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THE FINANCIAL STATEMENT DATA OF FAILED COMPANIES: THE ROLE OF THE AUSTRALIAN ACCOUNTING PROFESSION

by

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SUMMARY

This thesis tests two related hypotheses referred to as the misinformation hypothesis and the responsibility hypothesis. The misinformation hypothesis postulates that

> *certain failed or failing companies produced financial statement data which misrepresented their results and financial position, and therefore, did not provide investors with a clear warning of their demise.*

The responsibility hypothesis postulates that

> *the accounting profession can be held responsible, at least in part, for any misrepresentations in these data.*

The hypotheses are tested using six case study companies which failed in Australia between the early 1960s and the late 1970s. First, the losses of investors in the company are calculated to show that the failure is significant from the investors' viewpoint. Next, the misinformation hypothesis is tested in two separate steps. The condition of the company prior to failure, as depicted by its financial statement data, is assessed. Then, any misinformation embodied in the financial statement data is identified. Finally, where misinformation exists, the responsibility hypothesis is tested by determining whether the misinformation resulted from compliance with, violation of, or ignorance of generally accepted accounting principles. The case studies are selected from two decades in an attempt to isolate any effects of improvements in the specification and enforcement of accounting principles since the early 1960s.

The evidence from the case studies is consistent with the misinformation hypothesis. Each of the case study companies, or companies closely associated with them, have produced some financial misinformation. However, the evidence is not consistent with the responsibility hypothesis. In four of the six case studies, the misinformation resulted largely from the violation of accepted accounting principles and, therefore, was primarily the responsibility of the

management and the individuals involved in the preparation and audit of the case study financial statement data. In the remaining two case studies, the misinformation related to the valuation of development real estate and was probably the responsibility of qualified valuers rather than accountants. Whilst the accounting profession cannot be held responsible for misinformation contained in the financial statements of the case study companies, the profession can be criticized for its apparent failure to discipline members for non-compliance with accepted accounting principles and for its failure to develop clearly defined principles in the troublesome area of accounting for development real estate.

DECLARATION

I hereby declare that this thesis contains no material which has been accepted for the award of any other degree or diploma in any University and that, to the best of my knowledge and belief, the thesis contains no material previously published or written by another person, except when due reference is made in the text of the thesis.

I give my consent to this copy of my thesis, when deposited in the University Library, being available for loan and photocopying.

Helen Thorne

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CHAPTER 1

INTRODUCTION

1.1 The Hypotheses

This thesis tests two related hypotheses. First, it is hypothesized that

> *certain failed or failing companies produced financial statement data which misrepresented their results and financial position and, therefore, did not provide investors with a clear warning of their demise.*[1]

This hypothesis will be referred to as the 'misinformation hypothesis'. Second, given the role of accountants in both preparing and auditing financial statement data, and despite the legal responsibility of company directors for financial statement data, it is hypothesized that

> *the accounting profession can be held responsible, at least in part, for any misrepresentations in these data.*

This hypothesis will be referred to as the 'responsibility hypothesis'.

The misinformation hypothesis implies that had timely and accurate information about the performance and financial position of these companies been available, investors would not have contributed funds to them, or could have taken action to retrieve existing investments in them, or could have forced remedial action by their management before large losses were incurred. It is implied, therefore, that financial statement misinformation contributed to the size of these company failures and hence to the size of their investors' losses. An implication of the responsibility hypothesis is

[1] The "warning" implication requires the assumption that investors are influenced by financial statement data. The validity of this assumption is assessed in Chapter 2.

that the accounting profession can be held responsible, at least in part, for these losses.

The first part of this chapter outlines public reaction to some of the most significant company failures in Australia in recent years. The evidence suggests that there is substantial support for both hypotheses within the community at large. Indeed, this type of reaction has been one of the factors behind mounting pressure for increased government regulation of the accounting profession, particularly in the development and enforcement of accounting standards. In this environment, therefore, it is particularly important to establish the validity of these hypotheses. The second part of this chapter describes the format to be followed in testing the two hypotheses.

1.2 Reaction to Public Company Failures in Australia

The 1970's will be remembered by Australian investors for its wave of major public company crashes. Large public companies placed into receivership during this period include Gollin Holdings Ltd., Mineral Securities of Australia Ltd., Mainline Corporation Ltd., Cambridge Credit Corporation Ltd., VIP Insurances Ltd., Saltergate Insurance Corporation Ltd., Associated Securities Ltd. and Palmdale Insurance Ltd. In addition, companies such as Commercial and General Acceptance Ltd., Industrial Acceptance Corporation Ltd. and Finance Corporation of Australia Ltd. suffered serious reverses and only avoided receivership through support operations mounted on their behalf by their parent companies.

The financial press provides an indication of the reaction against the accounting profession following these failures. For example, following the failure, in 1979, of two major finance companies, Associated Securities Ltd. (hereafter A.S.L.) and Finance Corporation of Australia Ltd. (hereafter F.C.A.), The *Adelaide Advertiser*, commented

> "'The best way to find a suitable accountant' so the joke went 'is to ask several of them what two and two make. And then employ the one who asks, What answer do you have in mind?'
>
> That joke has turned sour in recent weeks with revelations involving the finance companies Associated Securities and Finance Corporation of Australia."[2]

This article queried the validity of balance sheets which significantly overstated the value of current assets. It claimed that A.S.L. and F.C.A. had overstated the value of their current assets by $55m and $58m, respectively. It criticized the accounting profession for allowing such a situation to arise.

On a national level, the *Australian Financial Review* claimed that the A.S.L. and F.C.A. write-downs had

> "... shaken faith in all finance company directors' statements and investigating accountants' audit reports - as prepared under present accounting standards."[3]

Similarly, an editorial column in the *Australian Financial Review,* entitled "Something to believe in", held that A.S.L.'s accounts had misled the company's investors, and hence contributed to their losses. It commented that

> "The A.S.L. statement of affairs last week reveals the real lesson of the A.S.L. collapse to be the misleading way many companies present their financial affairs to shareholders and the stock exchange ... The type of balance sheets being produced in this country in many cases in recent years have lulled many shareholders into a sense of false security and ultimately robbed them of their investments.
>
> A.S.L. could perhaps have avoided receivership if assets had been more accurately valued."[4]

[2] *Adelaide Advertiser,* 26 May 1979, p.5.

[3] *Australian Financial Review,* 29 May 1979, p.44.

[4] *Australian Financial Review,* 9 April 1979, p.2.

Charges of financial statement misinformation and criticisms of the accounting profession were not confined to the A.S.L. and F.C.A. failures. For example, the *Australian Financial Review* reported that after investigating the affairs of Gollin Holdings Ltd., John Spender, Q.C., had questioned the auditors' failure to qualify Gollin's last set of accounts over the value of the company's investments.[5] Subsequently, the *Australian Financial Review* reported that the Gollin investigators had also queried the auditor's failure to qualify their report over the non-disclosure of the managing director's house account of more the $0.3m.[6]

The collapse of Mineral Securities of Australia Ltd. resulted in criticisms of the accounting profession. In January 1971, Minsec announced a half-yearly profit, to 31 December 1970, of $3.5m. A few days later, it announced a revised result of a loss of $3.3m. The "profit" had been due to Minsec's "sale" of several million shares to a stockbroker, at a book profit of $6.63m. The "sale" had been recorded a few weeks prior to the profit announcement. After the profit announcement, Minsec repurchased these shares at the same price plus brokerage and duty costs. The transaction was entered into solely to enable Minsec to report the loss of the previous six months as a profit. Although the original profit announcement was unaudited, a government investigation found that the Minsec auditors had been negligent in carrying out their professional duties.[7] They knew that the profit which was to be reported depended entirely on the one share transaction. The partner-in-charge of the audit felt uneasy about this transaction. Thus, according to

[5] *Australian Financial Review*, 15 September 1975, p.24.

[6] *Australian Financial Review*, 3 August 1977, pp. 2, 3 and 6.

[7] New South Wales, Parliament [1977].

the government investigators, the auditors had a duty to communicate to Minsec their doubts about this transaction and the proposed profit announcement. It was the investigators belief that if this duty had been fulfilled, the Minsec profit announcement would not have been made. This finding attracted front page coverage in the *Australian Financial Review*.[8] On the other hand, the *Australian Financial Review* subsequently acknowledged that the reversal of the profit announcement was made "at the behest of the accountants".[9]

One of the most widely publicized failures of the decade was that of Cambridge Credit Corporation Ltd. The Cambridge collapse resulted in considerable criticism of the accounting profession. For example, the *Australian Financial Review* commented that, in September 1974, Cambridge had reported an 'audited' profit of $3m, yet

> "Two weeks later it was in receivership and debenture holders are now in doubt as to whether they will be paid. One can forget shareholders, and unsecured creditors face a bleak prospect ... one hopes that the accounting profession will not let that Cambridge example slip away without taking a few lessons."[10]

Held up with the instigation of receivership, Cambridge's audited accounts for 1973-74 were eventually filed in February 1977. These accounts reported a loss of $70.4m. The *Australian Financial Review* reported details of the accounts and drew attention to the discrepancy between the final results and the audited profit of $3.1m announced in September 1974.[11] It also noted that

> "With the benefit of hindsight, the auditors of Cambridge Credit Corporation (receiver appointed) heavily qualified the company's

[8] *Australian Financial Review*, 2 March 1977, pp. 1 and 12.

[9] *Australian Financial Review*, 26 June 1979, pp. 1 and 16.

[10] *Australian Financial Review*, 15 September 1975, p.24.

[11] *Australian Financial Review*, 16 February 1977, pp. 1 and 8.

> 1973-74 annual accounts... The interesting thing stemming from the extensive qualifications of the Cambridge accounts is that 14 days before the company collapsed the auditors agreed that the company had made a net profit of $3.1 million."[12]

The difference between Cambridge's final results for 1973-74 and the audited results announced immediately prior to receivership may have been due to the change from a going-concern to a liquidation basis of valuation. However, the first hint that more than this was involved, appeared in the *Australian Financial Review* in June 1977, when it was reported that Cambridge had issued three writs against their auditors, relating to prospectuses issued between April 1971 and May 1972.[13] Although the court case did not relate specifically to the 1973-74 loss, its focus on prospectus data cast doubt on the performance of the accounting profession with regard to the provision of investor information. More detailed evidence against the accountants involved with Cambridge appeared in the financial press two months later. The Cambridge collapse had been under investigation by the N.S.W. Corporate Affairs Commission. The Commission's first interim report was tabled in the N.S.W. parliament in August 1977. According to the *Australian Financial Review,* the Corporate Affairs Commission found that Cambridge's reported profits of $3.06m for the year ended 30 June 1974 and $1.97m for the six months ended 31 December 1973 had been overstated by $3.73m and $3.95m respectively. Moreover, the investigators concluded that Cambridge's auditors had been negligent in performing their duties both as auditors and as reporting accountants for the prospectus issued in May 1974.[14]

The second interim report on Cambridge, tabled in the N.S.W. parliament in August 1979, strengthened the case against the accounting profession. It

[12] *Australian Financial Review,* 16 February 1977, p. 27.

[13] *Australian Financial Review,* 7 June 1977, p. 1.

[14] *Australian Financial Review,* 25 August 1977, pp. 1 and 24.

showed that from 30 June 1966, Cambridge had overstated pre-tax profits and shareholders' funds and, thus, failed to disclose that it was without further debenture borrowing capacity. These findings were drawn to the attention of the public in an article entitled "Eight year deceit by Cambridge - report", published in the *Australian Financial Review* in September 1979.[15]

The extracts given above show that, for some of the most substantial public company collapses in the 1970s, the financial press criticized, either directly or implicitly, the accounting profession for the publication of financial statements and, in Cambridge's case, prospectus auditors' reports which were misleading. According to the financial press, these data failed to provide investors with an accurate description of the condition of their companies in the period prior to failure. Although the media is usually considered to reflect (indeed, sometimes to lead) the opinion of society at large, it could be argued that the financial press, in seeking the spectacular, has publicized the exception rather than the rule. Thus, in establishing the degree of support for the two hypotheses, it is necessary to look further.

In June 1980, the Director of the Australian Shareholders' Association, R. J. Tanner, presented a paper entitled "Can shareholders rely on reports prepared by accountants and auditors?", to members of the City Business Group of the N.S.W. Division of the Australian Society of Accountants.[16] Regarding the accounts of failed companies, Tanner stated

[15] *Australian Financial Review*, 12 September 1979, pp. 1 and 39.

[16] R. J. Tanner, "Can shareholders rely on reports prepared by accountants and auditors?", address to Australian Society of Accountants, N.S.W. Division, City Business Group, 24 June, 1980.

> "The Association has in recent times received numerous complaints from shareholders in collapsed public companies. I am not suggesting that auditors and accountants are responsible for the gross public deception that has occurred in the following cases but there can be no doubt that accounting standards greatly assist directors in misleading the public."

To illustrate this point, he quoted the reversal of the Minsec profit announced in January 1971, the overstatement of profit by Cambridge in 1973-74, and the overstatement of current asset values by A.S.L. and F.C.A. According to Tanner, these cases show

> "... that under current accounting standards there is unlimited scope for anticipating profits that haven't yet, and may never, materialize."

Similarly, a representative of the Company Directors Association of Australia, C.A. Turnbull [1980 p.29], noted

> "... the lack of confidence in the integrity and standards of corporate reporting. The adverse reaction to the Gollin collapse, or that of Cambridge Credit, which occurred so shortly after the release of an audited result, confirms the view that investor confidence has been badly shaken."

Thus, the opinions of representatives of two major interest groups, shareholders and directors, both coincide with the hypotheses. However, evidence of similar views within the profession itself is, perhaps, even more telling. In June 1977, Phillip Cox, then president of the Institute of Chartered Accountants in Australia (I.C.A.A.), told a joint congress of the N.S.W. and Qld. Divisions of the I.C.A.A.

> "I believe that there is an underlying theme emerging in attitudes toward us ... no less than a fundamental questioning of our integrity and competence to perform our function as accountants, of our ability to act ... as skilled independent professionals. We will need to deal with this question if we are to maintain our credibility and status."[17]

[17] *Australian Financial Review*, 3 August 1977, p.2.

Although Cox's warning did not relate specifically to the quality of the audited accounts of failed companies, it is interesting to note that the Minsec report, with its criticisms of the financial statements and auditors, had been released three months earlier. As one of the Minsec investigators, Cox had played an important part in the preparation of that report.

Cox's warning was not an isolated opinion within the profession. Two years later, at the congress of the N.S.W. Division of the I.C.A.A., Bernard McInerney, a partner of Arthur Young & Co., told fellow members that

> "... it must be admitted that if inappropriate reporting procedures had been revised on a timely basis it may have highlighted the fact that companies actually in financial difficulties were being allowed to continue operating.
>
> It has been possible to actually misrepresent the real financial position of a company yet be in conformity with reporting procedures required by law and existing accounting standards.
>
> The legislators and the profession must accept responsibility for the state of affairs."[18]

In academic circles, the problem of the misrepresentative accounts of failed companies has long been recognized. In discussing the accounting profession's response to corporate failure in the 1960s, Birkett and Walker [1971, p.131] noted that

> "Many of the failures followed hard on the heels of the publication of audited financial statements depicting a profitable past and an apparently sound present... Their financial statements had not only failed to inform investors - they had also been misleading. These financial statements had been prepared by accountants, signed by auditors. In the public's eye they were the responsibility of the accounting profession."

[18] Institute of Chartered Accountants in Australia, *N.S.W. Division Congress*, 9-10 June 1979, quoted in *Australian Financial Review*, 11 June 1979, p.52.

Almost a decade later, in a letter to the editor of the *Australian Financial Review*, Clarke, Dean and Wolnizer, members of the Department of Accounting, Sydney University, noted that

> "... frequently investigations reveal that companies' financial positions, solvency, liquidity and financial progress were substantially different than might have been inferred from the published accounts at various times...
>
> The autopsies done on companies which have failed, or experienced financial difficulties, consistently indicate that their published accounts gave no basis from which to infer they had problems.
>
> The credibility of accounting data is properly called into question in respect of each of these affairs."[19]

The strongest evidence of a social problem is found when such an issue attracts government attention and the quality of financial statement data, particularly of failed companies, has been questioned at both state and federal levels. At the state level, in November 1977, the N.S.W. government appointed an Accounting Standards Review Committee, chaired by Professor R. J. Chambers, to examine the company accounting standards promulgated by the accounting profession. Released in May 1978, the Chambers report noted that

> "Companies which have appeared from their accounts to be solvent and profitable have been found, unexpectedly, to be insolvent and unprofitable. To name just a few the Reid Murray group, Cambridge Credit Corporation and Mineral Securities ... are cases of collapse without warning, of companies whose accounts represented them to be sound."[20]

At the federal level, the issue of the accounting profession's role in corporate failure was raised in the Australian parliament, in the Securities Commission Bill debate in October 1979. In proposing an amendment to the bill, so as to provide for the establishment of an accounting standards review

[19] *Australian Financial Review*, 8 May 1980, p.11.

[20] Accounting Standards Review Committee, N.S.W. Government [1978 p.18],

board, A.L.P. member Ralph Jacobi criticized the quality of published financial statements. He cited a number of recent corporate failures, including the collapses of Cambridge Credit, A.S.L., Gollin Holdings, Mainline Corporation, and the proprietary company, Computicket Australia, in which he estimated that investors had lost $297m. Jacobi informed parliament that

> "The available evidence suggests that a partial cause of some, but not all, of the company failures in recent years, particularly in the case of large companies, has been an inability of the accounting profession to enforce its own standards."[21]

He argued that had accurate financial statements been available, investors in these companies would have been able to avoid, or at least limit, their losses. Although the amendment to have an accounting standards review board established under the Securities Commission Bill was defeated, the matter was referred to Ministerial Council. The concept was approved and the first Accounting Standards Review Board was appointed in January 1984.

The evidence presented above shows that in the decade of the seventies, and earlier, the accounting profession was the subject of widespread criticism over the accounts of failed companies. This criticism has been expressed in the financial press, by members of shareholder and director organisations, by accountants in public practice and in academia, and, finally, it has been raised by governments at both a state and federal level. The evidence suggests that there is widespread support within the community for both the misinformation and the responsibility hypotheses. The purpose of this thesis is to determine whether such support is justified.

[21] Australian Parliament, House of Representatives, *Parliamentary Debates, Daily Hansard*, 23 October 1979, p.2357.

1.3 The Scope of The Thesis

The aim of this study is to assess whether the accounts of certain failed companies accurately reflected their condition prior to failure and, if not, to what extent the accounting profession should be held responsible. The thesis takes the following format. Chapter 2 reviews recent literature relevant to the hypotheses. Chapter 3 defines the terms and outlines the method to be followed in testing the hypotheses. Chapter 4 reviews the development of generally accepted accounting principles within Australia. This chapter lays the foundation for determining the responsibility of the accounting profession for any weaknesses in the financial statements of the case study companies.

Chapters 5, 6 and 7 analyse the financial statement data of Reid Murray Acceptance Ltd., Latec Investments Ltd. and Stanhill Development Finance Ltd., respectively. Each of these entities were major finance companies which failed in the early 1960s. Chapters 8, 9 and 10 analyse the financial statement data of Cambridge Credit Corporation Ltd., Associated Securities Ltd. and Finance Corporation of Australia Ltd., respectively. Each of these entities were major finance companies which failed during the mid-to-late 1970s. The aim of these chapters is to establish whether the financial statement data of the case study companies misrepresented their state of affairs in the period leading up to their collapse and, if so, the extent to which the accounting profession can be held responsible.

Finally, Chapter 11 draws together the results of the six case studies and reaches some general conclusions about the role of accounting information in these corporate failures and its implications for the accounting profession.

CHAPTER 2

LITERATURE REVIEW

The literature relevant to this study falls into three distinct areas. First, there has been limited attention paid to the quality of the financial statements of failed companies in Australia and the responsibility of the accounting profession for those data. This literature relates directly to both the misinformation and the responsibility hypotheses. Second, there has been considerable attention paid to the use of financial statement data for the prediction of corporate failure. This literature relates indirectly to the misinformation hypothesis. If there is a large body of literature which shows that corporate failure can be reliably predicted on the basis of a clearly defined set of financial ratios, drawn from financial statements, then the case for the misinformation hypothesis is weakened. The existence of an effective failure prediction model would indicate that generally financial statement data have provided a clear warning of the demise of failing companies. Third, there has been a good deal of attention paid to investors' reliance on financial statement data and the related issue of the information content of these data. The misinformation hypothesis implicitly assumes that investors do act on financial statement data. The literature in the third area tests the validity of this assumption.

2.1 The Quality of the Financial Statement Data of Failed Companies and the Role of the Accounting Profession

Chapter 1 showed that public opinion has held that the financial statement data of some of the major failed public companies in Australia were misleading and that the accounting profession was responsible, at least in part, for the inaccuracies and inadequacies of those data. Although such criticisms have been widespread, research into the quality of the financial statements of failed companies in Australia and the responsibility of the accounting profession for these statements has been limited. Government investigations have followed a number of the major company failures. Whilst the reports of some of these investigations have considered the quality of, and responsibility for, financial statement data, they have tended to focus on the legal responsibility of individuals. Indeed, there have been only two studies which are directly relevant to the two hypotheses. Both of these, one by Birkett and Walker [1971] and the other by a research committee of the Australian Society of Accountants [1966] relate to company failures in the 1960s.

Birkett and Walker cited a number of companies which had failed during the 1960s and which apparently had produced misleading financial statement data. They based their claim that the financial statement data of these companies were misleading, on a number of different sources. For example, in some cases they contrasted pre-collapse conditions according to prospectuses and/or financial statements, with post-collapse conditions according to statements of affairs. In other cases, they highlighted the short period between the acceptance of debenture subscriptions and default on payment of debenture interest and principal. And, in one case, they showed an inconsistency between a company's interim and full-year results which was associated with a change of management. Their most substantive evidence of misleading financial statement data, however, consisted of excerpts drawn from the reports of government investigations into these company failures, although they tended to rely upon the general conclusions reached by the government inspectors, without explaining the reasons behind these conclusions.

Birkett and Walker also assessed the response of the accounting profession to the problem of the misleading financial statement data which had been produced by failed companies. For example, they traced the development of accounting and auditing recommendations. They identified the issues central to the profession's congresses and conferences and the topics discussed in the profession's journals. On this basis, they concluded that the accounting profession was slow to come to grips with the issue of the misleading financial statements of failed companies. At first, the profession blamed individual accountants for these statements and advocated more effective control over its members. The profession also attributed much of the criticism of the financial statements to the ignorance of financial statement users. It argued that, had users understood the technical limitations of financial statements, they would not have been misled. However, according to Birkett and Walker [1971, p.136],

> "What was required was ... critical research into the profession's standards, into all that accountants had traditionally done, into the 'tenets of professional faith'."

Birkett and Walker, therefore, concluded that the financial statements of some major companies which had failed in Australia in the 1960s were misleading and that the accounting profession was responsible for this situation because of its inadequate accounting standards. Thus, as far as the decade of the 1960s is concerned, Birkett and Walker's study supports both the misinformation and the responsibility hypotheses. However, their conclusions can be criticized. Their study did not analyse the financial statements of the failed companies but relied on secondary sources of information. They did not identify the particular areas in which the accounts were misleading and could reach only general conclusions, such as the need for research into accounting standards. For less general conclusions, more detailed analysis is necessary.

The other study in this area, published by the Australian Society of Accountants [1966], consisted of a report on the accounting principles and practices criticized by the government investigations into various company failures in Australia in the early 1960s. It covered the investigations of major companies, such as the Reid Murray group and Stanhill Development Finance Ltd., as well as of a number of smaller companies, including Sydney Guarantee Ltd., New Investments Ltd. and Commonwealth Land and Investment Co. Ltd. The report focused on the specific aspects of the financial statements which these investigations considered were misleading and attempted to determine where the responsibility lay for these aspects. The terms of the report specifically excluded an examination of any broad issues of principle.

The various government inspectors' reports released in the early to mid-1960s had questioned generally accepted accounting principles in the areas of hire purchase sales and debtors, land transactions and the presentation of consolidated accounts. According to the A.S.A. report, the criticisms relating to hire purchase transactions reflected the inspectors' failure to understand the implications of concepts such as accrual based accounting and the going concern convention. Similarly, the criticisms relating to consolidations reflected the inspectors' lack of appreciation of the nature and purpose of consolidated statements. Moreover, the accounting for land transactions, which the inspectors had also criticized, had not complied with generally accepted accounting principles. Thus, according to the A.S.A., a major reason why the financial statements had been considered misleading was that users were unaware of the technical limitations of those statements. There were aspects of the statements which were misleading, but it was argued that these resulted largely from non-compliance with generally accepted accounting principles rather than from inappropriate principles. The report did recognize the need for continuing attention to the formulation, promulgation and review of accounting principles. However, more emphasis was placed on the need to obtain members' adherence to existing generally accepted accounting principles.

The misinformation hypothesis is supported by the A.S.A. report, to the extent that it acknowledged that there were misleading aspects of the financial statements of various companies which failed in the early 1960s. However, the A.S.A. was reluctant to support the responsibility hypothesis. It attributed the misinformation largely to the negligence of individual accountants rather than to the negligence of the profession as a whole. This conclusion is inconsistent with that of Birkett and Walker despite the fact that both studies used the same major data sources. The inconsistency may be due to additional data sources used by Birkett and Walker. A more probable explanation is that the A.S.A.'s terms of reference specifically excluded any consideration of broad issues of principle.

The two studies thus suggested that the financial statements of some of the major companies which failed in Australia in the 1960s were misleading. Birkett and Walker argued that the accounting profession was responsible, but the A.S.A. tended to blame individual accountants. Both studies had weaknesses. Birkett and Walker paid no attention to the specific aspects in which the statements were misleading and the A.S.A. ignored the broad issues of principle raised by the very existence of misleading accounts. Despite these inadequacies, no further studies have been published in this area. Even the major corporate failures of the 1970s and the renewed criticism of accountants and their financial statements have not stimulated any further published investigations in this area.

2.2 Predicting Corporate Failure on the Basis of Financial Statement Data

The notion that financial ratios can be useful indicators of corporate failure is not new. Fitzpatrick [1932] studied various ratios for 19 pairs of failed/non-failed firms and found differences in the ratios for at least three years prior to failure. According to Fitzpatrick, the ratios net profit/net worth and net worth/debt were the best indicators of failure. Winakor and Smith [1935] examined various ratios for 183 failed firms for ten years prior to failure and found a clear deterioration in the mean values of some ratios over this period. Moreover, the rate of deterioration increased as failure approached. They concluded that the ratio of working capital/total assets was the best indicator of failure. Winakor and Smith's study did not include a control group of non-failed firms but focused on changes in ratios over time as firms moved towards failure. In the largest of these early studies, Merwin [1942] examined various ratios for 900 small corporations which had failed over the decade 1926 to 1936. He found significant differences between the ratios of failed and non-failed firms as much as six years prior to failure. His best indicators were working capital/total assets, net worth/total debt and current assets/current liabilities.

Each of these early studies originated in the U.S. They established systematic differences between the ratios of failed and non-failed firms or of firms moving towards failure. They were univariate, focusing on individual ratios, and generally were descriptive, identifying ratio differences but not testing their predictive ability. They differed as to which ratios were the best indicators of failure and as to the period prior to failure over which ratio differences were apparent. The differences between these studies may, to some degree, reflect different focuses. For example, Merwin studied the ratios of small firms. The failure paths of small firms and the effect on financial ratios may differ from those of large firms. The differences may also reflect methodological shortcomings. For example, Fitzpatrick's sample was very small, Merwin's period of study was long, allowing for interference from temporal factors, and Winakor and Smith omitted a control group of non-failed firms.

The early studies of the relevance of financial ratios as indicators of corporate failure were not confined to univariate analysis. Wall [1936] developed an index of failure based upon the combined effects of seven ratios. The ratios and weights of the Wall index were the current ratio (25 per cent), worth/debt (25 per cent), worth/fixed assets (15 per cent), sales/receivables (10 per cent), sales/inventories (10 per cent), sales/fixed assets (10 per cent), and sales/worth (5 per cent). Wall's weights were chosen arbitrarily. In another study, Secrist [1938] used multiple discriminant analysis to establish a multivariate function to distinguish between failed and non-failed banks in the U.S. His study attracted little attention, perhaps because it was confined to the banking industry. However, as discussed below, multiple discriminant analysis was later to become the accepted tool for developing failure prediction models. Although rarely acknowledged in the literature, Secrist was a pioneer in this area.

Despite the fact that these studies, both univariate and multivariate, suggested that financial ratios could be useful indicators of failure, no significant advances were made in this area for almost a quarter of a century. Moreover, despite the existence of Secrist's methodology for developing multivariate indicators of failure, the first "new" studies were univariate. These studies, however, were more useful than the earlier studies since they examined the ability of financial ratios to *predict* corporate failure. For example, Beaver [1966] analysed 30 financial ratios for 79 pairs of failed and non-failed firms, drawn from the period 1954 to 1964. His sample consisted of pairs of U.S. industrial firms, matched by industry and asset size. Beaver defined failure as the inability of a firm to pay its financial obligations as they matured. Under this definition even an overdrawn bank account constituted failure. The test ratios were selected on the basis of good performance in previous studies, popularity in the literature and relevance to cash flow. Beaver compared the mean ratios of the failed and non-failed groups and found significant differences between them, thus substantiating the results of earlier univariate studies. Then, he split his sample randomly into two groups, which he called the "estimation sample" and the "validation sample". He chose a cutoff point for each ratio on the basis of the estimation sample and classifed firms in the validation sample, solely on the basis of this point. Using this dichotomous classification technique, Beaver concluded that the ratio of cash flow/total debt was the best predictor of failure, giving a 13 per cent misclassification rate one year prior to failure, rising to a 22 per cent misclassification rate five years prior to failure. The ratios of net income/total assets and total debt/total assets were the second and third best indicators, respectively. Other useful indicators included working capital/total assets, current assets/current liabilities and the no credit interval.[1]

With the same sample, Beaver [1968] used the predictive ability of ratios to evaluate alternative accounting measures. He tested the predictive power of 14 ratios over five years prior to failure. The ratios included 11 measures of liquid assets divided into three groups, a total asset group, a current debt group and a turnover group, and 3 non-liquid asset ratios. He hypothesized that the liquid asset ratios would be better predictors of failure in the short-run and that the non-liquid asset ratios would be better predictors of failure in the long-run. In fact, he found that the non-liquid

[1] The no credit interval is (quick assets - current liabilities)/operating expenses - depreciation).

asset ratios, cash flow/total debt, net income/total assets and total debt/total assets, were generally the best predictors in each of the five years. As in his 1966 study, the ratio cash flow/total debt was the best predictor. It outperformed all other ratios in the first two years prior to failure, and performed as well as the next best predictor, net income/total assets, three to five years prior to failure.

Also using Beaver's 1966 sample and a univariate approach, Lev [1971] tested the predictive power of balance sheet decomposition measures. The measures included the decomposition of total assets, total liabilities (including owners' equity) and the total balance sheet. Decomposition measures indicate the relative stability of financial statement data. Failing firms usually experience large changes in assets and liabilities. Thus, it is expected that, prior to failure, failed firms will exhibit larger balance sheet decomposition measures than non-failed firms. Indeed, Lev found that the decomposition measures of the failing firms were larger for at least 62 per cent of the matched pairs, for individual years before failure, and for at least 73 per cent of the pairs where the average decomposition measures over four years before failure were used. Applying a dichotomous classification test, he showed that balance sheet decomposition measures had a lower misclassification rate than all of Beaver's financial ratios except his best predictor, cash flow/total debt. This ratio performed only slightly better than the decomposition measures.

There was no theoretical basis underlying the selection of test ratios in the Beaver and Lev univariate studies. Wilcox [1971] presented a theoretical model of failure prediction, based on the behaviour of failing firms, specified in terms of the Markov chain process. He used this model to explain the significance of Beaver's ratios. Wilcox [1973] provided an empirical test of his 1971 model. Using the methodology developed by Beaver [1966], he tested measures related to cash flow, such as mean cash flow, cash flow variance and cash position, as predictors of failure. His sample included 52 pairs of failed/non-failed firms, drawn from the U.S. industrial sector over the period 1949 to 1971. Pairs were matched by industry, size and data availability. Wilcox defined failure as legal bankruptcy.[2] Given that his ratios were selected on the basis of his 1971 model, rather than derived from the sample itself, the accuracy of his model could be tested against the original sample. Wilcox's model produced misclassification rates of 6 per cent one year prior to failure, 10 per cent two years prior to failure and 24 per cent five years prior to failure. He concluded that the potential for failure of similarly sized firms, within broadly defined industries can be identified as far as four years ahead.

