



PUBLIC ACCOUNTS COMMITTEE

The Role of Auditing and Accounting in Recent Corporate Collapses



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Charter of the Committee

The Public Accounts Committee has responsibilities under the *Public Finance and Audit Act 1983* to inquire into and report on activities of government that are reported in the Total State Sector Accounts and the accounts of the State's authorities.¹ The Committee, which was established in 1902, scrutinises the actions of the Executive Branch of Government on behalf of the Legislative Assembly.

The Committee recommends improvements to the efficiency and effectiveness of government activities. The sources of inquiries are the Auditor-General's reports to Parliament, referrals from Ministers and references initiated by the Committee. Evidence is primarily gathered through public hearings and submissions. As the Committee is an extension of the Legislative Assembly its proceedings and reports are subject to Parliamentary privilege.

Members of the Committee

The Committee comprises members of the Legislative Assembly and assumes a bipartisan approach in carrying out its duties.

Chairman: Joseph Tripodi MP, Member for Fairfield

Vice-Chairman: Pam Allan MP, Member for Wentworthville

Members: Ian Glachan MP, Member for Albury

Katrina Hodgkinson MP, Member for Burrinjuck

Richard Torbay MP, Member for Northern Tablelands

Barry Collier MP, Member for Miranda

¹ See Part 4 of the Act – The Public Accounts Committee.



Committee Secretariat

Secretariat members involved in the Inquiry were:

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Chairman's Foreword

This report covers the key findings and meeting reports from the Committee's study tour to the United States of America, France, Belgium, Italy and the Hong Kong Special Administrative Region from 14 July to 3 August 2002. The Committee's delegation comprised the following people:

- Joseph Tripodi MP, Member for Fairfield;
- Richard Torbay MP, Member for the Northern Tablelands; and
- Vicki Buchbach, the Committee's Senior Project Officer.

The aim of the study tour was to observe changes to accounting and auditing practices in other countries resulting from large scale corporate collapses and assess whether there would be any implications for the Australian private and public sectors.

This topic is of vital importance given the high cost to the Australian community of the collapse of HIH and One.Tel.

I would like to thank the agencies and organisations that donated their time and expertise in helping the delegation gain an understanding of such a complicated and technical area.

I would also like to thank the people and organisations who helped make the study tour such a success, in particular the PAC's secretariat staff David Monk, Vicki Buchbach and Jacqui Isles.

The Committee trusts the information presented will help inform the debate and assist the Parliament in overseeing arrangements for accountability.

A handwritten signature in cursive script that reads 'Joe Tripodi'.

Joseph Tripodi MP
Chairman



Chapter One

Introduction

The Committee resolved at its meeting on 19 June 2002 that a delegation consisting of the Chairman, Mr Joseph Tripodi MP and Mr Richard Torbay MP should make a tour to the United States of America, Europe and Hong Kong. The aim was to investigate potential changes to private sector accounting and auditing practices resulting from recent international corporate collapses and the effect of these changes on the public sector.

Corporate collapses

In late 2001 Enron, the USA's largest energy trading company, collapsed with the loss of 4000 jobs. At the time it was the largest corporate collapse in US history and had enormous effects on investors. It was apparent Enron had continued to trade while insolvent and had hidden the extent of its debts by establishing complex multiple partnership arrangements with wholly owned entities. The financial status of these entities was not reported in Enron's financial reports.

In 2002, Worldcom, the third largest US telecommunications company, collapsed with the loss of 14,000 jobs, after admitting it had misreported operating expenses as capital expenses for some time. Xerox misreported anticipated income in financial reports and was fined and forced to refile its statements. Tyco, a communications company, collapsed with its executives accused of fraud. There are several other examples of prominent corporate malfeasance such as insider trading of Imclone and the collapse of Adelphia and Global Crossing. In Europe, accounting problems contributed to the inflated stock price of the French media company Vivendi.

While the circumstances of these collapses varied in detail, they shared common problems of weak internal controls, a lack of disclosure to shareholders, a culture that promoted growth in the stock prices and a lack of vigilance by boards and internal and external auditors. In some cases the frauds were complex, in others simple.

The collapse of the insurance company HIH and the phone company One.Tel in Australia can be attributed to a similar range of problems of poor corporate governance and lack of disclosure of problems.

Auditing profession

Of particular significance is the role of Arthur Andersen in the collapse of Enron. The company was indicted for failing to retain documents relevant to the investigation of Enron and later itself collapsed under the burden of fines it was unable to pay. However, problems of auditors having conflicts of interest and lacking independence from their clients have not been limited to this firm. It has been suggested auditing firms were more interested in increasing the sale of non-



audit services such as financial management software and management consulting than ensuring audits were performed thoroughly.

Response to problems

The USA has developed legislative and administrative responses to these problems to improve corporate accountability and auditor independence. In the European countries visited by the delegation, the response has been more measured. A European Commission recommendation on auditor independence was released in 2001, however, a high level working group on corporate governance, the Winter Group, was established more recently.

In Hong Kong, proposals to change listing rules for the Hong Kong Stock Exchange for corporate governance were amended in light of the problems identified in relation to the collapse of Enron.

These developments will certainly have significant effects on the operations of Australian businesses trading internationally. Effects will also almost certainly be felt locally: it was recently announced Australian accounting standards would be harmonised with the International Accounting Standards by 2005. The final form of these standards is likely to reflect responses to recent corporate collapses.

Relevance to the Committee

These issues will be of central importance to the future operation of this Committee as it has a duty to inquire into the State public accounts. This includes those of State trading enterprises and universities which may have large corporate entities as subsidiaries. This Committee also has a role in commissioning and overseeing the triennial review of the Audit Office of New South Wales. The next review will commence shortly.

Conduct of the Study Tour

The delegation visited a number of organisations from both the public and private sectors in order to develop an understanding of the implications for public sector financial management of likely changes to auditing practices. A list of agencies and companies visited is in the Appendix.

Key aspects of this issue which were discussed with organisations on the study tour are:

- independence of auditors;
- provision of non-audit services to audit clients by accountancy firms;
- peer review of auditors;
- likely outcomes of a series of US congressional investigations and debates into the collapse of Enron;
- revision of accounting and auditing standards; and
- how private sector auditing practices will affect public sector financial

management.

The major areas of discussion related to the debate in US Congress about legislative responses to concerns about corporate accountability and how that tallied with responses in other places visited. The Bill to address these concerns (the Sarbanes-Oxley Bill) was being debated while the delegation was in the USA and was signed into law by the United States President while the delegation was in Hong Kong.

The delegation learnt about efforts to address problems with corporate accountability in France, Belgium, Italy and Hong Kong. The delegation also learnt about the views organisations in these places held about the legislative response in the United States.

In the following two chapters, this report describes the major issues discussed in more detail and the lessons learnt that can be applied to the NSW public sector.



Chapter Two

Key Issues

Causes of recent corporate collapses

The Committee asked a range of organisations their views of the cause of several recent corporate collapses.

