommended that a National Corporate Affairs Commission should be formed. New South Wales, Victoria and Queensland formed their own separate Corporate Affairs Commissions (CAC) on the 18 February 1974.

In the preface to his commentary 'The Rae Report – Quo Vadis,' author Robert Baxt states that:

> *The Rae Report is a work which apart from exposing the inadequacies of the security industry legislation and administration at the time of the mining boom, raises very directly the question of a national approach to our company and securities law. This question will continue to be a central one as we await and debate the Australian Government's securities bill and national companies bill (Baxt, 1974, p. v).*

Baxt strengthened his view that an important nexus existed between the two pieces of legislation:

> *It is in my view impossible to look at securities law properly without looking long and hard at company law as well* (Baxt, 1974, p. 1).

The Rae Report has been cited many times in this chapter in particular in relation to Case Study 4 Minsec. The dramatic collapse of Minsec became a prime focus of the Rae Committee and the longest chapter of the report dealt with Minsec's collapse.

The Rae Committee was looking at an industry which suddenly found itself in the grip of an investment boom most probably unlike anything experienced in Australia before and Minsec was by far the most outstanding player.

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5.6.2. Regulation and Legislation Change

The most important regulation and legislation change to occur in the 1970s was the implementation of the recommendations of both the Eggleston Committee's Report and the Rae Report regarding the formation of a National Corporate Affairs Commission.

As discussed in 5.6.1, four states NSW, Victoria, Queensland, and Western Australia had formed their own CAC brought under the umbrella of the ICAC. An Act to bring about the formation of ICAC was enacted in May 1974 styled: *This Act may be cited as the Companies (Interstate Corporate Affairs Commission) Act 1974* (Victorian Government, 1974).

The Act involved is an amending Act to the principal Act the Companies Act of 1961. The participating states entered into an agreement with the following interpretation:

> …*Interstate Corporate Affairs Agreement means the agreement between the States of New South Wales Victoria and Queensland relating to the establishment of an Interstate Corporate Affairs Commission executed on the 18th day of February 1974 a copy of which is set out in Schedule One to the Companies (Interstate Corporate Affairs Commission) Act1974* (Victorian Government, 1974, p. 150).

However, not all States were bound by the ICAC agreement and did not form their own corporate affairs commissions until they were required to do so when the scheme to replace ICAC came into being in the early 1980s (Mees & Ramsay, 2008).

The inter-state corporate agreement proved an ad hoc and inadequate affair. The underfunding or lack of adequate resourcing has been a complaint against the current corporate watchdog ASIC (Spits, 2013).

According to (Mees & Ramsay, 2008) ICAC was*:*

> *Declaimed by Senator Rae as an inflexible monstrosity, its replacement was one of the more notable economic and legal reforms that emerged during the Fraser government years* (p.26).

The National Companies and Securities Commission (NCSC) was established in 1979 but did not commence operations until 1980.

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5.6.3. Profession Action

Chapter 4 included discussion regarding the profession being more concerned with protecting the reputation of members and the profession generally than in examining the probable causes of the corporate failures. This section includes a brief discussion on actions by the accounting profession commenced in the mid 1960s and continuing to the mid 1970s.

Initially the profession was reluctant to accept responsibility for the allegations made against it. However, when the criticisms came close enough to threaten the profession's status as a profession the two major accounting bodies the A.S.A and the I.C.A.A., started acting. Gradually the cause of corporate failure was changed from certain individuals acting improperly to a realisation that the rules and procedures of the profession were found wanting. The two major accounting bodies were criticized for not responding quickly or effectively to the question of corporate collapses at the time. During the 1970s the main accounting bodies issued many joint exposure drafts, forming standard setting and research committees and issuing various standards (Keown, 1968).

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5.6.4. Summary of major causes underlying the corporate failures

The main cause of Minsec's failure was buying shares in a falling market (Table 7). The company spent $30.1 million buying shares from June 1970 to December 1970 by which time the market value had fallen to $24.6 million. Most of the funds used were borrowed on the short term money market.

In the case of Cambridge (Table 8), there is a similarity with Case Study 1, Reid Murray Group, pursuing the same strategy of development of large tracts of land for housing, i.e. borrowing short and investing long, a major factor in the collapse. The inspectors of Cambridge during the course of writing their reports made similar complaints and accusations to those in previous case studies in this research regarding the actions of the directors and auditors of the companies. They included, misuse of funds, back dating company minutes, flagrant breaches of the Companies Act, falsification and back dating of statutory and accounting records, sometimes after audit, concealment by the auditors of the true situation, diverting funds to cover up losses and intermingling of public company funds with the private family companies of the dominant founder and managing director (Ryan, 1979).

Table 7: Case Study 4 – Mineral Securities Limited

Cause	Detail
Lack of Provision for Doubtful Debts and Bad Debt write-offs	Not applicable
Misleading statements in Prospectus/Financial Statements Report	Directors charged for publishing false profit statement 1970-1 half year (Sykes, 1995). Misleading statements regarding substantial profits being made (Rae Report Part 1 volume 1, 1974).
Excessive borrowings & lack of repayment strategy	Huge outlays in the short term money market which were used to buy shares
Related party transactions/conflict of interest	Insider trading by E. R. Hudson as managing director of Queensland Mines Ltd and Kathleen Investments Ltd (Rae Report Part 1 Volume 3, 1975).
Borrowing short, investing long	Huge borrowings in short term money market to make massive purchases of shares in falling market (Rae Report Part 1 volume 1, 1974)
Incorrect valuation and allocation of assets	Not applicable
Ponzi scheme	Not applicable
Lack of disclosure	Small note re sale of Poseidon shares, no disclosure that transaction backdated (Rae Report Part 1 volume 1, 1974)
Unstructured rapid expansion	Expanding rapidly into a falling market (Rae Report Part 1 volume 1, 1974).

Table 8: Case Study 5 – Cambridge Credit Corporation Limited

Cause	Detail
Lack of Provision for Doubtful Debts and Bad Debt write-offs	Cause of overstatement of Cambridge net profits before tax (Ryan, 1979)
Misleading statements in Prospectus/Financial Statements Report	Net profits and Shareholders' Funds in financial statements for many years considered false by inspectors (Ryan, 1979)
Excessive borrowings & lack of repayment strategy	Relied upon continual inflows of borrowed funds to continue the expansionary strategies and suffered in 1973/4 credit squeeze (Ryan, 1977)
Related party transactions/conflict of interest	Moving losses into related companies without proper valuation or provisions for losses (Ryan, 1979)
Borrowing short, investing long	Investing in large tracts of undeveloped land for long term subdivision and sale financed by short term borrowings (Ryan, 1977).
Incorrect valuation and allocation of assets	Failure to provide for diminution in value of investments in subsidiaries and other companies(Ryan, 1979)
Ponzi scheme	Dependent upon renewal of expiring debentures and notes and increased new debenture and note subscriptions to fund payment of expiring investments (Ryan, 1977)
Lack of disclosure	Total front end profits included as income when holding an interest in the purchaser (see page183)
Unstructured rapid expansion	Investing huge sums of money in large tracts of land for future development and long term subdivision and sale (Sykes, 1998).

The extent of the poor management (as described by the inspector) in the Cambridge Credit Corporation Group is demonstrated by the findings in the matrix (Table 12) which shows that all nine causes were found in the analysis of this group.

In Chapter 9 the commonality and causes of unexpected corporate failure for all the case studies in this thesis are compared in a matrix (Table 12).

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5.6.5. Theoretical Applications to Case Studies in this Chapter

This study depicts the actions of individuals in the two case studies in this chapter using agency theory, whereby individuals are assumed to be rational, self-interested and utility-maximising. These characteristics, in combination with the fraud triangle, enable the identification of particular factors associated with both of the unexpected corporate collapses.

The fraud triangle concept (see figure 1) applies to both case studies in this chapter. There were no management controls in place and when pressure was applied on the companies by the 1973/4 credit squeeze the management resorted to fraudulent deceptive behaviour.

6. CHAPTER 6 - Case Study of an Unexpected Corporate Collapse 1981-1990

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6.1. Introduction

The purpose of this chapter is to analyse a further case study of unexpected corporate failure between the years 1980 to 1991, the regulatory framework in place at the time of the failure and any subsequent changes to the regulations and relevant legislation, if any, as a result of the failure. The case study in this chapter, Bond Corporation Holdings Ltd, refers to matters up to 35 years ago and some information is scarce with primary data generally not available therefore, as for the preceding two chapters, there is heavy reliance on literature from a limited range of sources. For this chapter, there is reliance on the work of Sykes (1996), Clarke and Dean (2003), Barry (1990), various newspaper reports and the Senate Select Committee Report known as the Rae Report (1975). The chapter concludes with a table summary of the major causes underlying this corporate failure during this decade. The case study will be assessed using agency theory as a lens through which to analyse the actions of the management of the corporations

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6.2. Economic Conditions 1980s

In Australia during 1980, unemployment fell below 6% while inflation, although below the Organisation for Economic Co-operation and Development's (OECD) norm was above 10%. In addition the resources boom indicated that a new wages push was imminent (Paul Kelly, 2010).

There has been four periods of economic downturn in Australia in the 30 years from the early 1980s to the end of 2010. The first two, during the early 1980s and 1990s respectively were considered severe and protracted recessions with a marked decline in economic activity and rising unemployment (Australian Bureau of Statistics, 2010). The U.S. economy also experienced a deep recession between 1980 and 1982. One cause was the 1979 Iranian Revolution which caused a large round of oil price increases. Another cause was the disinflationary monetary policy adopted by the Federal Reserve (University of California, 2011).

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6.3. Economic Event 1980s

The economic event in the early 1980s was the recession (see section 6.2). The main economic event to occur in the 1980s was the share market crash of 1987. On 19 October 1987 the Dow Jones index fell 22.5% or 508 points. In Australia the Dow Jones fall had a similar effect on the S&P/ASX 200 index falling 516 points. Melbourne stockbroker Bruce Teele stated:

> *That the entrepreneurial era that had been driven by greed and supported by cheap cash was over* (McMahon, 2007, p. 1).

The high-flying Australian entrepreneurial culture, epitomised by Alan Bond, Christopher Skase and Robert Holmes a Court, was reported as a major factor in what is now regarded as the classic bubble syndrome.

Teele recalls:

> *It was a period of rampant inflation and the fiscal management at the time was reckless, with money freely available and people were being sucked into the market by all the get-rich-quick stories, but cowboys only get away with it if people ride in their posse. Once you build up a culture that this is the way to make money lots of people want to join in* (McMahon, 2007, p. 2).

This Chapter will analyse the corporate failure of one of the main players in the Australian entrepreneurial culture, Alan Bond.

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6.4. Case Study 6 – Bond Corporation Holdings Ltd (Group)

6.4.1. Background

Bond Corporation Pty Limited (Bond Corporation) was formed in 1967 by Alan Bond. Bond was a sign writer and head of Nu Signs Pty Ltd, originally formed in 1956. Bond Corporation achieved a back door listing on the stock exchange by a reverse takeover [12] in 1969 of the West Australian hardware merchant W.Drabble Ltd (renamed Amalgamated Industries Ltd) (Sykes, 1996).

It is beyond the scope of this thesis to cover all deals and acquisitions carried out by the Bond group. Such deals numbered in their hundreds. The group

[12] Reverse Takeover - RTOBy root | November 25, 2003 A type of merger used by private companies to become publicly traded without resorting to an initial public offering. Initially, the private company buys enough shares to control a publicly traded company. The private company's shareholder then uses their shares in the private company to exchange for shares in the public company. At this point, the private company has effectively become a publicly traded one. Also known as a "reverse merger" or "reverse IPO"

consisted of in excess of 600 subsidiaries and each of the related companies within the group, while doing its own unique thing, on the side owned a piece of the major action of the others (Clarke, et al., 2003). As with previous case studies in Chapter 4 such as Reid Murray Holdings and HG Palmers, and the Chapter 5 case study for Cambridge Credit Corp, individual company and group actions were inextricably intertwined. The Bond Corporation Group's actions were no different and the*:*

> *Byzantine configuration had the potential to be a house of cards. And it would prove to be a nightmare for creditors, auditors, judges and administrators when the pack imploded* (Clarke, et al., 2003, p. 171).

The analysis in this chapter will be limited to some of the larger transactions which clearly show the nature of the way Alan Bond and his directors operated and how the transactions contributed to the group's collapse.

Bond Corporation Holdings (BCH) expanded at a breathtaking rate, buying existing companies, revaluing their assets and then borrowing on the strength of the revaluation. However, growth- by- acquisition using funds borrowed on the revalued assets and using those assets as collateral, continually depends upon the veracity of the valuations.

> *BCH spent more than $5 billion on acquisitions including the 'too good to refuse' $1 billion purchase of the Nine Television Network from Kerry Packer, a US$262 million stake in the Chile telephone company Componia de Telefonos De Chile, an investment in Chilean gold mines and in September 1987, the US$1.3 billion acquisition of the ill-fated*

fourth –largest US brewer, G.Heileman & Co.(Clarke, et al., 2003, p. 177).

It was clear that with total debt of $6 billion, continual up-to-date valuations of the group’s assets were necessary however that never occurred. Looking back it is difficult to understand why banks and other lending institutions did not insist on up to date valuations of the group’s assets being securities for their loans.

From 1985 the acquisitions continued at a fast pace. $1.2 billion was spent by BCH purchasing all the issued capital of Castlemaine Tooheys in 1985, followed in February 1986 by the acquisition of the US regional brewer, Pittsburgh Brewing Company for US $29.8 million and in April the Screen Entertainment Division of Thorn EMI was purchased for £125 million. Zero income tax was paid because of the use of Jersey’s tax haven status, a strategy, according to Barry used by many companies during the 1980s (Barry, 1990).