With or without a theoretical basis, these univariate models showed that systematic differences existed between the ratios of failed and non-failed firms and that these ratios could be used to predict failure a number years in advance. A weakness of univariate analysis is that it is difficult to accept that a single ratio can fully describe a firm's condition any better than a single financial statement item could. Indeed, it is possible for several univariate ratios to give conflicting results. These difficulties led to an increased emphasis on the development of multivariate failure prediction models, based on statistical techniques such as multiple discriminant analysis and regression analysis. Multiple discriminant analysis is designed to classify an observation (for example, a firm) into *a priori* groupings (for example, failed and non-failed) on the basis of observations of individual characteristics (such as financial ratios). The analysis derives the

[2] In the U.S., the term "bankruptcy" applies to both corporate and non-corporate entities. In contrast, in Australia this term is used for individuals but not for companies.

combination of all or some of these characteristics that best discriminates between the groups. It can be used to fit both linear and quadratic functions. The functions yield a single score which can be used to classify firms as failed or non-failed. A linear function is considered appropriate where group dispersion matrices are equal, whilst a quadratic function is considered appropriate where the matrices are unequal. Regression analysis can be used instead of multiple discriminant analysis where the dependent variable is dichotomous and, thus, can be run as a dummy variable, taking a value of zero for one classification and a value of one for the other. This is the case for failure prediction models. For example, the dependent variable can be given the value of zero for non-failed firms and one for failed firms and the various financial ratios can be treated as independent variables. Regression functions can be fitted in linear or quadratic forms. Under these conditions, regression analysis yields results similar to discriminant analysis.

Altman [1968] is usually acknowledged as the pioneer of multiple discriminant multivariate failure models, although, as discussed above, Secrist [1938] developed a similar approach thirty years earlier. Altman analysed 22 test ratios for 33 pairs of failed and non-failed U.S. manufacturing firms, for each of five years prior to failure. His study covered the period 1948 to 1965. Pairs were matched by industry and asset size, although the sample specifically excluded firms with assets of less than $1m or more than $25m. Failure was defined as legal bankruptcy. The 22 test ratios were selected on the basis of relevance and popularity in the literature. Using multiple discriminant analysis, Altman identified a linear function which enabled the classification of firms according to their failure status. The critical ratios in this function were working capital/total assets, retained earnings/total assets, (earnings before interest and taxes)/total assets, market value of equity/book value of debt and sales/total assets. When tested against the original sample this function had misclassification rates of 5 per cent one year prior to failure, 17 per cent two years prior to failure and 64 per cent five years prior to failure. However, discriminant analysis results generally have an upward bias with respect to original sample classification accuracy, because the same observations are used in the classification test as were used in developing the model's parameters. Thus, Altman tested the predictive power of his model against a new "hold-out" sample of 25 failed firms and 66 firms which had suffered losses in the previous three years but not failed. His model misclassified 4 per cent of the failed firms and 21 per cent of the non-failed firms one year prior to failure.

The Altman [1968] model was further tested by Altman and McGough [1974] who attempted to develop criteria to aid the auditor to identify going concern problems. They tested the model against the financial statement data, one and two years prior to failure, of 34 U.S. companies that had entered bankruptcy since 1970. They found that, based on data one and two years prior to failure, the model misclassified 18 per cent and 42 per cent, respectively, of the sample. These rates were much higher than the misclassification rates for the original sample, on which the model was based. This model had misclassification rates of 6 per cent for *failed firms* (as distinct from all firms) one year prior to failure and 28 per cent two years prior to failure.

Deakin [1972] also used multiple discriminant analysis to establish a linear multivariate failure prediction model. He analysed 14 test ratios, for 32 pairs of U.S. firms, matched by industry, size and year of failure. Deakin's test ratios were those used by Beaver [1968] in his univariate study. In contrast to the Altman study, which identified only one linear function, Deakin identified five separate functions, one for each of the five years prior to failure. Each function included the same fourteen variables, cash flow/total debt, the ratios of net income, total debt, current assets, quick assets, working capital and cash to total assets, the ratios of current assets, quick assets and cash to current liabilities and the ratios of current assets, quick assets, working capital and cash to sales. These ratios carried different weights (i.e. had different coefficients) for each of the different years prior to failure. Tested against the original sample, the "one year prior" function had a misclassification rate of 3 per cent. The "two years prior" function had a misclassification rate of approximately 4 per cent and the "five years prior" function had a misclassification rate of 17 per cent. On a hold-out sample of 11 failed and 23 non-failed firms, the misclassification rates were 22 per cent, 6 per cent and 15 per cent respectively.

Edmister [1972] used regression analysis to identify a failure prediction function, which included six ratios. They were the ratios of quick assets/current liabilities, cash flow/current debt, current liabilities/equity, net working capital/sales, equity/sales and inventory/sales. He derived this function from the analysis of 19 test ratios, selected on the basis that they were either advocated by theorists or found to be significant predictors of business failure in previous studies. His sample included 42 firms which had defaulted on small business loans, matched by 42 non-failed firms. Edmister's function yielded a 7 percent misclassification rate one year prior to failure. He did not test it against a hold-out sample but did present simulation tests supporting the statistical significance of the classification results obtained on his original sample.

Blum [1974] used multiple discriminant analysis to develop a linear function, based on 12 financial statement variables for 115 pairs of failed/non-failed industrial firms. Pairs were matched by industry, sales, number of employees and fiscal year. Small firms, namely those with liabilities of less than $1m at the time of failure, were excluded from the sample. The study covered the period 1954 to 1958. Failure was defined as the legal meaning attributed to it in the context of U.S. anti-trust cases, which is an inability to pay debts as they became due, entrance into bankruptcy, or explicit agreement with creditors to decrease debts. The 12 variables were selected on the basis of Blum's consideration of the ways failure might be reflected in accounting data. In selecting these ratios, Blum viewed failure in terms of Beaver's cash flow concept, although he did not identify any specific relationships and thus develop an explicit theory of failure. Unlike earlier studies, the independent variables included measures of change and variability in ratios, as well as levels. The twelve variables comprised five measures of liquidity, one measure of profitability and six measures of variability. The liquidity variables included the ratios of quick assets/current liabilities, net quick assets/inventory, cash flow/total liabilities, market value of net worth/total liabilities and book value of net worth/total liabilities. The measure of profitability consisted of the rate of return to common stockholders who invest for a minimum of 3 years and the six measures of variability included the standard deviation, trend breaks and slope of net income and the standard deviation, trend breaks and slope of net quick assets/inventory. Using these variables, Blum fitted the function separately to the data for each of the five years prior to failure, thus identifying five functions with common variables but different coefficients. The original sample was split in half, with the discriminant functions being identified for half the sample and their validity tested against the remaining half. Tested against the derivation sample, the model had misclassification rates of approximately 6 per cent one year prior to failure, 11 per cent two years prior to failure and approximately 17 to 18 per cent three to five years prior to failure. For the validation sample, the model had a similar misclassification rate one year prior to failure, but rates of approximately 20 per cent and 30 per cent respectively for two years and three to five years prior to failure.

Elam [1975] considered whether the consistent use of different accounting methods affects the predictive ability of financial distress models, by examining the effect of the addition of capitalized lease data on such models. He defined failure as legal bankruptcy. His sample comprised 48 pairs of failed/non-failed firms, matched by industry, year of failure and method of reporting leases. The study covered firms which had failed over the period 1966 to 1972. In multiple discriminant analysis, the number of variables which can be tested is limited to the number of observations. Elam's sample size decreased as the number of years prior to failure increased, because of data limitations. For the fifth year prior to failure his sample was reduced to 25. Thus, the maximum number of ratios which Elam could test was 25. He made no attempt to reduce this number, given that the purpose of his model was not to optimize its predictive power, but rather to analyse the effect of the lease data on this predictive power. Initially Elam identified ten multiple discriminant functions two for each of the five years prior to failure, one with and one without lease data. Although each of his functions included fifteen variables, the ratios which were consistently weighted most heavily in these functions were cash flow/sales, cash flow/total assets, cash flow/total liabilities, net profit/sales and (current plus long-term liabilities plus preferred stock)/total assets. The remaining variables included cash flow/net worth, net profit/net worth, (earnings before interest and tax)/sales, sales/total assets, total debt/net worth, long-term debt/current assets, current assets/current liabilities, quick assets/current liabilities, current liabilities/total assets and cash/current liabilities. Elam used two validation procedures. He tested the functions with and without lease data for the third year (arbitrarily selected) against the data for the other four years. Also, he tested two functions based on the average of the weights of the ratios from the functions for all five years prior to failure, both with and without lease data. Elam's tests of accuracy were limited to the relative accuracy of the models, with and without lease data. He did not disclose details of the overall accuracy of his models.

Libby [1975] developed a model of failure prediction in an attempt to determine whether accounting ratios provide useful information to loan officers in predicting business failure. His sample included 30 pairs of failed/non-failed firms drawn at random from the sample used by Deakin [1972]. Libby based his model on the 14 ratios studied by Deakin (who in turn had selected these ratios on the basis of Beaver's [1968] study), for 10 pairs of firms, for each of one to three years prior to failure. Using principal components analysis, which groups variables into a few factors that retain a maximum of information contained in the original variable set, Libby identified five independent sources of variation within the 14-ratio set. His critical ratios included net income/total assets as a measure of profitability, current assets/sales as a measure of activity, current assets/current liabilities as a measure of liquidity, current assets/total assets as a measure of asset balance and cash/total assets as a measure of cash position. This ratio set had misclassification rates of 15 per cent for the original sample and 28 per cent for a double-cross validation test.[3]

Moyer [1977] tested the accuracy of Altman's [1968] model in predicting the failure of large manufacturing, retailing and railroad firms in the U.S. and found that it had a misclassification rate of 24 per cent one year prior

[3] The double-cross validation test uses the chi-square classification method and Bayes Theorem to determine posterior probabilities of group membership. See Libby [1975, p.154.]

to failure. Moyer's study was based on 27 pairs of failed/non-failed firms, matched by industry and size, with total assets ranging from $15m to $1 billion. It covered the period 1965 to 1975. Altman's original sample was limited to manufacturing firms, with total assets ranging from $1m to $25m, and covered the period 1946 to 1965. Moyer's results suggest the Altman's [1968] model may have been sensitive to time span, firm size and/or industry. Moyer then used the financial statement data of the 27 pairs of firms to develop two linear discriminant functions, the first based on a stepwise reduction of Altman's five variables and the second based on two variables, Beaver's best predictor, cash flow/debt, and Lev's balance sheet decomposition measure. The Altman based function had three critical ratios, working capital/total assets, retained earnings/total assets and (earnings before interest and tax)/total assets. This function had misclassification rates of approximately 9 per cent in classifying the original sample one year prior to failure, and 26 per cent three years prior to failure. The misclassification rates of the Beaver/Lev based model ranged from 15 per cent one year prior to failure, to 35 per cent three years prior. However, Moyer did not present any evidence to validate these misclassification rates.

Altman, Haldeman and Narayanan [1977] developed a discriminant function, which they called "Zeta", to replace Altman's [1968] model. Their sample comprised 58 non-failed firms matched against 53 failed firms, according to industry and year of data. The sample was confined to manufacturing and retailing firms with assets of more than $20m. Failure was defined as a situation of bankruptcy, or where a firm remained non-bankrupt only due to extraordinary external support. Twenty-seven ratios were tested. These were selected largely on the basis of emphasis in existing literature, although several new measures were included, the two most notable being earnings stability and asset size.[4] Although the data exhibited unequal group dispersion matrices, Altman *et al* tested a linear as well as a quadratic form of the model. Both functions were based solely on data from the first year prior to failure. Both functions included the variables, retained earnings/total assets, stability of earnings, (earnings before interest and tax)/total assets, (earnings before interest and tax)/interest expense, current assets/current liabilities, common equity/total capital, and total assets. Based on the original sample (i.e., for firms one year prior to failure), both the quadratic and linear functions had misclassification rates of approximately 7 per cent. Using the Lachenbruch validation test the quadratic and linear functions had misclassification rates of 13 percent and 9 per cent respectively one year prior to failure.[5] Given that the functions were derived from the data one year prior to failure, observations from the second to the fifth years prior to failure could also be treated as holdout samples. On this basis, the misclassification rates of the quadratic and linear functions over two to five years prior to failure varied from 15 per cent to 30 per cent and 11 per cent to 23 per cent, respectively. Thus, despite the existence of unequal group dispersion matrices, the linear function outperformed the quadratic function.[6] Therefore, the linear form of the "Zeta" model was recommended. "Zeta" performed similarly to the 1968 model for the first two years prior to failure. However, it provided a marked

[4] Earlier studies tended to eliminate the influence of size by using it as one of the matching criteria.

[5] The Lachenbruch method for testing the reliability of discriminant models uses the original sample as a "hold-out" sample. One observation at a time is isolated as the "hold-out" firm, with the remaining sample determining the model. This process is repeated for the entire sample and the classification accuracy of the "hold-out" firms is cumulated.

[6] A major criticism of Altman's [1968] model had been its use of a linear rather than quadratic function, although Altman [1977] reported that a quadratic form made very little improvement to this earlier model.

improvement over the earlier model for three to five years prior to failure.

A study by Ketz [1978] compared failure prediction models based on historic cost financial statements, with models based on general price level adjusted financial statements. His sample included 75 firms which had failed between 1970 and 1975 and 100 non-failed firms chosen from 1973. The study included 16 test ratios. The basis of ratio selection was not discussed. Using multiple discriminant analysis, Ketz fitted both linear and quadratic functions based on the full set of 16 variables and on a reduced set of 9 variables, for both the historic cost and price adjusted data. The sixteen variable quadratic functions were most successful, with misclassification rates of approximately 7 per cent, for both the historic cost and price adjusted models. The corresponding misclassificaton rates for the reduced models were only slightly higher, at approximately 9 per cent and 8 per cent. The low overall misclassification rates are somewhat misleading, however, in that Ketz's model was successful in classifying non-failed firms but unsuccessful in classifying failed firms. The high misclassification rate for failed firms is disguised in the overall misclassification rate because the model was structured to include only 75 observations from failed firms, one from each firm, and nearly 600 observations from non-failed firms, one from each firm for each of the six years between 1968 and 1973. In addition, Ketz's misclassification rates were based on his derivation sample rather than a validation sample, although this may be acceptable given his large number of observations. The critical ratios identified in the reduced models were cash flow/total assets, cash flow/total debt, current assets/current liabilities, current assets/total assets, current debt/total assets, total debt/total assets, net income/total assets, current monetary assets/current debt and working capital/sales.

Norton and Smith [1979] also derived failure prediction functions to compare the performance of models based on historic cost and general price level adjusted data. Their sample included 30 large industrial firms, which had failed between 1971 and 1975, and 30 non-failed firms, matched by industry, asset size and data availability. Failure was defined as the commencement of bankruptcy proceedings. The study covered financial statement data issued four years prior to failure. It included 32 test ratios selected on the basis of usefulness in previous studies. Using multiple discriminant analysis, Norton and Smith derived price adjusted and historic cost linear functions for each of the four years prior to failure. They used four different approaches to determine which ratios should be included in the discriminant functions. The most successful model included all 32 ratios. Its misclassification rates varied from 7 per cent one year prior to failure, for both historic cost and price adjusted data, to 17 per cent for historic cost data and 12 per cent for price adjusted data four years prior to failure. A second approach, based on the stepwise technique of selecting an optimal set of variables, indicated that the critical ratios varied for the different years prior to failure and between the historic cost and price adjusted models. The misclassification rates for this model were only slightly higher than for the 32 variable model. A third approach, based on univariate prediction ability, selected 13 critical ratios which included the current ratio, cash/current liabilities, quick assets/current liabilities, working capital/total assets, cash flow/total assets, cash flow/total liabilities, net income/total assets, net income/total liabilities, current liabilities/total assets, total liabilities/total assets, (total liabilities plus preference stock)/total assets, net worth/total liabilities and net worth/fixed assets. The misclassification rates for this model were slightly higher than for the stepwise model, but this model had the advantage of including the same variables in each function. The fourth approach, based on regression analysis, multiple discriminant analysis and "the judgement of the researcher", included 11 ratios, but generally had a higher misclassification rate than the 13 variable model.

Dambolena and Khoury [1980] also used discriminant analysis to develop a linear failure prediction model. Their sample, drawn from the U.S. manufacturing and retailing sectors, included 46 firms which had failed between 1969 and 1975 and 46 non-failed firms, matched by industry. They did not define failure. Their 19 variables included financial ratios and measures of their stability, selected on the basis of data availability, general acceptability in relation to their intended use and relevance as an indicator of profitability, activity, liquidity or leverage. They tested a number of functions including individual functions for one, three and five years prior to failure based on ratios alone, functions for one, three and five years prior to failure based on ratios and their standard deviations over the past four years, and functions for years one to four years prior to failure based on the variables from the year five function using ratios and standard deviations. They found that the introduction of standard deviations as measures of ratio stability improved the predictive ability of the model, particularly in the earlier years prior to failure. The misclassification rates of the most general model, with the same variables but different coefficients for each of the years prior to failure, ranged from 9 per cent one year prior to failure to 17 per cent five years prior to failure, for the derivation sample. Using the Lachenbruch validation method, the model's misclassification rates ranged from approximately 13 per cent to 22 per cent, over the period of one to five years prior to failure. The variables included in this model were net profit/sales, net profit/total assets, fixed assets/net worth, funded debt/net working capital, total debt/total assets, standard deviation of inventory/net working capital and standard deviation of fixed assets/net worth.

Ohlson [1980] introduced a new method for developing failure prediction models. It was a maximum likelihood estimation of a conditional logit model which calculated the probability that a firm will fail within some prespecified time. He developed his model on the basis of the financial statement data of 105 failed firms and 2058 non-failed firms, drawn from the U.S. industrial sector over the period 1970 to 1976. Failure was defined as bankruptcy. He tested four different models. These consisted of a model for each of the three years prior to failure based on 11 test ratios, and a fourth model with three additional test ratios. Test ratios were selected on the basis of "simplicity". The additional ratios included in the fourth model made no improvement. Ohlson identified four factors as being statistically significant in affecting the probability of failure. They were the size of the company (measured by log total assets/G.N.P. price level index), its financial structure (measured by total assets/total liabilities), its performance (measured by net income/total assets and/or funds from operations/total liabilities), and its current liquidity (measured by working capital/total assets, or working capital/total assets and current liabilities/current assets jointly). Tested against his derivation sample, the one year prior model gave an average misclassification rate of approximately 15 per cent. The two year prior model, when used to predict failure one year before, actually gave a slightly lower misclassification rate of approximately 14 per cent, which led Ohlson [1980, p.130] to conclude that the two models "were essentially equivalent as predictive tools". The predictive ability of his three year prior model was not discussed. Ohlson's tests of predictive accuracy were based on his original sample. He acknowledged that the use of a validation sample was preferable. However, he claimed that tests against the derivation sample were acceptable given the size of the sample, and because logit analysis, in contrast to discriminant analysis, is not designed to find an optimal function, trading off one type of error against another.

Each of the above studies related to business failure in the U.S. In the U.K., Taffler and Tisshaw [1977] analysed 80 ratios for 46 pairs of failed/non-failed manufacturing firms, for each of four years prior to failure. Pairs were matched by industry and size. Failure had occurred since 1969, and was defined as entry into receivership, creditors' voluntary liquidation, compulsory winding up by the court, or government action undertaken as an alternative. The test ratios were selected as being typical of those used by financial analysts. Using multiple discriminant analysis, they derived a linear function which included the ratios of (profit before tax)/current liabilities, current assets/total liabilities, current liabilities/total assets and the no credit interval. Tested against the derivation sample, this function had a misclassification rate of 1 per cent, one year prior to failure. The performance of the model in other years was not discussed. The model was not subjected to any validation procedures.

In a more thorough study, in Holland, Van Frederikslust [1978] attempted to develop a financial theory of corporate failure. His aim was to select and test discriminatory ratios on the basis of this theory. His sample comprised 20 pairs of failed/non-failed firms quoted on the Amsterdam Stock Exchange between 1954 and 1974. Pairs were matched by industry, size and general economic conditions. Failure was defined as technical insolvency, that is an inability to pay obligations as they fell due. In developing his theory, Van Frederikslust identified the determinants of an entity's cash balance. Given that failure occurs when the cash balance is less than zero, Van Frederikslust argued that failure can be predicted by predicting the value of the determinants of cash balance. However, the data necessary to make these predictions are not included in financial statements. As an alternative, Van Frederikslust attempted to identify the global relationship between the cash balance of firms and observed values of explanatory variables of the cash balance. He used linear regression analysis to identity the relationship between these variables for his sample of failed and non-failed firms. Van Frederikslust specified his explanatory variables by manipulating his cash balance equation. They included a measure of liquidity (the internal coverage of short term debt), a measure of profitability (the rate of return on equity), a measure of solvency (debt/equity), and measures of the variability of profitability and liquidity (the annual growth of internal coverage and the rate of return, their prediction errors and coefficients of variation). Subsequently Van Frederikslust dropped the solvency variable as it added nothing to the liquidity and profitability variables. He identified separate functions for each of five years prior to failure using only the levels of profitability and liquidity as explanatory variables, and for each of four years prior to failure using the variability as well as the level variables. Overall, the level and variability model performed best. Its misclassification rates, based on the Lachenbruch method, ranged from approximately 8 per cent to 22 per cent over one to four years prior to failure.

In Australia, Castagna and Matolcsy [1977] used multiple discriminant analysis to develop a quadratic failure prediction function. Their model was based on a sample of 20 pairs of failed/non-failed firms, drawn from the industrial sector, spread across the period 1963 to 1975. They defined failure in the strict legal sense of receivership or liquidation. They selected 13 test ratios on the basis of significance in previous studies and popularity in the literature. Because of their small sample, they did not attempt to identify a separate function for each year prior to failure.

Instead, they produced 65 observations by averaging each of the ratios over time spans varying from one to five years. The critical ratios of their function were (earnings before interest and tax)/total assets, total debt/total assets, current assets/current liabilities, retained earnings/total assets and market capitalization/total debt. Based on the Lachenbruch test, the misclassification rates of their model *for failed firms* were 20 per cent one year prior to failure, 15 per cent two and three years prior to failure, 22 per cent four years prior to failure and 26 per cent five years prior to failure. Misclassification rates for non-failed firms were not disclosed, thus it is not possible to calculate the overall misclassification rates for this model. Using the same approach, Castagna and Matolcsy [1978a] produced a revised failure prediction function. The critical variables in this function were (earnings before interest and tax)/total assets, (earnings before interest, tax and depreciation)/(total assets less investments), net tangible assets per share/share price, (short term plus long term financial debt)/total assets, and market capitalization/total debt. The misclassification rates of this model for failed firms were approximately 6 per cent for each of the five years prior to failure. The overall misclassification rates of the model varied from approximately 15 per cent one year prior to failure, to 24 per cent two years prior and 17 per cent five years prior to failure.

Castagna and Matolcsy [1981] expanded their sample slightly to include 21 pairs of failed/non-failed firms, drawn from the period 1963 to 1977. They selected ten test ratios found useful in earlier studies, particularly by Altman, Haldeman and Narayanan [1977]. Using these data, they evaluated 40 different models testing the effects of linear versus quadratic formats, temporal versus atemporal models, equal versus unequal prior probabilities of failure, and variable reductions. They found that no one model consistently outperformed all others over the five year period prior to failure.

Therefore, they argued that the appropriate format depends on the utility preference of the user. For example, in classifying failed companies the linear atemporal model with equal prior probabilities performed best, with the misclassification rates of this model, based on Lachenbruch tests, varying from approximately 10 per cent one year prior to failure, to 33 per cent four years prior to failure and 19 per cent five years prior to failure. The 10 variables included the rate of return on shareholders' funds, (earnings before interest and tax)/total assets, operating income/operating assets, (current assets less inventories)/(current liabilities less bank overdraft), current assets/current liabilities, gross cash flow/total debt, total debt/total assets, working capital/total assets, retained earnings/total assets and market capitalization/total debt.

Also in Australia, Booth [1981] used multiple discriminant analysis to derive a linear failure prediction function based on balance sheet decomposition measures. His sample included 38 pairs of failed/non-failed industrial firms matched by asset size, industry and financial statement data. He defined failure as a state of insolvency or bankruptcy, where control of assets is exercised for the benefit of creditors, not directly for the owners of those assets. His study covered the period 1964 to 1979. The function he derived included measures of average liability decomposition, balance sheet decomposition for year one, average balance sheet decomposition, equities decomposition for year one, and the coefficient of variation of this equities decomposition measure. Booth's function had a misclassification rate of 15 per cent in classifying his original sample one year prior to failure. To validate this result he split his sample into derivation and validation subgroups. For the validation sample, the function had a misclassification rate of 37 per cent one year prior to failure. Booth concluded that, contrary to Lev's findings, it was not confirmed that balance sheet decomposition measures were useful in models to predict corporate failure.

Lincoln [1982] used multiple discriminant analysis to derive separate failure prediction models for Australian manufacturing, retail and property sectors. In addition, he derived functions for combined manufacturing and retail sectors, combined property and finance sectors, and for a combination of all four sectors. Lincoln defined failure as the appointment of a receiver or liquidator under the provisions of the companies legislation, although he extended this definition for the finance industry to include forced mergers. His study was based on financial statement data for a five year period, for 41 failed and 90 non-failed firms. He tested two separate combinations of ratios, one comprising 39 accounting ratios and the other comprising 30 ratios.[7] He also included variables covering the effects of firm size and variability in balance sheet structure and in profitability. The usefulness of his individual sector models was limited by the small sample size for each sector. Indeed, he did not attempt to fit a model to the finance sector sample which included only four failed and twelve non-failed firms. For the other sectors and the various combinations of sectors, he fitted a linear function for each of the five years prior to failure, using the two different variable sets. Thus, he derived two sets of five discriminant functions, for six industry classes. Using original sample and hold-out sample validation techniques, Lincoln calculated the classification accuracy of the various models averaged over five years. For the 39 ratio combination, which performed better than the 30 ratio combination, the four sector model had misclassification rates of approximately 13 per cent for manufacturing firms, 9 per cent for retail firms, 26 per cent for property firms and 35 per cent

[7] Lincoln aimed to test all possible accounting ratios. By flow charting the paths of individual financial statement items he decided that these ratios could be covered by two separate combinations of 39 and 30 ratios.

for finance firms. The two sector models improved the average accuracy for manufacturing and retail firms by less than one per cent, and for property and finance firms by approximately 6 and 8 per cent, respectively. On the other hand, the separate sector model improved the average accuracy over the two sector models by approximately 3 per cent for manufacturing and retail firms, but made no difference for property firms. The critical ratios of his more general manufacturing-retail model included (cash flow before tax)/current liabilities, current assets/total assets, quick assets/current assets, current liabilities/total liabilities, quick liabilities/current liabilities, retained earnings/total assets and total liabilities/total assets. His industry specific property and finance model was based on only two ratios, (earnings before interest and tax)/total assets and total liabilities/total assets. To assist in the interpretation of these functions, Lincoln computed an insolvency risk table from which one could read the probability, at a particular time, of a firm failing.[8]

The studies discussed above, originating both from overseas and within Australia, generally were developed for broad sectors of the economy. For example, many of them applied to industrial, manufacturing and/or retail sectors. Whilst it was acknowledged that interindustry differences may influence failure patterns and failure prediction factors, the effects of those differences usually were eliminated in the initial sample selection by using industry as one of the matching criteria. In addition to these general studies, a number of failure prediction models have been developed for specific industries. For example, in the U.S., Meyer and Pifer [1970] and Sinkey [1975] developed failure prediction models for banks. Altman [1973]

[8] Apart from the Castagna and Matolcsy, Booth and Lincoln models, there has been one other general failure prediction study in Australia, by Altman and Izan. However, the results of this study have not yet been published.

developed a model for railroads, Altman and Loris [1976] developed a model for brokers and dealers and Altman [1977] developed a model for savings and loans associations. In Australia, Craswell [1981] developed a failure prediction model for the land development industry and, as discussed above, Lincoln [1982] developed a model for property and finance firms. These industry specific studies have identified a wide range of ratios relevant to failure prediction. This diversity is not surprising, given the potential influence of inter-industry differences.

In the more general studies, however, one would expect some consistency amongst the relevant ratios. Table 2.1 lists the financial ratios included in the various general failure prediction models discussed above. Although most of these studies claimed that financial ratios could be used to predict business failure a number of years prior to the event, there has been little agreement over which particular ratios should be used. The twenty-seven studies recommended a total of sixty-nine different financial ratios. Given the difference in emphasis and the weaknesses of a univariate approach, inconsistencies between univariate and multivariate models are not surprising. However, the twenty-one multivariate studies alone included sixty-six different ratios. The most popular ratio, the current ratio, was included in ten of these twenty-one studies. The next most popular ratios, cash flow/total debt and total debt/total assets, appeared in only seven of the twenty-one multivariate studies. Working capital/total assets, net profit/total assets, retained earnings/total assets and (earnings before interest and tax)/total assets were included in six of the multivariate studies. Often where a ratio was common to more than one study, it reappeared in a follow-up study by the same author, or at least in a study based on the same data, rather than being identified by an independent source. Of the remaining fifty-nine variables identified in the multivariate studies, thirty-nine were unique to the study in which they were identified.

TABLE 2.1: FAILURE PREDICTION RATIOS RECOMMENDED IN THE LITERATURE

	Return on S.H.F. or Net Profit/Net Worth	Net Worth/T. Debt	Working Cap/T. Assets	C. Assets/C. Liabs	Net Worth/F. Assets	Sales/Receivables	Sales/Inventory	Sales/F. Assets	Sales/Net Worth	Cash Flow/T. Debt	Net Profit/T. Assets	T. Debt/T. Assets	No Credit Interval	B.S. Decomp. Measures	Cash Flow	Cash Position	Cash Flow Variance	Ret. Earnings/T. Assets	E.B.I.T./T. Assets	N. Worth(Market Value)/T. Debt	Sales/T. Assets	C. Assets/T. Assets	Q. Assets/T. Assets
Univariate																							
Fitzpatrick	X	X																					
Winakor & Smith			X																				
Merwin		X	X	X																			
Beaver [1966]			X	X						X	X	X	X										
Lev														X*									
Wilcox [1973]															X	X	X						
No. of Univariate Studies	1	2	3	2						1	1	1	1	1	1	1	1						
Multivariate																							
Wall		X		X	X	X	X	X	X														
Altman [1968]			X															X	X	X	X		
Deakin			X	X						X	X	X										X	X
Edmister																							
Blum	X	X								X										X			
Elam	X			X						X											X		
Libby				X							X											X	
Moyer (a)			X															X	X				
Moyer (b)										X				X									
Altman et al.				X														X	X				
Ketz				X						X	X	X										X	
Norton & Smith		X	X	X	X					X	X	X											
Dambolena & Khoury											X	X											
Ohlson			X	X							X												
Taffler & Tisshaw													X										
van Frederikslust	X																						
Castagna & Matolscy [1977]				X								X						X	X	X			
" " [1978]																			X	X			
" " [1981]	X		X	X						X		X						X	X	X			
Booth														X*1									
Lincoln												X						X				X	
No. of Multivariate Studies	4	3	6	10	2	1	1	1	1	7	6	7	1	2	-	-	-	6	6	5	2	4	1
Total No. of Studies	5	5	9	12	2	1	1	1	1	8	7	8	2	3	1	1	1	6	6	5	2	4	1

	Cash/T. Assets	Q. Assets/C. Liabs	Cash/C. Liabs	Cash/Sales	C. Assets/Sales	Q. Assets/Sales	Working Cap/Sales	Cash Flow/C. Liabs	C. Liabs/Net Worth	Net Worth/Sales	Inventory/Sales	Net Q. Assets/Inventory	Variab/Stability of Net Profit	Variab N.Q.Assets/Invent.	Cash Flow/T. Assets	Cash Flow/Sales	Net Profit/Sales	T. Debt+Pref Stock/T.Assets	Cash Flow/Net Worth	E.B.I.T./Sales	T. Debt/Net Worth	L.T. Debt/C. Assets	C. Liabs/T. Assets
Univariate																							
Fitzpatrick																							
Winakor & Smith																							
Merwin																							
Beaver [1966]																							
Lev																							
Wilcox [1973]																							
No. of Univariate Studies																							
Multivariate																							
Wall																							
Altman [1968]																							
Deakin	X	X	X	X	X	X	X																
Edmister		X					X	X	X	X	X												
Blum		X										X	X*	X*									
Elam		X	X												X	X	X	X	X	X	X	X	X
Libby	X				X																		
Moyer (a)																							
Moyer (b)																							
Altman et al.													X										
Ketz							X								X								X
Norton & Smith		X	X												X			X					X
Dambolena & Khoury																	X						
Ohlson																							
Taffler & Tisshaw																							X
van Frederikslust													X*								X		
Castagna & Matolscy [1977]																							
" " [1978]																							
" " [1981]																							
Booth																							
Lincoln								X															
No. of Multivariate Studies	2	5	3	1	2	1	3	2	1	1	1	1	3	1	3	1	2	2	1	1	2	1	4
Total No. of Studies	2	5	3	1	2	1	3	2	1	1	1	1	3	1	3	1	2	2	1	1	2	1	4

	E.B.I.T./Int. Exp.	T. Assets	Common Equity/T. Cap.	C. Mon. Assets/C. Liabs.	F. Assets/Net Worth	Funded Debt/N.Work.Cap	Variab Invent/N. Work Cap.	Variab F. Assets/Net Worth	T. Assets/T. Debt	Funds from oper'ns/Total Liab	Pre-tax Profit/C. Liabs	C. Assets/T. Debt	Cash and Earned Resources/C. Liabs	Variab of Internal Cover	E.B.I.T. & Depreciation/T. Assets-Investments	MAB/Share/Share Price	S.T. & L.T. Lin. Debt/T. Assets	Oper.Income/Oper.Assets	Q. Assets/Q. Liabs	C. Liabs/T. Liabs	Q. Liabs/C. Liabs	Q. Assets/C. Assets	Net Profit/T. Liabs	No. of Ratios
Univariate																								69
Fitzpatrick																								2
Winakor & Smith																								1
Merwin																								3
Beaver [1966]																								6
Lev																								3
Wilcox [1973]																								3
No. of Univariate Studies																								18
Multivariate																								
Wall																								7
Altman [1968]																								5
Deakin																								14
Edmister																								6
Blum																								12
Elam																								15
Libby																								5
Moyer (a)																								3
Moyer (b)																								2
Altman et al.	X	X	X																					7
Ketz				X																				9
Norton & Smith																							X	13
Dambolena & Khoury					X	X	X	X																7
Ohlson		X							X	X														6
Taffler & Tisshaw											X	X												4
van Frederikslust													X	X*										9
Castagna & Matolscy [1977]																								5
" " [1978]															X	X	X							5
" " [1981]																		X	X					16
Booth																								5
Lincoln																				X	X	X		7
No. of Multivariate Studies	1	2	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	156
Total No. of Studies	1	2	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	174

* included 3 different measures

*1 included 5 different measures

Chen and Shimerda [1981] used principal components analysis to reconcile the results of eight failure prediction models which included thirty-four different financial ratios. They argued that many of the different ratios overlapped, for example because they were variants of the balance sheet equation. Their analysis showed that twenty-four of the ratios could be classified by one of seven factors, namely return on investment, capital turnover, financial leverage, short-term liquidity, cash position, inventory turnover and receivables turnover. Nine of the remaining ten ratios correlated highly with various ratios classified within the seven factors. According to Chen and Shimerda, the selection of one ratio to represent each factor can account for most of the information provided by the remaining ratios of that factor. Moreover, the inclusion of more than one ratio from a factor results in statistical problems which distorts the relationship between dependent and independent variables and causes sample sensitivity. However, their study did not identify which ratio should represent each factor and thus did not provide a testable failure prediction model.