Culture of promoting the stock price

One key reason identified was a new emphasis on the price of stock rather than companies' profitability. Kathleen Bisaccia, Branch Chief of the Securities and Exchange Commission's San Francisco Office of Enforcement, told the delegation:

The dotcom boom led to a lot of incentive to make companies' numbers look good. Unlike in the past where for instance the dividends paid by blue chip stocks were the major income for stockholders, the stock price became the major source of profit. Bad financial news could send the stock price down.²

James Duffy, of the New York Stock Exchange, indicated booming economic conditions made people disinclined to question the veracity of reports:

The euphoria of the bull market was such that everyone was interested in the price going up. No-one was complaining that the numbers looked too good.³

Quarterly reporting

The delegation heard that, in Europe, the US practice of companies reporting earnings every quarter was the object of heated debate. The European Federation of Accountants were of the view management needed to report consistent growth in earnings. This encouraged poor practices as the markets would punish reduced earnings in a lower stock price.⁴ Antoine Bracchi, President of the French National Society of Accountants, told the delegation investors should mistrust entirely good news. He described a study of US quarterly earning reports that showed consistent earnings growth over time rather than more credible sharp increases and occasional decreases.⁵

² Ms Kathleen Bisaccia, Branch Chief of the Securities and Exchange Commission's San Francisco Office of Enforcement, 15 July 2002

³ Mr James E Duffy, Senior Vice President and Associate General Counsel, New York Stock Exchange, New York, 19 July 2002

⁴ Mr Henri Olivier, Secretary General, European Federation of Accountants (FEE), Brussels, 25 July 2002

⁵ Mr Antoine Bracchi, President, French National Society of Accountants, Paris, 24 July 2002



However, opinion on the benefits of quarterly reporting is divided. The delegation also learnt the introduction of quarterly earnings reporting is part of the reforms to the listing requirements for the Hong Kong Stock Exchange.⁶

US standards

The delegation heard US corporate collapses could be attributed at least in part to the US standards only requiring reporting of issues above a certain threshold. Carlo Biancheri, of the Italian corporate regulator (CONSOB), stated that in Europe the rules require whatever is material to be disclosed. Disclosure is enforceable by the regulator and the burden of proof lies with the company to determine materiality.

Mr Biancheri noted Enron traded until bankrupt and stated this could not happen in Europe as the situation would require disclosure. He stated his organisation was surprised by the Enron collapse as Italian regulators would not accept the existence of wholly owned subsidiary entities, which Enron used to disguise the level of its debt, and would require consolidation of the debt.⁷

Other concerns included US accounting standards being based on rules rather than principles as they are in other countries. This means efforts are made to find exceptions to rules and argue the rules do not apply to a particular practice. There are also concerns about the quality and timeliness of the work of the US's private sector accounting standards developer.⁸

Push towards less regulation

Another factor identified as contributing to recent collapses was pressure to decrease the level of corporate regulation. According to Kathleen Bisaccia, of the SEC's Enforcement Division, the previous head of the Securities and Exchange Commission, Arthur Leavitt, was particularly active in trying to improve disclosure, especially for high technology companies with no demonstrated earnings. His efforts were resisted by both companies and legislators at the time.⁹

Stock Options

The use of stock options in remunerating company staff and directors has also been criticised for the twofold reason that:

- the extent of options packages was not always disclosed to shareholders and could affect the health of the company by the dilution of stock. Under existing rules, the options are not accounted for in any way; and

⁶ Ms Estella Ng, Senior Vice President Listing Division, Hong Kong Exchanges and Clearing Ltd (HKEx), Hong Kong, 2 August 2002

⁷ Mr Carlo Biancheri, Director of the International Relations Office, Commissione Nazionale per le Società e la Borsa (CONSOB), Rome, 29 July

⁸ Ms Kathleen Bisaccia, *op. cit.*

⁹ *ibid.*



- staff could be motivated by personal gain to agree to promote the price of stock by any means possible.

The use of options in remuneration packages is more common in the US than other countries. Ms Bisaccia, of the SEC, considered it highly unlikely stock options would be banned as they are pervasive in the US business community. However she considered it likely there would be an increase in the number of companies including options in financial statements as expenses. For example, in July 2002, Coca Cola announced it would do this.¹⁰

Auditing profession

In some cases auditors have been blamed for failing to alert regulators to problems with companies because they had conflicts of interest. The delegation heard from Phil Calder, of the US General Accounting Office, that in auditing firms there was pressure to increase revenue by broadening the services performed because:

There was a perception for a number of years that audit was a commodity and firms were interchangeable. This led to an emphasis on differentiation by special services. Audit boards [of companies] also saw their role as to push down the audit fee.¹¹

Mr Calder also commented that the professional accounting organisation, the American Institute of CPAs, had undergone “devolution” from a professional organisation to a trade organisation which promoted the sale of non-audit services on its website.

Ms Kathleen Bisaccia, of the Securities and Exchange Commission, described the case of Waste Management which committed large scale accounting fraud without its auditor, Arthur Andersen, apparently noticing. She stated the firm was loss leading or “low-balling” its auditing work in order to increase the sale of non-audit services. Waste Management had capped Arthur Andersen’s auditing fees at \$2.5 million but paid them \$18.9 million in consulting fees.¹²

An additional risk to auditor independence was due to long term relationships with clients. This has led to discussion of the need to rotate auditing firms. Roger Picard, from the French Bureau of Audit, noted auditing companies are not independent. For instance, they are paid by the client and auditors working for a company for a long time are almost considered employees. Performance of consulting work also compromised auditor independence as this work could mean direct participation in the management of the company.¹³

¹⁰ *ibid.*

¹¹ Mr Phil Calder, Chief Accountant, General Accounting Office, Washington, 17 July 2002

¹² Ms Kathleen Bisaccia, *op. cit.*

¹³ Mr Roger Picard, Director, Bureau of Audit, Ministry of the Economy, Finance and Industry, Paris, 23 July 2002



The delegation also learnt these problems were exacerbated by weaknesses in the oversight of the profession, particularly in the US. The system of firms performing peer reviews of each other's work was regarded inadequate. Charles Grieve, of the Hong Kong Securities and Futures Commission, commented Ernst and Young admitted systematic ownership of shares of clients' companies which led to a settlement with the SEC but two weeks later they received a clear peer review report.¹⁴

In Europe there are strong external controls on auditors. In Italy the auditors report to CONSOB, the corporate regulator, which is able to sanction the auditors. CONSOB has uniquely strong powers to visit or call auditors in at any time and to see the working papers. When there are doubts about financial statements there is direct dialogue with the auditor. In France there is also strong external control of auditors but managed by the professional association rather than directly by the corporate regulator.¹⁵

Prevalence of these problems

The delegation was unable to establish how prevalent the problems contributing to the collapse of major companies were. A number of people stated the particular problems causing the collapse of US companies could not happen in their jurisdictions but no-one claimed their jurisdictions were entirely free of trouble.

Consequences of corporate collapses

The scale of recent corporate collapses in the US is enormous and has had significant economic impacts for individuals. The Comptroller-General of the United States explained:

There are three feet on the metaphorical stool of retirement: health care, savings and pensions. Now the system is in doubt because personal savings are at risk.¹⁶

The delegation heard that as well as the immediate consequences of massive financial losses, losses of jobs, and reductions in the value of many pension funds, there was another potentially long term consequence – the loss of trust in the market by investors. Kathleen Bisaccia, of the SEC, stated:

For many years the SEC has been encouraging investors to inform themselves adequately and read all available material before purchasing stock. The difficulty recently has been that even by reading all the available material, potential investors

¹⁴ Mr Charles R Grieve, Director of Accounting Policy, Corporate Finance Division, Securities and Futures Commission, Hong Kong, 1 August 2002

¹⁵ Mr Carlo Biancheri, *op. cit.*; Mr Phillippe Danjou, Director of Accounting, Commissions des Operations de Bourse (COB), Paris 24 July 2002

¹⁶ Mr David M Walker, Comptroller General of the United States, General Accounting Office, Washington, 17 July 2002



may not be aware of the true state of a company because of instances of corporate fraud.¹⁷

Antoine Bracchi, of the French National Society of Accountants, advised that people do not trust financial statements any more. He did not consider this would be remedied in the near future as it would take time for companies to prove their integrity to the public. Mr Bracchi described the example of GE which, just after the Enron collapse, issued its financial statements. These had 11 more pages of notes than the previous statements. This led to a 10 percent fall in the share price arising from the lack of confidence in the company which was based not on the contents of the notes, but on their size.¹⁸

Edward M Harrington, Controller of the City and County of San Francisco, identified a further negative result of efforts to limit the provision of non-audit services by accounting firms in order to preserve auditor independence. For example, KPMG performs audits and undertakes work on such things as financial systems. Auditor independence has prompted KPMG to split up. This has left the city with a financial system chosen in part because it was backed by a multinational company. This is no longer the case as the system is now owned by a much smaller local company.¹⁹

On the other hand, James Duffy, of the New York Stock Exchange, emphasised the management improvements resulting from reforms to corporate law and enforcement:

The system will work better for a while because everyone on the Board will have had this recessionary experience and want the stock to go up a bit more slowly. There are incentives to behave more professionally when the SEC is scrutinising more closely and plaintiff lawyers are standing in the wings to take class actions against CFOs who certified accounts later found to be fraudulent. There is a collective set of pressures to make people behave well, however this is a cyclical pattern.²⁰

Administrative and Legislative response in the US

The delegation heard rapid action was taken by both the US legislature and the Securities and Exchange Commission (SEC) in identifying and addressing the underlying causes of corporate collapses.