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6.4.2. Collapse

The share market crash of 1987 was a clear indication that the investment world had changed. However, Alan Bond turned a blind eye and BCH continued to expand at a great pace. Two of the biggest and worst judgements involving expansions were made after the October 1987 share crash, with the purchase of shares in Lonrho and Bell Resources.

Some of the major transactions that contributed to the BCH group collapse are analysed in this section are:

1. Lonrho:
2. Sale of the Capital Centre in Sydney (including the Hilton Hotel):
3. Sale of the Porta di Roma Land:
4. Bell Resources: and
5. Purchase of G.Heileman & Co.

1. Lonrho

Lonrho was an international trading house and the chief executive was Tiny Rowland (Rowland). Alan Bond had a cordial relationship with Rowland until Bond suggested BCH buy shares in Lonrho to help protect the company from raiders (Sykes, 1996). In September 1988 Bond launched a raid on Lonrho, spending $655 million buying 20% of the company. The acquisition made BCH the largest shareholder of Lonrho. According to Sykes, Rowland - realising BCH had to borrow to fund the purchase - decided to make the borrowing difficult by attacking BCH's credibility. Rowland launched a full scale attack on the Bond group's accounts (Sykes, 1996). Rowland's accountants produced a 93 page document in November 1988 with the opening page stating:

> *Bond group companies are technically insolvent, the commercial existence of which is through extraordinary bank support* (Sykes, 1996, p. 218).

The circulation of the Rowland report caused the share price to drop from $2.25 to $1.12.

> (Clarke, et al., 2003) state the plan for the raid on Lonrho was to: *use the cash and asset power of Lonrho to buy the British brewer Allied-Lyons and use the latter's cash flow to venture into the field of telecommunications* (p.183).

The attack by Rowland had the effect of BCH failing to go ahead with the planned takeover proposal and Lonrho survived.

2. Sale of the Capital Centre in Sydney (including the Hilton Hotel)

In March 1989 the ABC screened its Four Corners programme, an investigation into Alan Bond. The programme was led by Paul Barry whose book, 'The Rise and Fall of Alan Bond' is an important work in the literature for this case study. The disclosure in the programme was that the profit shown in the financial accounts of BCH for the year ended 30 June 1988 had been inflated by the inclusion of the prospective profit of two real estate deals. Both sales had not been completed by June 1988 and had still not been completed some nine months later (Sykes, 1996).

The first deal was the sale of the Capital Centre in Sydney which included the Hilton Hotel, the second deal was the sale of the Porta di Roma land (see point 3). The Capital Centre transaction was to have been completed in December 1987 for a purported profit of $80 million and sold to Singapore businessman, Ong Ben Seng. There was a great difficulty tracing the transaction as it was owned through a chain of companies using exotic tax havens. Mr Justice Beach of the Victorian Supreme Court stated his frustration:

> *The Ong transaction is one of the more mysterious transactions I have ever been called upon to investigate during the course of my legal career. In some respects it has been like dealing simultaneously with a slippery eel and a large and very active octopus. When one feels one is making some headway towards gaining an understanding of the true nature of the transaction one suddenly finds oneself up a blind alley and obliged to start afresh* (Sykes, 1996, p. 219).

3. Sale of the Porta di Roma Land

BCL in its 1988 annual report stated that it had purchased approximately 260 hectares of land in an area nine kilometres north of Rome, and in the same year disposed of a minority interest for a substantial profit. The minority interest in the land was sold to a company, Kitool Pty Ltd (Kitool), that was not a subsidiary company and the profit on the sale was included in BCL's result for the financial year ended 30 June 1988. However, the sale was never settled and the profit was reversed in the subsequent annual accounts for 1988/89. Kitool was a $2 shelf company and at no time appeared able to complete the transaction. The conclusion reached by the author of the literature was that Kitool was at no stage a genuine arm's length buyer of the land.(Sykes, 1996).

4. Bell Resources

Entrepreneur Robert Holmes a` Court, in April 1988 owned, *inter alia*, a 40% stake in Bell Resources Ltd (BRL), a listed public company whose main asset was a 20% share of BHP. He wanted to liquidate his share of BRL, however the share price after the October share crash had fallen to $1.50 from $3.85. He could not sell the 40% holding in BRL at a higher price without the buyer, under company law, offering the same price to the remaining 60% of shareholders. So the solution was to split the holding into two parcels each of 19.9% (as a 20% holding required an offer to all shareholders by the 20% holder) and sell them at the same time to the State Government Insurance Office of Western Australia (SGIOWA) and to BCH for $2.70 each. This was a classic case of agency theory at work with Bond acting in his own self-interest to the detriment of the remaining shareholders who were denied the same price that Holmes a` Court received. After the purchase from Holmes a` Court, BCH and related companies owned 53% of Bell Resources seemingly under the control of Alan Bond (Clarke, et al., 2003) The transfer of $1.2 billion from the Bell Resources group's cash reserves to BCH and subsidiary companies together with related party companies has been described as Australia's largest corporate fraud (Clarke, et al., 2003). The transfer was an example not only of agency theory (see section 2.2) at work but also the effect of TCL (see section 2.2.1).

After the 1987 share crash, the Bond group suffered an increasing liquidity crisis as the group was still spending big on acquisitions while cash inflow was slowing down to less than the outflow. Once again, the solution was to use back-to-back lending. While BCH only owned 53% of Bell Resources, its assets - which were mostly cash - were dealt with as though they were wholly owned by BCH. Also BCH had agreed with Bell's major financiers that Bell would not make any loans to BCH except for short term accommodation. It is not known whether this was a legally binding agreement. However when Bond got control of the Bell Group, it is claimed that he regarded the Bell Group as a cash cow (Sykes, 1996). Using a company called Markland House, Bond moved a large quantity of funds from Bell Resources through Markland House and its subsidiaries to the Bond Group mainly the financing arm, Bond Corporation Finance. These actions were in direct conflict with the undertakings given by Bond to the various lenders to not lend funds from the Bell group to the Bond group (Sykes, 1996).

5. Purchase of G.Heileman & Co

In September 1987 BCH acquired G. Heileman & Co (Heileman) for USD1.25 billion. Heileman was the fourth largest brewing company in the US. The acquisition merged together with Bond Brewing produced the fourth largest brewing company in the world (Clarke, et al., 2003). In a strongly worded criticism of the purchase (Sykes, 1996) called the purchase of Heileman: *Bond's biggest single mistake and the reason for the mistake appears to have been sheer incompetence (p. 213).*

Sykes continues that according to the BCH 1988 annual report:

> *…managing director Peter Beckwith said Bond Corporation undertook eight months of meticulous preparation before launching its bid for Heileman. Either this preparation did not disclose that Heileman's core beer operations were trading at a loss or the meticulous planners chose to ignore the fact (Sykes, 1996, p. 213).*

Immediately after BCH purchased the Heileman group it sold its non-core assets of baking, snack foods and machine products. These products were the profit making products and, as mentioned above, beer was making a loss. In the first eight months after BCH acquired Heileman and after selling the profit making assets, Heileman made a $95 million loss and another $70 million loss in the first full year. Peter Coors head of the Coors Brewing group said that Heileman in his estimation was only worth US$388 million in 1988, less than one third of the US$1.25 billion price paid by Bond (Sykes, 1996).

Another strategic mistake made by Bond was the attempt to gain a foothold in the media industry. BCH spent $1 billion in purchasing the Nine Network from Kerry Packer (Packer). When Bond's empire crashed Packer took back control of the nine network for less than $500 million.

BCH's growth strategy was very similar to previous case studies in this thesis. Borrowings needed to finance investments and the capacity to borrow relied upon yearly profits increasing and a good public image (Clarke, et al., 2003). The main cash generating entity in the Bond group was Bond Brewing Limited. Following numerous breaches of the company's loan agreement with the National Australia Bank a receiver was appointed on 29 December 1989. As (Sykes, 1996) states:

> *It would be tedious to trace the death throes of the Bond Empire from this point. There was a series of long tortuous law cases as Bond fought his creditors in the court at every point in delaying actions that covered more than two years* (p.233).

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6.4.3. Investigation

There were many investigations into BCH and Bond personally. Tiny Rowland's Lonrho private investigation into BCH contributed to a slide in the share price. Australian Ratings then downgraded the credit rating of BCH from B to CCC, signifying 'poor debt protection levels' (Clarke, et al., 2003). Paul Barry, the journalist with the ABC television programme 'Four Corners' investigated Alan Bond's balance sheet and in the process destroyed the Bond corporate image by revealing the company was lying to its shareholders and bankers, and was on the point of collapse (Barry, 1989).

The National Companies and Securities Commission (NCSC) commenced an investigation in 1989 focussing on whether, in view of BCH dealing, the share market had been kept fully informed. In March 1989 another investigation headed by South Australian QC John Sulan was commenced (as a special investigation under the Companies Code). Constant legal challenges by Bond frustrated the investigation. On 1 January 1991 the Australian Securities Commission (ASC) came into existence and took over responsibility for the continuation of the investigation (Hall, 1995). In August 1991 a joint Federal Police/ASC investigation was established to focus, *inter alia*, into the alleged $1.2 billion fraud on the bell Group and in particular Bell Resources Ltd. It was an extremely difficult and complex investigation taking almost three years to complete before a brief was handed to the Commonwealth Director of Public prosecutions (DPP) (Hall, 1995).

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6.4.4. Prosecution

Bond faced several criminal trials.

1. **Rothwells**

Bond was jailed for a year in 1992 on the Rothwells' charges but released after three months on appeal. He was acquitted on the retrial.

2. **La Promenade**

In June 1993 Bond was charged with:

failing to act honestly by not notifying the BCH board that it had the opportunity to acquire a Manet painting named La Promenade at a cost substantially below market value (Sykes, 1996, p. 236).

In 1996 Bond was found guilty of fraud charges and sentenced to two years' jail on one count and one year's jail on another.

3. Bell Resources

Three directors Bond, Antony Oates and Peter Mitchell were committed for trial on charges related to the Bell Resources stealing of $1.2 billion. Bond and Mitchell were found guilty and Bond was sentenced to four years jail which was increased to seven on appeal, (the increase later dismissed on a further appeal). Mitchell was sentenced to four years jail and Oates fled the country to Poland.

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6.5. Chapter 6 Summary and Conclusions

6.5.1. Government Inquiry

There were three relevant Senate inquiries during the 1980s.

1. The Committee of Inquiry into the Australian Financial System (Campbell Committee 1981):
2. Report of the Joint Select Committee on Corporations Legislation (Lavarch Committee (April 1989): and
3. Report on the Social and Fiduciary Duties and Obligations of Company Directors (Cooney Committee Nov 1989).

1. The Committee of Inquiry into the Australian Financial System (Campbell Committee 1981)

In September 1981 the Australian Government published the final report of the committee of inquiry (Committee) into the Australian Financial System known as the Campbell Report. The report contained 838 pages and covered an extensive examination of the Australian financial system. The part that is examined here is the relevant Section B, Company Reporting and Accounting Standards, and Accountability.

The first item in the section (a) Reporting Standards, deals with the question of disclosure standards or what is reported. Because of the differing levels of disclosure in company reports, the committee suggested:

> *21.36 It accordingly suggests that the National Companies and Securities Commission NCSC should confer with the Australian Institute of Management (and other appropriate bodies) on the need, or*

otherwise, for government action to improve the standard of reporting by public companies and like institutions (Campbell Report, 1981, p. 369).

It is interesting to note that the body encouraging corporations and others to report information beyond the statutory minimum was the Australian Institute of Management (AIM) and not the leading bodies of the accountancy profession.

In the second part of the section, part (b) the report called for consistency of reporting by financial intermediaries such as banks, credit unions and building societies. However it stressed that striving for stability by such intermediaries should not prevent disclosure of important variables such as bad and doubtful debts (Campbell Report, 1981). The Committee at paragraph 21.44 recommended:

> *…that all financial intermediaries should be subject to consistent reporting requirements, which should be prescribed in regulations to the relevant legislation* and:
>
> *21.45 The requirements of the Companies Act should serve as a benchmark, but with variations to allow for the specific nature of the business undertaken* (Campbell Report, 1981, p. 370).

The third part of section B is (c) Accounting Standards and Enforcement.

Criticism of the then existing accounting standards opened the section on the grounds that:

> • *they lack sufficient precision and objectivity and thus permit the same transactions to be reported differently, so impairing the comparability of financial statements;*

> • *the progress of reform is slow because of inadequate research into standards and lack of agreement within the accounting profession;*
>
> • *the standards are not effectively or consistently enforced, there being no single body to ensure compliance; and*
>
> • *the standards can affect investment behaviour in the economy and should not therefore be left solely to the accounting profession to determine (Campbell Report, 1981, pp. 370-371).*

The report quoted critics linking the existing standards to unexpected corporate failures:

> *21.47 Critics point out that some major company collapses during the 1970s closely followed the publication of audited financial accounts (or prospectuses containing accounts) which showed the companies concerned to be solvent and even profitable (Campbell Report, 1981, p. 371).*

If the committee had further examined the claims of the critics there was ample evidence in the 1960s of similar scenarios as per the three case studies in Chapter 4 of this research. The Committee discussed the 1978 report of the Accounting Standards Review Committee which *inter alia* was critical of the existing standards including lack of definition or interpretation of terminology such as state of affairs, profit and true and fair view. The financial accounts being prepared on an historical cost basis was claimed to not provide a valid indication of the state of affairs and profit of a company (Campbell Report, 1981). The Committee also considered that as there was no legislative support there was no adequate enforcement of existing standards. The following recommendation was made by the committee:

21.57 The Committee therefore recommends that:

(a) The two professional accounting bodies should continue to be responsible for the design and development of accounting standards.