The effectiveness of the various models is difficult to gauge but appears to have varied considerably. Generally, the effectiveness of the models was reported in terms of their misclassification rate one or more years prior to failure. However, there were some inconsistencies in the way in which these misclassification rates were calculated. For example, some of the studies reported misclassification rates specifically for failed firms rather than an overall rate for both failed and non-failed firms. In addition, some of the studies reported misclassification rates based on derivation samples rather than on validation samples, despite the fact that discriminant analysis results generally have an upward bias with respect to original sample accuracy. Table 2.2 compares the accuracy of the various studies which reported overall misclassification rates for one or more years prior to failure, based on validation samples, or original samples where these samples were not actually used to derive the model. This table indicates that the misclassification rates of these models one year prior to failure varied from 6 per cent to 37 per cent. Four of the eleven studies included in Table 2.2 had misclassification rates of less than 10 per cent one year prior to failure. A further five had "one year prior" misclassification rates between 10 per cent and 16 per cent and the remaining two models had misclassification rates of more than 20 per cent. Thus, whilst it can be claimed that several of the models were effective one year prior to failure, many of them had significant misclassification rates. Moreover, generally the misclassification rates increased substantially as the period prior to failure increased.

More importantly, the follow-up studies did not replicate the misclassification rates reported in the original studies. For example, when Altman and McGough [1974] tested the Altman [1968] model on a sample ot firms which had failed since 1970, they found that the model misclassified 18 per cent and 42 per cent of the sample one and two years prior to failure, respectively. The misclassification rates for *failed* firms reported in the original study were 6 per cent one year prior to failure and 28 per cent two years prior to failure. Likewise, when Moyer [1977] tested the Altman [1968] model he found it had an overall misclassification rate of 24 per cent one year prior to failure.

Furthermore, even the four reasonably effective models did not agree over variables. For example, the models of Wilcox [1973], Blum [1974], Altman *et al* [1977] and Van Frderikslust [1978] each had misclassification rates one year prior to failure under 10 per cent, yet none of the ratios in Wilcox's model were present in the other three models. Only two of Blum's eight ratios were included in the Altman *et al* or the Van Frederikslust model. Likewise,

Table 2.2 Effectiveness of Failure Prediction Models

Author	Misclassification Rate (%): Year Prior to Failure				
	1 year	2 years	3 years	4 years	5 years
Beaver [1966]	13				22
Wilcox [1973]	6	10			24
Altman [1968]	16				
Deakin [1972]	22	6			15
Blum [1974]	6	20	30	30	30
Altman *et al* [1977]	9	11			23
Dambolena and Khoury [1980]	13				22
Van Frederikslust [1978]	8			22	
Castagna and Motolcsy [1978a]	15	24			17
Castagna and Matolcsy [1981]	10			33	19
Booth [1981]	37				

only one of the Altman *et al* seven variables was included in Van Frederiklust's model.

Clearly, there were significant differences amongst the various studies in both ratio selection and effectiveness. These differences may have reflected differences in format. For example, some studies identified separate functions for each of a number of years prior to failure. Some of these had the same variables and different coefficients, while some also had different variables. Other studies identified only one function applicable to a number of years prior to failure. Some functions included large numbers of variables while others were based on reduced sets. Other factors which may have contributed to the inconsistencies amongst the models include inconsistent definitions of failure, differences in sample sizes, differences in the rationale underlying the selection of test ratios (and hence the test ratios selected), inconsistent matching criteria, differences in firm sizes included in the various studies and differences in the periods to which the studies related and hence possible interference from temporal factors.

Moreover, Begin *et al.* [1979] suggested that inconsistencies amongst the U.S. models may also reflect inconsistent data sources.

The inconsistencies in the variables amongst the various failure prediction models may simply reflect the use of overlapping ratios or the inconsistencies in approach discussed above. Alternatively, they may reflect the existence of a number of different failure processes, each with its own set of financial ratio symptoms. In this situation, a number of different failure prediction models would be appropriate. The basic premise of the failure prediction studies has been that, although failure may be caused by different circumstances, it can be predicted by developments in certain ratios which are common indicators of, a firm's state of health. Recent studies, however, have suggested the existence of a number of different failure processes.[9] It is possible that these different processes may be reflected in financial statements in different ways. The ratios which predict failure for a firm subjected to one failure process may not be appropriate for firms subjected to other failure processes.

Consider an analogy between corporate and human health. When the heart stops beating, the human body is dead. When a firm goes into liquidation, legally it has died. The process of dying is often referred to as if it were a disease but, in fact, any of a large number of diseases may cause death. Likewise, corporate failure is considered the route to corporate death, but it seems that there may be a number of different failure processes. The various failure prediction studies have attempted to predicte corporate death through one set of objectively determined symptoms, namely financial ratios. Yet the different studies found different ratios were indicators of failure. The medical profession would not find this surprising. The human body is dead

[9] See, for example, Argenti [1976] and Miller [1977].

when the heart stops, there is no pulse, no blood pressure and no temperature. However, in the process of dying, the pattern of temperature, pulse, and blood pressure will vary according to the disease. Indeed, it is this very pattern of these symptoms which enables the diagnosis of the particular disease. A terminal illness may cause a rapid pulse, a very weak pulse or it may not affect pulse at all. It may cause a burning fever, abnormal coldness or it may not affect temperature at all. Likewise, blood pressure may be too high, too low or normal. The corporate body is dead when liquidated, but while dying perhaps it may display any of a number of symptoms (financial ratios), in varying conditions and in varying combinations, depending on the particular disease (failure process) affecting it.

In conclusion, it was argued that the existence of an effective failure prediction model based on a clearly defined set of financial ratios would help to refute the misinformation hypothesis. A review of the literature in this area shows that a large number of failure prediction models have been developed. These models have differed considerably over which particular ratios should be used to predict failure. It is possible that different ratios are appropriate for predicting different types or processes of corporate failure. However, very few of the models developed so far have been effective. The misclassification rates of most of them have been quite high, particularly as the period prior to failure increases. Moreover, various follow-up studies produced much higher misclassification rates than originally reported and therefore, cast some doubt on the general applicability of failure prediction models. Even the few apparently effective models have not been tested against independent data sets. Instead of attempting to substantiate them, later studies have developed new models. The literature indicates that an effective failure prediction model has not yet been developed. This lack of progress in this area may reflect inconsistencies in the financial statement data of the failing companies. In this case, it could be argued that the evidence supports, rather than refutes, the misinformation hypothesis. Clearly, the literature in this area does not reduce the need to consider whether the financial statements of failing companies have misled investors.

2.3 Investors' Reliance on Financial Statement Data

There have been a number of surveys, reported in the literature, which have examined the reliance of shareholders on financial statement data. For example, Courtis [1982] surveyed 4400 Australian shareholders from 11 public companies, to determine their reliance on annual reports and the various sections of these reports. From approximately 2000 usable replies, he found that 66 per cent of respondents considered the annual report an important source of information for equity investment decision making. Forty one per cent of those respondents considered the profit and loss statement as the most important item influencing buy/sell decisions, while 33 per cent of them considered the balance sheet most important. Other annual report items were ranked lower. Anderson [1979] surveyed 2682 Australian shareholders from 15 public companies, receiving 966 usable replies. His results also ranked the profit and loss statement as the most important part of the annual report for investment decision making and the balance sheet as the second most important part. The annual report was considered the most important source of information for equity investment decision making by 38.6 per cent of Anderson's respondents. However, 46.4 per cent of the respondents ranked stockbrokers' advice as the most important source. Winfield [1978] surveyed 850 shareholders in a private Western Australian company, and found that 70.5 per cent of his 319 respondents relied on the annual report as a source of investment information. The section of the annual report considered most informative by Winfield's respondents was the directors'/chairman's report (56.4 per cent), with the financial statements ranked second (41.1 per cent). Chenhall and Juchau [1977] surveyed 1025 Australian shareholders from two investor interest groups and received 476 usable replies. They based their study on investor interest groups because they felt that members of such groups would be active in evaluating stock and participating in stock trading. According to their survey, 30.0 per cent of respondents considered financial statements the most important source of information for equity investment decision making. Stockbrokers ranked second (27.5 per cent) and newspapers/magazines ranked third (16.6 per cent).

These surveys focused on individual investors. In addition to individual investors, a substantial and increasing part of the Australian sharemarket is now occupied by institutional investors.[10] A survey by Anderson [1981] of the usefulness of annual reports to 300 institutional investors in Australia, received 188 responses. It showed that most institutional investors considered annual reports as their most important information source. Stockbrokers' advice ranked second and company visits third. In focusing on the most important annual report items for the hold/sell decision, Anderson found that the profit and loss statement ranked first, the balance sheet second and notes to the accounts third.

A number of the studies quoted above showed that investors place strong reliance on stockbroker advice in making equity investment decisions. Clift [1973] approached 110 Victorian stockbroking firms, to determine the information sources they considered critical to equity investment decision making. From 51 interviews, he found that 60.8 per cent of respondents

[10] See Lawrisky, M. [1978] for evidence of increasing concentration of ownership and control of Australian companies.

considered annual reports critical to equity investment decision making, 56.9 per cent considered interim reports critical and 54.9 per cent considered the chairman's report critical. Other items such as company visits (23.5 per cent), current market information (21.5 per cent) and contacts (19.6 per cent) were of less significance. Thus, according to recent survey research, annual reports, particularly financial statement data, are an important source of information for equity investment decision making for both individual and institutional shareholders in Australia. Stockbrokers are also important but they, in turn, place heavy reliance on annual report data. Although these surveys generally have had response rates of less than fifty per cent, the evidence indicates that a substantial number of Australian shareholders relies either directly or indirectly on financial statement data in making investment decisions.

The reliance by shareholders on financial statement data is consistent with the concept of fundamental analysis. Fundamentalists hold that each security has an intrinsic value, which can be estimated by detailed analysis of data such as earnings, capital structure, growth and dividends. Intrinsic value is not necessarily equal to market price, because the market includes large numbers of individual investors who are relatively unsophisticated in their ability to understand and interpret information. Thus, according to fundamentalists, analysis of financial statement data underlies investors decision making and provides the opportunity for astute investors to "beat the market".

Although the concept of fundamental analysis concords with the findings that investors rely on financial statement data in making investment decisions, the fundamentalist view of capital market operations appears inconsistent with recent research in this area. In his survey of the literature on capital market efficiency, Fama [1970] identified three forms of market efficiency. The market is efficient in the weak form if security prices fully reflect information regarding past sequences of prices. The market is efficient in the semi-strong form if security prices fully reflect all publicly available information. The market is efficient in the strong form if security prices fully reflect all information, including inside information. The semi-strong form of the efficient markets hypothesis is significant in establishing the relevance of financial statement data to investors, as financial statement data constitute publicly available information. An implication of the semi-strong form of the efficient markets hypothesis is that, contrary to the fundamentalist view, analysis of financial statement data by investors in search of abnormal returns is pointless, given that this information is reflected fully in security prices immediately and in an unbiased fashion.

However, consideration of the mechanism through which market efficiency is achieved shows that, even under the semi-strong form of the efficient markets hypothesis, financial statement data are relevant to investors. Whilst the haphazard responses of naive investors to new information, such as financial statement data, may cancel each other out, the rapid and discerning responses of sophisticated investors and analysts cause a security's price to be a fair estimate of its worth. Thus, the market is dependent on the analysis of new information by skilled analysts to keep it efficient.

A pertinent question is, that if there are no opportunities for abnormal gains in an efficient market, why do sophisticated investors and analysts use financial statement data and keep the market efficient? Ball, Brown and Finn [1977, p.2] attempt to explain this apparent inconsistency by arguing that security prices reflect heterogeneous expectations. They suggest that

> "Security prices are based on expectations of future returns, and since the future is not perfectly predictable,

> expectations only rarely turn out to be perfect descriptions of actual events ... The analyst who can make superior forecasts of fundamental factors, such as changes in earnings and dividends, will be in a position to earn abnormal returns."

The availability of abnormal earnings to analysts with superior forecasting ability was substantiated by Foster [1979]. He studied the effects of 15 articles by Briloff, involving 28 companies. Briloff's articles, based only on publicly available information, suggested that the reported earnings of those companies were manipulated by management. According to Foster, the Briloff critiques stimulated a permanent average share price fall of around 8 per cent. Since the information used by Briloff was available publicly, in an efficient market it should have had no effect. However, Foster argued that, with the recognition of heterogeneous analytical abilities, the test of efficiency becomes more complicated, depending on the price reaction appropriate to individuals' analytical abilities.

Under the efficient markets mechanism, capital markets adjust quickly and in an unbiased manner to new information. Thus, as recognized by Ball and Brown [1968, p.161], in their study of security price reactions to annual earnings announcements, in the New York Stock Exchange

> "an observed revision of stock prices associated with the release of the income report would thus provide evidence that the information reflected in income numbers is useful"

Ball and Brown claimed that it is unexpected, as distinct from expected, information which is of value. Their first step was to derive a model which could be used to calculate expected income. The amount of new information in income data was measured in terms of the difference between actual and expected income, which they described as income forecast errors. They then used the correlation between income forecast errors and stock price changes, after adjustment for general market price movements, to indicate the extent to which the information conveyed by the annual earnings data was new and relevant to investors. Price behaviour was examined over the period twelve months prior to and six months after the earnings announcement for securities where actual earnings were higher than expected and for securities where actual earnings were lower than expected. The results showed that unexpected income changes were associated with specific stock price movements, thus confirming that the income data contained information useful to investors. However, Ball and Brown's study found that only 10 to 15 per cent of the price adjustment took place in the month of the income announcement. Most of the information content of earnings data was actually anticipated by the market, presumably on the basis of more timely data sources. Thus, Ball and Brown's study implied that earnings data contained information useful to investors but that the usefulness of this information tended to be pre-empted by other more timely sources of data. It must be noted that their conclusions are highly dependent on the model used to predict expected income and to calculate unexpected earnings changes.

Beaver [1968a] looked at both price and volume reactions on the New York Stock Exchange following annual earnings announcements. He argued that if earnings data convey information to investors, in terms of influencing their expectations, an atypically large volume of share transactions will occur at and subsequent to the release of these data. Using a sample of 143 firms which released their earnings data over 1961 to 1965, he found that the volume of transactions in a firm's shares in the announcement week was approximately 33 per cent greater than in the average nonreport period, and that the volume in weeks immediately preceding the announcement was low and in the weeks immediately after the announcement was high. Thus, according to Beaver [1968a p.74]

> "Investors do shift portfolio positions at the time of the earnings announcements and this shift is consistent with the contention that earnings reports have information content."

More recent studies have focused on the information content of quarterly, as distinct from annual, earnings data. For example, Brown and Kennelly [1972] used Ball and Brown's technique to show that quarterly earnings-per-share data convey new and useful information to investors. Likewise, May [1971], focusing on price reactions, and Kiger [1972], focusing on volume and price reactions, confirmed that quarterly earnings announcements contain information useful to investors. The usefulness of quarterly earnings data is consistent with Ball and Brown's findings that most of the information content of annual data is pre-empted by more timely sources.

Certainly financial statement data do not have a monopoly on information. Gonedes [1972] noted the competitive context of financial statement numbers. Information competitors include data which reflect industry and economy wide events, such as industrial production numbers, government policy announcements and national income forecasts. They also include data which relate specifically to the firm, such as statements by company officials and brokers' releases, as well as quarterly earnings announcements. Where security prices shift prior to the release of financial statements, it appears that these competing sources pre-empt the informational value of financial statement data.

Although most of the studies of the information content of accounting numbers have concentrated on earnings data, Martin [1971] included eight annual report accounting variables in his model to explain the variability in price earnings ratios. According to Martin [1971, pp.1-2], his results showed that

> "a real and definite relationship exists between annual report data and market rates of return"

thus showing the decision relevance of his annual report variables. Gonedes [1974], on the other hand, showed that, although several accounting numbers considered jointly provide information pertinent to assessing security returns, these results differed little from those based simply on earnings per share data.

In the Australian context, Brown [1970] used Ball and Brown's method to assess the information content of annual earnings data. He found that approximately one-half of the annual adjustments in share prices can be related to earnings per share reports but that only 20 to 25 per cent of these adjustments occurred in the month in which the annual report is released. Thus, Australian investors anticipated approximately three-quarters of the information content of annual profit announcements.[11]

The security price reaction studies suggest that financial statement data are relevant to investors but that much of their information content is preempted. However, these studies have a number of weaknesses. For example, they overlook the fact that financial statements contain useful information even if they merely confirm expectations based on other data sources. Indeed, Hines [1982] argued that, since competing data sources such as interim profit announcements and brokers releases are not subject to audit requirements, financial statements contain new information in terms of the auditors' report, which validates previous information. A study by Firth [1978], in the U.K., showed that security prices reacted immediately and in the direction expected,

[11] Lev [1974] attributed the higher information content of Australian annual earnings data, compared to their American counterparts, to the fact that more timely interim reports were released only half-yearly in Australia, compared to quarterly in the U.S.

after the release of certain types of audit qualifications. Likewise, in a study of the effects of audit qualifications on the security price estimates of financial analysts, in the U.S., Estes and Reimer [1979, p.161] concluded that

> "The auditors opinion is not merely a conveyor of information, its form is a separate stimulus in the decision models of informed investment-oriented users of financial statements."

In Australia, Ball, Walker and Whittred [1979] also found an association between certain types of audit qualifications and changes in shareholders' assessments of the value of securities. These studies are consistent with the concept that audited financial statements contain new information.

The security price reaction studies have tended to focus only on short-term reactions. For example, the Ball and Brown [1968] study looked at stock price movements 12 months before and 6 months after the release of earnings data. Beaver [1968a] looked at price/volume reactions eight weeks either side of the information release. Hines [1982] argues that these studies ignore the impact of financial statement data over the longer run. Timeliness becomes less significant once it is recognized that investors have heterogeneous predictive abilities. An investor with superior ability is not prevented from earning abnormal returns simply because information is not new. In addition, frictions, such as transactions costs and short-term capital gains taxes, may retard investors' reactions. Thus, financial statement data may have a delayed input in investor decision making. Moreover, security price and security trading volume measurements assume that financial statement data only contain information relevant to buy, hold and sell decisions. However, these data may also influence shareholders to remove directors or, at least, to modify their management.

Furthermore, security price reaction studies may understate the relevance of financial statement data to risk assessment. Dyckman, Downes and Magee [1975] argued that accounting data's relevance to risk assessment may or may not produce market effects, or may produce market effects which are offsetting. Beaver, Kettler and Scholes [1970] provided evidence that accounting data are relevant to the market's assessment of systematic risk. In Australia, Castagna and Matolcsy [1978] confirmed the existence of a relationship between accounting variables and systematic risk. As Hines [1982, p.308] concluded

> "Just how investors assess risk is not known ... However the evidence indicating that risk assessment is improved by the use of accounting variables which are extracted from financial statements suggests that annual reports may be useful for risk assessment and prediction."

It seems, therefore, that the security price reaction studies have understated the relevance of financial statement data to investors.

Briefly, the semi-strong form of the efficient markets hypothesis implies that investors' analysis of financial statement data, in search of abnormal returns, is pointless. Such information is said to be reflected in security prices instantaneously and in an unbiased way. Nevertheless, in practice, market efficiency is actually achieved through the rapid and discerning reaction to new information, particularly by skilled analysts. The analysts are motivated by the opportunity to earn abnormal returns, through their superior predictive ability. Under this mechanism, security prices react rapidly, but not instantaneously, to new information. Thus security price reactions can be used to indicate the informational value of financial statement data. The empirical evidence in this area indicates that financial statement data, particularly earnings, have information content for investors, but that most of this information content is pre-empted by other more timely data sources. However, these studies have ignored the validation role of the auditors' report, overlooked the possibility that financial statement data may have a delayed impact on investors and have not taken account of the relevance of financial statement data to investors' risk assessments.

In conclusion, a review of the literature shows that the assumption that financial statement data are relevant to investors seems appropriate, at least as far as shareholders are concerned. It is supported by surveys of shareholders and their advisers. It is basic to the concept of fundamental analysis. It is not invalidated by research in the efficient markets context. Despite the existence of a substantial body of literature on the relevance of financial statement data to shareholders, their relevance to other investors, such as debenture holders, note holders and depositors has received little attention in the literature to date.

CHAPTER 3

METHODOLOGY

3.1 Defining the Terms

The hypotheses postulate that certain failed companies have produced finncial statement data which misrepresented their results and financial position, and that the accounting profession can be held responsible for this situation. In this context, the accounting profession refers to the body of accountants represented by the two professional accounting groups in Australia, the Australian Society of Accountants (the A.S.A.) and the Institute of Chartered Accountants in Australia (the I.C.A.A.). However, the concept of failure is more difficult to define.

A brief survey of the literature indicates that there is no single definition of business failure. Chapter 2 showed that, even within the narrow context of failure prediction studies, a number of different definitions existed. In general, however, these definitions tended to focus on the legal aspects of failure. In a broader context, it has been recognized that failure also may occur in an economic sense. For example, Altman [1971, p.2] identified economic failure as

> "the situation where the realized rate of return on invested capital, with allowances for risk considerations, is significantly and continually lower than prevailing rates on similar investments."

whereas he considered that legal failure referred to the situation

> "when a company can no longer meet the legally enforceable demands of its creditors."

Moreover, according to Altman [1971, p.2], at least in the U.S. the terms failure, insolvency and bankruptcy often are used interchangeably.[1] Insolvency in a technical sense occurs when a firm cannot meet its current obligations, whereas insolvency in a bankruptcy sense occurs when a firm's total liabilities exceed the realizable value of its assets.

In a similar vein, Schall and Haley [1980, pp.740-741] recognized that failure could be economic or contractual. Under their definition, economic failure occurs when a firm

> "does not generate after tax revenues sufficient to cover its costs of production and to yield a return on investment adequate to justify that investment in the enterprise."

Contractual failure occurs when a firm

> "is unable to meet its contractual obligations to its creditors".

Moreover, they identified two types of contractual failure, illiquidity and insolvency. Illiquidity occurs when a firm is unable to meet its maturing debt obligations and interest payments, and insolvency occurs when the firm's total liabilities exceed the value of the firm.

Some authors have focused on the legal or contractual concept of failure, ignoring the economic concept. For example, Van Horne [1977, p.652] considered technical insolvency and insolvency in bankruptcy as the two extremes of business failure, defining failure as "the entire range of possibilities between these extremes". Likewise, Lev [1974, p.133] interpreted failure as

[1] As discussed Chapter 2, in the U.S. the term "bankruptcy" is used for companies as well as individuals but in Australia the term is not used in the corporate context. However, for ease of exposition the term is used here. The literature from the U.S. places considerable emphasis on bankruptcy as a form of buisness failure and despite differences in nomenclature, the condition which it describes constitutes failure in Australia as much as in the U.S.

> "severe financial and/or operational difficulties reflected in either insolvency or bankruptcy."

As discussed in Chapter 2, in his pioneering work on the prediction of corporate failure, Beaver [1966, p.71] classified firms as failed if they were unable to pay preference dividends or meet debenture commitments, or had overdrawn bank accounts, as well as those which went bankrupt. His definition formalizes Schall and Haley's concept of contractual failure. In an Australian context, Waite [1980, p.23] defined corporate failure as

> "the situation when a company is insolvent, unable to meet its commitments and either placed into receivership or liquidation or needs to be the subject of a corporate rescue."

This definition also represents an interpretation of the conditions of illiquidity, recognizing that illiquidity may be relieved through corporate rescue instead of progressing through to legal failure.

Other writers have defined failure in more general terms. For example, Argenti [1976, p.6] considered that failure referred to

> "a company whose performance is so poor that sooner or later it is bound to have to call in the receiver or cease to trade or go into voluntary liquidation, or which is about to do any of these, or has already done so."

This definition combines economic failure with contractual failure, recognizing that poor profitability results in legal consequences such as receivership or liquidation. Moreover, Argenti [1976, p.6] distinguished failure from collapse which he defined as

> "the transformation from corporate wealth to a struggle for survival"

Miller [1977, p.43] also emphasized performance in his definition of failure. He considered that a firm had failed if it had suffered from periods of poor profitability and eroding market share, although it may not necessarily have gone bankrupt. Miller's definition is essentially one of economic failure although it is less specific than the Altman and Schall and Haley definitions.

Thus, there is no generally accepted definition of business failure. Failure may occur in an economic sense or in a legal/contractual sense. Moreover, within the legal context, failure may occur in a liquidity sense or in a negative net worth sense. Some definitions have recognized both the economic and legal aspects of failure. Others have focused on one aspect to the exclusion of the other. Some definitions have defined specific conditions of economic or legal failure. Others have been more general. An examination of these definitions suggests that, rather than business failure being a specific condition, it is a continuum of conditions, with economic failure at one end of the spectrum and insolvency or bankruptcy at the other. Economic failure in its broadest sense refers to poor profitability. Depending on the degree of profitability problems and the period over which they extend, economic failure may result in liquidity problems.[2] Unresolved economic failure will eventually result in the net worth of the business becoming negative. Although Argenti distinguished corporate collapse from failure, corporate collapse fits within this continuum as it reflects economic failure which has converted a previously successful company to a struggling one. The extent of the collapse determines whether the failure is simply economic or whether the company fails in the legal sense as well.

The examples quoted in Chapter 1 indicate that criticism of financial statement data and the accounting profession has followed a number of

[2] Although, poor cash management can result in liquidity problems without economic failure.

different failure situations. In some cases, it has followed the placement of companies into receivership and/or liquidation, which is legal failure. Criticism of the accounting profession has been particularly prominent where liquidation has resulted in assets realizing well below their book value, that is where legal failure in the negative net worth sense has occurred. In other cases, criticism has followed major reversals of reported profits or substantial asset writedowns, that is where economic rather than legal failure may have occurred. In the cases where legal failure has occurred, it has followed economic failure. For example, Cambridge Credit was unprofitable over a considerable period before being put into receivership and eventually liquidated. However, where economic failure has occurred, legal failure has not necessarily followed. For example, F.C.A.'s profitability declined and its assets required major writedowns, but it was not placed into liquidation or receivership. Criticism of the accounting profession following economic failure has been based on a general concept of economic failure rather than a specific concept, such as Altman's rate of return on invested capital. Moreover, firms which have suffered the milder forms of economic failure, such as unsatisfactory profitability over time, have not produced any public outcry against the accounting profession.

Thus, in the context of this study, corporate failure refers to substantial economic failure and/or legal failure. It is these types of failures which have resulted in criticism of Australia's accounting profession.

3.2 Selecting the Case Studies

3.2(i) The Relevance of a Case Study Approach

To test the hypotheses, it is necessary to analyse the financial statement data of companies which have experienced substantial economic failure or legal failure, to determine whether these data provided a clear and timely warning of failure and, if not, to assess the accounting profession's responsibility. Given the depth of analysis required, it is not possible to examine the financial statements of all companies which have failed, even within the last decade. Instead, this thesis is based on a case study approach.

The case study approach is often criticized for its failure to provide any basis for generalization. However, it is an accepted research method in other areas of social science, particularly in the behavioural and organizational sciences and there is mounting evidence to suggest that it is an appropriate tool for accounting research. For example, Hagg and Hedlund [1979] discuss the use of the case study approach in accounting research and marshall several arguments in its favour. First, from the "holistic" viewpoint, the meaning of data may only become apparent when they are interpreted as part of their environment. Case studies can provide an efficient means of observing accounting data in their environment. Second, the case study approach is particularly relevant in accounting where there is no recognized theory to guide the selection and interpretation of data. Third, case studies are dynamic. Instead of simply drawing accounting data from a particular point in time, case studies would recognize the historical developments which produced these data. Moreover, Hagg and Hedlund reject the commonly held notion that the case study approach is appropriate for hypothesis generation but not for hypothesis testing. Some hypotheses may require in-depth investigation to observe the phenomemon being tested. In this situation, it is most appropriate to use case studies to test hypotheses. The case study approach is also appropriate for testing hypotheses where the context of the phenomenon being observed is not constant. According to Hagg and Hedlund, the case study approach has not been widely used in accounting research. However, they conclude (p.142) that

> "Case methods could play an important role in accounting research ... Indeed, ... we would venture to suggest that in the longer term case methods will come to be accepted as one of the many research strategies that are available and useful for the conduct of research in all areas of accounting."

Whilst it is true that the case study approach has received little attention in the field of financial accounting research, it appears to have gained some acceptance in management accounting research. For example, Markus and Pfeffer [1983] used a case study approach to analyze the effects of power structures on accounting and control systems in various organizations. They advanced three hypotheses to explain resistance and system difficulty and used several cases collected by themselves or drawn from the literature to test their hypotheses. According to Markus and Pfeffer [1983, p.210] these cases

> "... can be used to illustrate and illuminate the arguments. [They] ... offer some support for our hypotheses, as well as providing data on the specifics of the processes we have described."

They concluded that the evidence from the case studies indicates that the failure to consider contextual factors, such as power distributions, has limited both the practice of designing and implementing accounting and control systems and the research perspectives on these systems. They used their study to suggest areas for future research.

Boland and Pondy [1983] also used a case study approach to examine the interaction of natural and rational aspects of accounting in organizations. Their study was based on two cases. In one case, they examined the budgeting process in a university during a period of limited growth. In the other case, they examined the role that accounting analysis played in the decision to close branches of a school in an area with declining enrolments. Boland and Pondy [1983, p.233] considered that these two studies

> "provide a basis of appreciating accounting in organizations as an interaction of natural and rational systems."

Merchant [1985] used a case study approach to explore how one class of decisions, discretionary program decisions, are controlled in decentralized firms. He based his research on the study of discretionary program decisions in two firms. Merchant used evidence from interviews with managers at the two firms, combined with evidence from the literature, to generate two main hypotheses. He then conducted a questionnaire survey with a sample of managers from one of the two firms, which he described as the target company because of its reputation for management excellence. He analysed the results of this survey using formal statistical analysis and identified a number of factors which influenced discretionary program decisions. However, on the one hand, he considered that the fact that the statistical data were collected from only one firm made generalizing to other firms risky, because each firm has unique management systems and philosphies and these factors can influence discretionary program decisions. On the other hand, he recognized that the case study approach was necessary "to allow for an intensive study of the research site". Merchant [1985, p.82] concluded that

> "These limitations notwithstanding, some of the findings were found both in the interviewing and questionnaire phases in the study and statistical significance was demonstrated, so progress can be said to have been made. But certainly much more study is needed about this very complex, but important, function of management which relies heavily on the use of AIS. And, as has been pointed out in increasing frequency in recent years in the accounting literature ... field research is the most fruitful path toward gaining first hand knowledge of how accounting and control systems work in the actual contexts in which they operate."

These three studies indicate that the case study approach is an accepted research method in the area of management accounting. In each of these studies, an in-depth approach was required to obtain an understanding of the phenomena being examined. The case study approach ensured that these phenomena were interpreted in context and in the light of the dynamic processes which had influenced their development. Each of the three studies used cases to test hypotheses although Merchant initially used his cases, in conjunction with the literature, to generate his hypotheses. The studies differed over the extent to which generalizations could be made. Merchant considered generalization "risky". He argued that "progress had been made" but that further study was necessary. Markus and Pfeffer considered that their cases "illustrated" and "illuminated" certain arguments and offered some support for their hypotheses, which were expressed in terms of organizations in general. Moreover, they discussed the implications of their findings for the practice of designing and implementing systems as though they were of universal application. However, they also identified the need for further study in the area. Boland and Pondy also generalized from the results of their two case studies, by suggesting that they provide "a basis for appreciating" the interaction of natural and rational systems in accounting in organizations.