Legislative Response

The House of Representatives Standing Committee on Financial Services held hearings within 10 days of the collapse of Enron. The House passed a Bill in April 2002 which was defeated in the Senate. A separate and more stringent Bill, the

¹⁷ Ms Kathleen Bisaccia, *op. cit.*

¹⁸ Mr Antoine Bracchi, *op. cit.*

¹⁹ Edward M Harrington, Controller, City and County of San Francisco, 16 July 2002

²⁰ Mr James E Duffy, *op. cit.*



Sarbanes Bill, was passed unanimously by the Senate in July. While the delegation was visiting Washington, the House voted to go to conference with the Senate to find a meeting point.²¹ This Bill was agreed and signed into law by the President on 30 July 2002.

The most significant provisions of the final Sarbanes-Oxley Act are described in the table on the next page.

Changes to administrative rules

While the legislation was being developed, the SEC worked on developing potential administrative changes. Susan Koski-Grafer, of the Washington Office of the Chief Accountant, told the delegation that in March 2002 Harvey Pitt, the SEC Chairman gave testimony to Congress on his detailed plan of reform. This is being implemented progressively as the SEC develops rule changes. The reforms occur as they are formulated and are issued for comment at the same time as Congress debates them. If the laws change while they are preparing their rule changes, then the plan will change to follow the new laws. Initiatives described in Mr Pitt's plan include:

- Shortening reporting times for quarterly reports from 90 to 60 days;
- Requiring the CEOs of companies as well as the Chief Financial Officers to sign financial statements;
- Requiring statements about critical accounting methods in reports; and
- Establishing a Public Accountability Board to oversee the accounting profession.²²

Some of these initiatives have been overtaken by the legislative response.

In the US, the private sector standard setter, the Financial Accounting Standards Board (FASB) has been criticised for the lack of timeliness of its standards and the appearance of conflict of interest in funding sources. A third of FASB funding comes from donations. Phil Calder, of the General Accounting Office, told the delegation this situation may improve in the wake of the recent corporate collapses and the SEC may exercise closer oversight of the FASB but there is unlikely to be any stronger Government role in issuing standards.

In addition, the SEC asked the New York Stock Exchange to develop changes to its listing rules in order to improve corporate governance. A draft of new listing rules was released for comment in June 2002 and these were adopted by the Exchange in August.²³ The delegation was told the major thrust of the new listing

²¹ Mr Terry Haines, Majority Staff Director, House Committee on Financial Services, Washington, 17 July 2002

²² Ms Susan M Koski-Grafer, Associate Chief Accountant, Office of the Chief Accountant, Securities and Exchange Commission, Washington, 19 July 2002

²³ See the New York Stock Exchange's website at www.nyse.com



Major Provisions of the Sarbanes-Oxley Act 2002²⁴

Oversight of Accounting Profession

- Creates Public Company Accounting Oversight Board to oversee public accountants
- 5 member board appointed by SEC to have staggered five year terms
- Only two members can be accountants, past or present
- Board would enforce auditing, quality control, and independence standards and rules
- SEC to have oversight and enforcement authority over Board
- Board funded by fees on all publicly traded companies

Auditor Independence

- Provision of non-audit services to audit client requires pre-approval by audit committee
- Mandatory audit partner rotation
- One-year employment restriction on accountants (to work on firm providing the auditing services)

Corporate Responsibility

- Mandatory listing standards relating to audit committees
- CEO and CFO certification of periodic reports, subject to civil and criminal penalties
- Makes it a crime for issuer to interfere with audit
- Disgorgement (repayment) of bonuses paid to executives preceding a company's restatement of financial performance
- Lifetime ban for "unfit" officers and directors
- Prohibition on executive insider trades during "blackout" periods (before reporting)
- Rules of professional responsibility for corporate attorneys
- Prohibitions on loans to company executives
- Establishes FAIR account to hold the civil penalties levied by the SEC as a result of any judicial or administrative action for the benefit of harmed investors

Improved Information to Investors

- Enhanced financial disclosures, including periodic reviews for largest issuers and real time disclosure of material company information

Analyst conflicts of interest

- Enhanced firewalls between securities research analysts and investment bankers

Funding for SEC

- Authorises \$776 million for SEC in FY 2003

Studies and Reports

- Requires various studies and reports, including studies on investment banks, credit rating agencies, and SEC enforcement actions

Tougher Criminal Penalties

- Enhanced criminal penalties for broad array of white collar crimes
- Increase in statute of limitations for securities fraud lawsuits
- Temporary freeze on extraordinary payments to employees of companies under investigation by SEC
- Makes it a crime to retaliate against corporate whistleblowers

²⁴ Edited version of House Committee on Financial Services press release "House passes Sarbanes-Oxley Conference Report on Corporate Accountability 423-3", 25 July 2002



rules was to strengthen corporate accountability by requiring company boards listed on the exchange to contain a majority of directors who are independent of management.

The other recommendations are ancillary to this central recommendation. For example, the report suggested independent directors be able to meet amongst themselves without management. This should empower them so they are accustomed to meeting in this way and would therefore be more likely to be effective when they need to address a crisis.²⁵

Response in Europe

During its meetings in Paris, Brussels and Rome, the delegation was told the response to recent corporate collapses was more measured than in the United States and regulators were more likely to be continuing with existing projects than to develop new ones. For instance, Phillippe Danjou, of the French corporate regulator, commented:

There are not likely to be big reforms here. It is more about tightening every link in the chain. France has much more statutory authority than the Anglo-Saxon countries.²⁶

Representatives of the European Commission described:

- their recent work on auditor independence which is currently being implemented by community members;
- the plans for adoption of International Accounting Standards in 2005 by community members; and
- the corporate harmonisation programme's establishment of an expert group on company law reform (the Winter Group) which will address governance.²⁷

Henri Olivier, of the European Federation of Accountants (FEE), commented in a paper prepared in response to the collapse of Enron, they were criticised for not reporting anything new but they considered they had been working towards improved corporate accountability for years, in contrast to the US. Mr Olivier noted US President Bush's recent comments about the need for jail penalties to be available for corporate criminals and commented criminal penalties already applied to CEOs in Europe.²⁸ Phillippe Danjou, of the French corporate regulator, also noted CEOs in France are required to certify the accuracy of their financial reports already and therefore are liable for their contents.²⁹

²⁵ Mr James E Duffy, *op. cit.*

²⁶ Mr Phillippe Danjou *op. cit.*

²⁷ Mr Karel Van Hulle, Head of Unit, Financial Reporting and Company Law Unit, Financial Markets Directorate, European Commission, Brussels, 25 July 2002

²⁸ Mr Henri Olivier *op. cit.*

²⁹ Mr Philippe Danjou, *op. cit.*



However, a number of organisations expressed grave concerns at the extraterritorial effect of the US legislation. Before the finalisation of the legislation, Karel van Hulle, of the European Commission, commented:

We have been trying to influence the Sarbanes Bill as it has large extraterritorial effects as it will affect European companies operating in the US. Auditors will need to be registered in the US if they audit European based subsidiaries of US companies. This is bad because the auditors will have to register in the US and pay fees and provide working papers to the SEC.³⁰

Mr van Hulle was particularly concerned the Public Oversight Board headed by the SEC has far-reaching powers over the auditing profession in other countries. This includes summoning auditors and their working papers, and requiring auditors of companies listed in the US to apply US standards regardless of their location. He commented this extraterritoriality would affect 80 percent of European companies as well as many Australian firms.