(b) An Accounting Standards Review Board should be established with responsibility for deciding on the adoption of accounting standards, having regard to the needs of different users; the NCSC, professional accounting bodies and other interested parties should be represented on the Board.

(c) Accounting standards recommended by such a board should be given legislative support (Campbell Report, 1981, p. 372).

Therefore, accounting standards were to receive the force of law (see section 6.5.2) The Committee ensured that the relevant Corporate Affairs Commission gained representation on any committee with the following:

21.62 The Committee therefore recommends that the National Companies and Securities Commission should arrange with the two accounting bodies for representation of the relevant Corporate Affairs Commission, at its discretion, on any committee appointed to inquire into public interest cases, and on any disciplinary committee that may be established (Campbell Report, 1981, p. 373).

2. Report of the Joint Select Committee on Corporations Legislation (Lavarch Committee (April 1989)

The Lavarch Committee was established to report on a package of 16 Bills known as the Corporations Legislation package including the Corporations Bill 1988. The Committee was also to report on the adequacy of the legislation to improve regulation of companies, facilitate performance of the securities and futures markets, and ensure investor protection (thus recognising agency theory) and report on the fundraising provisions (Melbourne Law School, 2011).

The relevance of the report to this thesis is twofold. First the bills known as 'the new scheme' would replace current administrative and legal arrangements of uniform companies and securities law. Second is the formation of the Australian Securities Commission (ASC) to replace the NCSC. The ASC will administer Commonwealth laws instead of State laws. The changed arrangements are set out in the report as follows:

> *1.2 The new scheme will replace the existing Co-operative scheme in which companies and securities law is based upon State legislative power but in which the States co-operate to achieve uniformity through a Ministerial Council with a national scheme based upon Commonwealth legislative power.*
>
> *1.3 The administrative proposal inherent in the scheme is that each State Corporate Affairs Commission (CAC) will continue to operate as a separate entity but will become delegates of the Australian Securities Commission (ASC) and will administer Commonwealth laws rather than State laws* (Lavarch Committee, 1989, p. 1).

3. Report on the Social and Fiduciary Duties and Obligations of Company Directors (Cooney Committee Nov 1989)

There were 24 recommendations from the Cooney Committee. There are two matters raised in the recommendations that are particularly relevant to this study. The first refers to the establishment of an audit committee (recommendations 11-13) and the second the creation of civil penalties where no criminality is involved (recommendations 7, 22 and 23).

Audit Committee

The recommendations were as follows:

> ***11*** *(i) The establishment of an audit committee be made a requirement for public listing of a company;*
>
> *(ii) the chairperson and a majority, or all, of the members of the audit committee be non-executive directors;*
>
> *(iii) the audit committee be required to meet regularly and report to the board;*
>
> *(iv) the audit committee have direct access to the company's auditors (internal and external) and senior managers, and the ability to consult independent experts where necessary; and*
>
> *(v) as a high but lesser priority, similar requirements be introduced for larger non-listed companies. (para 8.15)*
>
> ***12*** *Audit committees have the following functions:*
>
> *(i) reviewing financial information to ensure its accuracy and timeliness and the inclusion of all appropriate disclosures;*

(ii) ensuring the existence and effective operation of accounting and financial controls;

(iii) overseeing the audit of the company, including nominating the auditors, approving the scope of the audit and examining the results;

(iv) providing a link between the auditors and the board; and

(v) any other functions allocated to it by the company, provided that the extra functions do not compromise its ability to perform the tasks set out in paragraphs (i)-(iv) above. (para 8.16).

***13** Smaller unlisted companies be encouraged to set up audit committees, or, in the absence of an audit committee, have auditors present at board meetings which approve financial statements prior to their distribution to shareholders. (para 8.17)*(Cooney Report, 1989, pp. xii-xiii).

Civil Penalties

***7** Criminal liability under companies legislation not apply in the absence of criminality. (para 5.57)*

***22** Section 229(2) of the Companies Code, or its equivalent, be amended so that criminal liability under that section only applies where conduct is genuinely criminal in nature. (para13.12)*

***23** Civil penalties be provided in the companies legislation for breaches by directors where no criminality is involved, and, in appropriate circumstances, people suffering loss as a result of a breach be enabled* *to bring a claim for damages in the proceedings taken to recover the penalty. (para 13.15)*(Cooney Report, 1989, p. xi and xv).

These recommendations followed the Committee's discussions on the decriminalisation of company law. There were two points of view one to completely decriminalise company law, (Professor Baxt), and two, create civil penalties and retain criminal liability in the worst instances of violation (Professor Fisse).

Professor Fisse used the term, pyramid of enforcement, …with civil measures at the base of the pyramid for the general run of cases, and criminal liability at the apex for the more exceptional instances of law-breaking (Cooney Report, 1989, p. 190).

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6.5.2. Regulation and Legislation Change

The National Companies and Securities Commission (NCSC) was established in 1979 (see section 5.6.2) as a result of recommendations from the Rae (see section 5.6.1) and Eggleston (see section 4.7.2[h]) Committees. However, it did not commence operating until 1980. The two main pieces of legislation at the beginning of the 1980s were the Companies (Acquisition of Shares) Act 1980 (Cth) dealing with takeovers and The Companies Act 1981 (Cth) (Cooperative Scheme) dealing with matters of incorporation, company affairs and winding up (Tomasic, et al., 2002). It was called the cooperative scheme as the 1981 Act was a uniform Commonwealth Act to be administered uniformly by the corporate affairs bureaucracies of each State and Territory (Tomasic, et al., 2002).

The main relevance to the current study was the introduction of five new sections to the Companies Act 1981, 266B to 266F establishing the Accounting Standards Review Board (Companies Act, 1983).

The NCSC was superseded in 1989 by the Australian Securities Commission Act 1989 No. 90 of 1989 the objects of which were:

> *…to establish an Australian Securities Commission to administer the laws of the Commonwealth relating to companies, securities and the futures industry* (Companies Act, 1989, p. Sect 3 (1) a).

The government's corporate watchdog changed from the NCSC to the ASC in 1989 and, as will be discussed in Chapter 7, the ASC was superseded on 1 July 1998 by the Australian Securities and Investments Commission (ASIC). All the changes that occurred to the regulations during the 1980s had no apparent effect on the collapse of Bond Corporations Holdings Ltd.

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6.5.3. Profession Action

The Chairman of the NCSC, Sir Henry Bosch in 1987 was quoted by Lotte Poole in her article, 'Creative Accounting – a race for the bottom?' when he said:

> *The competitive pressures to dress up the accounts are already building up and unless we blow the whistle we will have a downward spiral, a race for the bottom in which the voice of reason and objectivity will finally be drowned by the thundering feet of Gaderene swine*[13] (Poole, 1987).

Creative accounting and dressing up the accounts were features by other names in previous case studies in this research. The accountancy profession while striving to maintain self-regulation over standards came under continued criticism from the media and other stakeholders when companies failed.

[13] The Gaderene Swine Fallacy (GSF) is the fallacy of supposing that because a group is in the right formation, it is necessarily on the right course

Poole's article was featured in the May 1987 edition of *The Chartered Accountant in Australia* journal.

When asked, 'what is creative accounting?' the then president of the Institute of Chartered Accountants in Australia (ICAA) Geoffrey Cohen (Cohen) suggested that there are two types of creative accounting:

> *One which uses initiative to recognise genuine changes in business practices, and the other reflecting undesirable 'window-dressing' which merely tends to distort financial information, such as inconsistencies in the respective accounting treatment of profits on the one hand and losses on the other*·**(**Poole, 1987, p. 42**).**

The latter type of creative accounting, undesirable window dressing distorting financial information, was very prominent during the decades covered by this research.

Bosch in an address to the State Congress of the ICAA in Bunbury Western Australia in March 1987 gave five main reasons why accountants should resist being involved in creative accounting (Poole, 1987).

The five reasons are:

> *(i) because it misleads investors and distorts business judgement,*
>
> *(ii) the Ethical Rulings of the Institute lay down the obligation to report objectively,*
>
> *(iii) the credibility of the Australian business community will be undermined,*

(iv) that free enterprise is only kept alive through objective company accounts;

and

(v) that the benefits of creative accounting are only short term (Poole, 1987, p. 46).

The benefits mentioned in (v) above are only long term if the creative accounting producing those benefits is continued from one accounting period to the next. For example if the method of calculating depreciation is changed to increase net profit then the same method would have to be used for the life of the asset to make use of the creative accounting.

Media financial critics can often summarise succinctly why companies fail. Poole quotes an unnamed source who gave the following review of the movements in stock prices early in 1987:

One thing can be said for sure about a roaring stock market such as this it will go down. When it does, a great deal of sloppiness in the financial management of Australia's companies will be exposed and in one or two cases, possibly more, the sloppiness or plain bad practices will be such that the companies concerned will collapse (Poole, 1987, p. 46).

A prophetic statement indeed as definitely more than one or two companies did fail when the stock market crashed in October of 1987. The accounting profession’s attitude expressed by Cohen was a more resigned approach:

> *It's a cyclical movement. There will be a crash the standards and regulations will be tightened and then after a couple of years all will be relaxed, until the next crash* (Poole, p. 48).

The Accounting Standards Review Board (ASRB) was established by the Ministerial Council for Companies and Securities to review the standards produced by the profession and give them the force of company law, where approved by the ASRB (Accounting Standards Review Board, 1984) The ICAA's response to compliance with the standards according to its Technical Director, Bob Ellis is that it's: *often caused by ignorance or lack of understanding*. Ellis then said:

> *Accountants do not have time to read the standards. In many cases they are required to plow through verbage to get to the crux – that is if they ever find it. Members understand standards much less than I would have expected* (Poole, 1987, p. 48).

Surely an amazing statement to admit that accountants not only do not have time to read the standards, but they do not understand them anyway.

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6.5.4. Summary of major causes underlying the corporate failure

The Bond group failed because it could not repay its debts (Table 9). It failed because it paid too much for acquisitions that were made without adequate due diligence being carried out to assess the viability of the asset being purchased, e.g. Channel 9 group and Heileman Brewery. Money was lent to failing corporations in the group with no security and little or no interest being charged. The damning analysis report issued by Lonrho when Bond made the failed takeover bid caused the share price to fall and the continuation of the reckless expansion policy at any cost even when share market crashed was a major contribution to the group's downfall.

A comparison can be made with all of the other case studies with regard to unstructured rapid expansion especially with HIH and ABC in relation to overseas acquisitions.

Table 9: Case Study 6 – Bond Corporation Holdings Ltd (Group)

Cause	Detail
Lack of Provision for Doubtful Debts and Bad Debt write-offs	Not applicable
Misleading statements in Prospectus/Financial Statements Report	False profits in financial accounts for Y/E June 1988 re sale of two parcels of real estate sold post June 1988 but profits included in June 1988 Financial Statements (Sykes, 1996)
Excessive borrowings & lack of repayment strategy and security	$1.2 billion of cash reserves were borrowed from Bell Resources by Bond Corp without security on highly favourable terms to Bond Corp (Hall, 1995)
Related party transactions/conflict of interest	Back to back loans contrary to undertakings given to financiers of Bell Resources (Sykes, 1996)
Borrowing short, investing long	Not applicable
Incorrect valuation and allocation of assets	Buying companies revaluing their assets and borrowing on the new valuation without checking the veracity of the valuation (Clarke, et al., 2003)
Ponzi scheme	Not applicable
Lack of disclosure	Bond found guilty of four counts of fraud regarding the Manet painting La Promenade. The transaction (purchase by Dallhold) was not disclosed and Bond's private company Dallhold Investments made a profit of $14.54 million (Anon, 1996)
Unstructured rapid expansion	Breathtaking rate of growth by acquisition using borrowed funds (Clarke, et al., 2003)

In Chapter 9 the commonality and causes of unexpected corporate failure for all the case studies in this thesis are compared in a matrix (Table 12).

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6.5.5. Theoretical Applications to the Case Study in this Chapter

This study depicts the actions of individuals in the case study in this chapter using agency theory, whereby individuals are assumed to be rational, self-interested and utility-maximising. These characteristics, in combination with the fraud triangle, enable the identification of particular factors associated with the unexpected corporate collapse.

The transfer of $1.2 billion from Bell Resources group's cash reserves to the Bond Group and associated companies has been described as Australia's largest corporate fraud and clearly demonstrates the involvement of the three components of the Fraud Triangle (Clarke, et al., 2003). Bond himself is an example of TCL, a part of agency theory, being the founding CEO who was apparently unable to transition from a private company governance structure to the rigors of public company accountability.

7. CHAPTER 7 - Case Study of an Unexpected Corporate Collapse 1991-2000

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7.1. Introduction

The purpose of this chapter is to analyse a further case study of an unexpected corporate collapse between the years 1990 to 1999, the regulatory framework in place at the time of the failure and any subsequent changes to the relevant regulations and legislation, if any, as a result of the failure. It should be noted that the case study in this chapter, HIH Group, refers to matters up to 20 years ago and, as for the preceding chapters, some information is scarce with primary data generally not available therefore there is reliance on the literature from Sykes, Clarke and Dean, Mr. Justice Owen and the HIH Royal Commission Reports and various journal and newspaper reports.

The case study will be assessed using agency theory as a consistent lens through which to analyse the actions of the management of the corporations. The chapter concludes with a table summary of the major causes underlying this corporate failure during this decade.