These studies confirm the Hagg and Hedlund view that the case study approach can be useful in accounting research, especially in areas where it is important that data are viewed in context. It is particularly important that the financial accounting of failing companies is studied in depth. After all, these companies may have a vested interest in manipulating their accounting data to disguise their demise. To the extent that this occurs, the published financial statements of failing companies are an unreliable data source. (Indeed, creative accounting may explain the high misclassification rates of some of the failure prediction models.) The studies also support the Hagg and Hedlund view that the case study approach can be used for hypothesis testing, although they differ over the extent to which case study results may be generalized. However, the misinformation and responsiblity hypotheses are cast in specific rather than general terms. They are confined to the financial statement data of *certain* failed or failing companies. Thus, there is no problem with using case studies to test these particular hypotheses. Moreover, although the hypotheses are specific, the findings of the case studies may have important implications for the accounting profession as a whole. For example, the accounting profession requires *all* members to produce financial statements which present a true and fair view of a company's results and financial position. If it can be shown that some members ot the profession have produced financial statements which do not present a true and fair view, these findings may have implications for the profession, in terms of its definition of a true and fair view and/or its control over its members.

3.2(ii) The Six Cases

The case studies comprise six finance companies, Reid Murray Acceptance Ltd., Latec Investments Ltd., and Stanhill Development Finance Ltd., each of which failed in the early 1960s, and Cambridge Credit Corporation Ltd., Associated Securities Ltd. and Finance Corporation of Australia Ltd., each of which failed in the mid to late 1970s.

Reid Murray Acceptance Ltd. (R.M.A.) was the finance company for the Reid Murray group which collapsed in the early 1960s. R.M.A. was placed into receivership in January, 1963. At that time, this was the largest public company failure in the history of Australia. According to estimates, R.M.A.'s failure cost investors approximately $41m.

Latec Investments Ltd. started as a small finance company in 1953. Throughout the 1950s, it expanded rapidly and developed a reputation as a dynamic company and a growth stock. Latec was placed into receivership in September, 1962. Although it eventually traded out of its difficulties, it is estimated that Latec's collapse cost investors more than $8m.

Stanhill Development Finance Ltd. (S.D.F.) was the finance company associated with the Stanhill group of companies, which was heavily involved in the development of the ill-fated Chevron Sydney Hotel. S.D.F. was floated in late July, 1960. By December of the same year it was suffering from severe liquidity problems, although it managed to avoid receivership until early 1963. Subsequently, the receiver was appointed as liquidator and, according to estimates, the collapse of S.D.F. cost investors at least $5m.

The failure of Cambridge Credit Corporation Ltd. was one of the largest company crashes in the history of Australia. The company went into receivership in September, 1974. Although the affairs of Cambridge have not yet been finalized, investor losses are estimated at between $67m and $90m.

Associated Securities Ltd. (A.S.L.) was placed into receivership in February, 1979. Its affairs also have not yet been finalized, but it is estimated that A.S.L. investors lost between $80m and $88m.

Finance Corporation of Australia Ltd. (F.C.A.) was the finance company owned by the Bank of Adelaide. Although F.C.A. was not placed into receivership, it suffered a significant collapse during 1979. It was forced to make major asset writedowns which resulted in the Bank of Adelaide having to merge with the Australia and New Zealand Banking Group. According to estimates, the writedowns resulted in investor losses of approximately $39m.[3]

[3] As discussed later, in most cases these estimates understate the investor losses because of their failure to take account of losses in purchasing power and opportunity costs, on funds eventually retrieved.

3.2(iii) Criteria for Case Selection

These six companies were selected for several reasons. First, being finance companies, they were highly geared and relied heavily on public subscriptions. Their failures cost investors dearly. Indeed, it was failures such as these which stimulated the criticisms which underlie both the hypotheses. Second, three of the case study companies failed in the 1960s and three failed in the 1970s. The cases have been selected from two decades to identify the relevance of improvements in accounting standards, in testing the responsibility hypothesis. Third, finance companies, with their dependence on public subscriptions and hence on investor confidence, may have more incentive to disguise failure than most lower geared companies. In a sense, these finance companies represent extreme cases which means that if there is any evidence of companies producing financial statement misinformation, it should appear in these cases. Finally, four of the six companies were the subject of government investigations which were instigated under the *Uniform Companies Act (1961)* and a fifth company was the subject of a Supreme Court inquiry. The reports of these investigations provide a rich data source. It should be noted that under the *Uniform Companies Act (1961)*, investigations were instigated where

> "It is desirable for the protection of the public or of the members or creditors of a company or of the holders of debentures of a company or of interests made available by a company."[4]

Misleading investor information would satisfy these conditions. Thus, four of the cases are also "extreme" in this sense, as there is a greater likelihood of misleading information having been produced by failed companies investigated under the Act, than by failed companies which did not attract

[4] *Uniform Companies Act (1961)*, s.170 (1)(a).

government investigation.

The selection of extreme cases is an accepted technique in the case study approach. According to Hagg and Hedlund [1979, pp.139-140],

> "Usually the most economic research design is to select for intensive study some 'cases', the elucidation of which will provide maximum information for a given amount of scientific resources. Therefore atypical cases (observations) may be more valuable than typical representative ones."

Thus, the use of extreme cases rather than representative ones does not cause any methodological problems provided that the results of the individual case studies are interpreted carefully. As discussed above, the hypotheses are worded in specific terms and therefore in each case study the acceptance or rejection of the hypotheses will relate only to the financial statements of the case study company. Whilst no attempt will be made to draw conclusions about the quality fo the financial statements of failing companies in general, this does not prevent discussion of the implications of the findings of various cases for the accounting profession.

The cases do not include a group of non-failed companies. The inclusion of non-failed comapnies would serve two purposes. First, it would give some indication of whether the production of financial statement misinformation was confined to failing companies and therefore related to the failure process. However, to identify financial statement misinformation it is necessary to compare a company's actual condition with the condition described in its financial statements. For the failed companies, the assessment of actual condition depends largely on post-failure reports by third parties, such as receivers' statements of affairs, valuations by potential merger partners, and government inspectors' reports. Generally, such information is not available for companies which have not failed and, thus, it would be difficult to identify financial statement misinformation for non-failed companies. The second reason for including non-failed companies as case studies is that their data could be used as a control against which the data of the failed companies could be assessed. An in-depth analysis of the financial accounting of several successful companies is beyond the scope of this thesis and, in any case, would be restricted by the data limitations discussed above. However, the control purpose can be met, to some extent, by analyzing the financial ratios for various non-failed finance companies, although it is acknowledged that this relatively superficial approach runs the risk of presenting data out of context. The final section of this chapter presents financial ratios for the industry as a whole and for two non-failed finance companies. Significant differences between these data and the financial statement data of the failed finance companies may indicate that the case study financial statements contained useful information rather than misinformation.

3.3 Testing the Misinformation Hypothesis

3.3 (i) The significance of financial statement data to investors

The misinformation hypothesis implicitly assumes that investors are influenced by financial statement data. It is beyond the scope of this thesis to test whether the financial statement data of the case study companies actually influenced investors. However, according to the literature reviewed in Chapter 2, recent research shows that shareholders consult financial statement data in making equity investment decisions and that these data have information content for shareholders. Little research has been done on the reliance of other investors, such as debenture holders, note holders and depositors, on financial statement data. Like shareholders, these investors must choose between certain, current consumption and expected (uncertain), future consumption. In their case, the future consumption depends upon interest payments and principal repayment, which are in most cases more certain than the expectations associated with shares. However, intuitively, it would seem that financial statement data are likely to be useful in assessing the security of these expectations. Certainly this belief is consistent with U.S. and Australian interpretations of financial reporting objectives. For example, in the U.S., the Financial Accounting Standards Board [1978] asserted that

> "Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence."

More emphatically, the American Accounting Association [1971, p.610] stated that

> "Accounting reports provide the information by which millions of investors judge corporate investment performance and by reference to which they make investment decisions. Every day, decisions concerning the allocation of resources of vast magnitude are made on the basis of accounting information."

Barton [1982] considered the objectives of accounting in Australia. In his view, the major role of published financial reports is to provide investors with information about operations, resources and obligations, for accountability purposes. He viewed the provision of information for investment decision making as a secondary role, which was limited by the aggregated form of published financial reports and their lack of timeliness. Barton [1982, p.58] concluded

> "Because of the nature of the capital market, investors must rely mainly on other sources of information for share investment and loan decisions, and when it (i.e. financial report information) becomes available to revise their expectations and to make decisions about future actions."

Although Barton acknowledges that published financial reports are relevant to investment decision making, this role is less significant than that attributed to them by the American accounting profession. However, the available evidence suggests that practising accountants in Australia believe that financial statements have played an important role in providing information for investment decisions. A survey conducted by the Accountancy Research Foundation in the late 1960s showed that accountants practising in Australia considered that the major role of published financial statements was to inform shareholders of the company's progress. However, it was also

> "recognized that these statements are used by people other than the shareholders who are members of the company, such as debenture or noteholders, potential investors and trade creditors, whose needs cannot be ignored."[5]

Kenley and Staubus [1972] quoted the results of this survey in their study of the objectives and concepts of financial statements in Australia. They considered that financial statements should be directed primarily at the investment decisions of existing and potential shareholders. Nevertheless, they also recognized that lenders and potential lenders make investment decisions similar to those made by shareholders and, therefore, have similar needs for information from financial statements. Kenley and Staubus did question, however, whether financial statement data, in their existing form, adequately meet these needs.

Australian companies legislation has also recognised the relevance of financial statement data to debenture holders and potential investors, as well as to existing shareholders. For example, s164(1) of the *Uniform Companies Act (1961)* required that financial statements be sent to all existing shareholders, whilst s164(2) required that they be made available to existing

[5] Accountancy Research Foundation [1968, p.386.]

debenture holders on request. As far as potential investors were concerned, s39 required that prospectuses (which under s37 must accompany share and debenture issues) include details of profit and losses for the past five years and assets and liabilities at the last balance date. The *Uniform Companies Act (1961)* was superseded by the *Companies Act, 1981*, which contains similar provisions in regard to the availability of financial statement data to existing and potential investors. Companies legislation prior to 1961 also contained similar provisions.

In conclusion, legislation, the attitude of the accounting profession and recent research, all suggest that the assumption that investors are influenced by financial statement data is reasonable. However, the case studies do not test whether the investors have been influenced by the financial statement data and, therefore, it cannot be proved that they have been misled. It should be noted that where the term misinformation is used in the case studies it refers to financial statement data which have misrepresented results and/or financial position. It is not meant to imply that the data have actually misled the investors.

3.3 (ii) Determining investor losses

A major implication of the misinformation hypothesis is that financial statement misinformation may cause investor losses, by not providing existing and potential investors with a timely warning of failure. The financial statement misinformation is significant, as far as society is concerned, because of its potential to cause these losses. Thus, the starting point for each case study is the calculation of the investor losses associated with failure. The losses to shareholders can be measured in terms of the deterioration in shareholders' funds.[6] The losses to debenture holders, note holders and depositors can be measured in terms of irrecoverable principal and outstanding interest. In addition, it is necessary to consider the opportunity cost of having funds, eventually recovered, tied up in a non-earning capacity and the losses in purchasing power associated with the delay in the recovery of these funds.

3.3 (iii) The condition of the case study companies according to their financial statement data

The next step in testing the misinformation hypothesis is to determine the condition of the case study companies, according to their financial statement data. There is a complication because, at the time of the case studies, legislation required that different data sets be made available to the different classes of existing and potential investors. For example, it required that existing shareholders be provided with annual reports which include audited financial statements, and that existing debenture holders have access, on request, to these statements. Potential shareholders, debenture holders and noteholders were to be provided with prospectuses which contained accountants' reports disclosing details of past profitability and current financial position. There were no specific legal requirements with respect to financial statement data for depositors. However, the legislation required that copies of audited financial statements and prospectuses be filed with the Registrar of Companies and be made available for inspection by the public.

Since the prospectus data were based on data contained in the audited financial statements, one would expect the two sources to be consistent. However, in its statement *Accountants' Reports for Prospectuses*, the I.C.A.A. [1963c] advised members that

[6] Alternative measures based on the decline in market capitalization have not been attempted because of data difficulties. It was considered that in this context, losses based on book values would give satisfactory indication of the significance of the failures.

> "It may ... be necessary, in order that the trend of past profits may be fairly presented having regard to the purpose of the prospectus, either to make appropriate comments thereon or to adjust the figures"

and

> "Adjustments or comments may also be necessary in relation to the statement of assets and liabilities shown in the accountant's report."

This statement recommended adjustments to profit and loss data where material facts affecting previous years results became known; where the results included non-recurring material sources of revenue or categories of expenditure; where there had been a material change in accounting principles; or where accepted accounting principles had not been applied. Adjustments to the balance sheet data were also required where the effects of events occurring subsequent to the balance date might have had a material bearing on the conclusions of the intending investor. Thus, in assessing the financial statement data available to the investors in the case study companies, it is necessary to evaluate the accounting data presented in both the prospectus accountants' reports and the audited financial statements.[7] It is also necessary to determine whether the annual reports and prospectuses contained accounting information other than that disclosed in the audited financial statements and accountants' reports.

Since failure occurs over time and the misinformation hypothesis is concerned with the lack of warning of this failure process, the financial statement data issued over the life of the case study companies should be

[7] Three of the case study failures occurred prior to the release of the I.C.A.A. recommendation. However, this series of I.C.A.A. recommendations tended to endorse existing practices, rather than introduce new concepts. The prospectus data of the 1960s case studies, therefore, cannot be assumed to be the same as the data in the audited financial statements.

analysed. However, the large amount of information contained within financial statements combined with the longevity of some of the case study companies, make it necessary to limit the amount of data evaluated from each set of statements and, in some cases, the time span over which the statements are analysed. The period of analysis for the case study companies with long lives is limited to the period during which the company was active in seeking the investors' funds which were lost in the company's failure. This is the period over which the financial statement data may have influenced new investors to subscribe these funds and possibly encouraged existing investors to leave their funds in the company.[8]

The problem of deciding which financial statement items to select in assessing a company's apparent condition is more complex. If the efficient markets interpretation of the mechanisms operating in capital markets is correct, financial statement data are, or should be, relevant to sophisticated analysts but not to naive investors. This being the case, the financial statement data should be analysed from the viewpoint of sophisticated analysts. However, there are a wide variety of techniques available to financial analysts. Moreover, in Australia, the various shareholder surveys showed that financial statement data were used by a wide range of investors in making investment decisions. Likewise, in the U.S. the Financial Accounting Standards Board [1978], in its statement of objectives, emphasized the information needs of the individual investor, who is assumed to be diligent and with a reasonable understanding of business and economic activity, although not necessarily skilled. This thesis, therefore, analyses the case study financial statement data through the application of ratio analysis, which is a recognized technique of financial analysts but is also a method

[8] It should be noted that this approach fails to take account of the activities of buyers in secondary securities markets.

available to well informed individual investors. As discussed in Chapter 2, there have been numerous attempts to predict corporate failure through the application of multivariate ratio analysis. This study has adopted a multivariate approach to the extent that a number of financial ratios are assessed for each case study. However, a multivariate approach in the form of an explicit multivariate failure prediction model has not been adopted for two reasons. First, this approach is beyond most well informed individual investors. Second, despite a large body of literature in this area, there is no generally accepted multivariate model of failure prediction.

Generally, shareholders and secured debenture holders were the two main classes of investors in the the case study companies. In addition, some of the case study companies borrowed substantial amounts through unsecured notes and deposits. Investors tend to assess their investment in terms of profitability and security, with profitability being related to efficiency and security being related to solvency over both the short and long run. However, different classes of investors tend to place a different emphasis on the relative importance of profitability and security, and assess these two aspects on different bases. For example, on the one hand, shareholders, as part-owners, probably emphasize long run profitability, which is measured by ratios such as the rate of return on shareholders' funds. In the shorter run, the dividend rate also may be of interest as a measure of income. Apart from a concern with profitability, shareholders will probably have some interest in the security of their investment, which can be measured by data such as net asset backing per share or by indicators of capital structure such as the debt ratio. On the other hand, debenture holders, as secured creditors, tend to emphasize security over profitability. Common indicators of security of principal include the asset cover available for debentures as well as indicators of long run solvency such as the debt ratio. Debenture holders are also interested in the security of their interest payments, which is indicated by the interest cover ratio. In addition, given that in the long run profitability determines solvency, debenture holders also are interested in profitability. The rate of return on assets is a relevant measure of profitability from the debenture holders' perspective, as it omits the influence of leverage. Noteholders, who are generally medium term creditors, tend to be interested in the same ratios as debenture holders, except for asset cover because the principal subscribed for notes rarely is secured.

The depositors in the case study companies were not provided with financial statement data, although they had access to the audited financial statements and prospectuses through the various State Companies Offices. On the one hand, given the short term and often minor nature of this form of investment, it is difficult to imagine that many depositors sought out financial statement data. On the other hand, the depositors may have included institutional investors, who probably would have used these data. The ratios relevant to noteholders, therefore, may also have been of interest to depositors. In addition, as essentially short term creditors, depositors tend to be interested in indicators of liquidity, such as the current ratio.

It has been decided, therefore, to assess the condition of the case study companies from the perspective of the various classes of investors, on the basis of the ratios set out in Table 3.1.[9] Although none of the multivariate models have been used, it should be noted that some of these ratios, particularly the current ratio, the debt ratio, the return on total assets and the return on shareholders' funds, were amongst the most popular predictors of corporate failure in the multivariate models (see Table 2.1). In addition to using these ratios, it has been decided to assess the probable image created

[9] The method of calculating these ratios is set out in Appendix A.

TABLE 3.1: Indicators of Investment Profitability and Security

Class of Investors	Profitability	Security
Shareholders (owners)	Long run: return on shareholders' funds Short run: dividend rate	Asset backing per share Debt ratio
Debenture holders (medium to long-term secured creditors)	Return on total assets	Principal: asset cover and debt ratio Interest: interest cover
Note holders (medium to long-term unsecured creditors)	Return on total assets	Principal: debt ratio Interest: interest cover
Depositors (short-term unsecured creditors	Return on total assets	Principal: debt ratio Interest: interest cover Liquidity: current ratio

by net profit data as a result of the prominence attached to the data in the chairman's and directors' reports in annual reports, in the accountants' or auditors' reports in prospectuses, and in various secondary information sources such as stockbrokers' reports and the financial press.

Ratio analysis can be based on time series or cross-sectional data. Variations in the ratios of the case study companies over time provide the basis for time series analysis. Variations between the ratios of the case study companies and the industry averages and/or the ratios of the two non-failed finance companies presented in the final section of this chapter, provide the basis for cross-sectional analysis. On these bases and on the basis of changes in net profit, the condition of each company, according to its financial statement data, can be assessed.

However, the limitations inherent in this approach should not be overlooked. First, the financial statements of each of the case study companies were drawn up under the principles of historic cost accounting and, therefore, fail to take account of changing market values of assets and the effects of inflation. Historic cost data provide inappropriate measures of investment security because the worth of assets available for security depends on realizable value rather than acquisition cost. The relevance to ratio analysis of the failure to account for inflation is unclear. For example, Norton and Smith [1979] found little difference between the performance of a failure prediction model based on historic cost data and one based on price-level adjusted data. Yet, Ketz [1978] found that his failure prediction model based on price-level adjusted data performed better for classifying failed firms than a model based on historic cost data. Moreover, these findings may not be relevant to univariate ratio analysis.

In addition, there are limitations inherent in ratio analysis itself. For example, in cross-sectional analysis there are problems in establishing appropriate standards. Generally it is held that such standards may be influenced by industry, firm size, accounting methods and stage of development. Certainly Horrigan [1967] showed that some ratios are influenced by industry group and firm size and Holdren [1964] and Nelson [1963] showed that some ratios are influenced by accounting methods. However, on reviewing the literature in this area, Lev [1974, p.38] concluded that

> "there is only little evidence to indicate that violating the comparability criteria will seriously disrupt financial statement analysis."

The case studies use industry averages and the ratios of two non-failed finance companies as cross-sectional standards, thus reducing potential comparability problems with regard to industry, but not with regard to the other sources of variability.

Other limitations relate to specific ratios. Apart from the problems of historic cost data which undermine ratios which use asset or equity measures, there are also difficulties with ratios using current assets and earnings as indicators of liquidity. For example, the current ratio implies that all current assets are available to meet current liabilities at a point in time when, in fact, solvency depends on the timing of future receipts and payments. Likewise, the interest cover ratio implies that earnings before interest and taxes are available to meet interest commitments, when, in fact, it is liquidity which determines the ability to pay interest as it falls due. Despite these limitations, ratio analysis is an accepted technique of financial statement analysis which, with careful interpretation, should provide an insight into the condition of the case study companies according to their financial statement data.

3.3 (iv) Identifying the misinformation

Where it is shown that the financial statement data of the case study companies provided no clear warning of failure, either these data must have been inaccurate or failure occurred subsequent to the company's last balance date. However, given that the process of failure is not instantaneous, the lack of warning suggests financial statement misinformation. The next step is to determine the particular areas of misinformation. There are several data sources relevant to this task.

As discussed above, the reports of government investigations, supported by substantial resources and investigative powers, are useful. The affairs of four of the six case study companies have been subjected to a government investigation and a total of six interim and three final reports have been tabled in various state parliaments. Some of these reports deal specifically with the quality of the accounting information published by the failed company and, therefore, are most useful in testing the misinformation hypothesis. Others are less useful. The relevance of these reports to testing the misinformation hypothesis seems to depend on the terms of appointment of the various investigations and on the background of the inspectors. Under the Part VIA of *Uniform Companies Act (1961)*, the terms of appointment of a government investigation may cover all the affairs of a company or only particular affairs. The reports of the Cambridge investigation are particularly relevant to the misinformation hypothesis because its terms of appointment specifically required an investigation of some of the company's prospectuses, directors' reports and profit announcements. Moreover, one of the Cambridge inspectors was a chartered accountant. Particular affairs were not identified in the terms of appointment of the other three case study company investigations. As a result, the reports on these investigations tend to be more general, although the three inspectors appointed for the Latec investigation were chartered accountants and their report is also particularly useful. None of the reports, however, are relevant to testing the responsibility hypothesis since they focus on issues of legal rather than professional responsibility.

In addition to the data contained in the government reports, a comparison of financial position immediately before and after the identification of the failure, for example using data contained in statements of affairs or merger proposals, may be useful. However, under historic cost accounting, financial statements record non-current assets at acquisition cost, and not at realizable value. Differences between the pre-collapse financial statement values of non-current assets and post-collapse estimates of their realizable value are, therefore, probably irrelevant. The only exception may be where it can be shown that the going concern assumption was inappropriate. In this case, the financial statements should have valued all assets on a liquidation basis and differences between these values and statement of affairs values would provide evidence of misinformation. Conservatism requires that current assets be recorded in financial statements at the lower of cost or realizable value. Differences between these values and statement of affairs values may also provide evidence of financial statement misinformation. However, under the going concern assumption, realizable value is determined in the ordinary course of business and is not necessarily equal to liquidation value because of factors such as forced sale or interrupted development. As with the non-current assets, differences between current asset values in the audited accounts and in the statement of affairs could provide evidence of financial statement misinformation only where it can be shown that the going concern assumption was inappropriate. Differences between pre-collapse financial statement data and post-collapse asset values based on merger offers usually cannot be attributed to a switch to liquidation valuations. In this case, however, problems arise in using merger offers as estimates of realizable value because of the vested interest of the offeror, although, tautologically, an *accepted* offer determines post-collapse realizable values.

Other indications of misinformation in the financial statements of the case study companies may be obtained from stock exchange and financial press reports. In addition, a comparison of financial statements over time or a comparison of the financial statement data from the two different sources, such as prospectuses and annual reports, may provide evidence of inadequacies in particular aspects of the financial statements.

3.4 Testing the Responsibility Hypothesis

3.4(i) The role and responsibilities of accountants in the preparation and presentation of financial statement data

Having identified the financial statement misinformation of the case study companies, it is then necessary to determine the responsibility of the accounting profession for this misinformation. The first step in this process is to determine the role and responsibilities of accountants in the preparation and presentation of financial statement data. In practice, financial statements are prepared by company accountants, generally under the guidance of a chief accountant or principal accounting officer. These accountants are employed by, and are answerable to, the management of the company. Thus, management, ultimately represented by the board of directors, is effectively responsible for the preparation of financial statements, although usually the chief accountant has some autonomy. Directors may have an accounting background. In addition, accountants, acting as auditors, are appointed by shareholders to provide an independent assessment of the company's accounting records and financial statements. Auditors also play an important role in the provision of financial statement data in prospectuses as these data are usually contained in a report prepared by, and issued in the name of, the company's auditors. Prospectuses may contain an additional, or alternative, report prepared by accountants other than the company's auditors.

As far as the legal responsibility is concerned, under the *Uniform Companies Act (1961)* the legal responsibility for financial statement data rested with the directors, although the principal accounting officer and the auditors were required to attest to the truth and fairness of these data. For example, s162(1) and (3) required directors to "cause to be made out" a profit and loss account and a balance sheet giving a true and fair view of the results and financial position of the company. Similarly s39(4) held directors responsible for prospectuses, which are the other major source of financial statement data available to investors. Section 162(12) of the Act required directors to cause to be attached to the financial statements a statement, signed by the principal accounting officer or other person in charge of the preparation of the company's accounts, which stated whether the accounts gave a true and fair view of the profit and loss and financial position of the company. This requirement was introduced in the *Companies Act Amendment Act, 1971-72,* and became effective from mid-1973. Prior to this, under s162(13) the company secretary was required to sign a declaration attesting to the truth and correctness of the accounts. In s167, the companys' auditors were also required to report on the accounts and accounting records of the company. In particular, they were required to state whether, in their opinion, the financial statements were drawn up in compliance with the Act and, more generally, so as to give a true and fair view of the company's results and financial position. Company auditors were required, under s9, to register annually with the Companies Auditors Board. To be eligible for registration, auditors were required to be members of the I.C.A.A. or A.S.A. or to meet their educational requirements. Company accountants including principal accounting officers were not required to be registered. The *Uniform Companies Act (1961)* was effective from 1961 to 1981. Some of the case study data were produced before 1961. Earlier legislation required only auditors to attest to the accuracy of the accounts and this requirement was defined in terms of a 'true and correct', rather than a 'true and fair', view.

Thus, legislation required the case study financial statements to give a true and fair, or before 1961 a true and correct, view of the company's results and financial position and auditors to verify this view. Moreover from 1961, directors, and from 1973, principal accounting officers, were required to attest to the truth and fairness of the view provided by company accounts. According to Ryan [1967, p.96], true and fair should be interpreted in a literal sense, that is "in accordance with reality" and "just, unbiased, equitable or legitimate", although it is difficult to operationalize such an interpretation. The *Uniform Companies Act (1961)*, in particular the Ninth Schedule, set out some specific disclosure requirements to assist with the preparation of true and fair accounts. However, according to the Act, compliance with these requirements did not necessarily ensure a true and fair view. The true and fair view was an additional, overriding, but undefined requirement. In the era of the case studies, it was left to the accounting profession to operationalize the concept of the true and fair view.

The accounting profession defined a true and fair view in terms of compliance with generally accepted accounting principles. The profession's requirements applied to all members of the I.C.A.A. and A.S.A. whether acting as directors, auditors or company accountants. Compared to the legal requirements, the profession's requirements covered member-directors rather than all directors and they placed a greater duty on company accountants. The legal requirements applied only to the principal accounting officer, whereas any member-company accountant faced with a conflict between loyalty to management and duty to the profession was expected to comply with the profession's requirements. However, since there were no registration requirements for accountants other than auditors, company accountants were not necessarily members of the I.C.A.A. or the A.S.A. Auditors, on the other hand, were invariably members of either the I.C.A.A. or the A.S.A. Although the profession's requirement of compliance with accepted accounting principles is generally discussed in terms of the preparation of financial statements presenting a true and fair view, it is also applicable to the preparation of financial statement data for prospectuses.

3.4(ii) Responsibility criteria, some initial proposals

Having considered the role of accountants and their responsibilities according to the companies legislation and the accounting profession, it is now possible to derive some criteria to assess the responsibility of the accounting profession for any case study financial statement misinformation. This financial statement misinformation may have resulted from either the application of generally accepted accounting principles or the application of principles which were not generally accepted. Furthermore, the application of principles which were not generally accepted may have resulted from either the lack of clearly defined generally accepted principles or from non-compliance with generally accepted accounting principles.

Thus, it would appear that the Australian accounting profession could be considered at least partly responsible for any case study financial statement misinformation which resulted from

(i) the application of generally accepted accounting principles

(ii) a lack of clearly defined accepted accounting principles in areas where misinformation was produced

and possibly

(iii) the failure to enforce compliance with generally accepted accounting principles.

The case for this third criterion is not clear cut. On the one hand, the financial statement misinformation was not caused by any specific actions of the profession. The individual accountants involved in the preparation and audit of the case study financial statements were most clearly responsible for the misinformation. On the other hand, it could be argued that the accounting profession also had some responsibility, because of its failure to effectively enforce its generally accepted accounting principles.

However, the concept of professional responsibility is not static, rather it has evolved, and continues to evolve, over time. Thus before accepting these three criteria, it is necessary to evaluate them in the light of developments in the area of professional responsibility not just within the Australian accounting profession but in the accounting profession overseas, such as in the U.K. and the U.S., and in other professions, such as medicine and law.

3.4(iii) The development and enforcement of accounting principles in Australia, the U.K. and the U.S.

The role of the Australian accounting profession in defining and enforcing generally accepted accounting principles is outlined in detail in Chapter 4. The role of the accounting profession in the U.K. and the U.S. in defining and enforcing generally accepted accounting principles is outlined in Appendix B. The following information, drawn from Chapter 4 and Appendix B, is particularly relevant to establishing the responsibility criteria.

First, the accounting profession in each country considered that the application of generally accepted accounting principles resulted in meaningful financial statements. From an early stage in the development of the profession, members were expected to comply with generally accepted accounting principles or to justify non-compliance. However, little attempt was made to systematically codify generally accepted accounting principles until the 1930s at the earliest. The U.S. accounting profession led in this area with the introduction by the American Institute of Certified Public Accountants (A.I.C.P.A.), in 1939, of its *Accounting Research Bulletins*. In 1942, the

Institute of Chartered Accountants in England and Wales (I.C.A.E.W.) began to issue *Recommendations on Accounting Principles*. In 1946, the Australian accounting profession followed the U.K., with the publication of its series of *Recommendations on Accounting Principles*.

Second, attempts to define generally accepted accounting principles proceeded at different rates in the three countries. For example, by 1973 the various accounting principles committees of the A.I.C.P.A., in the U.S., had produced a total of 82 pronouncements, including 51 *Accounting Research Bulletins* and 31 *APB Opinions*. By 1970, the I.C.A.E.W., in the U.K., had produced 29 *Recommendations* and by 1972, the I.C.A.A. and the A.S.A., in Australia, had produced 21 pronouncements under various titles. From the early 1970s, the professions in each country restructured their procedures for defining principles, which by then were referred to as accounting standards. The new procedures improved the rate of progress in defining accepted accounting principles in each country although, once again, the achievements varied from country to country. For example, between 1973 and 1979, the Financial Accounting Standards Board (FASB) in the U.S. issued 34 standards. Over a similar period, the Australian accounting profession issued only ten standards and, in the U.K., between 1970 and 1979 fifteen standards were issued. Although some of these pronouncements were revisions of earlier pronouncements, particularly in the U.S., it can generally be concluded that the range of generally accepted accounting principles defined in the U.S. was considerably greater than in the U.K. and Australia.

Third, the profession in each country experienced, at some time, the dilemma of whether to devote its resources to defining specific accounting principles or to developing a comprehensive "theoretical" framework from which specific principles could be derived. In each country, attempts to develop a comprehensive framework have been unsuccessful.

Fourth, by the time the professional bodies in each country began to issue pronouncements on generally accepted principles, it was already widely understood that members were expected to comply with generally accepted accounting principles. However, at this stage pronouncements were not issued as binding on members. Compliance with them was effectively voluntary.

Fifth, the perceived role of the pronouncements changed over time. They became more decisive. Also, in the U.S. particularly, and to a lesser extent, in the U.K. and Australia, compliance with the pronouncements was expected. However, by the late 1960s, it had become apparent that the pronouncements in each country lacked authority.

Sixth, in the 1970s the professions in each country took steps to enforce their accounting standards. Pronouncements were issued which specifically required compliance, or disclosure of non-compliance, with accounting standards. In the U.S. and later in Australia, these requirements were included in the professions' codes of ethics. Previously, they had probably been covered under general misconduct provisions but the specific rulings gave the accounting standards much greater authority. In Australia, the I.C.A.A. introduced a systematic review of published financial statements to monitor compliance with accounting standards, although its function was more educational than disciplinary.

And finally, by the late 1970s, it had become apparent that the standard setting mechanisms introduced earlier in the decade had not been completely successful. In each country, there was general dissatisfaction within the community over the quality of financial statement information. There were calls for government regulation but, by the end of the decade, the profession in each country had largely retained its self-regulation.