Response in Hong Kong

The delegation was told the local reaction to the recent corporate collapses was not as marked as the response to the Asian financial crisis of 1997-98. Mr Alvin Wong, of the Hong Kong Society of Accountants, described the situation during that crisis. At the time there had been a great deal of accounting fraud, especially the simple removal of funds to other countries. This had been severe enough to shake investor confidence.

He commented people were dismayed problems were not picked up by the auditors and there was a great deal of criticism of the accounting profession. This led to initiatives to increase accountability, open up procedures and processes and improve transparency to the public. For instance it became a requirement for company Chief Financial Officers to be qualified accountants. Importantly there have been improvements to disciplinary actions for the profession. There was also recognition corporate governance was not as developed as it could be.³¹

Mr Wong commented Enron's method of disguising debt by diverting it to wholly owned subsidiaries would not work in Hong Kong because they have incorporated rules for these entities. Charles Grieve, of the Securities and Futures Commission, commented that:

[They] haven't seen the Enron scale of scandal here but the problems here tend to be complete failures of audits. Some do carry out frauds, not clever accounting tricks, more often just stealing money. As most manufacturing is now in China, there is a real question about how good an audit can you do in China because of

³⁰ Mr Karel van Hulle, *op. cit.*

³¹ Mr Alvin Wong Tak Wai, CPA, President, Hong Kong Society of Accountants, Hong Kong, 31 July 2002



disclosure and communication problems, although this is not necessarily deliberate.³²

In Hong Kong, Stock Exchange listing rules are particularly important for improving governance because, before the handover of Hong Kong to China, an extremely high proportion of locally listed companies established themselves in other countries such as the Cayman Islands. This means Hong Kong's corporations law do not apply to them.

The delegation heard from Ms Estella Ng, of Hong Kong Exchanges and Clearing, that a paper proposing improvements to corporate governance was published in January 2002 and they received more than 400 responses. Work on this report started in July 2001 in response to the economic slowdown and because most Hong Kong companies are family owned or controlled. This prompted the Exchange to strengthen governance and accountability. They did, however, add some new issues after the collapse of Enron.³³

The delegation heard there were concerns in Hong Kong, as well, about the extraterritorial effect of the US legislation. Mr Wong, of the Hong Kong Society of Accountants, commented the law will lead to the death of audits as protected information if all the papers could be used in court. He considered it a politically motivated overreaction to the problems.³⁴

Corporate governance

In addition to the responses to recent corporate collapses, other issues relating to corporate governance were raised in meetings with the delegation as possible ways to improve accountability. These are discussed in the following sections.

Separating the roles of Chair and CEO

One suggestion for improving the operations of corporate boards was for the roles of the Chief Executive and Chair of the Board to be performed by two different people. This would avoid over-concentration of power in one person and increase the likelihood of other board members expressing views.³⁵ Having these roles combined is quite common in the US, although Susan M Koski-Grafer, of the SEC, commented this trend is comparatively recent. She attributed this trend to a desire to increase prestige for incoming Chief Executives.³⁶

James Duffy, of the New York Stock Exchange, noted the roles are typically performed by different people in the US when two large companies merge. In

³² Mr Charles R Grieve, *op. cit.*

³³ Ms Estella Ng, *op. cit.*

³⁴ Mr Alvin Wong Tak Wai, CPA, *op.cit.*

³⁵ Mr Phil Calder, Chief Accountant, General Accounting Office, Washington, 17 July 2002, identified combining these roles as a problem with effective operation of boards.

³⁶ Ms Susan M Koski-Grafer, *op. cit.*



these situations, one company head would become CEO and the other, usually the older and closer to retirement, becomes Chairman for a couple of years. He commented separate CEOs and Chairs simply are not popular in US and cited the example of AOL-Time Warner where Stephen M Case, the Chairman, has been quoted as saying "I'm *just* the Chairman" with the implication the CEO is running the company.³⁷

This is not an issue of major concern in the meetings the delegation held in European countries. There are a number of different corporate models used throughout Europe. Counsellor Ennio Colasanti, of the Italian Court of Auditors, commented that, while in big firms the president and the CEO can be the same person, in smaller firms they are usually different people. However, he noted there was no pressure to separate the roles.³⁸

This did not seem to be an issue for major concern in Hong Kong where the roles tend to be performed by separate people. Gary W K Cheung, of the Hong Kong Securities Institute, commented in Hong Kong many companies are family owned or controlled. The role of the company chairman is voluntary, unpaid and performed as a community service by people who have already made significant business achievements.³⁹

Independent Directors

As noted above, the changes to the New York Stock Exchange's listing requirements will require companies to have a majority of independent non-executive directors.

The delegation was told these measures would not solve all problems with the operation of boards. For instance, Antoine Bracchi, of the French National Society of Accountants, wondered how companies could ensure non-executive directors remained independent, given people's propensity to socialise and make friends with other members of groups.⁴⁰

The delegation also heard it was at least as important for corporate governance as preserving independence to ensure non-executive directors have adequate time and resources to perform their role effectively. This includes having access to external advice or opportunities to meet in the absence of management. Phil Calder, of the US General Accounting Office, commented it was a problem that boards tend to focus on strategic advice and the bottom line rather than bringing managers into line. He considered these arrangements to be flawed, regardless of the talents of individual board members.⁴¹

³⁷ Mr James M Duffy *op. cit.*

³⁸ Counsellor Ennio Colasanti, Corte dei Conti, Rome, 29 July 2002

³⁹ Mr Gary W K Cheung, Chief Executive, Hong Kong Securities Institute, Hong Kong, 2 August 2002

⁴⁰ Mr Antoine Bracchi, *op. cit.*

⁴¹ Mr Phil Calder, *op. cit.*



It could also become difficult to recruit qualified directors if the level of responsibility is increased but the pay remained relatively low. Henri Olivier, of the European Federation of Accountants, pointed out, in the United Kingdom, companies are having difficulty in attracting non-executive directors because of liability issues and remuneration was not very high.⁴²

Alvin Wong, of the Hong Kong Society of Accountants, commented there were only a handful of independent non-executive directors in Hong Kong, despite the fact two are required on each board by listing rules. He attributed this to the low remuneration of these positions but considered increasing the pay could jeopardise independence. Charles Grieve, of the Securities and Futures Commission, commented almost all significant companies, except the Bank of Hong Kong, are controlled by families or have a controlling shareholder which is not always the majority shareholder. This means the position of independent directors has limited use as the dynamics of the shareholder and board are different.⁴³

Gary Cheung, of the Hong Kong Securities Institute, noted changes to the listing rules, which will be effective from March 2003, will make directors personally liable, with pecuniary and criminal penalties for a range of offences. Corporate governance courses developed to improve directors' qualifications and compliance with rules may become mandatory. These changes will apply to directors of publicly listed companies and market intermediaries such as brokers.⁴⁴

The composition of public sector boards is also important for the effective governance of these enterprises. For instance, according to Roger Picard, of the French Bureau of Audit, the boards of many French publicly owned companies consist of the president and director of the company and a board of directors composed of public servants. He suggested these directors might not have a great deal of technical or financial competence and might be reluctant to criticise management objectively, especially if the president is at the same level of public service as they are.⁴⁵

Improved disclosure to the Board

Another topic raised with the delegation was the need to have improved disclosure of issues to the Board. For instance Henri Olivier, of the European Federation of Accountants, noted:

Without proactivity, these people would not even be aware of bad news. The problem is getting the information. For example, CEOs of these companies tend to be charismatic and self-confident. The problem is that the bad news is NOT disclosed to the directors. The problem with corporate governance solutions is

⁴² Mr Henri Oliver, *op. cit.*

⁴³ Mr Alvin Wong Tak Wai, CPA, *op. cit.*; Mr Charles Grieve *op. cit.*

⁴⁴ Mr Gary W K Cheung, *op. cit.*

⁴⁵ Mr Roger Picard, *op. cit.*



putting the obligation on auditors. Of course auditors are supposed to ferret out information but directors are the first line of defence.⁴⁶

Steps to improve the qualifications of directors and resources available to them may help address this risk to effective governance.