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7.2. Economic conditions 1990s

The share market crash in 1987 and the financial excesses of the 1980s created a financial climate where a recession was inevitable. The Australian economy was overstretched in a number of areas and to many economists, Australia was therefore extremely vulnerable to any contradictory shock to confidence or to the economy itself. The shock duly arrived in the form of an international recession in the early 1990s (Macfarlane I, 2006).

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7.3. Economic Event 1990s

There were two economic events in the 1990s. The first was the international recession of 1990-91. The second was the Asia crisis in 1997. Although both were important the event with the most relevance to this research was the recession of 1990-91.

The Recession of 1990-91

The recession in Australia was referred to by the then Federal Treasurer Paul Keating as 'this was the recession we had to have'. In the second half of 1989 the Reserve Bank set the cash rate at 18%, the mortgage rate at 17% and loans to businesses were set at well in excess of 20%. The Reserve Bank said that the high interest rates were aimed to slow the economy by discouraging further borrowing particularly by business (Macfarlane I, 2006).

The former governor of the Reserve Bank explained:

> *The emphasis on interest rates and deregulation at least reminds us that what we are dealing with is essentially a financial event. The recession of 1990-91 was dominated by financial failure. In most cases, it was the fall in asset prices that meant that loans could not be repaid, thus transferring the distress to financial institutions* (Macfarlane I, 2006, p. 3).

The former Reserve Bank Governor suggested that a good indicator of the fall of asset prices was provided by the average price of office buildings which halved between the peak in 1989, and the trough in 1993. In fact, in 2006, some 17 years after the peak, they were still 15% below the peak 1989 figure (Macfarlane I, 2006).

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7.4. Case Study 7- HIH Group

7.4.1. Background

In 1968 Australian entrepreneur Ray Williams (Williams) together with a colleague Michael Payne (Payne) formed a small company M. W. Payne Underwriting Agency Pty Ltd. It was taken over in 1971 by British listed company CE Heath plc. In 1980 Williams was appointed to the board of CE Heath. The business of CE Heath plc transferred to CE Heath International Holdings Ltd (CE Heath) which was listed on the Australian Stock Exchange in 1992.

In 1995 CE Heath acquired CIC Insurance Group and in 1996 changed its name to HIH Winterthur International Holdings Limited (HIH Winterthur). In September 1998 HIH Winterthur announced a proposed takeover of FAI Insurance Ltd (FAI) and a month later in October 1998 HIH Winterthur changed its name to HIH Insurance Ltd (HIH Insurance, 2013). The HIH Group at one time operated in 16 countries and comprised over 240 separate companies (Clarke, et al., 2003).

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7.4.2. Collapse and Investigation

For this case study, the sections for Collapse and Investigation are combined to assist the exposition. On 29 August 2001 the Commonwealth Government established a Royal Commission to investigate and report why HIH failed and the three volume report by the Commissioner Mr. Justice Owen (Owen) extensively investigates the reasons for the collapse:

> *It is beyond doubt that the biggest single cause of HIH's collapse was, as I have said, the failure to provide properly for future claims* (The Hon Justice Owen Vol. I, 2003, p. xxix) Commissioner, the HIH Royal Commission.

Apart from the above quotation from the royal commissioner, the three volumes of the Royal Commissioner's Report (Report) titled 'The Failure of HIH Insurance' totals 1,500 pages and the report discloses in great detail the reasons the HIH group of companies failed. One of the main causes of failure was the domination of the management and board by the joint founder of the company, Ray Williams. (Williams).

In the previous six case studies in this research the same cause, domination of the board and management by the founder of the company contributed to the demise of each of the companies involved. In the case of HIH the commissioner said *inter alia* that:

> *There was blind faith in a leadership that was ill-equipped for the task and there was insufficient ability and independence of mind in and associated with the organisation to see what had to be done and what had to be stopped or avoided. Risks were not properly identified and managed. Unpleasant information was hidden, filtered or sanitised. And there was a lack of sceptical questioning and analysis when and where it mattered (The Hon Justice Owen Vol. I, 2003, p. xvii).*

There is also widespread criticism in the report concerning the accounting practices within the group. The major companies in the HIH Insurance group were placed in provisional liquidation on 15 March 2001; however the Report refers to major problems emerging as far back as 1 January 1998.

When CE Heath acquired CIC Insurance Group (CIC) in 1995 by issuing shares to the holding company CIC Holdings Limited (CIC Holdings) CIC ordered legal due diligence from Blake Dawson Waldron and accounting due diligence from Ernst and Young, noted by the Hon Justice Owen:

> *Blake Dawson Waldron issued their report and noted eight major concerns. The main concern was that HIH had not made a complete transition from an entrepreneurial company strongly influenced by senior management – and from which senior management benefited considerably – to a company listed on the Australian Stock Exchange and run primarily in the interests of shareholders.*(The Hon Justice Owen Vol.II, 2003, p. 5).

The Hon Justice Owen’s comments aptly describe the components of agency theory wherein senior management, the agents, benefited from their decisions to the detriment of the shareholders, the principals.

Ernst and Young did not receive all information they required for their report and information they did receive was not received on a timely basis. Also some information supplied by officers of HIH had subsequently proven to be incorrect. Ernst and Young additionally had a similar major concern to Blake Dawson Waldron regarding the influence of senior management in HIH:

> *HIH has traditionally been under strong influence by senior management and may be described as having a strong entrepreneurial flavour. The management structure of HIH is also very decentralised. The impression formed by a number of individuals involved in the due diligence review is that the management style and approach of HIH is very different to the management style and approach of CIC* (The Hon Justice Owen Vol.II, 2003, p. 5).

After receiving the due diligence reports Owen said that the management approach was more like a private company approach, stating:

> *As early as 1995 an independent due diligence report described HIH as a ‘company which has not yet made a complete transition from an entrepreneurially run company influenced strongly by senior management, and from which senior management benefits significantly, to that of an ASX listed company run primarily in the interests of shareholders’. In my view, this remained true for the remainder of the company’s life* (The Hon Justice Owen Vol. I, 2003, p. xxvii).

The commissioner in Volume I of the report detailed the mismanagement of HIH and the total lack of board knowledge of the future strategy of the company. Owen also criticized the board for not appreciating the risks which came as a result of failure to critically analyse a long term strategy plan (The Hon Justice Owen Vol. I, 2003).

Apart from detailing under-provisioning as the biggest single cause of the collapse of HIH, Owen detailed three failures of major proportion which sustained major losses. Two of the three failures involved overseas expansion.

The first failure was the UK operations, the second failure was the US operations, and the third failure was the FAI acquisition. The expansion by HIH into overseas markets was a prime example of imprudent and ultimately very costly poor decision making.

UK Operations

HIH established a UK branch in mid-1993 and began underwriting in September of that year. The Report details a total lack of contribution by the Australian operation towards the construction of a business plan for the new UK branch. There were no responsible underwriting controls:

> *Poor quality management information and inadequate accounting systems impaired the Australian management's ability to monitor and control the UK operations effectively* (The Hon Justice Owen Vol. I, 2003, p. xxii).

The estimated losses in the United Kingdom may amount to as much as $1.7 billion.

US Operations

The US operations story was similar to the UK operation. After selling the business on favourable terms in 1994 in anticipation of a change in the legislation causing premium rates to fall, HIH began attempting to reacquire the business in 1996. No satisfactory due diligence was carried out and no appreciation of the risks involved. As it turned out the re-entry into the US market was a debacle. The estimated losses cost the group about $620 million (The Hon Justice Owen Vol. I, 2003).

FAI Acquisition

The HIH group had been interested in a takeover or at least acquiring a strategic shareholding in FAI since early 1993. However, all approaches to FAI were rebuffed by FAI's CEO, Rodney Adler, as he refused to agree to HIH's condition that due diligence would have to be carried out prior to any takeover. In September 1998 seven of the 12 directors met, three in person and four by video link. The remaining five directors were overseas and due to the shortness of notice (the morning of the evening meeting) the board decided to proceed with the takeover although the only information they had to make their decision was all publically available information. What was not available was excessive under reserving in FAI's business a similar provisioning problem to HIH. Owen estimated that the cost to HIH of the FAI acquisition was $590million (The Hon Justice Owen Vol. I, 2003).

The Allianz Joint Venture

The joint venture with Allianz Australia Limited (Allianz) was a prime example of the complete lack of expertise of HIH management and board of directors.

The Commissioner stated:

> *The transaction that, in retrospect, hastened the inevitable demise of the HIH group was the Allianz joint venture, which was negotiated in the second half of 2000 and came into effect on 1 January 2001. It involved the sale of HIH's profitable retail lines—most of which had come from the FAI acquisition—into a joint venture with Allianz Australia Limited. The arrangements agreed between HIH and Allianz ultimately caused HIH to experience an insurmountable cash flow crisis in early 2001 and largely dictated the timing of HIH's collapse. Somewhat bewilderingly, no one in management or at board level called for or did a full and accurate analysis of the likely cash flow implications of the transaction before HIH entered into the joint venture in September 2000* (The Hon Justice Owen Vol. I, 2003, pp. xxiv-xxv)*.*

The joint-venture arrangements included the setting up of a trust to ensure that the joint venture had sufficient funds to cover claims. HIH had to contribute an amount of cash and other assets totaling $500 million to assist in the setup of the trust. The amount of $200 million that Allianz had to pay HIH had to be used by HIH as it did not have enough cash to make up the $500 million. The premium income that HIH formerly received from the retail lines that became part of the joint venture went into the trust thus cutting off cash flow to HIH of about $1 billion per annum. Profits from the joint venture were distributed quarterly.

The directors were incapable of understanding the risks involved due to the time constraints and the fact that management failed to inform them in a timely fashion exactly what the restructure was all about until it was too late. HIH simply ran out of cash within 10 weeks of the start of the joint venture and was placed in provisional liquidation on 15 March 2001.

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7.4.3. Prosecution

The Commonwealth Department of Public Prosecutions (CDPP) in their publication for 2008/9 titled ‘Prosecutions Arising Out of the Collapse of HIH’ states that, following Commissioner Justice Owen handing down his HIH report on 4 April 2003. recommended *inter alia* that 56 matters be referred to ASIC for investigation and possible criminal prosecution. The Government announced that the CDPP would be the vehicle for any criminal prosecutions arising from the collapse of HIH and related companies (Australian Government, 2008-9).

Arising from ASIC's investigations CDPP conducted 18 prosecutions although some were related to the same defendant. Ten persons were convicted of offences four were acquitted or discharged at committal and charges were discontinued in relation to one person (Australian Government, 2008-9).

Three directors were given jail sentences. Adler was sentenced to four and a half years jail with a non-parole period of two and a half years. Adler pleaded guilty to four criminal charges which included:

> *Two counts of disseminating information knowing it was false;*
>
> *One count of obtaining money by false or misleading statements;*
>
> *One count of being intentionally dishonest and failing to discharge his duties as a director in good faith and in the best interests of the company* (Clarke T, 2007, p. 449).

The sentencing judge, Justice John Dunford said that Adler's offences displayed an *appalling lack of commercial morality (Clarke T, 2007, p. 449).*

The co-founder Ray Williams was sentenced to four and a half years' jail with a non-parole period of two years and nine months after pleading guilty to three criminal charges arising from his management of the HIH group of companies in the three year period 1998 to 2000:

> *Failing to properly exercise his director's duties;*
>
> *Misleading investors in an annual report by overstating the HIH profit by $92 million; and*

Omitting an important piece of information about the company in an attempt to raise money from the public (Clarke T, 2007, p. 450).

The third person jailed was Brad Cooper, a business associate of Adler.

He was found guilty of six charges of corruptly giving a cash benefit to influence an agent of HIH under section 249B of the Crimes Act. He was also found guilty of seven charges of publishing false or misleading statements with intent to obtain a financial advantage under section 178BB of the Crimes Act. He was sentenced to eight years jail and served a minimum of five years before being eligible for parole on 30 October 2010 (Adams M, 2009, p. 450).

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7.5. Chapter 7 Summary and Conclusions

7.5.1. Government Inquiry

The only Government Inquiry into the failure of HIH was the Royal Commission in 2001. There was an inquiry into the Australian Financial System known as the Wallis Inquiry and the subsequent report, the Wallis Report presented to the parliament on 18 March 1997.

The Financial System Inquiry was established in May 1996 under the chairmanship of Mr Stan Wallis to undertake three tasks:

- *to examine the experience of financial deregulation in Australia;*
- *to identify the main forces for change in the Australian financial system; and*
- *to recommend appropriate changes to current regulatory arrangements in the light of continuing evolution of the Australian financial system* (Harper I. R., 1997, p. 288).

The Wallis Report is not relevant to this thesis because it focused on the financial system rather than corporate regulation.

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7.5.2. Regulation and Legislation Change

There were many changes to the Corporations Law during the 1990s. The uniform legislation scheme came into operation in 1991 (see section 1.9) and was repealed by the Corporations Act 2001 (Cth) the current legislation.

1991-2001: THE NATIONAL SCHEME

In June 1990 the Commonwealth agreed with the States and the Northern Territory on a new national scheme of uniform companies and securities regulation to be based on the *Corporations Act* 1989 and the *Australian Securities Commission Act* 1989. It became known as the national scheme.

The first component of the national scheme was uniform legislation which applied nationally. The second component of the scheme was the uniform administration of the legislation. The main responsibility for this lay with the Australian Securities and Investments Commission (or ASIC), as it had become known in July 1998 (see Appendix 1) which was the single regulatory body, directly accountable to the Commonwealth Attorney-General. The name change was to incorporate the additional powers given to ASIC including responsibility for consumer protection over superannuation, insurance and banking (Mees & Ramsay, 2008).