3.4(iv) The codification and enforcement of standards in other professions

The three responsibility criteria identified earlier focused on the role of the Australian accounting profession in defining and enforcing generally accepted accounting principles. Before refining these criteria in the light of the developments outlined above, consideration should also be given to the achievements of other professions in codifying and enforcing their standards or rules of conduct. Appendix C outlines the major developments in the Australian medical and legal professions in these areas. The following information drawn from Appendix C is particularly relevant to the responsibility criteria.

The legal profession in Australia has not codified any technical standards or rules of conduct. The responsibility for the enforcement of the legal profession's unwritten rules of conduct has rested largely with the profession itself. To practise, lawyers are required to hold a practising certificate which is renewable annually. State legislation generally grants the various state Law Societies, which are the major professional associations within the legal profession, the right to issue practising certificates. State legislation also confers considerable disciplinary powers on the Law Societies. A major part of the disciplinary process is carried out by officers and committees of the Law Societies. The Law Societies refer serious offences, such as professional misconduct, to an "independent" statutory disciplinary tribunal. However, the legislation in most states effectively grants the control of disciplinary tribunals to the Law Societies. The disciplinary powers conferred on the Law Societies cover non-members as well as members. There is some evidence to suggest that the disciplinary mechanisms within the legal profession have been largely ineffective.

The medical profession in Australia has not codified any technical standards although, since the principles of medicine are derived from a scientific basis, such standards may not have been warranted. The medical profession in Australia, as represented by the Australian Medical Association (A.M.A.), has codified its rules of conduct from 1966 and prior to 1966 rules of conduct were spelled out by the various state professional associations. An independent statutory body, the Medical Board, controls the registration and discipline of medical practitioners in each state. Complaints to the state Medical Boards generally emanate from outside the A.M.A. The A.M.A. considers that the Medical Boards have the main responsibility for discipline within the medical profession. Disciplinary measures within the A.M.A. are confined to minor breaches of etiquette. Although the Medical Boards are independent of the A.M.A., the legislation in each state generally assures that the majority of Board members are medical practitioners. Finally, there is some evidence to suggest that the disciplinary mechanisms within the medical profession also have been largely ineffective.

3.4(v) Evaluation of the proposed responsibility criteria

It is now possible to evaluate the proposed responsibility criteria in the light of developments in standards, or more generally ethical codes, and enforcement procedures in the accounting profession in Australia and overseas and in other professions in Australia.

The first criterion stated that the accounting profession could be considered responsible for case study financial statement misinformation which resulted from the application of generally accepted accounting principles. The accounting profession both in Australia and overseas has considered that the application of generally accepted accounting principles results in financial statements which are not misleading. Members, therefore, have been expected to comply with generally accepted accounting principles. However, it has been recognized that in rare circumstances a generally accepted accounting principle may not be appropriate and in these circumstances members have been expected to disclose and justify their non-compliance. Thus, it would seem reasonable to hold the accounting profession responsible for any case study financial statement misinformation which resulted from the application of generally accepted accounting principles. However, where there was evidence that unusual circumstances rendered the principle inappropriate, the individual accountants involved in the preparation and audit of the financial statements, rather than the profession, should be considered responsible.

The second criterion stated that the accounting profession could be considered responsible for case study financial statement misinformation which occurred in an area where there was no clearly defined accepted accounting principles. However, the history of the codification of accounting principles in Australia and overseas indicates that this criterion is unreasonable. The accounting profession, both in Australia and overseas, has been unable to identify a comprehensive theoretical framework from which a cohesive and consistent set of accounting principles may be derived. Thus, the codification of accounting principles has depended on the delineation of principles, or best existing practices, relevant to particular issues. Under these circumstances, it is unreasonable to expect the profession to have developed a set of principles which cover every possible situation. The evidence suggests that over time the profession has defined accounting principles which cover a wide range of issues. Perhaps the Australian profession could be criticized for not keeping up with its American counterpart in the codification of accounting principles. However, the resource base of the profession in Australia is much smaller than in the U.S. Moreover, the achievements of the Australian accounting profession in codifying its principles compare favourably with the efforts of the accounting profession in the U.K. and of the Australian legal and medical professions.

The accounting profession should not be held responsible for misinformation in areas where principles have not been defined. However, the profession's responsiveness to its standard setting responsibilities could be assessed by considering whether it subsequently issued pronouncements, within a reasonable period of time, in the areas where misinformation was produced. This *ex-post* approach cannot be used as a criterion for determining the responsibility for the case study misinformation, but it will provide some indication of how well the profession has met its responsibilities for defining accepted accounting principles and, therefore, acted to prevent future misinformation.

The third criterion stated tentatively that the Australian accounting profession could be considered at least partly responsible for the misinformation which resulted from non-compliance with generally accepted principles because of its failure to adequately enforce those principles. To evaluate this criterion, it is necessary to consider the enforcement mechanisms available to the accounting profession. Company financial statements are prepared by accountants on behalf of directors. The accountants are not necessarily members of the I.C.A.A. or the A.S.A. and, in contrast to the legal profession, there are no statutory mechanisms to give the professional bodies control over non-members. Indeed, in contrast to both the medical and legal professions, there are no registration requirements for accountants other than auditors and consequently there are no direct mechanisms to influence the behaviour of non-member accountants. Even where company accountants are members of the profession, they prepare financial statements on behalf of the company's directors who have the legal responsibility for them. Directors are not members of the accounting profession unless they happen to have an accounting background. Company accountants are answerable to directors and it would be unrealistic to expect them to be able to force an unwilling board of directors to comply with accepted accounting principles.

Legislation requires company financial statements to be audited by an auditor registered with the Companies Auditors Board. The educational requirements of the Companies Auditors Board ensure that virtually all company auditors are members of the I.C.A.A. or the A.S.A. The profession requires an auditor to ensure that financial statements comply with accepted accounting principles or that non-compliance is disclosed and justified. Unjustified material non-compliance should result in a qualified auditors' report. Although the Australian accounting profession did not set out these requirements in a general pronouncement until the early 1970s, they had been accepted principles of auditing both in Australia and overseas for some time.

It can be argued that while the profession has no direct power over non-member directors and company accountants it can influence their compliance with accepted accounting principles through the threat of a qualified auditors' report. However, there is considerable evidence to suggest that directors pay little regard to the threat of an audit report which is to be qualified, especially on technical grounds.[10]

Thus, as far as the case study financial statements are concerned the accounting profession could only influence compliance with accepted accounting principles by member-directors, member-company accountants and auditors. Indeed, the profession had no power to directly enforce compliance by members. Instead, it had the power to discipline members for non-compliance

[10] See, for example, Henderson and Pierson [1980, pp.101-102] and Chambers [1978, p.61].

and thereby encourage compliance by others. It would be most unusual for a professional association to have enforcement power, *per se*. There is no evidence of such powers within the accounting profession overseas or within the legal and medical professions in Australia. It seems, therefore, that the responsibility of the accounting profession in this third area can only be tested by examining the disciplinary action which the accounting profession took against the various members who had not complied, or disclosed non-compliance, with generally accepted accounting principles.

This *ex-post* approach cannot be used as a criterion for assessing the profession's responsibility for misinformation identified in the case studies. However, it will give an indication of the profession's attempts to discourage financial statement misinformation through the discipline of members who have not complied with accepted accounting principles. There is some evidence to indicate that professions in general have been largely ineffective in the discipline of their members but this does not absolve the accounting profession from any action in this area.

Thus, details are required of any disciplinary action taken by the I.C.A.A. or the A.S.A. against members involved in the case study companies. Unfortunately, both the I.C.A.A. and A.S.A. have refused access to this information on the grounds of confidentiality.[11] Brief summaries of major disciplinary cases are included in the journals of the I.C.A.A. and the A.S.A. However, the names of the members disciplined were not disclosed in the I.C.A.A. journal until 1974.[12] In 1963, the General Council of the A.S.A. resolved that the names of members involved in proven disciplinary cases

[11] Letter from Mr. V. A. L. Prosser, Executive Director of the I.C.A.A., dated 16 January 1986, and letter from Mr. T. R. F. Cowie, Manager, Corporate Services and Resources, A.S.A., dated 24 December 1985.

[12] *The Chartered Accountant in Australia*, August 1974.

should be published. However, prior to 1979 some reports did not include members names. In 1979, General Council resolved that the names of members should be published in *all* proven disciplinary cases, although in 1981 this resolution was amended so that the names of members involved in minor offences were not published.[13] In brief, it is not possible to determine whether any disciplinary action was taken by the I.C.A.A. against members involved with the 1960s case study companies and details of disciplinary action taken by the A.S.A. prior to 1979 are incomplete.

3.4(vi) The revised responsibility criteria

The responsibility criteria delineated earlier require some modification in the light of developments in the accounting profession overseas and in other professions in Australia. On the basis of this information, it is proposed to use the following criteria to assess the responsibility of the accounting profession for any case study financial statement misinformation.

> i) If the misinformation resulted from the application of generally accepted accounting principles and there was no evidence of unusual circumstances which rendered the principles inappropriate, the accounting profession will be held responsible.
>
> ii) If the misinformation resulted from the application of generally accepted accounting principles but there was evidence of special circumstances which rendered the principles inappropriate, the individuals involved with the financial statement data will be held primarily responsible.
>
> iii) If the misinformation occurred in an area where there were no clearly defined accepted accounting principles, the accounting profession will not be held responsible.
>
> In this situation, the profession should have subsequently defined accepted accounting principles. If it has done so, within a reasonable period of time, it will be considered responsive to its standard setting responsibilities. If it has not done so, it will be considered unresponsive to its standard setting responsibilities.

[13] *The Australian Accountant*, June 1979 and July 1981.

iv) If the misinformation resulted from non-compliance with generally accepted accounting principles, the individuals involved with the financial statement data will be held primarily responsible.

Where the individuals were primarily responsible for the financial statement misinformation and where those individuals were members of the accounting profession, the profession should have disciplined those members. If it has done so, it will be considered to have met its responsibilities. If it has not done so, the profession cannot be held responsible for the case study misinformation. However, it will be considered to have failed to meet its responsibilities as a profession.

3.5 Some Standards for Cross-sectional Ratio Analysis

The assessment of the financial statement data of the case study companies is to be based on ratio analysis. To give this analysis a cross-sectional dimension, it is necessary to determine some standards against which the case study ratios can be compared. One solution would be to consider matched pairs, and to calculate ratios of a non-failed finance company with characteristics approximating those of each of the case study companies. However, it is difficult to find companies with similar characteristics. Alternatively, cross-sectional ratio analysis is often based on industry averages. The use of industry averages removes the possibility of incomparability with standards because of industry influences but it does not overcome the possibility of incomparability because of other factors such as firm size, accounting methods and stage of development. For example, the case study companies covered a wide range of firm sizes. Their asset bases at the time of failure ranged from $76.94m to $497.92m. Moreover, the various case study companies used different accounting methods, failed at different stages of their development and, in some cases, in different economic climates. Thus, the characteristics of the case study firms are not comparable with each other and, therefore, many of them are probably not comparable with the characteristics of the "average" firm in the industry. However, as discussed

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earlier, Lev [1974, p.38] discounted the significance of the violation of comparability criteria. In his experience, industry averages are usually used as the basis of cross-sectional ratio analysis.

Table 3.2 presents ratio standards calculated on the basis of aggregate financial statements for all large finance companies in Australia. These data are not available prior to 1963-64. Given that ratios may be influenced by temporal factors, such as the general economic climate, these ratios provide questionable standards for cross-sectional ratio analysis prior to 1963-64. Moreover, it is not possible to calculate one of the case study ratios, net asset backing per share, from the industry data. To compensate for these inadequacies, Tables 3.3 and 3.4 present ratio standards based on the financial statements of two non-failed Australian finance companies, Australian Guarantee Corporation Ltd. (A.G.C.) and Beneficial Finance Corporation Ltd. (B.F.C.). The B.F.C. ratios are calculated from 1960-61, the company's first full year of operation, through to 1978-79. They cover a period three years earlier than the industry average data but are of limited value for cross-sectional analysis prior to 1960-61. However, the A.G.C. ratios have been calculated over the period 1952-53 to 1978-79. The year 1952-53 was the earliest any of the 1960s case study companies were incorporated.

A.G.C. was incorporated in 1925 to provide motor vehicle finance. By 30 September 1981, it had grown to be one of Australia's major finance companies with shareholders' funds of $422.49m, and offering a wide range of finance services including hire purchase, instalment credit, leasing, chattel and real estate mortgages, and project and development loans. In 1957, the Bank of New South Wales (now the Westpac Banking Corporation) acquired a 40 per cent interest in A.G.C. By 1978, this interest had increased to 76.7 per cent.

Table 3.2: Ratio Standards Based on Industry Averages

Year ended 30 June	Return on S.H.F.(%)	Av div rate (%)	Debt Ratio	Return on Assets (%)	Debenture cover	Interest Cover	Current Ratio
1964	n.a.	11.52	0.84	n.a.	2.00	1.49	2.76
1965	10.53	11.01	0.85	8.24	1.94	1.52	2.84
1966	10.96	9.76	0.84	8.29	1.88	1.53	2.90
1967	11.83	9.87	0.84	8.44	1.87	1.57	2.84
1968	14.29	10.20	0.85	9.04	1.82	1.62	2.64
1969	12.14	9.65	0.86	8.43	1.84	1.58	2.61
1970	13.54	10.28	0.86	8.96	1.85	1.61	2.51
1971	13.92	9.86	0.86	9.50	1.85	1.58	2.34
1972	13.78	10.31	0.87	9.47	1.94	1.57	2.21
1973	14.31	11.75	0.87	9.33	2.08	1.59	2.17
1974	12.48	10.03	0.88	9.68	2.42	1.41	1.82
1975	9.33	9.25	0.89	10.15	2.42	1.22	1.76
1976	13.71	9.74	0.88	10.52	2.29	1.29	1.72
1977	6.52	9.41	0.88	10.29	1.88	1.18	1.95
1978	4.41	8.50	0.89	10.29	2.00	1.16	2.08
1979	7.39	8.59	0.89	10.85	2.01	1.19	2.09

Source: Australian Bureau of Statistics, *Finance Companies: Assets, Liabilities, Income and Expenditure*, 1963-64 to 1978-79.

Table 3.3: Ratios of Non-failed Finance Companies - Shareholders' Perspective

Year ended Bal.date	Return on shareholders' funds (%)		Dividend rate on ord. shares (%)		Net tangible asset backing per share		Debt ratio	
	AGC	BFC	AGC	BFC	AGC (50c)[1]	BFC	AGC	BFC
1953	18.76		11.76		1.05		0.76	
1954	20.21		15.00		1.10		0.80	
1955	19.79		15.00		1.10		0.78	
1956	15.67		15.00		1.05		0.75	
1957	13.83		15.00		1.11		0.76	
1958	12.27		15.00		1.02		0.73	
1959	9.38		15.00		1.03		0.71	
1960	7.50		15.00		1.04		0.75	
1961	9.33	11.05	15.00	4.17	1.06	0.43	0.75	0.81
1962	11.41	11.11	15.00	6.67	0.83	0.51	0.75	0.76
1963	12.67	9.09	15.00	8.00	0.86	0.52	0.80	0.82
1964	13.12	8.70	15.00	8.00	0.91	0.53	0.82	0.84
1965	14.21	9.44	15.00	8.00	0.97	0.58	0.85	0.84
1966	14.54	9.85	15.00	8.00	0.99	0.59	0.84	0.85
1967	14.51	10.20	15.00	8.00	0.93	0.61	0.84	0.86
1968	13.38	11.24	15.00	8.50	0.97	0.64	0.84	0.87
1969	13.81	11.46	15.00	9.50	1.05	0.63	0.85	0.86
1970	13.73	11.70	15.00	10.00	1.11	0.63	0.84	0.87
1971	14.13	12.85	15.00	11.00	1.19	0.64	0.84	0.88
1972	18.19	13.40	15.00	11.50	1.32	0.68	0.85	0.88
1973	15.09	13.83	18.75	12.50	1.30	0.72	0.85	0.89
1974	13.64	14.16	15.00	13.50	1.41	0.79	0.88	0.89
1975	16.69	12.30	20.00	13.50	1.25	0.86	0.88	0.88
1976	17.14	11.26	15.00	13.50	1.34	0.86	0.88	0.88
1977	16.88	10.83	15.00	13.50	1.20	0.83	0.87	0.88
1978	16.42	9.39	15.00	13.50	1.34	0.84	0.87	0.88
1979	17.60	8.52	17.50	13.50	1.51	0.83	0.87	0.89

[1] A.G.C. ordinary shares had a par value of $2.00 prior to 1960, these asset backing figures have been calculated for 1/4 of a share, ie. per 50c equivalent.

Table 3.4: Ratios of Non-failed Finance Companies-Debenture Holders, Noteholders' and Depositors' Perspective

Year ended Bal.date	Return on assets[1]		Debenture cover[2]		Interest cover[3]		Current ratio	
	AGC	BFC	AGC[4]	BFC	AGC	BFC	AGC	BFC
1953	-		-		-		1.32	
1954	-		-		-		1.46	
1955	-		6.63		-		1.95	
1956	-		5.24		-		2.20	
1957	-		3.01		-		3.30	
1958	-		3.22		-		3.37	
1959	-		1.92		-		2.76	
1960	-		1.93		-		2.63	
1961	-	-	1.68	1.32	-	-	3.38	4.71
1962	8.48	-	1.79	1.62	1.94	-	2.96	4.77
1963	8.80	9.56	1.96	1.34	1.98	1.49	2.92	4.22
1964	8.60	8.81	2.21	1.30	1.84	1.39	2.92	5.04
1965	8.63	8.65	1.96	1.50	1.81	1.46	2.60	3.28
1966	9.17	8.69	1.93	1.49	1.83	1.47	2.99	3.25
1967	8.83	8.62	1.79	1.44	1.82	1.44	2.95	2.92
1968	8.74	8.60	1.77	1.45	1.76	1.44	2.63	2.69
1969	8.71	9.14	1.73	1.42	1.68	1.48	2.72	3.14
1970	8.94	8.99	1.70	1.48	1.75	1.48	2.89	2.75
1971	9.50	9.81	1.59	1.59	1.73	1.49	2.55	2.62
1972	12.23	9.97	1.58	1.55	1.79	1.52	2.70	2.42
1973	9.48	9.40	1.82	1.61	1.81	1.50	2.64	2.48
1974	9.98	10.10	1.78	1.79	1.54	1.45	2.66	2.11
1975	10.84	12.30	1.61	1.64	1.47	1.25	2.34	1.90
1976	11.60	11.16	1.61	1.58	1.43	1.25	2.26	2.18
1977	12.46	11.78	1.66	1.68	1.50	1.23	2.34	2.28
1978	12.46	12.08	1.58	1.66	1.44	1.21	2.60	2.47
1979	12.30	11.41	1.59	1.72	1.47	1.17	2.74	1.88

1 & 3. Interest data not available prior to 1962 for A.G.C and 1963 for B.F.C.

2. Assumes debentures ranked ahead of all other liabilities.

4. Debentures not identified prior to 1955.

Through its annual reports and the financial press, A.G.C. has developed a reputation as a large and successful bank backed finance company.

B.F.C. was formed in 1960 to undertake general financing. By mid-1981, B.F.C. had expanded its lending activities, particularly in the area of residential and subdivisional real estate loans, although the company is also involved in leasing, hire purchase and personal loans. By 30 June 1981, B.F.C. had shareholders' funds of $56.09m. Although not then a subsidiary of an Australian trading bank, B.F.C. had substantial overseas bank backing, with 41.55 per cent of its share capital owned by the Bank of Tokyo and 16.30 per cent owned by the International Bank of Detroit. B.F.C. remained profitable throughout the difficult mid-to-late 1970s. However, it suffered a major setback in 1979-80 when its profit was reduced to $0.08m, due to the creation of a special $5.0m provision for possible losses from the accelerated realization of real estate projects. B.F.C.'s profitability picked up again in 1980-81 and by this time only $1.7m of this provision had been used.

A.G.C. and B.F.C. are in the same industry as the case study companies. Their lending activities fall within the same general areas as those of the case study companies. A.G.C., like F.C.A., is a subsidiary of an Australian trading bank. B.F.C., like A.S.L., is not backed by an Australian trading bank, but does have substantial overseas bank ownership.[14] Apart from these similarities, A.G.C. and B.F.C. differ considerably from the case study companies. A.G.C. tended to be much larger than the case study companies and B.F.C. tended to be smaller.[15] Despite these problems, it is possible to

[14] Prior to A.S.L.'s "takeover" by Ansett Transport Industries in December 1976, the Royal Bank of Scotland owned 30 per cent of A.S.L.'s issued capital. Also it should be noted that in 1984 B.F.C. was taken over by the government backed State Bank of South Australia.

[15] Based on total assets, at corresponding balance dates.

use the A.G.C. and B.F.C. ratios as rough standards against which the case study ratios can be evaluated. In some ways, the A.G.C. and B.F.C. ratios represent the extremes of acceptable ratios for finance companies. Both companies have not failed. A.G.C. appears to have been highly successful, while B.F.C. has been more of a "struggler".

CHAPTER 4

THE DEVELOPMENT OF AUSTRALIAN ACCOUNTING STANDARDS

This chapter traces the development of accounting standards in Australia and identifies the areas where accounting principles have been codified by the profession. It also considers the accounting profession's attitude towards the enforcement of generally accepted accounting principles. It a serves three purposes. First, in tracing the profession's attempts to codify and enforce its accepted principles, it contributes to the development ot the responsibility criteria in Chapter Three. Second, the application ot these responsibility criteria hinges on the identification of the generally accepted accounting principles in existence at the time of the case studies. This chapter identifies the areas in which formal pronouncements have been issued on generally accepted accounting principles. It also identifies other publications issued by the Australian accounting profession, such as research papers, discussion papers and exposure drafts, which have dealt with generally accepted accounting principles in areas where formal pronouncements have not been issued. The generally accepted accounting principles in other areas relevant to the case studies must be identified from sources outside of the professional bodies, such as the accounting textbooks which were available at the time. The principles in these additional areas are identified in the individual case studies which follow. The third purpose of this chapter is to provide a basis for assessing the profession's disciplinary response to the financial statement misinformation by identifying the compliance requirements which members faced at the time of the case studies. This chapter covers the period immediately preceding Australia's first recommendations on accounting principles in 1946, until 1979, which was the year of the most recent case study failures.

4.1 Accounting Standards Before 1960[1]

Accounting standards have evolved in Australia over the last four decades. Their titles have varied from *Recommendations on Accounting Principles, Statements on Accounting Principles and Recommendations on Accounting Practice, Statements on Accounting Practice,* to most recently, *Statements on Accounting Standards,* but basically they are all authoritative pronouncements on preferred accounting practice, which should be followed in preparing financial statements. In addition, statements on auditing standards and practice have been developed in Australia over the last three decades. However, during the period covered by the case studies, the auditing statements tended to deal with details of practice rather than with generally accepted accounting principles.[2] The development of auditing standards, therefore, is not considered in this chapter.

Although it was generally agreed that financial statements should be prepared in accordance with "generally accepted accounting principles", little consideration was given to identifying Australia's generally accepted accounting principles until the late 1930's. The first sign of interest in this area was at the annual meeting of the Commonwealth Institute of Accountants in 1937, where it was resolved to express an opinion on generally accepted accounting practices. In March 1938, the Commonwealth Institute established a Committee on Accounting Principles. However, this Committee published no pronouncements on accounting principles. In 1946, the I.C.A.A.

[1] Zeff [1973] traced the development of Australian accounting principles in detail. Much of the information presented in the first two sections of this chapter is drawn from his work.

[2] The only auditing statement related directly to the area of generally accepted accounting principles is *AUP 7 Statement of Audit Practice: Going Concern* which was issued jointly by the Institute of Chartered Accountants in Australia and the Australian Society of Accountants, in June 1981.

issued members with five *Recommendations on Accounting Principles*, entitled

Form of Balance Sheet and Profit and Loss Account.
The Treatment of Taxation in Accounts.
The Inclusion in Accounts of Proposed Profit Appropriations.
Reserves and Provisions.
Disclosure of the Financial Position and Results of Subsidiary Companies in the Accounts of Holding Companies.[3]

A sixth recommendation, entitled *Depreciation of Fixed Assets*, was published in 1947 and a seventh, entitled *The Valuation of Stock-in-Trade*, was published in 1948.[4] These recommendations followed closely the *Recommendations on Accounting Principles*, issued by the Institute of Chartered Accountants in England and Wales, in 1944 and were Australia's first accounting standards.[5] Presumably, they assisted interested members in the preparation and presentation of accounts. However, their effectiveness was limited by two main factors. First, according to the I.C.A.A., they were issued

> "in the hope that these recommendations ... (would) be helpful to members in advising ... as to what is regarded as the best practice."[6]

They were not intended to be binding.[7] Second, they were applicable only to I.C.A.A. members, but the bulk of the profession belonged to other professional bodies.

In 1949, the Second Australian Congress on Accounting was held, and each

[3] Institute of Chartered Accountants in Australia [1946a,b,c,d, and e].

[4] Institute of Chartered Accountants in Australia [1947 and 1948].

[5] *The Chartered Accountant in Australia*, November 1946, p.278.

[6] *Ibid.*

[7] During this period the I.C.A.A. did conduct a campaign to increase its members awareness of, and compliance with, its recommendations, but at no stage were these recommendations considered binding. Indeed, according to Zeff [1973, p.4], the executive body's own attitude was that its authority should not extend to this area.

of Australia's five main accounting bodies was represented. Birkett and Walker [1971, pp. 98-99] reported that this congress identified the development of effective accounting standards as a vital issue for the profession. One would have expected, therefore, substantial developments in accounting standards in the early 1950s but, instead, most of the effort was devoted to the amalgamation of the professional bodies and only limited progress was made in the area of accounting standards. In 1952, the Commonwealth and Federal Institutes of Accountants amalgamated to form the Australian Society of Accountants. A year later, the Association of Accountants, and, in 1956, the Australasian Institute of Cost Accountants, also joined the A.S.A. The profession was then represented by only two bodies, the A.S.A. and the I.C.A.A.

The Commonwealth Institute had replaced its Committee on Accounting Principles with an Accounting Research Committee and this concept was adopted by the A.S.A. In 1954, the General Council of the A.S.A. considered that the immediate objective of this committee was

> "... to narrow areas of difference and inconsistency in accounting practices and to further the development of accounting standards".[8]

In 1955, a full-time research officer was appointed to this committee and, in 1956, the A.S.A. issued its members with their first *Statement on Accounting Practice*, entitled *Notes on the Preparation of Consolidated Statements*.[9] Two years later, the A.S.A. issued another *Statement on Accounting Practice*, entitled *Accounting for Hire Purchase Transactions*.[10] A number of other

[8] Australian Society of Accountants, *Report of General Council*, Year ended 31 December 1954.

[9] Australian Society of Accountants [1956].

[10] Australian Society of Accountants [1958].

Statements on Accounting Practice were issued but these were the only two which dealt with accounting principles. However, although they identified preferred practice, these statements were not "standards" as they were published as the views of State research committees and were covered by the caveat that

> "they do not purport to represent the views of the Australian Society of Accountants"[11]

As such, they lacked the authority required of standards. In the early 1950's, the I.C.A.A. concentrated on developing auditing standards. Accounting standards received little attention until 1958, when the I.C.A.A. began to review its existing recommendations which were, by then, more than ten years old. This review took nearly six years.

In summary, despite agreement within the profession on the need to delineate accounting principles, little progress was made during this period. The recommendations issued by the I.C.A.A. provided guidance to members but generally had a limited effect. The A.S.A. issued two statements on accounting practice which dealt with generally accepted accounting principles but gave them little status. The executive committees of both bodies were apparently reluctant to accept the promulgation of accounting standards as part of their responsibilities.

4.2 Accounting Standards in the 1960s

Early in the 1960s, the I.C.A.A. released two pronouncements on the balance sheet treatment of income yet to mature.[12] These statements were

[11] This caveat appeared on the title page of each A.S.A. *Statement on Accounting Practice*.

[12] Institute of Chartered Accountants in Australia [1960 and 1961].

endorsed by the General Council but were not made a part of the series of *Recommendations on Accounting Principles*. In January 1964, as a result of the 1958 decision to review existing recommendations, the I.C.A.A. issued two *Recommendations on Accounting Principles*, entitled *Presentation of Balance Sheet and Profit and Loss Account* and *Treatment of Stock-in-Trade and Work in Progr?ss in Financial Accounts*.[13] These replaced four of the original seven recommendations. The other three covering taxation, subsidiaries and depreciation remained current, in their unrevised state. In addition, in April 1964, the I.C.A.A. issued a third new recommendation entitled *Accountants' Reports for Prospectuses*.[14] When the new series of recommendations was published, the President of the I.C.A.A. commented that the 1946 recommendations had

> "had a powerful influence in raising the standards of accounting and reporting".[15]

Despite this claim, it is difficult to determine whether any improvements in financial reporting over this period were the result of the I.C.A.A. recommendations or were caused by more comprehensive companies legislation, such as the *Victorian Companies Act (1958)* and the *Uniform Companies Act (1961)*. The Institute's recommendations had guided the willing but the unwilling remained free to use alternative accounting methods. Moreover, there were many areas where recommendations had not been developed and, in some cases, existing recommendations were sufficiently general to allow the use of alternative accounting methods. Indeed, the President of the I.C.A.A.

[13] Institute of Chartered Accountants in Australia [1963a and b].

[14] Institute of Chartered Accountants in Austrlaia [1963c]. Although not issued until 1964, these recommendations were prepared for publication in 1963. Within the profession they were referred to as the 1963 recommendations.

[15] *The Chartered Accountant in Australia*, February 1964, p.493.

[1963, p.493] told members that

> "It should not 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."[16]

In addition, from the point of view of the profession as a whole, the problem remained that the majority of accountants were members of the A.S.A. rather than the I.C.A.A. In 1964, the I.C.A.A. confirmed its continued commitment to delineating accounting principles with the establishment of a standing Committee on Accounting Principles and Auditing Practice. However, according to Zeff [1973, p.12] over the next two years this committee met only once and achieved little other than to rename the I.C.A.A. pronouncements as *Statements on Accounting Principles and Recommendations on Accounting Practice*.

By the end of 1963, the A.S.A. had also resolved that its members should be guided by pronouncements on accounting principles. However, the A.S.A. General Council proposed that, rather than developing its own pronouncements, accounting standards should be developed and promulgated by a joint I.C.A.A./A.S.A. research body. In early 1964, the executive committees of the two bodies met to discuss this proposal. Pending the outcome ot these discussions, the A.S.A. ceased to issue its *Statements on Accounting Practice,* although the publication of *A.S.A. Bulletins* continued. The first *A.S.A. Bulletin* relevant to generally accepted accounting principles had been published in 1962. It dealt with the accounting and taxation concepts of business income.[17] In 1965, bulletins dealing with accounting for unearned income in instalment transactions and accounting for leases were issued.[18]

[16] *Ibid*

[17] Australian Society of Accountants [1962].

[18] Australian Society of Accountants [1965 a and b].

Each of these bulletins made specific recommendations on accounting practice. However, like the earlier *Statements on Accounting Practice,* they were released as the views of specific research committees and members were warned that the contents were not necessarily the views of the A.S.A.

A major event of the 1960's was the formation of the Accountancy Research Foundation in 1965. It was jointly sponsored by the A.S.A. and the I.C.A.A., and was charged with the consolidation and promulgation of accounting and auditing principles.[19] However, it achieved little over the next five years, largely because of staffing difficulties.

Meanwhile, in the late 1950's and early 1960's, a number of public companies had failed and the government inspectors' reports on these failures included criticisms of the accounting profession. In 1966 the A.S.A. responded to these criticisms with a report entitled *Accounting Principles and Practices Discussed in Reports on Company Failures.*[20] Although the terms of reference excluded consideration of broad issues of principle, the report did consider specific principles questioned by the government inspectors. It concluded that numerous well established accounting principles had not been followed by the companies being investigated and that the profession had a responsibility to formulate, promulgate and review accounting principles, and to enforce such principles through self-discipline.

The General Council of the A.S.A. referred specific matters raised by the report to the Accounting Research Committee which was asked to assess the need for pronouncements in these areas. This action was contrary to the earlier decision of the A.S.A to leave the Accountancy Research Foundation to

[19] In 1974, the Accountancy Research Foundation was renamed the Australian Accounting Research Foundation.

[20] Australian Society of Accountants [1966].

develop accounting standards but it may have been prompted by the inactivity of the Foundation at that time. In 1967, the A.S.A. published its first accounting standard. It was described as a Society Pronouncement. It was authorized by the General Council and dealt with accounting for debtors.[21] This was an area that had attracted criticism from the inspectors. Also in 1967, the A.S.A. replaced the *A.S.A. Bulletin* with the *Society Bulletin*. The first two *Society Bulletins* dealt with issues raised by inspectors' reports which were accounting for long-term land development projects and the preparation of consolidated statements.[22] However like earlier bulletins, they were published as the views of the research committees and not of the Society. The A.S.A.'s position on consolidations was further clarified in December 1968, when it released an exposure draft on the practice of deconsolidation and non-consolidation.[23] In late 1969, this was reissued as a *Revised Tentative Statement on Accounting Practice*.[24] The tentative nature of this statement was due to the I.C.A.A.'s dissatisfaction with its contents. It was effectively another exposure draft. Towards the end of the decade, the A.S.A. also published *Society Bulletins* dealing with reporting company income tax and funds statements.[25] Neither purported to be the views of the A.S.A.