Shareholder Activism

A common theme in meetings with the delegation was the lack of responsibility shareholders took for making boards and directors accountable. In particular, prior to corporate collapses, there was little criticism of managers' performance at meetings. Phil Calder, of the General Accounting Office, told the delegation most Americans hold shares indirectly through managed funds. He noted institutional managers do not tend to involve themselves in the operation of companies. However, Susan Koski-Grafer, of the SEC, disagreed and stated, since the collapse of Enron, institutional investors have been extremely critical and vocal because many pension funds lost a great deal of money. She stated shareholder activism was increasing.⁴⁷

James Duffy, of the New York Stock Exchange, stated many institutional investors would not consider themselves passive but their attempts to influence change has been successfully resisted by management. He commented best practice corporate governance did not encourage having institutional investors represented on boards as it would be too unwieldy. Therefore, in amending the Exchange's listing rules, they focussed on strengthening the position of independent directors.⁴⁸

Carlo Biancheri, of the Italian corporate regulator CONSOB, commented that, in theory, Italy is very advanced in corporate governance. The law requires companies to have audit committees, with representatives from minority shareholders, which are able to hold the board to account. There is a requirement that proposals about crossholdings of shares greater than 5 percent need to be put to the vote of investors. However, Italian shareholders tend to be very passive. Recently a large merger was rejected by shareholders. He expressed satisfaction that shareholders participated in the process.⁴⁹

One of the concerns about the recent corporate collapses was the extent of stock options packages which were not always disclosed to shareholders. James Duffy, of the New York Stock Exchange, told the delegation stock option plans available to all staff did not need shareholder approval under the SEC's rules, although the Stock Exchange had required voting on directors' and executive packages. He noted institutional investors became increasingly vocal in wanting stockholders to approve all of the options plans with the effect most are likely to go to shareholders in future. This should improve disclosure to shareholders.

⁴⁶ Mr Henri Olivier, *op. cit.*

⁴⁷ Mr Phil Calder, *op. cit.*; Ms Susan Koski-Grafer, *op. cit.*

⁴⁸ Mr James M Duffy, *op. cit.*

⁴⁹ Mr Carlo Biancheri, *op. cit.*



Family controlled companies in Europe and Hong Kong

Another common theme of meetings was corporate governance arrangements could be challenged by the fact that in Italy and Hong Kong many companies are family owned or controlled. Counsellor Colasanti, of the Italian Court of Auditors, commented:

In Italy with the publicly listed companies, often the majority of shares are owned by one family or a controlling minority. The family control the manager and this leads to the other shareholders not being able to appoint the managers and people not being willing to invest in the company as families would rather improve the business than pay dividends. Until recently 90% of investment was in government bonds. This was because of low levels of trust by shareholders and management.⁵⁰

Carlo Biancheri commented while as recently as five years ago 40 percent of Italian companies were family owned or controlled, he felt this phenomenon would be shortlived because of the internationalisation of the markets. This would especially be the case within the EU, as moving to the same currency has led to increased capital mobility.⁵¹

In Hong Kong the delegation was told the proportion of family controlled companies was even higher than in Italy: up to 85 percent of the total number of companies and at least half of the 34 constituent stocks on the Hang Seng. Alvin Wong, of the Hong Kong Society of Accountants, commented this was not necessarily a problem as the people running these companies are committed to their success compared to the West where there tends to be a separation of ownership and control. He noted there was no evidence family owned companies performed any worse.

However Estella Ng, of Hong Kong Exchanges and Clearing, commented in the past there were concerns when family companies used shares as security for loans which led to requirements to disclose off balance sheet liabilities of this sort.⁵²

Audit Committee

The delegation was told by a number of organisations effective audit committees consisting of qualified, independent, non-executive directors were vitally important for good corporate governance. Mr Philip Calder, of the General Accounting Office, stated he sees reform of audit boards as important:

These boards need to be independent of managers, choose the auditors and decide the fees. The fees will most likely go up as firms will need to increase fees in order to retain the and attract top people.⁵³

⁵⁰ Counsellor Ennio Colasanti, *op. cit.*

⁵¹ Mr Carlo Biancheri, *op. cit.*

⁵² Mr Alvin Wong Tak Wai, CPA, *op. cit.*; Ms Estella Ng, *op. cit.*

⁵³ Mr Philip Calder, *op. cit.*



Susan Koski-Grafer, of the SEC, highlighted the importance of audit committees having financial experience and access to outside counsel. The committee should consist of a group of non-executive directors with power to scrutinise the process. She noted recently audit committees were meeting only once a year and had a cursory role. There were also problems with their membership. For instance, members of the company's founding family, who would clearly not be independent, were often on the audit committee of public companies.⁵⁴

Mr Patrick Mommens, of the European Financial Reporting Advisory Group (EFRAG), noted the lack of accounting experience amongst the members of the Worldcom audit committee which meant the group was unable to detect problems.⁵⁵

Efforts to improve these committees are being made in other jurisdictions as well as in the US. Alvin Wong, of the Hong Kong Society of Accountants, told the delegation they recommended each company have an audit committee in 1996/97. Ms Estella Ng, of Hong Kong Exchanges and Clearing, noted more than 90 percent of Hong Kong companies already have these committees. It is now a proposed listing requirement to have audit committees consist of a majority of non-executive directors.⁵⁶

The delegation was also interested to learn from Carlo Biancheri, of the Italian corporate regulator (CONSOB), that in Italy each individual member of the audit committee is personally responsible under a crimes act for the probity of the process. They are obliged to report to CONSOB if they find anything irregular. He noted members are starting to provide more information than they did three years ago.⁵⁷

Sanctions

As noted above, the US Sarbanes-Oxley Act imposes criminal penalties for a wide range of corporate offences. The delegation heard there are a variety of sanctions available for corporate corruption.

Phil Calder, of the General Accounting Office, commented that, until recently, the US tended to rely on civil penalties, which often lead to shareholders paying fines indirectly through insurance companies. Insured directors often avoided personal responsibility. He also stated the penalties could be too low to act as a deterrent. For example, Xerox paid \$10 million in fines for a billion dollar overstatement of profits. He suggested there is a need to use criminal prosecutions selectively and noted:

⁵⁴ Ms Susan Koski-Grafer *op. cit.*

⁵⁵ Mr Patrick Mommens, Project Officer, European Financial Reporting Advisory Group, Brussels, 26 July 2002

⁵⁶ Mr Alvin Wong Tak Wai, CPA, *op. cit.*; Ms Estella Ng, *op. cit.*

⁵⁷ Mr Carlo Biancheri, *op. cit.*



In the aftermath of the Enron collapse, Arthur Andersen is out of business which is very sad but no-one is going to jail.⁵⁸

In Hong Kong, according to Charles Grieve, of the Securities and Futures Commission, the rights of minority shareholders are at risk because punitive damages are unavailable. This means, if matters are taken to court, plaintiffs are only able to win what was lost.

As noted above, the delegation heard criminal sanctions can be applied to company directors in many European countries.