The third component of the national scheme was a single court system to adjudicate matters arising under the scheme. This was achieved by the cross-vesting of jurisdiction between the State Supreme Courts and the Federal Court. That is either court could deal with Federal and State matters that arose under the national scheme (Tomasic, et al., 2002).

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7.5.3. Profession Action

The results of the spectacular number of corporate scandals in the 1980s flowed into the early 1990s and the public were increasingly concerned about business ethics and in particular accounting ethics.

In the book 'Creative Accounting, Fraud and International Accounting Scandals', edited by Michael Jones, Carnegie and O'Connell contributed a chapter on 'Accounting Scandals in Australia since the Late 1980s', and stated that:

> *Corporate failures and accounting scandals are often interrelated. History has repeatedly shown that accounting failure is frequently a determinant of unexpected corporate collapses* (Carnegie & O'Connell, 2011, p. 137),

These comments could apply to the six prior case studies in this thesis. In respect of those prior case studies there was always criticism of the accounting profession followed by changes in the regulations and legislation.

A study titled 'Desperately Seeking Ethics' (Cree & Baring, 1991) into the poor image of accountants confirmed international research that most business students are seen as ethically suspect. From their research in Australia of 380 business students they identified that 61% of the accounting students were open to an insider trading proposition even though they knew that insider trading carries the risk of imprisonment (Cree & Baring, 1991).

The disturbing consequence of that 1991 survey is that those accountancy students in 2015 could quite likely be in senior positions in business and the professions and according to the survey they had an inclination towards unethical practice if the price was right (Cree & Baring, 1991). It is interesting that the subject of ethics now is part of the Capstone subject of the CAANZ post graduate programme although as Derek Bok, an American lawyer and educator and the former president of Harvard University, says:

> *There's a great deal of difference between thinking reflectively about moral issues and achieving higher standards of ethical behaviour* (Bok, 2015).

Companies during the excesses of the 1980s utilized the existing consolidated accounting rules of avoiding consolidating companies where they had less than 50% of the shareholding. The Australian Securities Commission (ASC) the forerunner to the Australian Securities and Investments Commission (ASIC) alleged that:

> *…related party transactions using companies that had less than 50 per cent shareholding allowed the presentation of Group Accounts in an artificially better state than the underlying conditions justified* (Carnegie & O'Connell, 2011, p. 143).

Major changes were made to the Australian consolidation accounting rules by the profession leading to the issue of AASB 1024 Consolidated Accounts with statutory backing in 1991. Specifically:

…the definition of 'control' for consolidation purposes was broadened beyond prescribed ownership interests to embrace control over an entity's financial and operating policies, making use of the notion of 'substance over form' in determining the existence of a controlled entity (Carnegie & O'Connell, 2011).

The embracing of ethics education by the profession was certainly a desired outcome for the future to avoid the corporate collapses that dominated the 1980s.

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7.5.4. Summary of major causes underlying the corporate failure

Table 10 below summarises the major causes of the unexpected failure of the HIH Group.

The finding by the Royal Commissioner, The Hon Justice Owen, stated that:

It is beyond doubt that the biggest single cause of HIH's collapse was, as I have said, the failure to provide properly for future claims (The Hon Justice Owen Vol. I, 2003, p. xxix).

A similarity can be drawn with the failure of H.G. Palmer where the main cause of the collapse was the failure to write off massive bad debts and provide for future bad debts.

Table 10: Case study 7 – HIH Group

Cause	**Detail**
Lack of Provision for Doubtful Debts and Bad Debt write-offs	Royal Commissioner The Hon Justice Owen stated that : *It is beyond doubt that the biggest single cause of HIH's collapse was, as I have said, the failure to provide properly for future claims* (The Hon Justice Owen Vol. I, 2003, p. xxix).
Misleading statements in Prospectus/Financial Statements Report	Adler found guilty of disseminating information knowing it was false and was found guilty obtaining money by false or misleading statements (Clarke T, 2007).
Excessive borrowings, lack of repayment plan and long term strategy.	Three failures of major proportion which sustained major losses were the overseas operations in UK and US and the FAI acquisition (The Hon Justice Owen Vol. I, 2003) .
Related party transactions/conflict of interest	Three former HIH directors charged with attempting to prop up HIH share price with a related party transactions through a subsidiary of HIH – Pacific Eagles Equities (Clarke, et al., 2003).
Borrowing short, investing long	Not applicable
Incorrect valuation and allocation of assets	FAI transaction produced more than $530 million in losses from undisclosed under reserving in their portfolios (The Hon Justice Owen Vol. I, 2003) .
Ponzi scheme	Not applicable
Lack of disclosure	Between Directors and Management about restructure required for Allianz merger and that led to HIH running out of cash within ten weeks of the start of the joint venture (The Hon Justice Owen Vol. I, 2003).
Unstructured rapid expansion	*Overseas expansions in the UK and USA … proved critical in the Group's dwindling fortunes (Clarke, et al., 2003, p. 224).*

In Chapter 9 the commonality and causes of unexpected corporate failure for all the case studies in this thesis are compared in a matrix (Table 12).

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7.5.5. Theoretical Applications to the Case Study in this Chapter

This study depicts the actions of individuals in the case study in this chapter using agency theory, whereby individuals are assumed to be rational, self-interested and utility-maximising. These characteristics, in combination with the fraud triangle, enable the identification of particular factors associated with the unexpected corporate collapse.

The fraud triangle model is applicable in this case study as the leading players in HIH accepted 'as rules of the game' any risk that eased the pressure of lack of cash flow by falsifying financial statements and disseminating information knowing it was false. Management controls were ineffective or non-existent as Williams, Adler and Cooper made ad hoc and often self-interested decisions. Williams as co-founder but really the driving force in the initial formation of the company acted as described by TCL. (The Hon Justice Owen Vol. I, 2003)

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8.1. Introduction

The purpose of this chapter is to analyse a case study of an unexpected corporate collapse between the years 2001 to 2010, the regulatory framework in place at the time of the failure and the subsequent changes to the regulations, if any, as a result of the failure. The case study for this chapter is ABC Learning Centres Ltd. The analysis relies on the report from the Administrator, Ferrier Hodgson, the report from the Receivers and Managers, McGrathNicol, detailed coverage by Trevor Sykes in his book, Six Months of Panic, Media releases from ASIC and various newspaper reports by investigative journalists. This analysis is limited by the information available from the above sources.

The case study will be assessed using agency theory as a consistent lens through which to analyse the actions of the management of the corporations. This chapter will also include a brief summary of the economic conditions and events of the decade.

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8.2. Economic Conditions 2000s

The Reserve Bank of Australia (RBA) sponsored a conference in Sydney 2011 titled 'The Australian Economy in the 2000s'. There were many subjects presented, however, the conference introduction is of particular note as it contains a concise summary of the economic climate in the start of the 2001/2010 decade:

> *The Australian economy entered the 2000s in a healthy state. While the 1990s had its ups and downs, the papers at the Bank's Conference in 2000 provided a generally positive report on the economy. The strong economic growth, decline in unemployment, increase in productivity, and the resilience to the Asian financial crisis were generally attributed to the process of economic reform* (Reserve Bank of Australia, 2011, p. 1).

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8.3. Economic Event 2000s

The growing demand for Australia's commodities by countries in the Asian region was the largest single influence on the Australian economy from the middle of the 2000s. While emerging countries assisted in strong growth for Australia's exports, Australia was subject to two negative economic events during the decade. The first of these came with the collapse of the 'dot.com bubble'. This resulted in a relatively mild recession, both in depth and breadth (Rakoff J, 2014; Reserve Bank of Australia, 2011).

The major economic event in the decade 2001/2010 and which had a significant effect on the whole world was the Global Financial Crisis (GFC). The RBA delivered a soft description of the cause of the GFC using terms such as 'ongoing financial innovation' as one of the main causes:

> *Financial markets generally also displayed low volatility during these middle years of the decade, and so risk premia on many assets declined. Along with ongoing financial innovation, this set up an environment in which the risks that precipitated the global financial crisis could grow. In the end, it was excesses in the US housing market that triggered the first stages of the financial crisis in money and debt markets in mid-2007* (Reserve Bank of Australia, 2011, p. 2).

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8.4. Case Study 8 –ABC Learning Centres Ltd

8.4.1. Background

ABC Learning Centres (ABC) was founded as a privately owned company by Eddie Groves (Groves) in 1988 and, with slow growth, by 1997 was running 18 childcare centres across Australia. A dramatic change happened in 2000 when the Federal Government introduced the childcare benefit rebate system. The system allowed parents to apply for subsidized childcare. The demand for childcare centres grew dramatically and the largest group of childcare centres in Australia was ABC. In March 2001, ABC listed on the Australian Stock Exchange (Australian Society of CPAs, 2010).

Although ABC only had 31 centres upon listing, founder and CEO Groves had in mind a much larger empire. His plan was that by not having ownership of land or buildings, less capital and less debt, was required. Long leases were entered into and although rent was high, fees charged for childcare were set high enough to compensate and provide a profit after paying all other costs. The federal government in July 2000 introduced a Child Care Benefit (CCB) which subsidized low income families 110% of their childcare fees This development created a successful model for childcare corporatization and several other organizations listed on the stock exchange (Sykes, 2010).

A significant amount of ABC's business involved related party transactions. Groves' brother-in-law Frank Zullo (Zullo), through his company, Queensland Maintenance Services (QMS), provided maintenance and cleaning services for ABC earning for $5.7 million in 2006. QMS also received $68.9 million for capital development services in 2006.This amount was the builder's guarantee fee due if the initial income from the centres did not reach a certain figure in the first years of the opening of the centres.

Between 2002 and 2004 another Zullo company, Bright Horizons, earned $1.18 million renting its childcare centres to ABC. Groves also owned the Brisbane Bullets basketball team and ABC provided $1.5 million in sponsorship for the team. Some related party transactions were kept from the board. For example, Groves' longtime girlfriend, Viryan Collins-Rubie, operated a toy store on the Gold Coast and sold a reported $500,000 worth of stuffed bears similar to the one on the ABC company logo with no flow of income back to the centres. These actions by Groves were made on an ad hoc basis without consulting the board or management as though Groves still owned the company (Sykes, 2010).

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8.4.2. Collapse

One of the main reasons collapses occurred in the case studies reviewed in this thesis was the frantic expansion programmes undertaken by the management; ABC was no exception. When a company funds its expansion with equity, the expansion is easier to control. However when expansion is funded by borrowings, interest on the debt must be met as well as repayment of principal. Banks' lending funds usually impose strict conditions on maintaining their security level especially when one of the main criteria of their lending is the maintenance of the company's market capitalisation (Sykes, 2010).

The share price of ABC peaked at $8.80 in December 2006. As there had been a five for one split[14] in November 2002, the price represented $44 per share pre-split. From an accounting and investment perspective the shares were overpriced. The dividend yield was 0.6% and although the dividend increased

[14] All publicly-traded companies have a set number of shares that are outstanding on the stock market. A stock split is a decision by the company's board of directors to increase the number of shares that are outstanding by issuing more shares to current shareholders. For example, in a 2-for-1 stock split, every shareholder with one stock is given an additional share. So, if a company had 10 million shares outstanding before the split, it will have 20 million shares outstanding after a 2-for-1 split.

A stock's price is also affected by a stock split. After a split, the stock price will be reduced since the number of shares outstanding has increased. In the example of a 2-for-1 split, the share price will be halved. Thus, although the number of outstanding shares and the stock price change, the market capitalization remains constant.

for 2007 the yield only increased to 1.1%. Additionally the price/earnings ratio was a staggering 42:1 which meant that with the share price of $8.80 ABC was selling at 42 times its 2006 earnings. A good stock in normal times should sell at a price earnings ratio of between 10:1 and 15:1 (Birt, 2010).

ABC's net assets as per the 2006 accounts were $1.7 billion. However, the market capitalisation of the company at $8.80 per share was double at $3.4 billion. Most of the net assets were intangibles (Sykes, 2010).

Sykes in his book 'Six Months of Panic' looked at the effect of the Global Financial Crisis on Australia. In his lengthy analysis of the ABC failure he stated that although there were healthy-looking financial accounts published during ABC's growth period, it had four problems, none of which were easily visible before early 2008:

> *1. …as already noted one-off transactions and accounting devices tended to inflate both profits and its balance sheet;*
>
> *2. ABC was paying premium prices for its centres, which inflated goodwill-and hence assets-in its balance sheet;*
>
> *3. …the continuation of ABC's growth depended on the goodwill of investors and lenders, both of which were eroding by 2008; and*
>
> *4. ABC was being run inefficiently, particularly after its overseas expansions* (Sykes, 2010, p. 211).

David Ryan (Ryan), an experienced company director, was invited to join the board by the chairman Sallyanne Atkinson (Atkinson) in 2003. After the release of the December 2007 half-yearly accounts, Ryan held a meeting and stressed to management and the board that the preservation of liquidity was paramount.

The board resolved in late 2007 that there would be no further acquisitions of centres without specific board approval.

However, in early 2008 four centres were bought from Martin Kemp (Kemp), a director of the company, without board approval. The board passed the same resolution in February and, in breach of the board resolution, more centres were purchased in the June quarter in the United States. Management had ignored the resolutions. Groves, when asked for an explanation, said he thought the resolution only applied to the Australian operations (Sykes, 2010).

When ABC purchased centres in the UK and USA, the auditors Pitcher and Partners decided the group needed an auditor with international affiliations. After a selection process, Ernst and Young (EY) were appointed. While they were preparing the full year accounts for the year ended 30 June 2008 they were also working on extensive revisions for the accounts of prior years.