In the meantime, despite the establishment of a standing committee on accounting principles, the I.C.A.A. made little progress with accounting standards during the middle 1960's. In 1967, it replaced its Committee on Accounting Principles and Auditing Practice with a Research Committee and a

[21] Australian Society of Accountants [1967].

[22] Australian Society of Accountants [1967a and 1968].

[23] Australian Society of Accountants [1968a].

[24] Australian Society of Accountants [1969].

[25] Australian Society of Accountants. [1969a and 1969b].

Technical Committee. The Research Committee was to undertake research and prepare exposure drafts which were to be forwarded to the Technical Committee. The Technical Committee was then to prepare formal pronouncements, for the assistance and guidance of members, and to review standards of performance by members. This re-organization seems to have stimulated some development of accounting standards. In 1967, the I.C.A.A. issued its first exposure draft which dealt with the treatment of taxation in company accounts.[26] In 1969, further re-organization occurred with the Research and Technical Committees being replaced by an Accounting Principles Committee and a Professional Standards Committee. During this year, the I.C.A.A. issued an exposure draft on net income and two *Statements on Accounting Principles and Recommendations on Accounting Practice*, dealing with trust accounts and materiality.[27]

The decade closed with the rejection by I.C.A.A. members of an I.C.A.A./A.S.A. integration proposal. This rejection, combined with the apparent ineffectiveness of the Accountancy Research Foundation and the inability of the two bodies to agree over exposure drafts such as the I.C.A.A. company income tax draft and the A.S.A. consolidation draft, emphasized the difficulties which the profession faced in delineating generally acceptable accounting principles.

In summary, despite the fact that both the A.S.A. and I.C.A.A. recognized the need for clearly defined accounting principles and accepted that they had a role to play in the identification and promulgation of such principles, the development of accounting standards progressed only slowly during the 1960's. The I.C.A.A. revised four of its original recommendations on

[26] Institute of Chartered Accountants in Australia [1967].

[27] Institute of Chartered Accountants in Australia [1969a,b and c].

accounting principles and issued three new recommendations.The A.S.A., despite several technical publications in the area of accounting principles, authorised only one pronouncement during this period.

4.3 Accounting Standards in the Early 1970's

The promulgation of generally accepted accounting principles accelerated in 1970 with the issue of two I.C.A.A. exposure drafts and five statements.[28] By this time, the I.C.A.A. had renamed its pronouncements, *Statements on Accounting Practice*. Two of the statements, one on company income tax and the other on the balance sheet treatment of investments by trading companies, resulted from the finalization of the exposure drafts issued earlier in the year. For the first time, the exposure drafts required members to follow the recommended treatment in all but exceptional cases but this requirement was removed from the final statements. In addition, a statement on profit and loss accounts, based on the 1969 exposure draft, was issued and the profit and loss elements of the 1963 recommendation on the balance sheet and profit and loss account were deleted to provide a statement on the balance sheet. The fifth statement covered depreciation and replaced the 1947 recommendation. The material in this statement was considered so uncontroversial that it was issued without prior exposure.

In 1971, the I.C.A.A.'s preoccupation with the specification of accounting principles continued. It issued an exposure draft on expenditure carried forward and revised its 1969 statement on trust accounts.[29] However, probably the most significant pronouncement made by the I.C.A.A. during this

[28] Institute of Chartered Accountants in Australia [1970a,b,c,d,e,f and g].

[29] Institute of Chartered Accountants in Australia [1971a and b].

year was its *K1 Conformity with Institute Technical Statements*.[30] This pronouncement informed members that the General Council of the I.C.A.A. "desired to attain" a situation, where, in the preparation of financial accounts,

> "... members of the Institute who assume responsibility for financial accounts, either as auditors, directors or in some other capacity should observe the accounting practices and principles set out in the Institute Statements and Recommendations, knowing that they will be under an obligation to the Institute to disclose significant departures thereform and to justify their concurrence with any deviations from recommendations ..."

Members were urged

> "... to endeavour to ensure that the accounting practices and principles recommended by the Institute are followed and that appropriate disclosure is made in the accounts or notes thereto, or in the audit report thereon, of the effect where the practices and principles have not been adhered to."

This statement met with considerable opposition from I.C.A.A. members.[31] However, the Institute reassured critics that its intentions were educational not disciplinary.[32]

In 1971, the A.S.A. was also active in the area of accounting standards. It renamed its Accounting Research Committee, the Accounting Principles Committee, matching its I.C.A.A. counterpart, and released an exposure draft on consolidation and the equity method.[33] In August 1971, the I.C.A.A. adopted this draft for its members. In 1972, the General Council of the A.S.A. endorsed, as "general gudielines", two I.C.A.A. statements, one on profit and loss statements and the other on depreciation. However, it is

[30] Institute of Chartered Accountants in Australia [1971c].

[31] A. W. Graham [1972].

[32] "Letters", *The Chartered Accountant in Australia*, October, 1971, p.41.

[33] Australian Society of Accountants [1971].

unclear how closely the A.S.A. intended its members to be guided by these statements.

In late 1972, the Accounting Principles Committees of both bodies began a review of the I.C.A.A. statements issued since January 1970, with a view to amendment and reissue as joint standards. As a result, a joint exposure draft on materiality and a joint statement on expenditure carried foward were issued in December 1972.[34] These Committees assumed the task of developing and promulgating accounting principles which was originally intended for the Accountancy Research Foundation. By 1972, the Research Foundation had published a number of background studies relevant to the development of accounting standards. These included a study by Kenley [1970] which attempted to define the generally accepted accounting principles in existence in Australia; a study by Standish [1971] which surveyed current practices in the preparation of published accounts in Australia; and a study by Kenley and Staubus [1972] which sought to establish a conceptual framework for the development of accounting standards. Despite this background work, at this stage responsiblity for the development of accounting standards remained with the individual professional bodies.

While the A.S.A. had yet to clarify its position on compliance with standards, in February 1972, the I.C.A.A. softened its stance with a revised *K1 Conformity with Institute Technical Statements*.[35] The revised version was similar to the original *K1*, in that it required disclosure of departures from Institute statements, but the emphasis was on disclosure in the public accounts rather than to the Institute. As in the 1971 pronouncement, members

[34] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1972 a and b].

[35] Institute of Chartered Accountants in Australia [1972].

were informed that the Institute would peruse the accounts of public companies and that members may be requested to explain any significant departures. However, the 1972 pronouncement emphasized that such information was sought to help the Institute define best practices. This formalized the Institute's earlier assurances of its educational rather than disciplinary intentions. In line with this pronouncement, in 1972, the I.C.A.A. Professional Standards Committee began to review, annually, a sample of published accounts. Where departures from the Institute statements had not been disclosed, an explanation was sought from the members involved with the accounts but no disciplinary action was taken.

In January 1973, the I.C.A.A.'s *K1 Conformity with Institute Technical Statements* was again revised.[36] This was the third version issued in less than two years. The 1973 statement clarified which members were considered responsible for financial accounts. They were those

> "... signified by the association of their names with such accounts in the capacity of directors or other officers, auditors or reporting accountants ..."

It was also more forceful than earlier versions, requiring

> "that in all accounts in respect of financial periods ending on or after 1st July 1973 significant departures from applicable accounting standards be disclosed and explained. The financial effects of those departures should be estimated and disclosed ... This obligation will apply with respect to statements on accounting practice issued by the Institute after 1st January 1970".

Where the financial effects or significant departures were not disclosed, members were required to give the reasons for non-disclosure. Moreover, members were warned that

> "The Council will enquire into apparent failures by members to observe accounting standards or to disclose significant departures therefrom."

[36] Institute of Chartered Accountants in Australia [1973].

As was noted in the Institute's journal at this time, the intention of *K1* had become disciplinary.[37] Not surprisingly, the 1973 version of *K1* met with some criticism.[38] In reply, the President of the I.C.A.A. attributed the forcefulness of *K1* to pressure from the N.S.W. Commissioner for Corporate Affairs, who had been concerned with the apparent conflict between some directors and auditors, as evidenced by the large number of qualified auditors' reports.[39] It was feared that if the I.C.A.A. did not take action the government may intervene.

In July 1973, the A.S.A. finally took a stance on authoritative accounting standards through its *Statement 300, Conformity with Society Statements of Accounting Standards*.[40] This statement informed members that they were expected to observe the accounting standards promulgated by the profession and to take all reasonable steps to ensure that any departures and their financial effects were disclosed and explained. The intent was similar to *K1*, but the wording was less forceful and the range of statements to which it applied was narrower. *Statement 300* applied to the two Institute statements endorsed in 1972, on profit and loss and depreciation, and to the joint statement on expenditure carried forward. The I.C.A.A.'s *K1* covered, in addition, pronouncements on the balance sheet, company income tax, trust accounts and investments by trading companies.

Although the I.C.A.A. and the A.S.A. issued independent conformity requirements, the two Accounting Principles Committees (or Accounting Standards Committees, as they were renamed at the end of 1973) continued to

[37] "Editorial", *The Chartered Accountant in Australia*, February 1973, p. 3.

[38] See, for example, "Letters", *The Chartered Accountant in Australia*, March, 1973, p. 45 and August 1973, p. 52.

[39] "Letters", *The Chartered Accountant in Australia*, May 1973, p.35.

[40] Australian Society of Accountants [1973].

meet jointly. During 1973, their technical work was handed over to the Accountancy Research Foundation. Under this arrangement, three joint exposure drafts and two pronouncements were issued during 1973.[41] By this time, the pronouncements were called Statements of Accounting Standards. The exposure drafts dealt with the extractive industries, the equity method of accounting for investments in subsidiaries and accounting for foreign currency transactions. The standards dealt with the disclosure of accounting methods and profit and loss statements. The standard on profit and loss statements was a revision of the 1970 I.C.A.A. statement, endorsed by the A.S.A. in 1972.

In 1973, the International Accounting Standards Committee (I.A.S.C.) was formed with Australia as a foundation member. Member countries were required to adhere to I.A.S.C. pronouncements and, as such, the I.A.S.C. had the potential to become an important force in the development of Australian accounting standards. Over the next few years, a large number of exposure drafts and standards emanated from the I.A.S.C. These early pronouncements were published in full, and discussed, in the professional journals. However, in order to obtain international acceptance, the I.A.S.C. standards were necessarily general. Moreover, these early pronouncements related largely to areas already covered by Australian accounting standards and were compatible with those standards. As a result, the impact of the I.A.S.C. on the development of Australian accounting standards during this period was limited.

To summarize, the early seventies was a period of rapid development in the preparation and issue of Australian accounting standards. The I.C.A.A. followed up its progress in the late sixties with pronouncements on profit and loss statements, the balance sheet, company income tax, depreciation, investments by trading companies, and trust accounts. The A.S.A. followed this lead, endorsing the I.C.A.A. statements on profit and loss accounts and

[41] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1973a,b,c,d and e].

depreciation. At the end of 1972, the two bodies issued their first joint statement, on expenditure carried forward. In 1973, joint standards on disclosure and profit and loss statements were issued. More importantly, during this period both bodies issued pronouncements requiring compliance, or disclosure of non-compliance, with the existing accounting standards. Furthermore, the emphasis within the issued statements was changing. The generality of earlier pronouncements was being replaced by more definitive statements, which permitted fewer alternatives. This change in emphasis, combined with the conformity pronouncements, meant that an attempt was being made to specify clearly the generally accepted accounting procedures which could be applied in particular circumstances.

4.4 Accounting Standards from 1974 to 1979

In April 1974, the Australian accounting bodies established the joint Australian Accounting Standards Committee (A.A.S.C.), under the auspices of the Accountancy Research Foundation. The Research Foundation was now able to fulfil its intended role of preparing accounting standards, although final approval remained in the hands of the executive committees of the I.C.A.A. and A.S.A. During this year, standards were issued on depreciation, materiality and accounting for income tax, and the existing standards on profit and loss statements and disclosure were amended.[42] Also an exposure draft on post-balance date events and a preliminary exposure draft dealing with accounting for changes in purchasing power were issued.[43] The purchasing power draft was

[42] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1974a, b and c].

[43] Australian Accounting Standards Committee [1974a and b].

preliminary because the A.A.S.C. was not yet convinced that the method should be recommended.

Apart from the number of standards which appeared in 1974, the increased importance which the profession attached to accounting standards was evident in other areas. For example, for the first time the annual meeting of the I.C.A.A. canvassed the possibility of disciplinary action for serious departures from *K1*.[44] The A.S.A. reissued its counterpart, *Statement 300*, recognizing the additional standards to which it now applied.[45] From outside the profession, the listing requirements of the Australian Associated Stock Exchange (A.A.S.E.) were extended to include compliance with accounting standards or disclosure and explanation of non-compliance, in the preparation of public company accounts.[46] Also, in late 1974, five years after it had rejected the proposal, the I.C.A.A. sought to re-open integration negotiations. In the following February, the General Council of the A.S.A. agreed and once again members views were sought.

The rapid progress in the development of accounting standards did not continue in 1975. Instead the A.A.S.C. concentrated on the complex issue of current cost accounting and on a review of I.A.S.C. exposure drafts. Little was achieved in other areas. In June 1975, a preliminary exposure draft was issued on current value accounting as an alternative to the 1974 preliminary exposure draft on current purchasing power accounting.[47]

[44] *The Chartered Accountant in Australia*, February 1975, p.53.

[45] Australian Society of Accountants [1974].

[46] *The Australian Accountant*, June 1974, p. 263.

[47] Australian Accounting Standards Committee [1975].

In 1976, work on current cost accounting continued. The topic had proved highly controversial and, for the first time, oral presentations were sought from those who had submitted comments on the exposure drafts. Public reaction was considerable and, by the end of the year, a C.C.A. Co-ordination Committee had been established. The Committee was to advise the presidents of both bodies on matters pertaining to C.C.A. and to monitor and respond to published comments. In October 1976, a provisional standard on current cost accounting and an explanatory statement were released.[48] Being provisional, compliance was not mandatory although a proposed timetable for compulsory introduction was included. The A.A.S.E. once again put its weight behind the accounting standards, warning companies to move rapidly towards a position of being able to produce full current value accounts and suggesting that, in the interim, companies should provide supplementary information on current values.[49] The introduction of current cost accounting appeared imminent.

Although current cost accounting predominated, there were several other important developments in 1976. Standards were issued on inventory valuation and presentation and on accounting for the extractive industries.[50] The 1974 standard on tax effect accounting was amended to tighten up on the recognition of future income tax benefits and, most importantly, a joint *Statement K1/300* was issued on conformity with accounting standards.[51] The importance of this statement was twofold. First, members of the profession were now guided by

[48] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1976a and b].

[49] *The Australian Accountant*, September 1976, p.458.

[50] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1976c and d].

[51] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1976e].

the same set of standards and faced the same compliance requirements.[52] Second, the contents of the statement made important advances. For the first time, disciplinary action was threatened. Members were warned that, in the case of failure to meet the requirements of *K1/300*,

> "the relevant Council ... may take such action as it considers appropriate."

The statement also clarified the status of standards as

> "a definitive approach to the concept of what gives a true and fair view."

All members were required to support the standards and to disclose any departures from them. However, the new pronouncement differentiated between the roles of various members. Directors and principal accounting officers were required to disclose and explain the financial effects of departures. Whilst auditors' reports were required to disclose any departures not disclosed in the accounts. Where departure was deemed necessary to show a true and fair view, the auditor was required to state concurrence with the departure. Moreover, the specific standards covered by *K1/300* were listed and members were left in little doubt about their responsibility to comply with accounting standards, or to disclose and justify non-compliance.

Other developments in 1976 included the establishment, within the profession, of an Accounting Standards Review Committee to review the standards already issued, identify problem areas and recommend improvements. The first task of this committee was to review the standard on tax-effect accounting but its achievements in other areas were limited. Also in 1976,

[52] This softened requirements for I.C.A.A. members, as although D9 covering investments by trading companies had been withdrawn in 1974, D6 on trust accounts was covered by *K1* but excluded from the new *K1/300*.

the relevance of international accounting standards to the Australian accounting profession was clarified with the issue of the joint pronouncement, *Statement K3/300 Compatibility of Australian Accounting Standards and International Accounting Standards*.[53] Until 1976 the standards issued by the I.A.S.C. were compatible with existing Australian standards and, hence, their status had not been questioned. However, in 1976, the I.A.S.C. issued a standard on consolidated financial statements. No Australian standard had been finalized in this area, despite several attempts. The uncertain status of this international standard was clarified with the issue of *K3/300*, which required that Australian standards should have, as a minimum, the provisions of their international counterparts, and that existing Australian standards would be reviewed at the time of release of comparable international standards. Where an international standard covered an area outside existing Australian standards, it was to be published as an Australian standard, or should its requirements be insufficient in the Australian context, it was to provide the basis of an Australian standard. Where an international standard was inconsistent with an existing Australian standard, and not appropriate for Australian practice, the Australian standard was to note the inconsistencies. *Statement K3/300* effectively ensured that Australian standards were the only reference for members. Thus, the potential of the I.A.S.C. to influence the development of Australian accounting standards was limited. From the end of 1976, the professional journals no longer published international accounting standards in full. Instead their issue was merely announced and copies held in divisional offices. At most, the I.A.S.C. may have influenced the priority which the Australian profession gave to the development of particular standards.

[53] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1976f].

The current cost accounting debate had not subsided by 1977 and a C.C.A. Steering Group, comprising representatives of outside groups affected by C.C.A., was set up to advise the profession on the implementation of current cost accounting. One of the first recommendations of this group was that the adoption of full current cost accounting should be deferred for one year, until accounting periods commencing on or after 1 July, 1979. The profession accepted this recommendation. Also in 1977, the 1976 accounting standard on the extractive industries was amended and the 1974 standard on the disclosure of accounting methods was revised. In addition, an addendum was made to the standard on depreciation, to indicate its compatibility with its international counterpart, and a pronouncement was issued indicating that the provisional standard on current cost accounting, combined with the standard on disclosure of accounting methods, represented Australia's response to the international standard on accounting for changing prices.

At the end of 1977, a re-organization of the Research Foundation was announced. The Australian Accounting Standards Committee was abolished and a Foundation Executive Committee was charged with the development of general accounting standards. C.C.A. standards were to be developed by a separate C.C.A. Standards Committee, thus overcoming the C.C.A. bottleneck of the mid-1970's. In a further attempt to expedite the development of standards, as well as widen its resource base, the Research Foundation was to use outside contractors to develop and review draft standards. In addition, a Research and Review Committee was set up to advise the Foundation on trends in accounting thought and on the need to modify existing accounting standards.

In November 1977, the New South Wales government appointed an Accounting Standards Review Committee. Although the N.S.W. government had previously supported accounting standards, it now wanted an independent assessment of these standards.[54] The Committee's report, submitted in May 1978, argued strongly for standards with statutory or regulatory endorsement, but did not accept current accounting standards as worthy of such endorsement.[55] At this time, the role of government bodies in setting, reviewing and enforcing standards became the subject of widespread debate. The profession, whilst not adverse to government enforcement, jealously guarded its area of professional responsibility in setting and reviewing standards. The notion of an Accounting Standards Review Board stemmed from the N.S.W. report and, as discussed in Chapter 1, eventually filtered through to federal parliament. The proposal for an Accounting Standards Review Board was forwarded to Ministerial Council, where it was approved, and the first Accounting Standards Review Board was appointed in January 1984.

The re-organization of the Research Foundation took effect in early 1978 but it was some time before the C.C.A. bottleneck was cleared. In June 1978, the provisional standard on current cost accounting, issued in 1976, was amended to remove any mandatory timetable for the introduction of current cost accounting. As the President of the A.S.A. noted, in his annual report,

> "the profession in Australia had learnt a valuable lesson in humility from the history of the introduction of C.C.A."[56]

In July 1978, an exposure draft on the gains and losses on holding monetary resources in the context of current cost accounting and a C.C.A. working guide were published.[57] In August, the provisional C.C.A. standard was amended

[54] For example, in the investigation of published accounts the N.S.W. Corporate Affairs Commission had viewed non-compliance with accounting standards as *prima facie* evidence of failure to provide a true and fair view.

[55] Accounting Standards Review Committee [1978].

[56] Australian Society of Accountants, Annual Report for 1978, p.6, insert to *The Australian Accountant,* March, 1979.

[57] Australian Accounting Research Foundation [1978a and b].

further.[58]

Beyond the C.C.A. arena, a standard on post-balance date events was issued in September 1978 and the 1974 standard on tax effect accounting was amended for the second time.[59] The joint statement on conformity with accounting standards, *K1/300*, was revised, in September 1978, to take account of the materiality concept and to require auditors to disclose all material departures from existing accounting standards and to qualify their reports where they considered the departures unjustified or where compliance with the standards actually failed to produce a true and fair view.[60] The standard on the extractive industries was added to the list of statements covered by *K1/300*. It appeared that by this time, the conformity statement carried some weight. In his annual report for 1978, the President of the I.C.A.A. mentioned several cases of non-compliance, which had been referred to State Investigation Committees for determination of any further action necessary.[61] The September 1978 issue of the I.C.A.A. journal reported the exclusion of a member in Queensland for a number of offences including non-compliance with *K1/300*.[62] However, the other offences, on their own, probably provided sufficient grounds for exclusion. On the other hand, *K1/300* had promised members that they would be supported in their observance of accounting standards. The extent of this support was illustrated in November

[58] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1978b].

[59] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1978c].

[60] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1978d].

[61] Institute of Chartered Accountants in Australia, Annual Report for 1978, reproduced in *The Chartered Accountant in Australia*, October, 1978.

[62] "Institute News", *The Chartered Accountant in Australia*, September 1978, p.70.

1978, when the Executive Director of the A.S.A. attended the annual meeting of a company and publicly questioned the chairman over the company's financial statements. In particular, he queried the treatment of certain items which the (member) principal accounting officer had claimed were not treated in accordance with the standards.[63] However, such action can be construed as little more than moral support. The company did not change its financial statements, but did change principal accounting officers and auditors.

Meanwhile, the benefits of the revamped Research Foundation became apparent with the issue, in 1979, of exposure drafts on foreign currency transactions and statements, the equity method of accounting for investments and the revaluation of fixed assets.[64] The 1978 draft on gains and losses on holding monetary resources under C.C.A. was revised and reissued and two discussion papers were published, one on accounting for leases and the other on funds statements.[65] Under the new system, discussion papers were released prior to the preparation of exposure drafts in areas of complexity. In 1979, the Joint Standing Committe of the I.C.A.A./A.S.A. established an Advisory Research Panel comprising members in public practice, industry, government and academia to identify areas in which the Research Foundation should develop additional standards and technical studies. The question of compliance was pursued by the I.C.A.A. and the A.S.A., in 1979, when they formally adopted the recommendation that failure to comply with *K1/300* would expose a member to the possibility of investigation and disciplinary action. Until this time, a breach of *K1/300* had not been a disciplinary offence *per se* although action could be taken under the more general misconduct clauses of the Institute's

[63] McKeon [1979].

[64] Australian Accounting Research Foundation [1979a,b and c].

[65] Australian Accounting Research Foundation [1979d,e and f].

Charter or the A.S.A.'s Articles of Association.

Outside the profession, in 1979 the Interstate Corporate Affairs Commission decided to introduce additional disclosure requirements for auditors' reports on prospectuses. The I.C.A.A. [1963c] recommendation, *Accountants' Reports for Prospectuses*, remained valid for I.C.A.A. members, although it was not covered by *K1* compliance requirements from 1973. However, this recommendation was developed within the context of historic cost accounting. Whilst the profession debated the intricacies of asset valuation, it still produced accounts based upon historic cost and going concern. The Interstate Corporate Affairs Commission moved to improve the accounting information included in prospectuses and announced that, in a prospectus report, auditors may be required to state specifically the basis of asset valuation in the accounts, whether these valuations were based on any assumed support from other entities and whether, in the absence of this support, the asset valuations were currently realizable. This move followed the failure of a number of apparently sound companies and was well received by the financial press, the feeling being that if the accounting profession couldn't keep its own house in order, it was appropriate for the government to intervene.[66] In the same year, the A.A.S.E. withdrew its support for accounting standards by deleting the recommendation that public company accounts comply with accounting standards. This move, however, did not necessarily reflect dissatisfaction with existing standards since the A.A.S.E. deleted all listing recommendations at this time.

In summary, during the period 1974 to 1979, the specification of generally accepted accounting principles proceeded at an irregular pace. In 1974, standards were issued on depreciation, materiality and company income

[66] See, for example, *Australian Financial Review*, 7 June 1979, p.48.

tax. Late in the year, attention was focused on the need for some form of inflation accounting and all efforts were directed to this end in 1975 and early 1976. During 1976 and 1977, the preoccupation with current cost accounting continued, although standards were issued on inventories and on the extractive industries and a revised standard was issued on disclosure of accounting policies. The profession, aware of growing unrest in the business community, deferred the introduction of current cost accounting. The re-organization of the Research Foundation, at the end of 1977, overcame the C.C.A. bottleneck and exposure drafts were produced in a number of important areas. However, the post-balance date standard was the only standard finalized in the late seventies. In this period, increasing emphasis was put on enforceable standards, particularly as a result of the I.C.A.A.'s more stringent attitude towards discipline in this area and possibly as a result of the report of the N.S.W. Accounting Standards Review Committee.

4.5 Generally Accepted Accounting Principles in Australia

According to the methodology outlined in the previous chapter, the responsibility of the Australian accounting profession for any case study financial statement misinformation can be established by determining the extent to which the misinformation resulted from compliance with generally accepted accounting principles. The identification of the generally accepted accounting principles in existence at the time of the case studies and of the profession's compliance requirements is a prerequisite to this process. This chapter has outlined the areas in which the accounting profession has recognized principles as being generally acceptable by according them the status of accounting standards. It has also outlined the development of the profession's compliance requirements. In addition, it has identified the generally accepted accounting principles which have been considered and in some cases defined, but not endorsed, by the profession through the publication of various research papers and exposure drafts. This chapter has not taken account of the areas in which generally accepted accounting principles exist, but have not attracted specific attention from the accounting profession. For example, it ignores many "textbook" principles, which are so widely accepted that the profession has felt no need to promulgate them. Where relevant, these principles are specified in the individual case studies.

Tables 4.1 and 4.2 trace the evolution of Australian accounting principles and compliance requirements and show the principles with which members were required to comply over the period of the case studies. Accountants involved in the preparation and presentation of the 1960's case study company financial statements faced the general requirement of compliance with generally accepted accounting principles. Table 4.2 shows that no attempt was made to formalize this compliance requirement. Moreover, Table 4.1 shows that, for members of the A.S.A., no attempt had been made to formalize the accounting principles which were generally acceptable. Over this period, the A.S.A. did issue a number of bulletins containing recommendations on best practice but they were always published as the views of individuals or research committees and not of the A.S.A. For members of the I.C.A.A., standards had been issued in seven areas. However, these standards were more general than specific and were issued over the period 1946 to 1948.[67] By the late 1950's and early 1960's, they carried little weight and there were many areas not covered by the recommendations. Thus, the accepted accounting principles relevant to the 1960 case studies were largely unspecified. In some areas, these principles may have been widely understood

[67] The 1963 revised recommendations were issued after the failures of 1960s case study companies.

and accepted. However, it is unlikely that the few existing recommendations and technical bulletins covered the remaining areas of accounting.

The accountants involved in the preparation and presentation of the 1970's case study accounts also faced the general requirement of compliance with generally accepted accounting principles. Table 4.1 shows that, for members of the I.C.A.A., from the late 1960's, more of these principles had been defined. Standards had been issued in a number of new areas. Also several existing recommendations had been revised and re-issued. Moreover, unlike the earlier recommendations, these standards tended to be more specific. In addition, Table 4.2 shows that, from 1971, the I.C.A.A. introduced formal compliance requirements, which were strengthened in 1973. However, Table 4.1 shows that, prior to 1972, A.S.A. members had been issued with only one pronouncement which had the backing of the A.S.A. Executive Committee, although technical bulletins, specifying a view of best practice, continued to be produced. In 1972, the A.S.A. endorsed two I.C.A.A. standards. Thereafter, accounting standards were issued jointly by the A.S.A. and the I.C.A.A. With the A.S.A.'s release of its compliance pronouncement in 1973, the requirements facing A.S.A. members approximated those facing I.C.A.A. members. As discussed above, in addition to these standards there were a number of accounting principles which were widely understood and accepted. Although compliance with accepted principles was still required, these additional principles were not covered by the profession's statements on compliance, which were confined to the principles delineated as accounting standards. Moreover, despite the improved coverage by standards, there remained a number of areas not covered by either accounting standards or widely accepted principles.

Having identified the areas in which generally accepted accounting principles have received attention from the Australian accounting profession, for the period of the case studies, and having traced the profession's attempts to enforce its principles, it is now appropriate to analyse the financial statements of the case study companies. Any misinformation in the statements can be checked against the accounting principles in these areas, as a first step in assessing the responsibility of the accounting profession. If necessary, the accounting principles in other areas, which have not attracted any attention from the profession, can then be considered in the separate case study chapters which follow.

TABLE 4.1 Pronouncements and Other Publications on Accounting Principles and Practices, 1946 to 1979

Date of Issue		Title	Compliance Requirement	
			Title	Period in Force
		PART I, FOR MEMBERS OF THE I.C.A.A.		
		Recommendations on Accounting Principles		
1946	I	Form of Balance Sheet and Profit and Loss Account, superseded in 1963	-	-
1946	II	Treatment of Taxation in Accounts, superseded in 1970	-	-
1946	III	The Inclusion in Accounts of Proposed Profit Apropriations, superseded in 1963	-	-
1946	IV	Reserves and Provisions, superseded in 1963	-	-
1946	V	Disclosure of Financial Position and Results of Subsidiary Companies in the Accounts of Holding Companies	Kl	1971-72
1947	VI	Depreciation of Fixed Assets, superseded in 1970	-	-
1948	VII	The Valuation of Stock-in-Trade, superseded in 1963	-	-
1963	I	Presentation of Balance Sheet and Profit and Loss Account, superseded in 1970	-	-
1963	II	Treatment of Stock-in-Trade and Work in Progress in Financial Accounts, issued as D2 from 1970, superseded in 1976	Kl	1971-76
1963	III	Accountants' Reports for Prospectuses issued as D3 from 1970	Kl	1971-76
		Statements on Accounting Principles and Recommendations on Accounting Practice		
1969	IV	The Form and Contents of Accounts of Estates of Deceased Persons and Similar Trusts, superseded in 1971	-	-
1969	V	The Interpretation of 'Material' in Relation to Accounts, issued as D7 from 1970, superseded in 1974	Kl	1971-76
		Statements on Accounting Practice		
1970	Dl.1	Presentation of Balance Sheet	Kl	1971-76
1970	Dl.2	Presentation of Profit and Loss Statements (Net Profit, Prior Period Adjustments and Extraordinary Items), superseded in 1973	Kl	1971-73
1970	D4	Treatment of Income Tax in the Accounts of Companies, superseded in 1974	Kl	1971-74
1970	D5	Depreciation, Depletion and Amortisation of Fixed Assets, superseded 1974	Kl	1971-74

Table 4.1 continued.

1970	D9	Treatment of Investments in Balance Sheets of Trading Companies, withdrawn in 1974	K1	1971-74
1971	D6	Trust Accounts (The Form and Contents of the Accounts of Estates of Deceased Persons and Similar Trusts)	K1	1971-76
		Pronouncements of the General Council of the I.C.A.A.		
1960		Pronouncement of the General Council of the Institute on the Principle and Method of Apportioning Income Yet to Mature	-	-
1961		Pronouncement of the General Council of the Institute on the Principle and Method of Apportioning Income Yet to Mature	-	-
		I.C.A.A. Exposure Drafts		
1967		Treatment of Income Tax in the Accounts of Companies, superseded in 1970	-	
1969		Profit and Loss Statements (Net Profit, Prior Period Adjustments and Extraordinary Items), issued as statement in 1970	-	-
1970		Treatment of Investments in the Balance Sheets of Trading Companies, issued as statement D9 in 1970	-	-
1970		Treatment of Income Tax in the Accounts of Companies, issued a statement D4 in 1970		
1971		Expenditure Carried Forward to Subsequent Accounting Periods, issued as joint statement D10/303 in 1972	-	-
		PART II, FOR MEMBERS OF THE A.S.A.		
		Society Pronouncement		
1967		The Valuation of Book Debts, Bad Debts and Provision for Doubtful Accounts	-	-
		Endorsed I.C.A.A. Statements on Accounting Practice		
1972	D1.2	Profit and Loss Statements (Net Profit, Prior Period Adjustments and Extraordinary Items), superseded in 1973	300	1973
1972	D5	Depreciation, Depletion and Amortisation of Fixed Assets, superseded in 1974	300	1973-74
		Statements in Accounting Practice (unendorsed)		
1956	No 1	Notes on the Preparation of Consolidated Accounts	-	-
1958	No 3	Accounting For Hire Purchase Transactions	-	-

Table 4.1 continued.