There was also discussion of the appropriateness of sanctions for the auditing profession. Henri Olivier, of the European Federation of Accountants, commented there is a fixed cap on liability for auditors in three countries. He noted these can be too low. For instance, in Germany the cap was raised from 50,000 to 2 million Deutschmarks as it previously was not cost effective to undertake prosecutions. However, most countries have unlimited liability.⁵⁹

Auditing Profession

The delegation also discussed the possible changes to the auditing profession to improve accountability with the organisations visited.

Auditor independence in the public sector

The delegation learnt auditor independence is an important issue for auditing public sector agencies and enterprises. The General Accounting Office, the US Federal public sector accounting agency, recently amended the national standards (the Yellow Book) in order to address auditor independence. Although this will come into effect at the beginning of 2003, the work predates recent corporate collapses. The General Accounting Office took a principle-based, rather than rule-based, approach to the issue.⁶⁰

Elaine M Howle, the Californian State Auditor, described the importance of this work for state audit offices. Some offices may face concerns about their independence because they provide other services, such as attestation. In some states, the audit offices are too small to perform all the audits themselves so some are performed by external contractors. This could also lead to concerns about independence. A source of potential conflict for the Californian Office is particular roles prescribed in statutes. For instance, because of the Office's good reputation, the State Legislature had tasked them with oversight of the development of a

⁵⁸ Mr Phil Calder, *op. cit.*

⁵⁹ Mr Henri Olivier, *op. cit.*

⁶⁰ Mr Phil Calder, *op. cit.*



statewide child maintenance payment system. Ms Howle suggested they might have difficulty auditing the operation of the system.⁶¹

Auditor rotation

The issue of preserving auditor independence by preventing long term relationships between auditors and clients was raised with the delegation. For instance, Carlo Biancheri, of the Italian corporate regulator, stated, in Italy, listed companies are required to rotate the appointed auditing firms after a period of nine years and the same firm can only be appointed after a minimum three year intermission.⁶²

However, there are risks with requiring auditors to be rotated after a period of time. Warren Ruppel, of the City of New York Comptroller's Office, commented the city had an eight year maximum contract for auditors of its agencies but only received one response when they recently called for bids. He attributed this to a lack of interest in performing this work in the few qualified companies. Henri Olivier, of the European Federation of Accountants, commented the UK Government has just started an inquiry into competition between auditing firms. After the collapse of Arthur Andersen, there is real concern there may not be enough qualified accounting firms from which to choose.⁶³

The US legislation requires rotation of partners rather than of firms in order to preserve independence. The delegation heard a lot of comments in support of this approach. For example, both Alvin Wong, of the Hong Kong Society of Accountants, and Philippe Danjou, of the French corporate regulator, were in favour of rotating partners in auditing firms every seven years.⁶⁴

Non-audit services

As noted above, the new US legislation requires that the approval of the audit committee before a company's auditor can provide non-audit services. The delegation heard differing views on whether auditor independence could be preserved if the provision of non-audit services was legal. For instance, the General Accounting Office considered that provision of these services was acceptable as long as independence was not compromised.

In Italy, however, the provision of non-audit services by accounting firms is entirely banned. Henri Olivier, of the European Federation of Accountants, commented in Belgium for many years they split auditing and consulting services. In the early 1990s, however, they changed this as it was impossible to develop competence at

⁶¹ Ms Elaine M Howle, CPA, State Auditor, Californian State Audit Office, Sacramento, 15 July 2002

⁶² Mr Carlo Biancheri, *op. cit.*

⁶³ Mr Warren Ruppel, Assistant Comptroller for Accounting, Bureau of Audit, Office of the City Comptroller, New York, 19 July 2002; Mr Henri Olivier, *op. cit.*

⁶⁴ Mr Alvin Wong Tak Wai, CPA, *op. cit.*; Mr Philippe Danjou, *op. cit.*



Information Technology in solely audit firms and difficult to attract high quality staff.⁶⁵

Supervision of auditing profession

Another important area of discussion was how the competence of auditors was reviewed. The Sarbanes-Oxley Act replaces the private sector peer review system with a Public Company Accounting Oversight Board under the oversight of the SEC.

This arrangement contrasts with the requirements in other places visited by the delegation. In France, for instance, the corporate regulator closely oversees the review of auditors by the professional association. In Italy, individual auditors are supervised. The delegation learnt Spain also has strong supervision of auditors.⁶⁶

In Hong Kong, according to Charles Grieve, of the Securities and Futures Commission, the accounting profession needs to improve how it manages disciplinary proceedings. Proceedings can take up to three years, there are numerous appeals available and auditors are not deregistered during disciplinary processes. He considered the system had lost credibility and stated the Commission was considering following the example of the United Kingdom and directly regulating auditors independently of the profession.⁶⁷

Peer review

Henri Olivier, of the Federation of European Accountants, told the delegation about an expensive but highly effective peer review system for auditing firms which is used in Canada. Reviews are managed by an independent institute and performed by expert former auditors. Mr Olivier commented, in Europe, serious consideration is being given to the need for external review of firms' quality assurance programs.⁶⁸

The issue of peer review is also relevant to public sector auditors. Elaine Howle, the Californian State Auditor, described the triennial external peer review system used by US state audit offices. Under this system, four or five people from other states review a sample of audits and office processes according to the Yellow Book Standard and issue an opinion about compliance. There is a rotation of members of these review teams so individuals would not review the same state office again. Sometimes opinions are qualified where the state auditor is also the state comptroller or is a member of boards which staff of the office audited. Ms Howle considered this was a robust system, unlike private sector peer reviews.⁶⁹

⁶⁵ Mr Carlo Biancheri, *op. cit.*; Mr Henri Olivier, *op. cit.*

⁶⁶ Mr Philippe Danjou, *op. cit.*; Mr Carlo Biancheri, *op. cit.*

⁶⁷ Mr Charles R Grieve, *op. cit.*

⁶⁸ Mr Henri Olivier, *op. cit.*

⁶⁹ Ms Elaine M Howle, CPA, *op. cit.*



Accounting and Auditing Standards

Another key area of discussion with the delegation was how auditing and accounting standards could be improved.

Rule-based versus principle-based standards

The delegation heard standards which provided principles for application to particular problems were more effective than rule-based standards. Principle-based standards are used by Australia and in the International Accounting Standards. The USA uses a rule-based approach that arguably promoted non-compliance.

The problem with rule-based standards is that, in some cases, practitioners use them as checklists and find ways of avoiding them by arguing that, as the examples do not match particular circumstances, the rules do not apply.⁷⁰ Phil Calder, of the General Accounting Office, commented the SEC proposed a principles-based approach a few years ago but were strongly opposed by the accounting profession.

However, the delegation heard from Patrick Mommens, of the European Financial Reporting Advisory Group, the use of principle-based standards could be difficult for practitioners and he thought it was important examples be provided with the standards as a balance between the two models. He said the International Accounting Standards Board was providing some examples and implementation guidelines to accompany IAS37.⁷¹

Move to International Accounting Standards (IAS) 2005

The delegation heard that, as in Australia, there is a commitment for European countries and Hong Kong to adopt the International Accounting Standards (IASs) by 2005, either in entirety or with some local variation. However the US has made no similar commitment to harmonisation.

Charles Grieve, of the Hong Kong Securities and Futures Commission, was particularly pleased the administration was adopting these standards and noted, in general, they find, even when the IASs have faults, it is easier to implement them in an unmodified form than to attempt to modify them to suit local circumstances.⁷²

The delegation heard from Henri Olivier, of the European Federation of Accountants, that, despite this trend towards international harmonisation in many other areas, there are no global auditing standards. Mr Olivier commented auditing is a global industry and noted the Europeans are trying to convince the rest of the world of the need for global accounting, auditing and ethics standards and enforcement. He recommended these global auditing standards be developed

⁷⁰ Mr Antoine Bracchi, *op. cit.*

⁷¹ Mr Patrick Mommens, *op. cit.*

⁷² Mr Charles R Grieve, *op. cit.*



by monitored self-regulation as the involvement of the private sector would promote a higher level of harmonisation in a more timely fashion than if governments managed the process. He saw the current environment as an opportunity to develop new approaches.⁷³

Accounting for stock options

Another topic discussed with the delegation was whether it should be a requirement under accounting standards to include employee stock options as an expense or account for them by some other means.