Sykes, in his book ‘Six Months of Panic’ explains the complicated contractual arrangements where ABC bought many of their centres from developers who were contracted to provide a set number of centres to the company. The real estate was usually purchased by the developers and the centre was leased to ABC upon completion of the construction. The actual amount paid to the builder by ABC was in the form of a licence fee for the right to run the centre and was therefore included as goodwill in the balance sheet. However, there was a condition in the builders’ contract that if the centre did not reach a certain occupancy rate in the next two to three years, ensuring a profit level that would justify the price paid by ABC the builder would refund an agreed amount (Sykes, 2010).

When the guarantee was called up ABC recorded the amount as revenue in the books of account. This accounting treatment by management and agreed to by Pitcher and Partners (Pitcher), the auditors, was criticised by EY the new auditors as it was contrary to the accounting standards. Pitcher had agreed with the management's treatment of the payment as income without any impairment to the goodwill in intangible assets in the balance sheet as required by International Accounting Standard 36 (IAS 36), the standard for the Impairment of Assets at that time. All accounting standards had the force of law through the Corporations Act 2001.

EY stated they disagreed with these accounting methods and that the previous three years' financial statements would have to be restated. Reducing goodwill as an impairment in the balance sheet by the amount received as compensation fees from developers and then treating the impairment as a cost in the income account had the effect of reducing the stated profits by $25 million in 2005, $41 million in 2006 and $67 million in 2007 (Sykes, 2010).

With the share price dropping, ABC announced in March 2008 it was selling 60% of its US business to Morgan Stanley Private Equity for $750 million cash. However the sale was not finalised until June 2008 and, adjusting for debt and various fees, the total value of the deal was $462 million, a loss of $278.5 million (Sykes, 2010). On 6 November 2008 voluntary administrators from Ferrier Hodgson were appointed and ABC's banking syndicate immediately appointed McGrath Nicol as receivers. Ferrier Hodgson's brief summary of the history of ABC contained in its report stated:

A.B.C. Learning Centres Ltd operates day care centres for children aged six weeks to five years. The company was originally listed on the stock exchange on 13 March 2001 with a market capitalisation of approximately $25m. As at the time of my appointment as Administrator, there were some 548,820,427 fully paid ordinary shares on issue. As at its last trade of shares on the ASX, it had a combined market capitalisation of approximately $296,363,031 .Trading was suspended at the request of A.B.C. Learning Centres Ltd on 25 August 2008 pending the release of the 30 June 2008 Group financial results. Shares have not traded since this date. The company was delisted from the ASX on 31 August 2009 as a result of non-payment of listing fees. The accounts for the year ended 30 June 2008 for ABC were finally produced by Ferrier Hodgson in May 2010 showing a loss of $1.7 billion predominately due to asset values of $1.6 billion being written down (Moloney G & Walker P, 2010, p. 6).

	Consolidated	
Note 2. Profit from Operations	2007 $m	2006 $m
(a) Revenue		
Revenue from continuing operations consisted of the following items:		
Revenue from the rendering of services	1,615.7	753.3
Voucher income	12.2	–
Dividends:		
Subsidiaries	–	–
Other entities	1.2	4.3
Franchise Fees (USA)	10.3	5.7
Trust Distribution	2.5	–
Interest revenue:		
Bank deposits	5.0	4.2
Interest-bearing loans	10.4	1.1
Related Parties	–	–
Other	1.7	0.1
	1,659.0	768.7

Figure 6: Revenue from Note 2 of ABC Learning Centres Ltd 2007 Annual Report.

The revenue shown in Figure 6 for 2006 and 2007 does not separately disclose the receipt from builders included (contrary to accounting standards) in the revenue from the rendering of services. Therefore, a false impression was given regarding the total revenue resulting in a profit being recorded incorrectly. The guarantee fee should have been recorded in the balance sheet as a reduction of the intangible asset goodwill.

The administrators noted:

> *A large proportion of the A.B.C. Group's assets were intangible and their realisable commercial value became problematic given the declining operating performance of the businesses and market sentiment towards the A.B.C. Group in 2008; and The intangible assets included childcare licences which were not commercially severable or realisable without*

disrupting the core business of the A.B.C. Group (Moloney G & Walker P, 2010, p. 10).

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8.4.3. Investigation

On 6 November 2008, Gregory Moloney (Moloney) and Peter Walker (Walker) from Ferrier Hodgson (Qld) were appointed Voluntary Administrators to the ABC Group. On the same day the banking syndicate appointed Chris Honey, John Cronin and Murray Smith of McGrath Nicol Receivers and Managers of the ABC Group and took control of its assets. The Voluntary Administrator's Report also mentioned that they were aware that ASIC was undertaking their own investigations into the affairs of the ABC Group (Moloney G & Walker P, 2010).

The preliminary findings of Moloney had a familiar ring to the findings of most of the case studies in this thesis:

Upon my appointment as Administrator I proceeded to carry out investigations into the affairs of the Companies. My preliminary view is that poor operating performance and significant and rapid growth without *an appropriate strategic framework caused the failure of the A.B.C. Group* (Moloney G & Walker P, 2010, p. 3).

Trading of ABC shares was suspended on 25 August 2008 at the request of the company and it did not trade thereafter. The company was delisted from the ASX on 31 August 2009 as a result of non-payment of listing fees (Moloney G & Walker P, 2010).

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8.4.4. Prosecution

ASIC commenced an investigation into the affairs of ABC in November 2008 when ABC was placed into administration. Prosecutions by the Commonwealth Director of Public Prosecutions (CDPP) followed criminal charges laid by ASIC against Directors Groves and Martin Kemp on 28 January 2011. The charges alleged:

- *Mr Groves failed to discharge his duties as an ABC director in good faith and in the company's best interests and was dishonest* *by approving the payments made to Mr Kemp's companies between 9 and 12 January 2008.*

- *Mr Kemp breached his duties as a director and used his position as an ABC director to dishonestly gain an advantage for himself whereby he sought to sell three childcare centres to ABC between 9 and 12 January 2008.*
- *Mr Kemp failed to discharge his duties as a director of ABC in good faith and was dishonest on 1 and 21 February 2008 by not disclosing the transactions to ABC's board members.*

> *The criminal charges each carry a maximum penalty of five years imprisonment and/or a $200,000 fine* (ASIC 11-16AD, 2011, p. 1).

Following a two-week committal hearing, Kemp was committed for trial on 29 July 2011. In a related party transaction:

> *The charges relate to Mr Kemp's purported sale of three childcare centres owned by companies controlled by him to ABC…* and:
>
> *The board of ABC Learning was not informed of the transactions* (ASIC 11-153AD, 2011, p. 1).

Less than 12 months later on 5 June 2012, following a four week trial, Kemp was found not guilty on one count of breaching section 184(2) and one count of breaching 184(1) of the Corporations Act 2001 (ASIC 12-117MR, 2012).

An ASIC media release dated 23 February 2016 states that Groves will never have to appear before the court in relation to ABC Learning Centres:

ASIC has been advised by the Commonwealth Director of Public Prosecutions that it has considered all matters referred by ASIC and determined that there was no reasonable prospect of a conviction for any further criminal charges to be commenced. Accordingly, ASIC has closed its investigation into the collapse of ABC Learning Centres Ltd (ABC) (ASIC 16-044MR, 2016).

As discussed in section 8.4.2, Pitcher, the initial auditors were criticised for agreeing with management over the treatment of developer guarantee payments. Pitcher was dissolved on 28 November 2008. However, ASIC conducted an investigation into the conduct of the audit of the 2007 financial report by a partner of the firm at the time, Simon Andrew Peter Green (Green). As a result ASIC has accepted an enforceable undertaking (EU) from Green. The EU is effective from 6 August 2012. The main penalty under the EU is that Green is prevented from practising as a registered company auditor for a period of five years. During the period of suspension he is also required to:

- *notify any employer of the EU and if he is retained directly by a client, then inform the client of the EU,*
- *regularly report to ASIC any other audit and/or review work under the Corporations Act 2001 he undertakes outside of what only a registered auditor can perform, and*
- *participate, in each 12 month period, in an additional 15 hours of continuing professional development above the mandatory requirements of the ICAA.*

Following conclusion of the period of suspension, he is required to submit his first five audits for review by a registered company auditor approved by ASIC.

(ASIC 12-186MR, 2012, p. 1).

The main thrusts of ASIC's view that Green failed to adequately perform his duties as an auditor referred to obtaining sufficient appropriate audit evidence:

- *in relation to the correct accounting treatment for various fees which resulted in a significantly material overstatement of ABC's revenue*
- *to support the classification of income items – the consequence being that items not from the provision of childcare services were incorrectly classified as revenue which resulted in the overstatement of ABC's revenue*
- *to enable a reasonably competent auditor to conclude that ABC was a going concern*
- *to support his conclusions with regard to related party transactions, property plant and equipment, wages and salaries, and*
- *to support his opinion that ABC's 2007 financial report was free of material misstatement:*
- *adequately document the testing undertaken in respect to the risk of fraud*
- *develop audit procedures to deal with assessed risks*

- *perform sufficient and appropriate subsequent events procedures, and*
- *use professional judgement and scepticism when auditing ABC's 2007 financial report* (ASIC 12-186MR, 2012, pp. 1-2*).*

Four-and-a-half years after the collapse of ABC, ASIC, through the DPP, charged the former ABC CFO James Black (Black) with three counts of authorising false or misleading information. The information was made available to the audit partner of Pitcher during the conduct of the half yearly audit review of the accounts to 31 December 2006. The charges allege Black gave, or authorised the giving of:

> *…three engagement letters between three ABC-related companies and ABC Acquisitions Pty Ltd (Acquisitions). The letters related to the purchase of three overseas companies by ABC in December 2006* (ASIC 13-104MR, 2013, p. 1).

Two years later Black pleaded guilty to the charges on 2 March 2015 to be sentenced on 31 March 2015. The charge carries a maximum penalty of five years in jail and/or a fine of $22,000 (ASIC 15-042MR, 2015):

> Black was duly sentenced on 31 March 2015 *…to 18 months imprisonment, wholly suspended, to be released forthwith to enter into a good behaviour bond for two years with $2000 recognisance. Mr Black had earlier pleaded guilty to one rolled up count of making available false or misleading information about the affairs of ABC that he knew to be false or misleading in material particulars* (ASIC 15-073MR, 2015, p. 1).

The charges against Black were complicated. An unrelated, company ABC Acquisitions Pty Ltd (ABC Acquisitions), was authorised to receive a total of $46.5 million commission to which it was not entitled, as explained by ASIC in its media release 15-073MR:

> *ASIC alleged that Mr Black gave - or authorised the giving of – two engagement letters between two ABC-related companies (Learning Care Group (UK) and Learning Care Group Inc (USA)) and ABC Acquisitions Pty Ltd (ABC Acquisitions) which contained information that he knew was false or misleading in material particulars (specifically, information about the terms of commissions payable to ABC Acquisitions arising from the purchase of the two entities by ABC in December 2006). The engagement letters were provided to the auditor during the audit, as part of a number of documents used by ABC to justify the payments being made to ABC Acquisitions. Mr Black was aware that ABC Acquisitions had not been engaged by ABC to provide these services. ABC Acquisitions Pty Ltd was a private company and was not a related entity of any ABC Learning Centres Limited company. Mr Don Jones was the sole director of ABC Acquisitions. An engagement letter is a form of contract that was specific to this matter* (ASIC 15-073MR, 2015, p. 1/2).

Looking back the maximum penalty for each of the two charges that were brought against Black was five years in jail and/or a fine of $22,000. Black received an 18 month jail sentence wholly suspended and a two year good behaviour bond with a $2,000 recognisance. The penalties meted out to Black would appear to be extremely light especially when he pleaded guilty to both charges.

ABC Acquisitions Pty Ltd the unrelated company, was deregistered on 29 September 2012 owing tens of millions of dollars to ABC Learning Centres Limited (ASIC, 2016; Kruger).

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8.5. Chapter 8 Summary and Conclusions

8.5.1. Government Inquiry

Apart from the ASIC investigation, there was no specific governmental inquiry into the failure of ABC. However, on 6 November 2008 Ferrier Hodgson (Qld) were appointed Voluntary Administrators, and McGrath Nicol were appointed Receivers and Managers of the ABC Group (see section 8.4.3.).

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8.5.2. Regulation and Legislation Change

An investigation into the existing legislative and professional requirements on independence of company auditors was commissioned by the Federal Government's Minister for Financial Services and Regulation.

The investigation was headed by Professor Ian Ramsay (Ramsay) who is the Harold Ford Professor of Commercial Law, Director of Studies, Commercial Law, Corporations and Securities Law for the Melbourne Law Master's Program and Director, Centre for Corporate Law and Securities Regulation. In October 2001 Ramsay delivered a 296 page report to the Minister. While it is outside the scope of this research, Ramsay gave two reasons why the report was necessary:

> *Firstly, recent overseas work in the area of audit independence, especially in the United States of America and Europe, has moved independence requirements in those regions ahead of the equivalent requirements in Australia. For example, those parts of the Australian Corporations Act which have as their objective ensuring the independence of auditors by prohibiting certain employment and financial*

> *relationships between auditors and their clients, have not been updated for over 40 years. Meanwhile, major developments, including the growth of the largest accounting firms and an increase in non-audit services provided by these firms, highlight the need for Australian requirements to be updated* (Ramsay, 2001, p. 6).

One of the main reasons that the Act had not been updated for over 40 years is there was no Uniform Companies Act in Australia for most of that period and there lacked the existence of a strong Corporate watchdog similar to the Securities and Exchange Commission (SEC) in the USA.