		A.S.A. Bulletins		
1962	No 9	The Accounting and Taxation Concept of Business Income	-	-
1965	No 12	Accounting for Unearned Income in Instalment Transactions	-	-
1965	No 13	Accounting for Leases and the Associated Problems Relating to Lease or Buy Decisions	-	-
		Society Bulletins		
1967	No 1	Accounting for Long Term Land Development Projects	-	-
1968	No 2	Notes on the Preparation of Consolidated Accounts	-	-
1968	No 6	Reporting the Incidence of Company Income Tax	-	-
1969	No 10	The Funds Statement		
		A.S.A. Exposure Drafts		
1968		Consolidated Financial Statements and the Practice of Deconsolidation and Non-consolidation, superseded in 1971	-	-
1971		Accounting for Material Investments in Other Companies by Consolidation and the Equity Method	-	-
		Revised Tentative Statement on Accounting Practice		
1969		Omission of Subsidiaries from Consolidated Financial Statements, withdrawn in 1971	-	-
		PART III, FOR BOTH I.C.A.A. AND A.S.A. MEMBERS		
		Statements on Accounting Standards		
1972		D10/303 Expenditure Carried Forward to Subsequent Accounting Accounting Periods	Kl 300	1972- 1973-
		Statements of Accounting Standards		
1973		DS1.2/301 Profit and Loss Statements, amended in 1974	Kl/300	1973-
1973		DS11/304 Disclosure of Accounting Methods Used in Preparing Financial Statements, amended in 1974 and superseded in 1977	Kl/300	1973-77
1974		DS5/302 Depreciation of Non-Current Assets	Kl/300	1974-
1974		DS7/305 Materiality in Financial Statements	Kl/300	1974-
1974		DS4/306 Accounting for Company Income Tax, amended in 1976 and 1978	Kl/300	1974-
1976		DS2/307 Valuation and Presentation of Inventories in the Context of the Historical Cost System	Kl/300	1976-
1976		DS12/308 Accounting for the Extractive Industries, amended in 1977	Kl/300	1976-
1977		Accounting Policies: Determination, Application and Disclosure	Kl/300	1977-
1978		DS13/310 Events Occurring After Balance Date	Kl/300	1978-

Table 4.1 continued.

	Statement of Provisional Accounting Standards		
1976	DPS1.1 Current Cost Accounting, amended in June and August 1978	-	-
1976	DPS1.2 Explanatory Statement, the Basis of Current Cost Accounting	-	-
	Joint Exposure Drafts		
1972	Materiality in Financial Statements, issued as statement DS7/305 in 1974	-	-
1973	Accounting for the Extractive Industries, issued as statement DS12/308 in 1976	-	-
1973	The Use of the Equity Method of Accounting for Subsidiaries and Associated Companies, superseded in 1979	-	-
1973	Translation of Amounts in Foreign Currencies, superseded in 1979	-	-
1974	Events Occurring After Balance Date, issued as statement DS13/310 in 1978	-	-
1978	The Recognition of Gains and Losses on Holding Monetary Resources in the Context of Current Cost Accounting, revised in August 1979	-	-
1979	Translation of Foreign Currency Transactions and Foreign Currency Financial Statements in the Context of Historical Cost Accounting, revised in September 1983	-	-
1979	Equity Method of Accounting for Investments, issued as statement AAS14 in 1983	-	-
1979	Accounting for the Revaluation of Tangible Fixed Assets and Investments in the Context of Historical Cost Accounting, issued as statement AAS10 in 1981	-	-
	Revised Exposure Drafts		
1979	The Recognition of Gains and Losses on Holding Monetary Resources in the Context of Current Cost Accounting	-	-
	Joint Preliminary Exposure Draft		
1974	A Method of 'Accounting for Changes in the Purchasing Power of Money'	-	-
1975	Current Value Accounting, provisional statement issued in 1976	-	-
	A.A.R.F. Discussion Papers		
1979	No 1 Accounting for Leases	-	-
	No 2 Funds Statements	-	-
	Other Publications		
1978	The C.C.A. Working Guide	-	-

Table 4.2: Pronouncements on Compliance

Date of Issue	Title	Statements Covered
	For I.C.A.A. Members	
1971	K1 Conformity with Institute Technical Statements, superseded in February 1972	"the I.C.A.A. Statements and Recommendations"
1972	K1 Conformity with Institute Technical Statements, superseded in January 1973	"the Institute statements"
1973	K1 Conformity with Institute Technical Statements, superseded in September 1976	"statements on accounting practice and statements of standard accounting practice issued by the Institute after 1st January 1970"
	For A.S.A. Members	
1973	Statement 300 Conformity with Statements of Accounting Standards, superseded in September 1976	"Accounting standards promulgated by the Society in association with the Institute"
	For Both I.C.A.A. and A.S.A. Members	
1976	K1/300 Conformity with Accounting Standards, superseded in September 1978	"D51.2/301, DS2/307, DS4/306 DS5/302, DS7/305, D10/303, DS11/304 and subsequent Statements of Accounting Standards"
1978	K1/300 Conformity with Accounting Standards, superseded in December 1979	"AAS1(DS1.2/301), AAS2 (DS2/307), AAS3(DS4/306), AAS4(DS5/302), AAS5(DS7/305), AAS9 (D10/303), AAS6(DS11/304), AAS7(DS12/308) and subsequent Statements of Accounting Standards"

CHAPTER 5

REID MURRAY ACCEPTANCE LTD.

In October 1957, David Murray Holdings Ltd., a credit merchandising company, merged with the wholesalers, Robert Reid and Co. Ltd. At the time ot the merger, Reid's was a well established firm with net assets of $6.56m. Murray's, although smaller, with net assets of $2.72m, also had a successful trading history, dating back to the early 1940's. Although comprised of well established partners, the resultant Reid Murray Holdings Ltd. (R.M.H.) needed funds to expand. In June of the following year, R.M.H. established a wholly owned subsidiary finance company, Reid Murray Acceptance Ltd. (R.M.A.), to raise funds for the Reid Murray group of companies.[1] R.M.A. proved to be a most successful fund raiser. In October 1962, it closed its ninth debenture issue to which investors had subscribed $2.8m.[2] Less than two months later, on the 1 December, R.M.A. defaulted on interest payments of $1.2m due to debenture holders. On 10 January 1963, the trustee for the debenture holders succeeded in enforcing the trust deed and R.M.A. was placed into receivership.[3]

The statement of affairs revealed an estimated deficiency in shareholders' funds of $24.85m. This failure resulted in many questions. Why did the public invest $2.8m into a company about to collapse? Did the affairs of R.M.A. change suddenly over the last few months of 1962 or were subscribers to the ninth debenture issue, and possibly other R.M.A. investors, misled over the company's performance and financial condition? The Victorian government

[1] Victoria, Parliament [1963, pp.6-8].

[2] Victoria, Parliament [1963, p.48].

[3] Victoria, Parliament [1963, pp.36-37].

ordered an investigation into the affairs of the Reid Murray group, including R.M.A. The government inspectors criticized many aspects of Reid Murray's financial statement data. This chapter determines whether the financial statement data were potentially misleading for R.M.A. investors and, if so, the extent to which the accounting profession was responsible.

5.1 The Losses of R.M.A. Investors

At receivership, R.M.A. had two main sources of invested capital. These were shares and secured debentures.[4] With assets insufficient to cover liabilities, R.M.A.'s shareholders' funds which totalled $15.0m at receivership, were lost. Contributed share capital was $14.0m. It would be wrong, however, to assert that R.M.A.'s failure resulted in losses to the investing public of $14.0m or $15.0m. Table 5.1 identifies the sources of R.M.A.'s share capital. Apart from a few shares held by directors, as required by the company's articles of association, R.M.A. was, at all times, wholly owned by R.M.H. Table 5.1 shows that only $5.0m of R.M.A.'s share capital was raised from R.M.H. shareholders, that is from the investing public. The remaining $9.0m of R.M.A.'s issued share capital subscribed by R.M.H., was actually financed by loans from R.M.A. to R.M.H.[5] Eliminating the effects of these intercompany transactions, R.M.A.'s loss of share capital raised from the public was, therefore, $5.0m. In addition, retained earnings of approximately $1.0m were lost, although part of these earnings may also have resulted from intra-group transactions and, thus, should be eliminated.

[4] Although R.M.A. relied heavily on unsecured deposits early in its development, by 28 February 1962 deposits had dropped to $0.08m. The statement of affairs does not distinguish the sources of R.M.A.'s unsecured liabilities but, given that these totalled $0.04m, the losses incurred by R.M.A. depositors can be considered negligible.

[5] In their report the government inspectors concluded that these self-financed issues were made solely to overcome the limitations of R.M.A.'s trust deed, which restricted debenture borrowing to five times shareholders' funds. See Victoria, Parliament [1963, pp. 41-43].

Table 5.1: R.M.A. Share Issues ($m)

Date of Issue	Amount	Cumulative Paid up capital	Source of Funds
June, 1958	1.2	1.2	R.M.H. public issue
Feb, 1959	0.9	2.1	R.M.H. public issue
Aug., 1959	2.9	5.0	R.M.H. public issue
Dec., 1959	4.0	9.0	Loan from R.M.A. to R.M.H. of $4.0m
May, 1960	1.0	10.0	Loan from R.M.A. to R.M.H. of $1.0m
Aug., 1960	2.0	12.0	Loan from R.M.A. to R.M.H. of $2.0m
Feb. 1961	2.0	14.0	Loan from R.M.A. to R.M.H. of $2.0m

Source: Based on data drawn from Victoria, Parliament [1963, pp. 41-42]

R.M.A.'s major source of funds was debenture issues. Table 5.2 shows that R.M.A. raised $101.6m through debenture issues, including new subscriptions of $85.6m. The difference between the nominal sums to be raised, $13.9m, and the amount raised, $101.6m, represents oversubscriptions. As no intercompany transactions were involved, debenture subscriptions were public funds. At the date of receivership, R.M.A. owed debenture holders $60.5m, including principal of $58.2m and interest of $2.3m. The receivers initially estimated that, ignoring interest accruing between the date of receivership and realization, debenture holders would lose between $16m and $23m of the $60.5m outstanding. R.M.A. is still in receivership. At 31 July 1982, debenture holders were owed only $2.21m principal although interest of $33.81m was also outstanding.[6] At this date, R.M.A. had total assets of $3.14m and during the year 1981-82 it had made a loss of $0.79m, bringing the company's accumulated losses to $60.24m. Given this situation, even if R.M.A.'s debenture holders recover their principal in

[6] Distributions by the receiver have given priority to the repayment of principal.

Table 5.2: R.M.A. Debenture Issues (in $m)

Opening Date of Issue	Amount of Issue	Receipts of New Money	Conversions of Money Already Subscribed by Existing Debenture Holders	Total Raised
30/7/58	1.4	6.6	0.8	7.4
26/3/57	2.0	17.4	2.2	19.6
1/10/59	2.0	17.0	1.0	18.0
7/3/60	2.0	11.2	1.2	12.4
25/5/60	2.0	18.4	0.2	18.6
2/12/60	2.0	5.6	5.6	11.2
26/5/61	1.0	4.2	2.6	6.8
21/12/61	1.0	3.4	1.4	4.8
31/5/62	0.5	1.8	1.0	2.8
	13.9	85.6	16.0	101.6

Source: Victoria, Parliament [1963, p.48]

full, it seems unlikely that they will recover the interest accrued on this principal.

Moreover, interest has been accrued at rates applicable to the initial debenture issues, which ranged from approximately four to nine per cent. This understates the opportunity cost incurred by R.M.A.'s debenture holders. Had they been able to retrieve their principal when it was due, they would have been able to reinvest it at substantially higher rates. In addition, R.M.A. debenture holders have incurred substantial losses in terms of the decline in the purchasing power of any principal and interest eventually recovered. It is difficult to quantify these losses because of the declining principal outstanding and the generally increasing interest rates and price levels over time. However, $36.02m, the sum of the principal and interest owed at 31 July 1982, significantly understates the total real losses to R.M.A.'s debenture holders.

In conclusion, by the end of 1981-82, R.M.A. investors had lost approximately $41m, comprising $5m share capital and approximately $36m outstanding debenture principal and accrued interest. If the losses of retained earnings and purchasing power and the opportunity cost of investors being unable to place their funds elsewhere were taken into account, these estimated losses would be much greater.

5.2 Testing the Misinformation Hypothesis for R.M.A.

5.2 (i) The Relevant Period and the Relevant Data

The methodology outlined in Chapter 3 defined the relevant data as the financial statement data issued by the failed company and the relevant period as the period from incorporation to receivership or, in the case of companies with long lives, the period leading up to receivership. On this basis, it is necessary to analyse the financial statement data issued by R.M.A. between June 1958 and January 1963. However, the peculiar circumstances surrounding R.M.A.'s share and debenture issues indicate that this approach is not entirely appropriate.

As far as the shareholders are concerned, it is unlikely that subscriptions to R.M.A.'s share issues were influenced by published financial statement information about R.M.A. for three reasons. First, R.M.A.'s share capital was contributed wholly by R.M.H. As parent company, R.M.H. had available to it more extensive information than that contained in R.M.A.'s published financial statements. Second, as shown in Table 5.1, the funds subscribed by R.M.H. for four of R.M.A.'s seven share issues were, in fact, borrowed from R.M.A. According to the government investigation, these issues were made solely to overcome borrowing limits imposed by R.M.A.'s debenture trust deed.[7] Given this atypical motivation for R.M.A. making these issues and for R.M.H. subscribing to them, the information usually sought from financial statement data, for example, the rate of return on shareholders' funds, would have been irrelevant. Third, under these circumstances, the only shareholders who could have been misled were the R.M.H. shareholders whose subscriptions were used to take up the other three R.M.A. share issues. Table 5.1 shows that these issues were made in June 1958, February 1959 and August 1959, prior to the publication of R.M.A.'s first set of financial statements. Moreover these investors subscribed to R.M.H. shares not R.M.A. shares.

As far as the debenture holders are concerned, eight of R.M.A.'s nine debenture issues were guaranteed by R.M.H. and, therefore, it is necessary to analyse R.M.H.'s financial statements as well as the financial statement data issued by R.M.A. Indeed, R.M.A.'s prospectuses informed potential debenture subscribers that

> "The Company continues to trade substantially within the group, and more than half its funds are advanced at a nominal rate to other subsidiary companies of Reid Murray Holdings Limited. This naturally limits the earnings of Reid Murray Acceptance Limited, but as Reid Murray Holdings Limited guarantees the principal and interest of this issue of First Mortgage Debenture Stock, the surplus assets and the income of Reid Murray Holdings Limited and all its subsidiaries are a security covering the principal and interest liabilities of this issue."[8]

The significance attached to the R.M.H. guarantee is illustrated by the following extract from a letter to the editor of the *Australian Financial*

[7] See footnote 5, this chapter.

[8] This statement was included in Managing Director's Report in the fourth and fifth prospectuses. The Managing Director's Reports in the prospectuses issued for the other six debenture issues guaranteed by R.M.H. also drew attention to the assets and income of the Reid Murray group.

Review. The letter was written by an R.M.A. debenture holder, two days before the company was put into receivership.

> "Some two or three years ago, these (R.M.A.) debentures were suggested to me as a quite satisfactory, safe investment in the category in which I was interested. There was sound asset backing and interest cover; the Reid Murray Group was doing very well and the shares as a result were at a substantial premium in the market; the board of directors included the names of well regarded businessmen.
>
> Apart from this the prospectus emphasized that both principal and interest were guaranteed by the R.M. parent company and a trust deed ... provided that should the position of debenture holders deteriorate beyond certain defined limits (both as to asset backing and payment of principal and interest where due), then the whole of the issue and principal would become due and payable forthwith."[9]

Thus, in analysing the financial statement data relevant to R.M.A.'s debenture holders it is necessary to assess the profitability and security of the entire group. The R.M.A. data are relevant only to the extent that they provide an indication of the solvency of the legal entity and the security available for the third issue of debentures which was not guaranteed by R.M.H.

The methodology outlined in Chapter 3 recognized that debenture holders had two main sources of financial statement data available to them. Prospectuses, which contain certain elements of financial statement data, were provided to *potential* debenture subscribers. In addition, copies of the company's audited financial statements were available, on request, to *existing* debenture holders.

A brief survey of R.M.A.'s prospectuses shows that potential debenture subscribers were exposed to the financial statement data of both R.M.A. and

[9] *Australian Financial Review*, 8 January 1963, p.2. According to clause 34 of the debenture trust deed covering the first and second debenture issues, R.M.H. guaranteed repayment of all principal and interest owed to R.M.A. debentue holders which was not paid within 14 days of the due date. The trust deed covering the fourth to the ninth issues included a similar provision.

R.M.H. The first seven of R.M.A.'s nine prospectuses included a report by the investigating accountants, who were Wootton, Sons & Elvish. Generally, these reports comprised details of R.M.A.'s past profits, an R.M.A. balance sheet adjusted to include the effects of the proposed issue and an estimate of R.M.A.'s asset cover available to debenture holders. The reports in the third, fourth and fifth prospectuses also included R.M.A. balance sheets which omitted the effects of the proposed issue. In addition, each of the investigating accountants' reports, other than in the third prospectus, included earnings and balance sheet data for R.M.A.'s guarantor company, R.M.H. In each report, the earnings data for R.M.H. were consolidated. The balance sheet data were not consolidated in the first two prospectuses, although the first prospectus did include balance sheet data for each of the R.M.H. subsidiaries. The report in the second prospectus also included a statement of funds employed by R.M.H.

In addition to the investigating accountants' reports, each prospectus, except the first, contained a report by R.M.A.'s auditors, Fuller, King & Co. These reports included the most recent audited balance sheet and statement of profit and loss for R.M.A. In the fourth to the seventh prospectuses, they also included balance sheet data as at the previous balance date and profit and loss data for each year since incorporation. The auditors' reports in the third, fourth and fifth prospectuses largely duplicated the information contained in the investigating accountants' reports, since the latter included financial statements both with and without adjustments for the effects of the proposed issues. The auditors' reports in the eighth and ninth prospectuses also included balance sheets for R.M.H.

R.M.A.'s prospectuses, therefore, provided potential debenture subscribers with an investigating accountants' report and an auditors' report although these two sources sometimes provided the same data. The investigating accountants' reports for issues guaranteed by R.M.H. included details of earnings by the R.M.H. group and balance sheets for either the parent company or the group. The auditors' reports focused mainly on R.M.A. financial statement data. The accounting information in the prospectuses was largely confined to these two reports and any accounting information quoted elsewhere in the prospectuses tended to be drawn from them.

In addition to the data contained in the prospectuses, R.M.H.'s audited accounts should have been filed in the Companies Offices in the states in which R.M.H. shares and debentures were traded. Thus, R.M.A. debenture holders had access to R.M.H.'s audited accounts. It has not been possible to obtain copies of these accounts. However, the R.M.H. data relevant to R.M.A. debenture holders can be drawn from the reports on R.M.H., prepared by the *Investment Service* of the Sydney Stock Exchange. The *Investment Service* report for 1962 is not available. However, since the last R.M.A. prospectus was issued in May 1962, this omission is not particularly significant. It has also not been possible to obtain copies of R.M.A.'s audited financial statements which would have been available to existing debenture holders and relevant to assessing R.M.A.'s solvency and the security available for debentures not guaranteed by R.M.H.[10] The I.C.A.A. statement, *Accountants' Reports for Prospectuses* recognized that amendments to audited financial statements may be appropriate for prospectus reports, but, in R.M.A.'s case, no such amendments were made.[11] Thus, the financial statement data contained

[10] R.M.A.'s audited accounts for the period 1958-59 to 1960-69 are missing from the S.A. and Victorian Corporate Affairs files.

[11] See Institute of Chartered Accountants in Australia [1963c]. This statement was issued just after the R.M.A. failure but it formalized accepted accounting principles already in existence. However, a comparison of the prospectus data with various pieces of financial statement data quoted in the government inspectors' report indicates that the prospectus auditors' reports simply reproduced the audited financial statements.

in the auditors' reports in the third, sixth and eighth prospectuses, which related to the years ended 31 August 1959, 1960 and 1961 respectively, were the same as the data available from R.M.A.'s audited financial statements.

To summarize, Table 5.3 identifies the various sources of financial statement information likely to have been relevant to R.M.A. debenture holders. For the holders of debentures guaranteed by R.M.H., it is necessary to analyse the information about R.M.H. contained in the group's audited accounts and in the R.M.A. prospectuses. It is also necessary to assess indicators of solvency of the legal entity from R.M.A.'s financial statement information contained in R.M.A.'s audited accounts and prospectuses. For the holders of debentures not guaranteed by R.M.H., it is necessary to assess the profitability of the group from R.M.H.'s audited accounts and the security of the debentures from the R.M.A. financial statement data contained in R.M.A.'s audited accounts and the prospectuses.

Table 5.3: Financial Statement Information Relevant to R.M.A. Debenture Holders

Investors	Source of Financial Statement Data	Probable Use of Financial Statement Data
Debenture holders for issues guaranteed by R.M.H.	R.M.H. audited financial statements	To assess the profitability and security of the economic entity
	R.M.H. financial statement information included in prospectuses	
	R.M.A. audited financial statements	To assess the solvency of the legal entity
	R.M.A. financial statement information included in prospectuses	
Debenture holders for the issue not guaranteed by R.M.H.	R.M.H. audited financial statements	To assess profitability of the economic entity
	R.M.A. audited financial statements	To assess the security of their investment
	R.M.A. financial statement information included in prospectuses	

5.2 (ii) R.M.H.'s and R.M.A.'s Condition According to The Financial Statement Data

5.2 (ii)(a) Indicators of Profitability and Security from R.M.H.'s Financial Statement Data

R.M.H. was incorporated in October 1957. Table 5.4 is based on R.M.H. financial statement data drawn from the *Investment Service* reports and the R.M.A. prospectuses. The methodology developed in Chapter 3 required an assessment of investment profitability and security based on net profits, return on assets, asset cover, interest cover and debt ratios. The R.M.H. data are not available in sufficient detail to calculate the return on assets, asset cover and interest cover of the group. Thus, the analysis of R.M.H.'s financial statement data is confined to consideration of the group's net profits and debt ratios. The *Investment Service* data show that R.M.H.'s consolidated net profit increased over the previous year by more than 80 per cent in both 1958-59 and 1959-60. In contrast, in 1960-61 R.M.H.'s net profit decreased by 42.66 per cent. However, the *Investment Service* report noted that a change in accounting method in 1960-61 had allowed R.M.H. to increase its profit before tax by approximately $1.04m. Without that change, R.M.H.'s decline in profitability would have been much greater.[12] The R.M.H. net profits reported in the R.M.A. prospectuses were higher than the results reported in the *Investment Service* in 1957-58 and 1958-59 and lower in 1959-60 and 1960-61. Since copies of R.M.H.'s original audited financial statements are not available it is difficult to determine the cause of these differences. However, the prospectus data, like the *Investment Service* data, indicated that R.M.H.'s net profit had increased significantly from

[12] The increase in profit was caused by a change in the accounting for unearned income.

incorporation to 1959-60, and decreased significantly in 1960-61.[13] The prospectus reports also noted the effects of R.M.H.'s change in accounting methods.

Table 5.4: R.M.H.'s Profitability and Security

	INVESTMENT SERVICE DATA[1]			R.M.A. PROSPECTUS DATA[2]		
Period ended	Net Profit After tax ($000)	Change over previous year (%)	Debt Ratio	Net Profit After Tax $000	Change over previous year (%)	Debt Ratio
31/8/58	900.83	-	0.74	1072.31	-	0.71
31/8/59	1644.60	+82.57	0.76	1717.27	+60.15	0.76
31/8/60	3074.46	+86.94	0.77	2832.03	+64.91	0.77
31/8/61	1762.72	+42.66	0.80	1711.23	-39.58	0.80

Notes:
1. Drawn from Sydney Stock Exchange Research and Statistical Bureau, Reid Murray Holdings Limited, Reports published February 1960, and December 1961.
2. Drawn from Reid Murray Acceptance Ltd, *Prospectus Nos 4, 5, 6, 7, 8 and 9*.

Lqe debt ratios based on the *Investment Service* data are largely consistent with the prospectus data. They indicate that R.M.H.'s reliance on debt increased in each year from incorporation. By 31 August 1961, R.M.H.'s debt ratio was 0.80. It is not appropriate to compare R.M.H.'s debt ratios to the industry average ratios or the ratios of the non-failed companies which were presented in Chapter 3. These ratios were calculated for finance companies and R.M.H.'s activities extended beyond the finance industry.

In brief, R.M.H.'s financial statement data depicted the Reid Murray group as increasingly profitable prior to 1960-1961. However, the data for 1960-61 gave some cause for concern as profit decreased significantly and the group's dependence on debt continued to increase.

[13] The rate of return on assets would have provided a better indicator of R.M.H.'s profitability. However, the group did not disclose its interest expense and therefore it is not possible to calculate R.M.H.'s earnings before interest and tax. Likewise, it is not possible to calculate R.M.H.'s interest cover.

5.2(ii)(b) R.M.A.'s Condition According to its Financial Statement Data

Table 5.5 shows R.M.A.'s profits and the ratios relevant to debenture holders based on financial statement data from the prospectus investigating accountants' reports. Table 5.6 shows the profits and ratios based on the auditors' reports. The tables show that the two sources of net profit data were consistent, the only differences being that the auditors' report included profit earned in 1961-62, which was not included in the investigating accountants' reports, and the investigating accountants' reports included profit earned prior to September 1958, which was not included in the auditors' reports. According to these data, R.M.A. was profitable throughout the period covered by the reports. The changes in R.M.A.'s profitability over time are difficult to assess because of its short life and because of the lack of comparable data for the early periods. The results from the later periods, however, suggest that R.M.A. experienced declining profitability from at least 1959-60. For example, in the first half of 1959-60, reported profit increased by 60.60 per cent over profit in the first half of the previous year. Yet, reported profit for the whole of 1959-60 was only 34.42 per cent greater than profit in the previous year. In 1960-61, the rate of growth in profit declined substantially. In the first-half, profit increased over the previous first-half by only 7.62 per cent. The increase for the full year was 16.09 per cent. Moreover, this improvement probably reflected a change in accounting method rather than an actual increase in profitability. According to a note to the 1960-61 accounts, R.M.A. changed its accounting for unearned income and this change increased net profit before tax by $213,280, or 22.3 per cent. The effect on profit after tax was not disclosed but it is probable that the profit for 1960-61 would have been much lower, if it were not for the change in accounting method. In the first half of 1962, R.M.A.'s decline in profitability became apparent, when net profit was 15.23 per cent lower than the profit earned in the relatively poor first half of 1960-61.

Table 5.5: R.M.A. Prospectus Data, Investigating Accountants' Reports

Period	Net Profit After Tax ($000)	Change over Corresponding Period in Previous Year (%)	Net Tangible Asset Cover $	Debt Ratio
5/6/58-31/8/58	33.12	-	1.83(1)	n.a.
1/9/58-28/2/59	179.51	-	1.53	0.73
1/9/58-31/8/59	425.31	-	1.26	0.82
1/9/59-31/12/59	192.71	-	1.31	0.78
1/9/59-29/2/60	288.29	+60.60	1.28	0.81
1/9/59-31/8/60	571.70	+34.42	1.26	0.81
1/9/60-28/2/61	310.25	+7.62	1.29	0.81

Note: (1) At 14/7/58

Table 5.6: R.M.A. Prospectus Data, Auditors' Reports

Period	Net Profit After Tax ($000)	Change over Corresponding Period in Previous Year (%)	Net Tangible Asset Cover ($)	Debt Ratio	
1/9/58-28/2/59	179.51	-	1.55	0.72	
1/9/58-31/8/59	425.31	-	1.29	0.80	1958-59 Audited Accts
1/9/59-31/12/59	192.71	-	1.37	0.78	
1/9/59-29/2/60	288.29	+60.60	1.31	0.80	
1/9/59-31/8/60	571.70	+34.42	1.21	0.81	1959-60 Audited Accts
1/9/60-28/2/61	310.25	+7.62	1.30	0.81	
1/9/60-31/8/61	663.69	+16.09	1.30	0.81	1960-61 Audited Accts
1/9/61-28/2/62	263.01	-15.23	1.28	0.81	

Although the methodology outlined in Chapter 3 required the calculation of return on assets and interest cover as an indicator of profitability, this has not been done for R.M.A. because of R.M.A.'s special relationship with R.M.H. Since more than half of the funds raised by R.M.A. were lent to R.M.H. subsidiaries at nominal rates, measures of R.M.A.'s profitability are unlikely to be meaningful. Under these circumstances, R.M.H. group profit is the relevant indicator of profitability.

The estimates of net tangible asset cover and debt ratios, based on the investigating accountants' reports, differed from those based on the auditors' reports, because the investigating accountants' data included the effects ot proposed debenture issues. Although subscribers may have been interested in the effects of a proposed issue on debenture security, the investigating accountants' adjustments, based on the nominal amount of each issue, were largely invalidated because of the effects of oversubscription. Table 5.2 showed that R.M.A.'s nine prospectuses were issued to raise a nominal sum of $13.9m, whereas subscriptions totalling $101.6m were accepted. The data contained in the auditors' reports reflected actual assets, at book value, and actual liabilities, rather than estimates of assets and liabilities based on an inappropriate premise. The data from the auditors' reports, therefore, are likely to provide more meaningful measures of debenture security.

Table 5.6 which is based on the auditors' reports shows that the tangible asset cover available for each dollar of funds contributed by R.M.A.'s debenture holders ranged from a maximum of $1.55, at 28 February 1959, to a minimum of $1.21, at 31 August 1960.[14] Apart from these two extremes and an atypical peak of $1.37 at 31 December 1959, the asset cover available to R.M.A.'s debenture holders fluctuated around $1.30. Although there was no

[14] R.M.A. debentures had a face value of $200.

downward trend in asset cover, it was low, given that R.M.A.'s issued share capital increased from \$5.0m to \$14.0m between December 1959 to August 1961. Table 3.4 shows that A.G.C.'s debenture cover over the corresponding period, which ranged from \$1.68 in 1961 to \$1.92 in 1959, was considerably higher than the R.M.A. "average" of \$1.30. Estimates of B.F.C.'s debenture cover are available only for the latter part of this period. It was \$1.32, in 1961, and \$1.62, in 1962. Although the asset cover available to B.F.C. debenture holders in 1961 is only marginally better than R.M.A.'s asset cover, the B.F.C. figure is unrepresentative because 1961 was the company's first full year in operation. Over the period 1963 to 1979, the asset cover for B.F.C.'s debentures fell as low as \$1.30 only in 1963 and 1964. Estimates of industry debenture cover are not available until 1964. However, there is no reason to believe that the level of asset cover available to debenture holders is influenced by temporal factors. Table 3.2 shows that the average industry cover per dollar of debenture funds over the period 1964 to 1979, ranged from a high of \$2.42, at 30 June 1974 and 1975, to a low \$1.88, at 30 June 1966. The earliest figure available was \$2.00, at 30 June 1964. By any comparison, therefore, the asset cover available for R.M.A.'s debentures was low, although subscribers may have been reassured by guarantees provided by R.M.H.

The debt ratio provides an alternative indicator of principal security. Table 5.6 shows that apart from ratios of 0.72, at 28 February 1959, and 0.78, at 31 December 1959, R.M.A.'s debt ratio tended to fluctuate around 0.80 to 0.81. The trust deed limited borrowing to five times shareholders' funds, which implied a maximum debt ratio of 0.83.[15] From 30 June 1959, R.M.A.'s debt ratio was always kept slightly below the trust deed limit. This is

[15] A-L = SHF, if L = 5 x SHF then A = 6SHF

$$\therefore \frac{L}{A} = \frac{5SHF}{6SHF} = 0.83$$

hardly surprising, given the government inspectors' conclusions that the sole purpose of the R.M.A. share issues made since August 1959 was to overcome the limitations of the trust deed.

Table 3.3 shows that, A.G.C.'s debt ratio for 1959 was 0.71 and, over the period 1960 to 1962, it was constant at 0.75. Over the corresponding period, therefore, A.G.C.'s debt ratio was considerably lower than R.M.A.'s. On the other hand, B.F.C.'s debt ratios are available from 1961 and, apart from a ratio of 0.76 in 1962, have always been above 0.80. Moreover, Table 3.2 shows that the industry average debt ratios, available from 1964, have never fallen below 0.84. However, the substantial changes in economic climate, which occurred between the late 1950s and the early to mid-1960s, make the comparison of debt ratios over successive periods precarious. Thus, although the asset cover available for R.M.A.'s debentures was relatively low there is insufficient evidence to conclude that the company's debt ratios were relatively high.

5.2(ii)(c) Profitability and Security; The Perspective for the R.M.A. Debenture Holders

To summarize, R.M.A. was effectively the finance arm for the Reid Murray group. It advanced a large part of its funds to Reid Murray subsidiaries at nominal rates of interest. Moreover, eight of the nine R.M.A. debenture issues were guaranteed by R.M.H. for both interest and principal repayments. Therefore, the profitability and security available for R.M.A. debentures is best assessed by analysing R.M.H.'s financial statement data. Unfortunately, it has not been possible to obtain copies of R.M.H.'s original audited financial statements. However, according to the *Investment Service* reports on R.M.H. and the R.M.A. prospectuses, R.M.H.'s profits grew significantly in each year prior to 1960-61. The results for 1960-61 indicated a sudden and significant drop in profit, particularly when allowance is made for changes in accounting method. Moreover, R.M.H.'s dependence on debt increased in each year. By August 1961, the group had a debt ratio of 0.80. Thus, these data should have given debenture holders some cause for concern, although by the time the 1961 accounts were published seven of the nine R.M.A. debenture issues had been made. The remaining two issues were made after the 1961 accounts were published but even these accounts did not indicate that R.M.H.'s failure was imminent.