James Duffy, of the New York Stock Exchange, commented, in the past, business argued it was impossible to value options. To list them as expenses would be meaningless. However, he noted the idea of expensing is starting to take hold as a few large companies, such as Coca Cola, have started to do it. It has been acceptable to expense options since 1995. However, he considered if expensing becomes the norm, it will take the pressure off stockholder approval as there will not be many option packages any more.

Antoine Bracchi, of the French National Society of Accountants, which is responsible for developing French accounting standards, said the Council had decided options should be accounted for either as an expense or as an asset. This position generated opposition from Government and the industry.⁷⁴

An alternative to including stock options as expenses in financial reports is disclosing the existence of them in notes. There was general agreement it was important for shareholders to have some access to information about the extent of options programs if information about their cost was not readily available.

⁷³ Mr Henri Olivier, *op. cit.*

⁷⁴ Mr Antoine Bracchi, *op. cit.*



Chapter Three

Lessons from study tour

This concluding chapter of the report briefly describes the major lessons the delegation learnt on the study tour.

Effect of corporate collapses

The delegation observed the consequences of the recent spate of corporate collapses included catastrophic financial and job losses, as well as an intense loss of trust in the stock market. There have also been increased pressures on Government budgets and expenditures.

The US's legislative and administrative responses to these collapses will certainly have significant effects on the operations of Australian businesses trading internationally. In particular, the extraterritorial effect of the Sarbanes-Oxley Act means Australian based subsidiaries of firms listed in the US will need to be audited by auditors registered in the US using US standards. This is a significant burden.

It is also likely other responses to the collapses will be felt locally as the Commonwealth recently announced Australia would harmonise its accounting standards with the International Accounting Standards in 2005 in both the public and the private sectors. The final form of these standards are likely to reflect responses to recent corporate collapses.

The delegation heard many views about the best sort of corporate regulation. It had the opportunity to compare the highly regulated French and Italian models with the arrangements in Hong Kong and the United States.

The delegation considers recent corporate scandals show very well there can be problems with the operation of each of these models. The best system of corporate regulation should demonstrate accountability and provide a number of checks and balances.

The spate of recent collapses show the importance of good corporate governance and the consequences of catastrophic failure. However, the delegation heard the view expressed many times that, despite the best controls in the world, it was impossible to prevent fraud and dishonesty entirely.

The delegation also learnt it was important for sanctions to fit the crime and for these to be targeted at the people responsible, so, for instance, insurance did not cover fines for directors found to have acted inappropriately.

The delegation was told it was important for governments not to over-react to the collapses and governments needed to build confidence by developing measured legislation. The proposals in the USA are criticised for being an over-reaction and



not necessarily appropriate for circumstances in other countries.

Suggestions for the future

The delegation considers there may be merit in improving stakeholder participation in the development of accounting standards by having investor representatives on accounting standards boards. The delegation heard there were no such representatives on boards or opportunities for community participation in the countries visited. Attempts to include consumer protection representatives in the Hong Kong accounting standards committee had been unsuccessful to date.

The delegation also notes a substantial amount of effort will be needed for the public sector in NSW to adopt the International Accounting Standards in 2005. The Committee should keep a watching brief in how these efforts are progressing.



Appendix

Itinerary

Sunday 14 July

Travel from Sydney to San Francisco

Monday 15 July

Meeting with Securities and Exchange Commission Office of Enforcement

Participants: Ms Kathleen K Bisaccia, Branch Chief, Office of Enforcement
Mr Brian A Huchro

Topics:

- Securities regulation in the United States.
- Potential changes to corporate law.
- Causes and consequences of recent corporate collapses.

Travel to Sacramento

Meeting with California State Auditor

Participants: Elaine M Howle, CPA, State Auditor
Debbie Meador, CPA, Special Assistant State Auditor
Phillip Gelasic, Financial Auditor

Topics:

- Public sector auditing in California including the Office's mandate to perform an audit once it is approved.
- Peer review of state audit offices.
- General Accounting Office's recent publication on Auditor Independence.

Travel to San Francisco

Tuesday 16 July

Meeting with San Francisco City and County Controller

Participant: Edward M. Harrington, Controller, City and County of San Francisco

Topics:

- Effects on local economy of technology crash.



- Financial management and controls in San Francisco.
- Consequences for local government of legislative and administrative responses to recent corporate collapses.

Meeting with San Francisco Australian Consulate General's Office

Participant: Helen Jenkin, Acting Consul

Topics:

- The local economy in the aftermath of the decline in technology industries.

Travel to Washington

Wednesday 17 July

Meeting with General Accounting Office and Federal Accounting Standards Advisory Board

Participants: Ms Marie Novak, International Visitor Coordinator, External Liaison
Mr David M Walker, Comptroller General of the United States
Mr Philip Calder, Chief Accountant, GAO
Mr Robert Gramling, Consultant, Financial Management and Assurance, GAO
Ms Marci Buchanan, Assistant Director, Financial Management and Assurance, GAO
Mr Robert Bramlett, Assistant Director, Financial Accounting Standards Advisory Board (FASAB)

Topics:

- GAO's recent requirements on auditor independence which will come into effect in 2003.
- Public sector financial management in the United States including development of accounting standards and the joint financial services improvements model committee which works on improving agencies' financial management and accountability.
- Impact of recent corporate collapses on trust in financial markets.

Meeting with House of Representatives Committee on Financial Services and tour of Congress

Participant: Mr Terry Haines, Chief Counsel and Majority Staff Director

Topics:

- The Sarbanes Bill had been passed by the Senate unanimously days earlier. As this Bill differed from the House of Representatives Oxley Bill on the same



issue, the House was debating whether they should proceed to conference on the Bill.

- The provisions that may be included in the final Act.

Thursday 18 July

Meeting with Securities and Exchange Commission, Office of the Chief Accountant

Participant: Ms Susan M Koski-Grafer, Associate Chief Accountant, Office of the Chief Accountant

Topics:

- The SEC's plans for reform as described by Harvey Pitt in testimony to a congressional committee in March 2002.
- Importance of improvements to corporate governance especially strengthening audit committees and checks and balances on internal auditors.

Travel to New York

Friday 19 July

Meeting with New York Stock Exchange

Participants:

James E Duffy, Senior Vice President and Associate General Counsel
Alain Y. Morvan, Senior Vice President, International Relations
Glenn Tyranski, Vice President, Financial Compliance, Competitive Position Group
George Sierant, Managing Director, International Relations
Leslie Tepper Manager – International, Financial Compliance Department
Michelle Van, International Relations

Topics:

- The report of the New York Stock Exchange Corporate Accountability and Listing Standards Committee released in June is to be submitted and approved by the Board by 1 August.
- This made several suggestions about improvements to corporate governance.
- The operation of the Stock Exchange.

Meeting with City Comptroller's Office

Participant: Mr Warren Ruppel, Assistant Comptroller for Accounting, Bureau of Audit

*Topics:*

- Financial management in New York City and auditing of city agencies.
- Role of the State's Financial Oversight Board which can take over management of the City finances from the administration if the deficit exceeds \$100m.

Monday 22 July**Meeting with Office of the State Comptroller**

Participants: Ms Susan Grossman, Assistant Deputy Comptroller/Counsel
Directors: Lava Thimmayya, Thomas H Marks, Ken Bleiwas,
Michael Brisson and Bob Herwoods

Topics:

- Budget of New York including operations of the Financial Oversight Board which meets annually to discuss the finances of the city.
- The operation of bonds and other city debts and the state of the City finances after the attack on the World Trade Centre.