> *Secondly, following the failure of a number of listed Australian companies during the first half of 2001, the resultant publicity has included audit independence issues and has raised concerns about the adequacy of the Australian rules that ensure the independence of Australian accounting firms from the companies they audit* (Ramsay, 2001, p. 6).

The Ramsay Report suggested reforms that led to the enactment in 2004 of the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure Act) (CLERP9) which implemented the Ramsay Report's recommendations for tighter independence controls for auditors. As part of the tighter controls over audit and non-audit work there was criticism from researchers as to the different application by firms:

> *In the interests of independence, CLERP 9 places restrictions on the provision of non-audit services by auditors. However there Is little consistency in the approach adopted by audit firms in identifying and defining the difference between audit and non-audit work* (Green P, Walker J, & McKinnon A, 2010).

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8.5.3. Profession Action

In July 2002 the Australian Government announced that Australia would adopt the International Financial Reporting Standards (IFRS) on 1 July 2005. The Government's reason for the adoption of IFRS was that it would facilitate easier preparation of financial statements especially where companies have overseas affiliates and subsidiaries.

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8.5.4. Summary of major causes underlying the corporate failure

Table 11 below summarises the major causes of the unexpected failure of ABC. The findings of the voluntary administrators and the receivers and managers are as follows.

The voluntary administrators stated that:

> *… poor operating performance and significant and rapid growth without an appropriate strategic framework caused the failure of the A.B.C. Group* (Moloney G & Walker P, 2010).

The receivers and managers appointed on the same day as the directors appointed the voluntary administrators stated:

> *The Group's rapid domestic and international growth was driven by acquisitions which in many cases were transacted at inflated purchase prices, on uncommercial terms and were poorly integrated. As a result, management lost control of the Group's financial performance and*

cashflow, and we were appointed as Receivers and Managers by a syndicate of senior lenders (McGrathNicol, 2016, p. 1).

Table 11: Case Study 8 – ABC Learning Centres Limited

Cause	Detail
Lack of Provision for Doubtful Debts and Bad Debt write-offs	No provision or write off of debts owing by ABC Acquisitions Pty Ltd where builders liability was taken up as revenue.
Misleading statements in Prospectus/Financial Statements Report	Accounting devices such as one off payments from developers inflated both profits and assets (Sykes, 2010).
Excessive borrowings & lack of repayment strategy	Frantic expansion programme funded by borrowings with security tied to level of share price (Sykes, 2010). *…poor operating performance and significant and rapid growth without an appropriate strategic framework caused the failure of the A.B.C. Group* (Moloney G & Walker P, 2010, p. 3).
Related party transactions/conflict of interest	A great deal of ABC's business involved related party transactions. Some transactions were kept from fellow board members (Sykes, 2010).
Borrowing short, investing long	Not applicable
Incorrect valuation and allocation of assets	Excessive prices paid for centres yet developers' fees did not reduce the amount of goodwill on acquisition by way of impairment (Sykes, 2010).
Ponzi scheme	Not applicable
Lack of disclosure	Developers' fees to bolster revenue shortfall not shown separately in Profit and Loss Account.
Unstructured rapid expansion	*ABC bought centres and childcare companies at an astonishing pace …Companies which grow very quickly from a tiny base are often vulnerable to sudden collapse* (Sykes, 2010, p. 197/199).

The administrators, and receivers and managers, both highlighted in their reports of their findings, that unstructured rapid growth was a major cause in the collapse of the group. Unstructured rapid expansion was found to be a cause of 100% of the case studies in this thesis, as shown in the matrix in Table 12.

In Chapter 9 the commonality and causes of unexpected corporate failure for all the case studies in this thesis are compared in a matrix (Table 12).

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8.5.5. Theoretical Applications to the Case Study in this Chapter

The theories and models used to view the individuals in these case studies are set out in Chapter 2. Agency theory depicts individuals as rational, self-interested and utility maximising. A particular instance of agency theory, Transitional Control Loss (TCL), whereby a founder CEO struggles with the loss of unilateral decision making, was consistently observed in Groves throughout his time as CEO after the company was listed on the stock exchange. For example he unilaterally leased a helicopter for the company and his own use and charged ABC unbeknown to his fellow board members. He also arranged the purchase of Child Care Centres from a fellow director without the board's knowledge and many other similar events (Sykes, 2010).

ABC Acquisitions Pty Ltd an unrelated company to ABC received special treatment from ABC. The CFO issued documents of a misleading nature that led to ABC Acquisitions Pty Ltd receiving commissions in the sum of $46.5 million to which it was not entitled. The company, ABC Acquisitions Pty Ltd, collapsed and was deregistered on 29 September 2012 (ASIC, 2016).

9. CHAPTER 9 – Discussion and Conclusion

9.1. Introduction

The focus of this thesis is the research question: What are the fundamental causes of unexpected corporate failures in Australia over the 50 year period ended 2010 and what commonality of causes are evident?

Therefore, the overall aim of this thesis is twofold. First, it aims to investigate the fundamental causes of unexpected corporate failures in Australia over the 50 year period ended 2010. Second, it examines case studies of unexpected corporate failures over the five decades ended 2010 to determine whether there is commonality of causes of the unexpected failures.

The findings presented in this chapter show that there is commonality of causes throughout the eight case studies. These findings are listed in Table 12 which is a matrix comparing the commonality of causes against the list of case studies.

The findings will be of great interest to regulators, shareholders, creditors, directors and managers because they provide a reference list for interested parties prior to investing in a company and also to directors framing questions for managerial staff at board meetings.

9.2. Presentation of the Findings

9.2.1. First aim: To investigate the fundamental causes of unexpected corporate failures

The methodology for analysing the unexpected corporate failures across the decades is by analysing case studies from each decade.

Eight case studies which covered the five decades were analysed and the causes of unexpected failure were determined from the results of investigations by court-appointed inspectors, receivers and managers, liquidators, administrators and also from the research and professional literature. At the end of each chapter which includes a case study, the causes are tabulated with brief detail and referencing and the results recorded on a matrix (see Table 12) for evaluation.

9.2.2. Second aim: To determine whether there were commonality of causes of the unexpected failures.

The matrix shown in Table 12 was prepared with the nine most common causes of unexpected corporate collapses identified from the conclusions of the Government appointed inspectors or other investigators, for example, receivers, liquidators and administrators, in their respective reports, compared against the eight case studies to determine the extent of the commonality of the causes. The matrix shown in Table 12 is followed by a detailed evaluation of the causes also incorporating Tables 13,14,15 and 16.

Table 12: Commonality and Causes of Unexpected Corporate Failure

Cause / Company Case Study	Lack of adequate provision for Doubtful debts and bad debt write off	Misleading statements in Prospectus/ Financial statements report	Excessive borrowings & lack of repayment strategy	Related party transact-ions/conflict of interest	Borrowing short, investing long	Incorrect valuation and allocation of assets	Ponzi scheme	Lack of disclosure	Unstructured rapid expansion
1.Reid Murray Holdings Ltd	✓	✓	✓	✓	✓	✓	✓	✓	✓
2.Stanhill Development Group	✓	✓	✓	✓		✓		✓	✓
3.H.G. Palmer Ltd	✓	✓	✓	✓		✓	✓	✓	✓
4.Mineral Securities Limited		✓	✓	✓	✓			✓	✓
5.Cambridge Credit Corporation Ltd	✓	✓	✓	✓	✓	✓	✓	✓	✓
6.Bond Corporation Holdings Ltd		✓	✓	✓		✓		✓	✓
7.HIH Insurance Ltd	✓	✓	✓	✓		✓		✓	✓
8.ABC Learning Centres Ltd	✓	✓	✓	✓		✓		✓	✓

9.2.3. Evaluation of Matrix and the causes determined from the case studies

The results from the matrix revealed nine common causes of unexpected corporate failure extracted from the eight case studies. Six of the nine main causes identified were common to all eight case studies (Table 13) covering the five decades thus clearly demonstrating that although legislation, regulation and standards strengthened over the 50 years covered by the case studies, the five main causes continued to occur.

Table 13: Causes identified in case studies

Cause	% of 8 case studies
Misleading statements in Prospectus/Financial Accounts	100%
Related party transactions/ conflict of interest	100%
Unstructured rapid expansion	100%
Excessive borrowings & lack of repayment strategy	100%
Lack of disclosure	100%
Incorrect valuation and allocation of assets	87.5%
Lack of adequate provision for doubtful debts and bad debt write off	75.0%
Borrowing short and investing long	37.5%
Ponzi scheme [15]	37.5%

[15] A Ponzi scheme is defined by the SEC as:

…an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors (U.S.Securities and Exchange Commission)

Table 14 lists the eight case studies in the order of analysis and indicates the percentage of the causes applicable to each case study.

Table 14: Percentage of causes relating to each case study

Case study No.	Name of company/group	% of nine causes
1	Reid Murray Holdings Ltd	100.0%
2	Stanhill Development group	77.8%
3	H.G.Palmer group	88.9%
4	Mineral Securities Limited	66.7%
5	Cambridge credit Corporation Ltd	100.0%
6	Bond Corporation Holdings Ltd	66.7%
7	HIH Insurance Ltd	77.8%
8	ABC Learning Centres Ltd	77.8%

The causes referred to in Table 13 are divided into two categories.

The first part includes causes which demonstrate a lack of strategy and management expertise, these are listed in Table 15. The second part includes causes which can be clearly identified as relating to one or more of the points of the fraud triangle, these are listed in Table 16.

Table 15: Causes – Lack of strategy and management expertise

	Cause	% of 8 case studies
1	Excessive borrowings and lack of repayment strategy	100.0%
2	Lack of adequate provision for doubtful debts and bad debt write off	75.0%
3	Borrowing short and investing long	37.5%
4	Unstructured rapid expansion	100.0%

1: Excessive borrowings & lack of repayment strategy

When a company borrows either directly from the bank or by the issue of debentures and unsecured notes, it is imperative that there is an underlying strategy and plan as to how the money is going to be spent. Due diligence should be carried out so that there is no doubt in the minds of the management and board about how much is to be borrowed and the terms of those loans, also what security they have had to provide to the lenders. The board and management must ensure that the money raised is spent in such a way that the return to the company on the borrowings will be sufficient to repay interest and make provision for the repayment of the principal.

In the case studies in this thesis, this factor was generally overlooked. In fact this cause was common to all eight case studies. The attitude was that funds would always be available. There was a complete lack of strategy when issuing a prospectus and accepting over-subscriptions of how to spend the money. On many occasions money was spent unwisely purchasing non-viable businesses. There was a common mindset that there would always be a constant supply of investors for the companies' debenture offerings as long as the financial reports showed profitable results and therefore repayment of maturing debentures and unsecured notes would always be accommodated. In many of the case studies, where the situation occurred that the financial results were not going to show a favourable result, management acting in their own best interest (agency theory) manipulated the results to continue to show profitable outcomes. One of the main methods used to manipulate the results to disclose a profitable result instead of a loss was by not adequately providing for doubtful debts and failing to write off bad debts.

2: Lack of adequate provision for doubtful debts and bad debt write off

One of the leading causes of unexpected corporate failures, especially in the retail sector with hire purchase debtors, is the failure to conduct a regular assessment of the state of the trade debtors. The first point of the organisational fraud triangle (Figure 2) refers to the pressure imposed by the company leadership upon business units to reach performance targets.

In the cases of RMH (Case Study 1), SDC (Case Study 2), Palmers (Case Study 3) and Cambridge (Case Study 5), when sales and profits declined, there was a reluctance to write off bad debts and provide for doubtful debts and thus reduce net profit and current assets. The under provision for future claims by HIH (Case Study 7) had a similar dramatic effect on its net profit and balance sheet.

For example, a prime example of manipulating the financial performance in order to continue to disclose profitable results was Palmers (Case Study 3). Magistrate Mr Scarlett SM, commented at Palmer's trial that:

> *If bad debts had been written off there would not have been any profit for the company for many years* (Sykes, 1998, p. 381).

As also noted in the Case Study, there was further critical comment:

> *The reality was that H.G.Palmer had not made an actual profit in any year since incorporation, let alone the record profit levels for 1963 and 1964* (Clarke, et al., 2003, p. 84).

In fact, Palmer automatically created potential bad debts by ordering staff to lower the credit refusal levels which, while providing increased sales, also had the effect of increasing bad and doubtful debts for which there was no adequate provision.

There was no report required as part of the Financial Statements which provided information about the movement of cash and cash equivalents within the organizations. It was not until 15 July 2004 that such an important report was introduced. The Australian Accounting Standards Board (AASB) made Accounting Standard AASB 107 Cash Flow Statements under Section 334 of the Corporations Act 2001 applying to annual reporting periods beginning on or after 1 July 2007. The objective of this Standard is:

> *…to require the provision of information about the historical changes in cash and cash equivalents of an entity by means of a cash flow statement which classifies cash flows during the period from operating, investing and financing activities* (AASB, 2004, p. 8).

While being extremely useful, it is only beneficial if its results are acted upon.

3: Borrowing short and investing long

The Harvard Business Review comments in their article ‘How Long Should You Borrow Short’ that:

> *…companies often use short-term loans to finance permanent investments in working capital. Unfortunately, this strategy is very risky (*Viscione*, 1986).*

This is excellent advice as borrowing short and investing long could be best described as a poor management decision.

This cause applied to only three out of the 8 case studies but its impact was severe.

RMH (Case Study 1) and Cambridge (Case Study 5), both purchased vacant land with a view to long term development. Both companies relied upon short term borrowing to fund the land acquisition. In the case of RMH the receivership lasted 30 years and Cambridge 36 years which was the time taken to sell all land and housing developments. Minsec (Case Study 4) borrowed heavily on the short term money market to take large positions on the stock market and was left short when the market declined rapidly after the purchases.

In each case economic conditions changed and caused valuations of the assets to fall dramatically. Large losses were incurred as a result.

4: Unstructured rapid expansion

Corporate growth can happen in various ways but mainly by internal development of the existing business or growth by acquisition.

Growth by acquisition is by far the riskier strategy as, without sound planning and due diligence, it can easily go wrong.

In every one of the eight case studies the aim of the founder/CEO was to accelerate the size of their operation as quickly as possible. For example in the case of RMH, CEO O'Grady's expansion strategy was:

> *…relatively simple. He was prepared to acquire any business that was adequately profitable…*(Sykes, 1998, p. 303).

However, O'Grady's management principle was not to interfere with the management of acquired businesses but rely on the existing management at the time of acquisition to continue to run the business. Thus O'Grady lost control of the company as it grew.

In the case of Palmers

> *The Palmer Group did not so much add corporate value as acquire value that already existed. Growth by acquisition was the name of the game. It was easy and there for the taking* (Clarke, et al., 2003, p. 73).

In most cases the management of the holding companies did not have a strategic management plan to ensure that the acquired business stayed viable with growth into the future.

Table 16 identifies the causes that relate to one or more of the points of the fraud triangle. While a particular cause of the failure can be related to a particular point of the triangle, it should be noted that the three points of the fraud triangle are linked therefore provide solutions for prevention of fraudulent actions across the corporate structure.

Table 16: Causes – Relating to points of the fraud triangle

	Cause	% of case studies
1	Misleading statements in Prospectus/Financial Accounts	100.0%
2	Related party transactions/ conflict of interest	100.0%
3	Incorrect valuation and allocation of assets	87.5%
4	Ponzi Scheme	37.5%
5	Lack of disclosure	100.0%

1: Misleading statements in prospectus/financial statements report

In all eight case studies this cause was prominent. When a new prospectus was issued the financial reports often contained misleading statements regarding valuation of assets and expected projected profits. In some cases, for example, SDC (Case Study 2), a list printed in the prospectus of projects to be carried out utilising the funds subscribed to the prospectus bore no resemblance to the way in which the funds were actually distributed. They were used to prop up related companies short on cash flow and in part transferred money to the personal family companies of Korman. Korman created a culture typical of the CEO described in the TCL (see section 2.2.1) and also typical of the second point of the fraud triangle where the culture accepted the actions as rules of the game (see section 2.3).

Penalties for misleading statements in a prospectus, financial accounts and reports varied over the five decades due to a number of factors including lack of Uniform Corporations Legislation, and inordinate delays in bringing cases before the courts. Penalties ranged from small fines to jail sentences. The current legislation is complex and is dealt with by Section 728 of the Corporations Act 2001.

2: Related party transactions/conflict of interest

In 100% of the case studies in this thesis, this cause was prominent. For example, in SDC (Case Study 2) the inspector made further criticism of the directors in relation to the conflict of interest when advances were made from SDF to other companies within the group. In almost every case the directors of SDF were also directors of the borrowing company. The inspector formed the view:

> *…that such loans were considered by SDF's directors from the point of view of the borrower and not the lender. Normal prudence and due diligence were ignored* (Murphy, 1964, p. 73).

These actions are also typical of the second point of the fraud triangle where the culture accepted the actions as rules of the game (see section 2.3).

Currently related party transactions are administered under Accounting Standard AASB 124:

The objective of this Standard is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances, including commitments, with such parties (Australian Accounting Standards Board, 2015, p. 5).

In addition to AASB 124, ASIC has issued Regulatory Guide 76 titled Related Party Transactions the main purpose of which, set out in RG 76.3:

This guide aims to encourage transparency and best practice in the market, with a view to facilitating informed member decisions. It sets out our views about the type of information that is material to member decisions (ASIC 2011, p. 5).

3: Incorrect valuation and allocation of assets

(a) Incorrect valuation of assets.

In many of the case studies increased borrowing was enabled by an acceptable accounting practice of recording purchases of non-current assets at historical cost. However in the case of related party transactions this lead to improper use of the practice. An example of this action is found in SDC (Case Study 2) where assets were sold to a related company at an inflated selling price. The related purchasing company then used the inflated selling price as the historical cost for borrowing purposes. This is an example of the fraud triangle culture link where such an abuse of acceptable behaviour is assumed to be a rule of the game (see section 2.3).

(b) Incorrect allocation of assets.

Many case studies used the incorrect allocation of assets as a means of producing misleading financial accounts. Classifying freehold land as a current asset when the company acquired the land for future development is a classic example and used by RMH (Case Study 1) and Cambridge (Case Study 5). Erosion of the land values listed as current assets and not brought to account was used as a method of manipulation of the financial accounts.

4: Ponzi scheme

The Ponzi scheme for the purpose of these case studies has a reliance upon renewal by existing debenture holders and a constant flow of new investors to enable repayments to be made to holders of maturing debentures wishing to cash out their investments (U.S.Securities and Exchange Commission). This reliance upon a Ponzi-type scheme became imperative when each company experienced critical cash flow levels. For example, RMH (Case Study 1) relied upon a virtual Ponzi scheme to meet maturities of debentures for years 1963/64/65 totalling £19 million as they could only be repaid from further borrowing (Murray & Shaw, 1963).

These actions are also typical of the second point of the fraud triangle where the culture accepted the actions as rules of the game (see section 2.3).

5: Lack of disclosure

This cause was prominent in 100% of the case studies in this research. For example, as recorded in Case Study 6 Alan Bond purchased through his private company Dallhold a painting that BCH was leasing, without the knowledge of his fellow directors. Dallhold then sold the painting making a profit of $14.5 million. Bond was found guilty of four counts of fraud (see Case Study 6).

These actions are also typical of the second point of the fraud triangle where the culture accepted the actions as rules of the game (see section 2.3).

The current position regarding disclosure is extremely complex over many areas. However the general rule is that there must be continuous disclosure as the ASX has issued Guidance Note 8 – Continuous Disclosure: Listing Rule 3.1 which states:

> *Once an entity is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities, the entity must immediately tell ASX that information* (ASX, 2013, p. 301).

9.3. Implications for Theoretical Relationships

The major theoretical base for this thesis is agency theory which was used as a consistent lens through which to view and interpret the case studies. The nature of the corporate entity provides the fundamental environment for the principal/agent relationship because the principal is most often many hundreds and/or thousands of shareholders and the agent normally the board of directors and senior management carrying out the principal's aim of operating the business.

In all of the eight case studies in this thesis the agent strongly deviated from the principal's interest. The more the corporate entity moved closer to collapse the more agents were acting in their own self-interest. The pyramid enforcement model where civil penalties have been introduced, and the points of the fraud triangle, provided constraints which should have encouraged more rational behaviour and limited the destructive behaviour. If the agents thought they would be detected promptly and punished severely it could be argued that the outcome may have been different. However, in the summaries of the case studies regarding legal and professional changes, the indication is that while there have been some changes the underlying causes of collapse remain.

In every case study from Chapters 4 to 8, the behaviour of the original founder of the company aligns with the principles of transitional control loss. This is a distinct part of agency theory proposed by this researcher to highlight the unilateral behavior by the founder CEOs who are unable to transition from a private company governance structure to the rigors of public company accountability. Further research is necessary to fully clarify this distinct part of agency theory and its relationship to existing concepts and theories.

9.4. Practical Contributions

Alongside the theoretical contributions made by this thesis, the research has made a practical contribution in a key area. Evidence is provided that unexpected corporate failures continue to happen and the causes of the failures are often unchanged.

The analysis of the case study results spanning 50 years substantiates that notwithstanding amending legislation, changes to regulations, adoption of accounting and auditing standards that have the force of law, corporations continue to fail unexpectedly and the causes of the failures in many cases are unchanged.

The understanding of the continued subject of unexpected corporate failure and the commonality of causes based on the results of this thesis, will allow the regulator and legislators to implement proactive legislation and regulations; company directors and senior managers to better understand and more readily recognise warning signs and take preventative action; academics and the profession to update their educational focus, for prospective investors to assist in deciding whether to invest, and other interested parties.

9.5. Implications for Further Research

This research clearly demonstrates need for future research into the following three areas:

1. **Commonality of Causes List**

It is recommended that the regulators build on the findings of this thesis to assist in the formulation of proactive strategies to reduce the incidence of unexpected corporate failures in the future because, notwithstanding changes in regulations and legislations, unexpected corporate failures continue to happen.

2. **Transitional Control Loss as part of agency theory.**

In all the case studies in this thesis, the founder of each of the corporate groups negatively affected the performance of the entities. However, future research to establish whether the effect of TCL is always negative is strongly recommended as there may be companies where the founder/CEO is responsible for producing strong financial results. A cross disciplinary research approach between the disciplines of accounting, management and psychology could be beneficial.

3. **Method of Appointment of Auditors**

A further recommended subject for research is for the regulators to review the method of appointing auditors to public companies. Although the actions of auditors were not a direct cause of unexpected corporate failure in the case studies in this research, some audit firms came under criticism from the inspectors, investigators, liquidators, administrators and the courts.

The introduction of the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure Act) (CLERP 9) in 2004 was effective in ensuring the independence of auditors, however it could be argued that there is still room for improvement. This researcher suggests a possible solution would be for the auditors to be appointed by a regulatory body, for instance ASIC, in much the same way that the Queensland Audit Office (QAO) appoints auditors to local government authorities by using a strong, transparent process which includes calling for expressions of interest and tenders.

9.6. Conclusion

Over the decades academics and practitioners have analysed individual cases of corporate failure. However, there has been a lack of research identifying the fundamental commonality of causes of unexpected corporate failures across the decades. This thesis has addressed this research gap by identifying the fundamental causes of unexpected corporate failures over five decades ended 2010 and the commonality of causes evident.

Wherever possible in the case studies primary data has been sourced from government appointed inspectors' and investigators' reports of the unexpected corporate failures. Also reports from liquidators, administrators and receivers have been accessed, Where information from these sources is not available there is reliance upon material sourced from the writings and historical research published by a limited number of professional, semi-professional, academic and popular sources (i.e. mass media).

The study findings are of great practical relevance and will be useful to the regulators, professional bodies, potential investors, company directors, senior management and educators.

These findings provide valuable insights into the nature and characteristics of unexpected corporate failure by analysing the list of commonality of causes. The analysis included categorising the commonality of causes into two groups, those which exhibited lack of strategy and management expertise, and those which could be related to points of the fraud triangle.

The first group which exhibited lack of strategy and management expertise includes excessive borrowings and lack of repayment strategy, lack of adequate provision for doubtful debts and bad debts write off, borrowing short and investing long, and unstructured rapid expansion. The second group which could be related to the points of the fraud triangle included misleading statements in prospectuses and financial accounts, related party transactions and conflict of interest, incorrect valuation and allocation of assets, virtual Ponzi scheme and lack of disclosure.

Also included was discussion relating to the theory relevant to this research, agency theory, and emphasises the term transitional control loss within agency theory, which highlights the unilateral behavior by the founder CEOs. They are unable to transition from a private company governance structure to the rigors of public company accountability.

Unexpected corporate failures have been happening ever since there have been companies and continue to happen notwithstanding that, at the present time, there is the strongest governance and corporate law ever. This thesis takes one step forward in providing an holistic approach to understanding the factors that led to unexpected corporate failures of the past so that they may, possibly, be prevented in the future.

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11. Appendices

11.1. Appendix 1: **Corporate Regulators in Australia**

Corporate Regulators in Australia (1961 – 2010)

Throughout the thesis reference is made to the corporate regulator and actions taken by that body. The table below shows a brief overview of changes to the Australian corporate regulator that have taken place over the five decades covered by this thesis.

Corporate Regulators in Australia (1961-2010)

Year	Regulator	Detail
1961-62	State Corporate Affairs Commissions (CAC)	Uniform Companies Act. Wide divergence by States as to how the law was interpreted.
1974-79	Interstate Corporate Affairs Commission (ICAC)	The first institutional regulatory arrangement with a substantially national purview (Mees & Ramsay, 2008)
1981-89	National Companies and Securities Commission (NCSC)	Three Senate inquiries during the 1980s recommended wholesale changes to the Corporations Legislation (see section 6.5.1)
1989-98	Australian Securities Commission (ASC)	National register of companies and common reporting standards in new legislation. States compensated for lost revenue from company incorporations and reporting functions.
1998-	Australian Securities and Investments Commission (ASIC)	ASC rebadged to ASIC with extra responsibility for consumer protection in insurance, superannuation and banking.

11.2. Appendix 2: Corporate Law Summary of Changes

Corporate Law Summary of Changes (1961 – 2010)

The table below lists a summary of dates of major changes in the Corporations Law over the five decades covered by this thesis.

Dates of major changes in Corporations Law

Date	Name	Detail
1960-69	Uniform Companies Acts 1961-62	Each state over the period between 1961-62 enacted uniform legislation in an effort to remove difficulties caused by differing legislation between states.
1970-79	Uniform Companies Acts 1961 as amended. Eggleston Reports 1969-72 Rae Committee Reports 1974	Both committees called for the establishment of a National Securities Commission
1980-89	Companies Act 1981 (Cth)	Campbell Committee of Inquiry into the Australian Financial System. Establishing the Accounting Standards Review Board.
1990-99	Corporations Act 1989 (Cth) (Corporations Law)	Uniform legislation scheme that came into operation in 1991. Repealed by the Corporations Act 2001 (Cth)
2000-10	Corporations Act 2001 (Cth)	Superseded the Corporations Act 1989 (Cth) to become the legislation covering corporations today.