*Travel to Paris****Tuesday 23 July****Arrive in Paris***Meeting with Ministry of the Economy, Finance and Control, Bureau of Audit**

Participants: Roger Picard, Director, Bureau of Audit
Marie-Paul Gremeaux, Director, International Relations

Topics:

- Arrangements for public sector audit in France and operation of the bureau of audit.
- Comparison of the French system and that used in the United Kingdom, Australia and the United States of America.
- Public Private Partnerships in France.

Wednesday 24 July**Meeting with the Commission for the Operation of the Bourse (COB)**

Participants: Philippe Danjou, Director of Accounting
Mohamed Ben Salem, International Relations Division

Topics:



- Regulation of securities and investor protection in France.
- France has direct public control of auditors. The professional body inspects members but the COB inspects the method of supervision and has some direct powers such as access to work of individual auditors as part of engagement reviews.
- The COB can also oppose the appointment of particular auditors and review auditors' files.

Meeting with the Conseil National de le Comptabilite (accounting professional organisation)

Participants: Antoine Bracchi, President
Pascal H Gillot, Rapporteur
Alain Dorison, Secretary General

Topics:

- The Council is responsible for developing the national accountancy standards for both the private and public sector.
- Accrual accounting is being introduced in the public sector.
- The major result of corporate collapses is a loss of trust in the markets.

Travel to Brussels

Thursday 25 July

Meeting with European Commission, Internal Market Directorate-General, Financial Reporting and Company Law Unit

Participants: Karel Van Hulle, Head of Unit
Erik Van Der Plaats

Topics:

- Development and application of European company law directives and regulations and the complexity of making rules for so many countries with varieties of corporate practices.
- The European Commission's response to the extraterritorial effect of the United States' corporate reform legislation – European auditors for firms trading in the USA will need to be registered in the US and apply their standards.
- Private sector corporate governance and auditing practices in Europe.

Meeting with Federation of European Accountants (FEE)

Participants: Henri Olivier, Secretary General



Saskia Stomp, Technical Director

Topics:

- FEE is an association of national bodies of accountants. Their major role is to be the first point of contact with the EU as it is impossible for 15 states to liaise well with the EU.
- Discussed variations in corporate culture between different member states and the United States.
- Quality assurance and peer review for audit firms and liability caps for auditors.
- The difficulty of attracting non-executive directors to companies.

Friday 26 July

Meeting with European Financial Reporting Advisory Group

Participants: Patrick Mommens, Project Manager

Topics:

- Process for developing European position on IASB proposals for accounting standards. EFRAG manages technical development and formal consultation before making recommendation to the EC.

Travel to Milan

Monday 29 July

Meeting with the Court of Auditors (Corte dei Conti)

Participants: Counsellor Ennio Colasanti

Topics:

- The Auditors' Court is a chamber responsible for auditing Italian public sector agencies and companies majority owned by the Government. They must approve the budgets of these agencies.
- Many Italian companies are owned or controlled by families which means that other shareholders' rights may not be considered properly. For example, the family may decide to direct profits to improving the business instead of paying a dividend.
- Provision of non-audit services by audit companies is banned in Italy.

Meeting with the Commission for Securities and Companies (CONSOB)

Participants: Carlo Biancheri, Director of the International Relations Office
Paola Ciani, Ufficio Controllo Societari (the auditing department)

Topics:



- Powers of the CONSOB in regulating financial disclosure by companies.
- CONSOB directly regulates the auditing profession. These powers are unique. They are able to veto the engagement of particular auditors if they do not feel they are qualified.
- Italy bans provision of non-audit services by auditing companies.

Meeting with the Australian Embassy

Participant: Anne Cousens, Counsellor and Deputy Head of Mission

Topics:

- The Italian political and economic environment particularly in relation to recent decriminalisation of accounting fraud.
- Impact on the economy of the generous and mostly unfunded Italian pension schemes.

Tuesday 30 July

Travel to Hong Kong

Wednesday 31 July

Arrive in Hong Kong

Meeting with Hong Kong Society of Accountants

Participants: Mr Alvin Wong Tak Wai, CPA, President
Ms Winnie Cheung, Senior Director

Topics:

- Reforms to the accountancy profession disciplinary rules after the Asian financial crisis in 1998. Now disciplinary procedures are open to the public.
- Reforms to corporate governance such as mandating audit committees and accounting qualifications for chief financial officers.
- Concern about the extra-territorial effect of the US legislative response to corporate collapses.

Meeting with SW Kingsway Capital Holdings Limited

Participants: Mr Richard Yin, Deputy CEO

Topics:

- The discussion was about the economic situation in Hong Kong and the PRC and opportunities for trade with Australia.
- Mr Yin proposed developing a sister city agreement between Sydney and



Xi'an.

- On 25 July the Hong Kong Stock Exchange published a “Consultation Paper on Proposed Amendments to the Listing Rules Relating to Initial Listing and Continuing Listing Eligibility And Cancellation of Listing Procedures”. This led to a sudden drop in the price of these stocks and a large scandal.

Thursday 1 August

Meeting with Securities and Futures Commission

Participants: Charles R Grieve, Director of Accounting Policy, Corporate Finance Division

Topics:

- The market's reaction to the Hong Kong Stock Exchange's draft new listing rules was a misunderstanding as the paper proposed consolidating stock rather than delisting.
- Regulation of the markets in Hong Kong and the adoption of accounting standards based on the International Accounting Standards Board's standards.
- Corporate governance is different as many companies are family owned and controlled. The dynamics of shareholder and board are different.
- Real problems with effectiveness of audits in China. He sees significant issues with discipline of auditing profession. They are considering direct regulation of auditors rather than through the profession .

Meeting with the Treasury Department

Participants: Mrs Lucia Li, Deputy Directory of Accounting Services
Tsang Chi-hung, Assistant Director of Accounting Services
Leung Yiu Fat, Allen, Principal Assistant Secretary for Financial Services and the Treasury

- Economic and political situation in Hong Kong.
- Operation of the public sector under the Hong Kong Special Administrative Region Basic Law including transition to accrual accounting by Hong Kong public sector from 31 March 2003.

Meeting with Hong Kong Special Administrative Region Legislative Council's Public Accounts Committee

Participants: The Hon Fred Li (Li Wah-ming), Legislative Councillor, RSW, JP
Ms Miranda Hon, Clerk to the Committee

Topics:

- Election to and operation of the Hong Kong Legislative Council and operation of the Public Accounts Committee.



- The Administration consists of Secretaries in charge of portfolios who are public servants and prepare draft legislation for the Legislative Council to debate.
- There is also an Executive Council which operates similarly to a Cabinet consisting of Secretaries, five appointees, chairman of the liberal party and one other member of the Legislative Council.
- Legislative Council members are unable to introduce private members bills that affect policy or require funds to implement. However, the Council must approve spending of more than \$HK10 million.

Friday 2 August

Meeting with Hong Kong Securities Institute

Participants: Gary W K Cheung, Chief Executive
Sam Lee, Director Finance and Administration
Donna J Canestra, Director Corporate Communications and
Membership Services

Topics:

- The operation of the Institute, an educational body established in 1997 to maintain the professional standards of the securities industry through training and examinations.
- Following changes to listing rules to come into effect in March 2003, Hong Kong corporate governance courses will be mandatory for company directors.

Meeting with Hong Kong Exchanges and Clearing Limited

Participant: Ms Estella Ng, Senior Vice President Listing Division

Topics:

- In January 2002 the Exchange published proposed changes to listing rules for to strengthen accountability and corporate governance which included mandating audit committees and quarterly reporting.
- The Exchange's July paper proposing changes to listing rules, which included the proposal for delisting low priced stocks, was withdrawn and will be revised.

Saturday 3 August

Travel to Sydney