In addition to analysing the R.M.H. accounts, the R.M.A. accounts were relevant as indicators of solvency and of the security available to the holders of the third issue of debentures which were not guaranteed by R.M.H. These data also did not indicate that failure was imminent. They depicted R.M.A. as profitable. The accounts for the first half of 1961-62 showed a substantial drop in net profit but, by this time, investors had already subscribed to eight of R.M.A.'s nine debenture issues. At each balance date, the face value of the debentures was more than covered by the book value of R.M.A.'s assets. The debt ratio showed that trust deed restrictions on borrowing had been complied with and, thus, it would seem to be reasonable for investors to be satisfied that protection was adequate. Nevertheless, the asset cover available for R.M.A. debentures was low compared to other firms in the industry. Moreover, R.M.A.'s failure to file any accounts for the year ended 31 August 1962 should have aroused investors' suspicions although, given that R.M.A.'s last debenture issue opened on 31 May 1962, most subscribers would have been committed by this time.

5.2 (iii) R.M.A.'s Financial Statement Misinformation

The last set of audited accounts published by R.M.A. showed its financial position at 28 February 1962. Net profit had fallen significantly but, according to the balance sheet, R.M.A. remained in a sound financial position. During the period, unappropriated profits had increased by approximately $283,000. Yet ten months later, the receivers estimated that R.M.A.'s liabilities exceeded the realizable value of its assets by $24.85m.

In Chapter 3, it was shown that there are difficulties in comparing asset values in financial statements with those in statements of affairs because of their different valuation bases. Table 5.7 sets out the book and estimated realizable values of R.M.A.'s assets at receivership. The estimated realizable value of R.M.A.'s total assets was $38.81m less than their book value. The realizable value of the non-current assets was estimated to be less than half of their book value. However, the non-current assets were relatively insignificant and, under historic cost accounting and the going concern assumption, there is no reason why the two values should be the same. The bulk of R.M.A.'s deficiency related to its current assets which had an estimated realizable value $38.62m lower than their book value of $75.50m.

Generally accepted accounting principles require current assets to be recorded at the lower of cost and realizable value. It is possible, however, that the difference between the book and statement of affairs current asset values was due to the switch from a going concern to a liquidation basis of valuation. In this case, provided that the going concern assumption was appropriate prior to receivership, the deficiency cannot be considered evidence of financial statement misinformation. The government investigation found that, right up until receivership, the directors did not doubt the continued existence of R.M.A. In the directors' view, the going concern assumption was appropriate.[16] The directors had legal responsibility for the

[16] Victoria, Parliament [1963, p. 96] and [1966, p. 77].

Table 5.7: R.M.A. Asset Values (in $m)

	Book Value 10/1/63	Realizable Value 10/1/63	Deficiency
Current Assets			
Cash	0.03	0.03	-
Amounts due under hire purchase and other contracts	7.41	6.50	0.91
Advances secured by mortgage etc.	3.67	1.17	2.50
Other debtors and prepayments	0.02	0.02	-
Amounts owing by related companies	64.37	29.16	35.21
	75.50	36.88	38.62
Non-current Assets			
Leasehold properties	0.16	0.02	0.14
Plant and equipment	0.14	0.09	0.05
	0.30	0.11	0.19
Total Assets	75.80	36.99	38.81

Source: Reid Murray Acceptance Ltd. (Receivers Appointed), Statement of Affairs, as at 10 January 1963.

accounts and therefore, the going concern decision rested with them. However, the auditors should have qualified the accounts, if they considered the going concern assumption inappropriate.

An alternative explanation for the difference between the balance sheet and statement of affairs current assets values is that their realizable value was underestimated in the statement of affairs. More than 90 per cent of the gap between the book and realizable values of R.M.A.'s current assets was related to the group of accounts, "Amounts owing by related companies", which the receivers wrote down from $64.37m to $29.16m. By 31 July 1979, a total of $35.48m had been written off as bad debts from "Amounts owing by related companies".[17] The receivers' initial estimate of a $35.21m deficiency in this asset was, therefore, reasonably accurate.

The government investigation into the collapse of R.M.A. threw some light on the valuation of "Amounts owing by related companies". Table 5.8 shows the pattern of R.M.A.'s lending over time according to its financial statements. The table shows that, by 29 February 1960, R.M.H. was R.M.A.'s major debtor. Indeed, $32.21m of the $33.88m lent to "related companies" was borrwed by R.M.H. At this date, R.M.A.'s total receivables were $46.11m. From 31 August 1960, R.M.H. ceased to borrow from R.M.A. From this time, loans to "associated companies and firms" or "subsidiary and associated companies" accounted for the bulk of R.M.A.'s receivables. However, the inspectors found that in substance R.M.H. was always R.M.A.'s major debtor. Legally, from April 1960, R.M.A.'s major debtor was Re-Mur Finance Co, which is classified as an associated company in Table 5.8.[18] Re-Mur Finance Co. was owned by five companies, four of which were insolvent and a fifth which was of little substance. Re-Mur was a mere shell. All monies actually passed from R.M.A. to Reid Murray subsidiaries through R.M.H. At the end of each financial year, the balances outstanding in the subsidiaries' (including R.M.A.'s) books and in R.M.H.'s books, as interest bearing loans, were transferred by a journal

[17] Reid Murray Acceptance Ltd. (Receivers Appointed), Audited Financial Statements for the Year Ended 31 July, 1979.

[18] The details of the Re-Mur substitution are discussed in Victoria, Parliament [1963, pp. 50-52].

Table 5.8: R.M.A. Debtors Within and Outside the Reid Murray Group ($m)

	28/2/59	31/8/59	31/12/59	29/2/60	31/8/60	28/2/61	31/8/61	28/2/62
R.M.H.	3.06	2.57	28.64	32.21	-	-	-	-
Associated companies	4.59	13.24	1.34	1.67	-	-	-	-
Associated companies and firms	-	-	-	-	49.19	60.74	-	-
Subsidiary & associated companies	-	-	-	-	-	-	62.67	65.25
	7.65	15.81	29.98	33.88	49.19	60.74	62.67	65.25
Third parties	4.24	8.63	11.06	12.23	18.60	12.78	11.30	10.38
Total Receivables	11.89	24.44	41.04	46.11	67.79	73.52	73.97	72.63

Source: Reid Murray Acceptance Ltd., audited financial statements, various prospectuses.

entry so that Re-Mur was substituted as borrower, or lender, for R.M.H. These balances were retained in the books of Re-Mur. In this way, debts owing by and to Re-Mur built up rapidly. The net effect of these book entries was that sums of more than $52m were lent unsecured by R.M.A. to an entity consisting of four companies in insolvent circumstances, and another of little worth compared to the sums it was borrowing.

Moreover, substantial amounts were owed to R.M.A. by other R.M.H. associated companies. Table 5.8 shows that, by 28 February 1962, R.M.A. was owed more than $65m by Re-Mur and other R.M.H. companies. Re-Mur's and R.M.H.'s debtors were heavily involved in real estate and credit retailing and had been doing badly from as early as 1958-59. In these circumstances, R.M.A.'s accounts should have included a substantial provision for doubtful debts. Had such a provision been made, it would have resulted in a major reduction in the value of R.M.A.'s current assets and in its profit.[19] Instead, no provision was made. It can be concluded therefore, that the marked difference between the book value of R.M.A.'s debtors, according to the financial statements, and the realizable value, according to the statement of affairs, largely reflected the overstatement of the value of debtors in the financial statements. The switch from going concern to liquidation based values also may have contributed to this difference, because the forced liquidation of the debtor companies is likely to have decreased their ability

[19] The government inspectors also argued that debts owing from Re-Mur and R.M.H. should not have been classified as current assets. (See Victoria, Parliament [1963, p.80]). They estimated that repayment, even within five years, would have involved almost complete winding up of the Re-Mur and R.M.H. debtor subsidiaries. In such circumstances, the debt would not have realized its book value, as was eventually apparent from R.M.A.'s statement of affairs. This argument, however, ignores the fact that assets are classified as current if they are expected to be realized within the normal operating cycle of the business, which can extend over a number of years (See Kenley [1970, p.62]). In this case, if adequate provision had been made for debts unlikely to be realized at all, the current asset classification was probably appropriate.

to repay their debts.

The government inspectors criticized three other aspects of R.M.A.'s financial statements. First, they criticized the valuation of hire purchase debtors, on the grounds that these amounts were fully recoverable only if R.M.A. and the Reid Murray group continued in business. This amounts to a criticism of the going concern assumption. It is difficult to say at what point the going concern assumption was no longer appropriate for R.M.A. However, according to the statement of affairs, at receivership the realizable value of hire purchase debtors was only $0.91m below their book value. This criticism is, therefore, relatively unimportant. Second, from June 1962 to January 1963 R.M.A. assigned debts of $3.4m for $2.0m. The discount of $1.4m was treated as a loan secured by mortgage. It should have been charged against profits and the provision for unearned income. However, as this manipulation affected only the accounts for the year ended 31 August 1962, which were never made available to investors, it cannot be considered misleading. Finally, from the year ended 31 August 1961, R.M.A. adopted the "Rule of 78" in estimating unearned income. This change in method increased R.M.A.'s net profit before tax in 1960-61 by $213,280, or 22.3 per cent. The inspectors argued that the change in accounting method had been used for "creative" purposes.[20] However, the I.C.A.A. and the Hire Purchase Association had recommended the adoption of the "Rule of 78" in mid-1961.[21] R.M.A.'s generally poor collection record and inadequate provision for doubtful debts probably meant that gross income was overstated. Under these circumstances, the "Rule of 78" may not have been appropriate. In this situation, any fault lay with the failure to provide for doubtful debts rather

[20] Parliament of Victoria [1963, p. 70].

[21] Institute of Chartered Accountants in Australia [1961].

than with the application of the "Rule of 78". R.M.A.'s accounts for 1960-61 included a note specifying the effect of this change on net profit. The adoption of the "Rule of 78", therefore, cannot be considered deliberately misleading, although it did have the beneficial side effect of making difficult any comparison of post-1961 profits with earlier results and it did make the substantial decline in profits which occurred in 1961 less apparent.

To summarize, from the point of view of debenture subscribers, R.M.A.'s accounts were potentially misleading largely because of the significant overstatement of the current asset, "Amounts owing by related companies", and the associated overstatement of profit. These overstatements implied that there was sufficient liquidity to meet interest expenses and sufficient asset cover for the debenture principal. The importance to investors of R.M.A.'s financial statement misinformation was emphasized by the government inspectors, who noted that

> "it was the accounts for 1958, 1959 and 1960 which tempted much of the money that was subsequently lost. If more moderate figures had been shown in those years, the development of the Reid Murray boom would have been retarded and perhaps prevented and we think that if events had moved more slowly and the build up in the group had been more gradual, it is not improbable that no disaster would have occurred."[22]

5.2 (iv) The Reid Murray Group's Financial Statement Misinformation

According to the government investigation, which covered R.M.H. and its major subsidiaries, there were several areas where R.M.H.'s accounts could have misled investors. For example, generally there was no provision for bad debts in the accounts of the R.M. subsidiaries. R.M.A.'s failure to provide for the very doubtful Re-Mur debt was discussed above. In addition, the

[22] Parliament of Victoria [1963, p. 66].

treatment of hire purchase sales within the group, which were financed by R.M.A. with a right of recourse, was of particular concern. R.M.A. did not require a provision for doubtful debts, as it relied on its right of recourse. The selling company would be called on only in the event of default by the debtor, and, therefore, the selling company's liability was contingent. Nevertheless, somewhere in the group a provision should have been made for those debts which proved to be irrecoverable. For the year ended 31 August 1961, the auditors required some provision for doubtful debts within the R.M. group. R.M.H. created a $700,000 provision from unappropriated profits. This treatment was inappropriate for three reasons. First, and most importantly, the amount of the provision was inadequate. Second, the provision should have been shown in the accounts of the subsidiaries rather than R.M.H., although the effect on the group accounts would have been the same. Third, the provision should have been charged against current rather than unappropriated profits. As a result, the group's profit for the year was overstated.

There were other elements of misinformation in the group's financial statements. R.M.H. did not amortize the goodwill arising on the acquisition of a tax loss company as the tax losses were used up. In accounting for unearned income, R.M.H. changed to the "Rule of 78" for the year ended 31 August 1961, which increased group profit by $765,000. According to the inspectors, this profit manipulation was the reason for the change. However, as discussed above, the "Rule of 78" was the recommended method of apportioning the gross income from finance contracts over the term of the contract and its adoption should not be criticized simply because it increased profit. More significantly, the "Rule of 78" was not adopted uniformly throughout the group, despite R.M.H.'s claims that it was a group policy.[23]

Real estate was treated as a trading asset, but was valued in the accounts of R.M. subsidiaries at cost, even when realizable value was less than cost. According to the inspectors, real estate values in the group's accounts should have been written down, in 1961, by hundreds of thousands of dollars.[24] A major cause of this overstatement was the capitalization of interest and development costs, without regard to their recoverability. Capitalization continued where plans for land development and resale were interrupted for an uncertain period. Moreover, in their examination of Paynes Properties Pty. Ltd., a R.M.H. real estate subsidiary, the inspectors found that overdraft and intercompany interest was allocated to individual properties according to a set formula, but that this formula was abandoned whenever it resulted in decreased capitalization.[25] Paynes Properties' had also been involved in a series of land cross-sales at inflated prices. The inspectors found that in some cases land values had been inflated by up to 50 per cent.[26] No independent check of these values was made until 1962. In addition, the presentation of real estate in the group accounts changed between 1960 and 1961, making intertemporal comparisons difficult. In 1960 real estate values were shown net of the liabilities under contracts of sale, whereas in 1961 they were shown at their gross value. On a comparative basis, the 1961 current assets were overstated by $6.7m and working capital was overstated by $5.1m.[27]

[23] Victoria, Parliament [1963, pp.69-70].

[24] Victoria, Parliament [1963, p.79].

[25] Victoria, Parliament [1964-65, p.144].

[26] See, for example, Victoria, Parliament [1964-65, pp. 84-85].

[27] Stamp [1964, pp. 302-303].

Also in accounting for real estate, the apportionment of costs over individual estates was, in some cases, arbitrary, with the possibility that charges against revenue may have been unreasonably deferred and, thus, profits and assets may have been overstated.[28] Profit on the sale of real estate was recognized at the time of sale even though it often involved the sale of broad acres, on long and sometimes conditional terms, to purchasers of little substance.[29] Profits on the sale of houses were taken into account before the houses were built. The inspectors estimated that this increased group profit for 1960-61 by $40,000.[30] Real estate contracts not completed in a binding form were included in the group accounts for the year ended 31 August 1961. The inspectors estimated that this increased group profit by $300,000.[31]

There were other examples of misinformation in the R.M. subsidiary and group accounts. For example, one subsidiary included $190,000 as procuration fees, where no procuration services had been provided.[32] Pre-acquisition profits of a company taken over during 1960-61 were treated as part of group profits for the year. The inspectors estimated that this increased group profit by between $26,000 and $100,000.[33] In one subsidiary, a presumably redundant provision, raised by a charge against pre-acquisition revenue, was written back into profits for 1961, thus overstating post-acquisition profits. The inspectors estimated that this increased group profit by

[28] Victoria, Parliament [1963, p.62].

[29] Victoria, Parliament [1964-65, p.160].

[30] Victoria, Parliament [1963, pp. 76-78].

[31] *Ibid.*

[32] *Ibid.*

[33] Victoria, Parliament [1963, p.72].

$50,000.[34] One subsidiary changed its method of accounting for real estate, from a profit-emerging basis to taking to account the total profit at the time of sale. The inspectors estimated that this increased group profit in 1960-61 by $170,000, yet the change in method was not disclosed in the accounts.[35]

Another change in method involved the accounting for television and radio hire, by the subsidiary Radio Rentals Limited. Customers were given the option, at the end of an initial fixed rental period, to take the set on hire purchase. If accepted, the rental was credited towards the hire purchase. Previously, the credit for the rent was taken on an accrual basis. Under the new system, introduced in 1960-61, credit was taken immediately for the whole of the rental. The inspectors estimated that this change increased group profit for 1960-61 by approximately $272,000[36] The change in method was noted in the accounts. Also credit retailers took the whole of profit on hire purchase sales into account at the time of sale, despite the group's self-financing. The inspectors argued that, because of the reliance on intragroup financing, the profit should have been spread over the term of the sale, on a profit-emerging basis. Implicit in their argument was an assumption that profit was not receivable at the time of sale.[37]

Many of these distortions overstated group, and hence R.M.H., profits and assets, particularly debtors and real estate, by hundreds of thousands of dollars. The inspectors were unable to quantify the effects of all of these distortions, but they estimated that if there had been no changes in accounting method and no transfers from provisions, group profit, for the year

[34] *Ibid*.

[35] Victoria, Parliament [1963, pp.76-78].

[36] *Ibid*.

[37] Victoria, Parliament [1963, p.71].

ended 31 August 1961, would have been decreased from $2.5m to $0.6m before tax, or to a loss of $0.1m after tax.[38] Their calculations were confined to the year ended 31 August 1961, but many of these distortions also existed in earlier accounts. Clearly, R.M.A. debenture subscribers were misled about the security of their investment, in relation to the performance and backing available from R.M.H. Likewise, subscribers to R.M.H. shares which, in turn, financed the purchase of R.M.A. shares, were misled over the viability of the R.M. group. As the government inspectors concluded,

> "We do not think that the picture presented in the Fourth Annual Report (year ended 31 August 1961) on the state of the affairs of the Reid Murray Group and the results of the group for each year was true or fair."[39]

and, overall,

> "In our view ... the accounting techniques employed by the group largely disguised the true position"[40]

5.3 Testing the Responsibility Hypothesis for the Reid Murray Accounts

Having identified the financial statement misinformation of R.M.A. and of its guarantor R.M.H., it is necessary to determine the extent to which the accounting profession can be held responsible. This responsibility can be determined in terms of the responsibility criteria set out in Chapter 3, section 3.4(vi).

5.3(i) Responsibility for the R.M.A. Misinformation

R.M.A.'s financial statement data were potentially misleading largely

[38] Victoria, Parliament [1963, p.73].

[39] Victoria, Parliament [1963, p.80].

[40] Victoria, Parliament [1963, p.12].

because of the overstatement of the value of the current asset, "Amounts owing by related companies". The first accounting standard which dealt specifically with accounting for debtors was the pronouncement issued by the A.S.A. [1967], entitled *The Valuation of Book Debts, Bad Debts and Provision for Doubtful Accounts*, which stated that

> "... the only acceptable basis for valuing book debts is expected realisable value in the ordinary course of business, that is at book value less an adequate provision for doubtful debts... Book debts owing to a company by other companies within the group should be critically examined and, if necessary, a provision made for doubtful debts having regard to the real nature of the transaction."[41]

Although published several years after the collapse of R.M.A., this pronouncement confirmed principles which had been well understood and widely accepted within the profession for some time.[42] R.M.A.'s financial statement misinformation occurred, therefore, largely because of a failure to comply with generally accepted accounting principles.

It is difficult to determine whether the going concern assumption was appropriate, particularly for R.M.A.'s last set of accounts. If not, the accountants involved in the preparation, presentation and audit of these accounts can also be criticized in this respect. With a large part of R.M.A.'s assets consisting of unsecured loans to a company of little substance, the auditors should have had some doubts about R.M.A.'s viability. However, if the debtors had been accounted for properly, with adequate provision for doubtful debts, the difference between the going concern and liquidation based values would not have been so large.

[41] Australian Society of Accountants [1967].

[42] See, for example, Fitzgerald [1953, pp.74-80].

5.3(ii) Responsibility for the Reid Murray Group's Misinformation

With regard to the financial statement misinformation of the R.M. group, the failure to provide for doubtful debts prior to August 1961 contravened the generally accepted accounting principles discussed above. The charging of an inadequate provision for doubtful debts, in the August 1961 accounts, against R.M.H. unappropriated profits also contravened generally accepted accounting principles. The A.S.A. [1967] pronouncement required that

> "Provision for doubtful debts should always be charged to the profit and loss account and not to appropriation or any reserve account."

and

> "Each company in a group of related companies should make its own provision for doubtful debts and record the provision in its own profit and loss account regardless of whether consolidated accounts are prepared or not."[43]

Although this pronouncement was not issued until 1967, the principles requiring adequate provision for doubtful debts in the accounts of the subsidiary companies are likely to have been well understood and widely accepted in the Reid Murray era. The charging of the bad debts expense against unappropriated profits, rather than current profit, was prohibited under the 1973 version of the standard on profit and loss statements, but not under earlier versions.[44] However, according to the A.S.A. report, *The Accounting Principles and Practices Discussed in Reports on Company Failures*, published in 1966, this treatment violated generally accepted principles because

> "the practice of making provision for doubtful debts through the profit and loss appropriation account ... has the effect of unjustifiably increasing disclosed profits to the extent that the charge for doubtful debts relates to credit sales made during the

[43] Australian Society of Accountants [1967].

[44] Institute of Chartered Accountants in Australia [1973d].

> current period. Where the charge for doubtful debts relates to book debts carried over from prior accounting periods, a debit to the profit and loss appropriation account can be made, although even in these circumstances it would seem to be more appropriate to record the charge as a non-operating cost or loss."[45]

The charging of bad debts which related to previous periods to unappropriated profits was consistent with the matching principle but it was believed that the practice created an opportunity for inadequate disclosure.

R.M.H.'s failure to amortize the goodwill associated with the acquisition of a tax loss company, as the tax losses were used up, also contravened generally accepted accounting principles. The I.C.A.A. had issued a recommendation on consolidation in 1946 and the A.S.A. had issued notes on consolidation in 1956, but neither publication dealt specifically with the amortizaton of goodwill.[46] However, the I.C.A.A. recommendation on the depreciation of fixed assets, issued in 1947, advised the amortization of "leaseholds, patents and other assets which become exhausted by the effluxion of time".[47] Although not strictly a fixed asset, this principle could be applied to the goodwill associated with tax losses.

The R.M. group's application of the "Rule of 78" to unearned income complied with an I.C.A.A. pronouncement issued in 1961.[48] The group's inadequate provision for doubtful debts, rather than the application of the rule, was responsible for any overstatement of income on finance contracts. However, potentially misleading information was caused by Radio Rentals accounting for finance contracts. In 1960-61, Radio Rentals Ltd. changed its

[45] Australian Society of Accountants [1966, p.24].

[46] Institute of Chartered Accountants in Australia [1946e] and Australian Society of Accountants [1956].

[47] Institute of Chartered Accountants in Australia [1947].

[48] Institute of Chartered Accountants in Australia [1961].

accounting for rental credits on hire purchase contracts.[49] This misinformation can be attributed to the violation of the consistency convention. This basic principle of accounting requires accounting methods to be applied consistently over time. It does not prohibit changes in method warranted by changed circumstances. However, according to the government investigation, in this case the change was made solely to increase group profits in 1960-61.

Much of the misinformation in the R.M.H. accounts occurred in the accounting for real estate. Some of it occurred in areas where there were no clearly defined principles. Some of it resulted from non-compliance with accepted principles and in one area the misinformation resulted from the application of a generally accepted accounting principle which was inappropriate because of unusual circumstances. The R.M. group's heavy involvement in property trading meant that real estate was effectively trading stock. An I.C.A.A. recommendation on the valuation of stock-in-trade, issued in 1948, stated that

> "Stock-in-trade is a current asset held for realisation. In the balance sheet it is therefore usually shown at the lower of cost or market value."[50]

The relevance of this principle to Reid Murray's accounting for real estate was confirmed by the A.S.A., in 1966, when it stated

> "Where land is purchased for large scale development and later resale it is usually designated in the accounts as a 'current' or 'trading' asset ... Accepted accounting principles require that, if land is to be treated as a 'trading' asset, it should not be valued on the basis of cost (including the cost of development) if this

[49] Victoria, Parliament [1963, p.71].

[50] Institute of Chartered Accountants in Australia [1948].

> value exceeds its current market value based on realistic appraisals."[51]

This principle was reiterated by the A.S.A., in 1967, in its *Society Bulletin*, entitled *Accounting for Long-Term Land Development Projects*.[52] A major cause of the overstatement of the value of R.M. group real estate was the capitalization of interest and development costs, without regard to their recoverability, even where plans for development and resale had been interrupted for an uncertain period. In the early 1960s, no accounting standard dealt specifically with capitalization. The first standard in this area, *Statement on Accounting Practice, Expenditure Carried Forward to Subsequent Accounting Periods*, was issued in 1972.[53] The principles which should have been applied by the R.M. group were identified by the A.S.A. in 1966. According to the A.S.A.,

> "It is an accepted accounting principle to capitalize interest and other charges ... to the point where the development is regarded as complete. However, once the development has been completed, accepted accounting principles require that there should be no further capitalization ... while if the programme of development is ... terminated, or unreasonably deferred, or prolonged, then again further capitalization of charges should not take place.[54]

This principle was also reiterated in the 1967 *Society Bulletin*.[55] However, all of these publications, apart from the 1948 stock-in-trade recommendation, were issued after the failure of R.M.H. Moreover the stock-in-trade recommendation was issued in relation to stock-in-trade and included no specific references to real estate held by development companies. It can be concluded, therefore, that at the time the R.M.H. accounts were prepared there were no clearly defined principles in this area.

[51] Australian Society of Accountants [1966, pp.13-14].

[52] Australian Society of Accountants [1967a, pp.21-25].

[53] Institute of Chartered Accountants in Australia [1972b].

[54] Australian Society of Accountants [1966, pp.13-14].

[55] Australian Society of Accountants [1967a, p.24].

The Reid Murray group produced misinformation in another area of accounting for real estate, where accepted accounting principles had not been defined. The apparent overstatement of profits on real estate contracts was partly due to the arbitrary allocation of costs to individual estates and the recognition of profit at the time of sale despite the existence of long and conditional terms and purchasers of questionable substance. There has been no standard which covers the apportionment of costs over individual estates. According to the 1967 *Society Bulletin*, in practice costs were usually allocated to individual estates on the basis of relative sales value.[56] However, an A.A.R.F. discussion paper, published in 1982, recognized four different procedures by which the costs could be allocated.[57] These included apportionment by specific identification, pro rata to the number of lots, pro rata to a physical characteristic, or pro rata to sales value. Arbitrary apportionment of costs does not coincide with any of these procedures. However, both these papers were published subsequent to the period during which the Reid Murray accounts were prepared. These principles had not been defined at that time.

The lack of clearly defined principles in accounting for real estate has not yet been remedied. Despite the 1967 *Society Bulletin* and the 1982 discussion paper, the accounting profession has not issued a standard on accounting for real estate. It could be argued, however, that the lack of guidance on real estate capitalization principles was remedied by the 1972 statement on expenditure carried forward which outlined the general principles for capitalizing expenditures.

Other potentially misleading aspects of accounting for real estate within the R.M. group contravened generally accepted accounting principles. For

[56] *Ibid.*

[57] Australian Accounting Research Foundation [1982, pp.14-15].

example, the diversity convention allows an entity to adopt different accounting methods in different situations. However, the adoption by the R.M. subsidiary, Paynes Properties, of a different accounting method when the usual method resulted in decreased capitalization does not fall within the bounds of the diversity convention. The change between 1960 and 1961 from showing real estate contracts net of liabilities under the sale contract to showing them at their gross amount also contravened the consistency convention. Similarly, the change by one of the real estate subsidiaries, from recognizing revenue on a profit-emerging basis to point of sale, appears to have contravened the consistency convention.

With regard to the recognition of profit on group real estate sales, the A.S.A. [1966, p.13] argued that it was appropriate to recognize the profit at the time of sale as it was receivable at this point. According to the A.S.A., the R.M. accounts were inaccurate not because this profit was taken into account at the time of sale but because inadequate provision was made for bad debts on these sales. This principle was confirmed by the *Society Bulletin,* published in 1967.[58] However, R.M.H.'s auditors, Fuller, King & Co., argued against this method of accounting for real estate sales and recommended instead the profit-emerging method. In a letter to R.M.H. directors, concerning the 1961 accounts, the auditors stated

> "In many instances land is sold on terms, with a deposit being payable on the signing of the contract and the balance falling due by instalments. The policy of the group is to take up the full profit on the sale when the deposit is accepted, and in some cases it is not unusual for the profit to exceed the amount of the deposit. The method of recording the whole profit at this stage cannot be regarded as one to be recommended, as it involves taking credit for a debt which may never be received through the inability of either party to fulfil the conditions of sale."[59]

[58] Australian Society of Accountants [1967a, p.29].

[59] Victoria, Parliament [1963, p.116].

The auditors were familiar with the doubtful quality of the R.M. land transactions. It appears that the application of generally accepted accounting principles under these particular circumstances was inappropriate and, thus, resulted in misinformation. The difficulties in applying accepted accounting principles to the peculiar circumstances associated with real estate transactions were recognized, subsequently, in the A.A.R.F. discussion paper. According to the A.A.R.F. [1982, p.26], it may be necessary to apply certain tests to determine that the contract is reasonably assured, before recognizing the profit at the time of sale.

On a similar basis, the inspectors argued that profit on hire purchase transactions should have been recorded on a profit-emerging basis, rather than at the point of sale. Although no standard on accounting for hire purchase transactions had been issued in this area at this time, the A.S.A. [1958] had published an unendorsed statement in this area. According to this statement,

> "Commercial practice is to treat the time of acceptance of the offer to hire as the point of sale, and consequently the point at which gross profit is brought into account".[60]

The method by which the R.M. group accounted for its hire purchase transactions complied with this principle. Similarly, the A.S.A. [1966, p.10] argued that the principle of recording profit at the time of sale was appropriate as the income was receivable at this point. The problem, according to the A.S.A., was Reid Murray's failure to make adequate provision for customer defaults. This problem had been pointed out by the R.M.H. auditors prior to the preparation of the 1961 accounts. It appears, therefore, that the accounts were potentially misleading in this respect, not because of inappropriate accounting for hire purchase profit, but because of the failure to comply with generally accepted accounting principles in

[60] Australian Society of Accountants [1958, p.19].

providing for doubtful debts.

The treatment of pre-acquistion profits as part of current group profits violated generally accepted accounting principles. The I.C.A.A. recommendation on accounting for subsidiaries issued in 1946, required that

> "Profits earned and losses incurred by subsidiary undertakings prior to the acquisition by the holding company of the shares to which they are attributable should be viewed as being of a capital nature ..."61

Likewise, the unendorsed A.S.A. [1956, p.8] *Notes on the Preparation of Consolidated Statements* informed members that

> "In the general case the holding company's proportion of pre-acquistion profits and reserves should not be considered as profits for members of the holding company."

The acceptability of writing back a redundant pre-acquisition provision to post-acquisition profits is more difficult to determine. On the one hand, such a treatment violated the generally accepted principle of matching. Indeed, the A.S.A. [1966, p. 25] described this treatment as a departure from generally accepted accounting principles. On the other hand, as discussed earlier, entries made directly to unappropriated profits and reserves are now considered unacceptable, because of the potential for inadequate disclosure. Although this principle was not promulgated in a standard until 1973, the 1966 A.S.A. report had questioned the appropriateness of Reid Murray's charging of bad debts related to previous periods, against unappropriated profits. The crediting of a redundant pre-acquisition provision to post-acquisition profits, rather than unappropriated profits, could be justified on similar grounds. The appropriate principle may have been unclear, although one cannot help but suspect that in both cases the R.M. group chose the principle which maximized current profit, regardless of appropriateness. The lack of guidance

61. Institute of Chartered Accountants in Australia [1946e].

in this area was remedied with the profit and loss standard issued in 1973.

Other aspects in which the R.M. group accounts were potentially misleading, such as the recognition of profit on houses which had not been built and on real estate sales before binding contracts had been completed, and the charging of procuration fees where no procuration services had been provided, violated the generally accepted accounting principle of realization. Although not formulated as a standard, this principle was well accepted in the early 1960s. It required the provision of goods or services to an independent third party, and objective evidence of the resultant revenue, before such revenue could be recognized.[62]

5.3(iii) Responsibility for the Financial Statement Misinformation, A Summary

Table 5.9 classifies the R.M.A. and R.M. group financial statement misinformation according to whether it resulted from compliance with, violation of, or a lack of, generally accepted accounting principles. The table shows that 15 of the 19 sources of misinformation resulted from non-compliance with generally accepted accounting principles, although procedures specifically endorsed by the profession covered only two of these areas. The non-compliance in these 15 areas was not disclosed in the financial statements or the auditors' reports. In these cases, management and the individuals involved in the preparation and audit of the accounts can be held primarily responsible for the financial statement misinformation. The lack of endorsed procedures in 13 of these 15 areas was not particularly significant because the principles in these areas were widely understood and accepted.

Three of the remaining four sources of misinformation occurred in areas where there were no clearly defined accepted accounting principles. The

[62] See, for example, Fitzgerald [1953, p.27].

Table 5.9

Responsibility for the R.M.A. and R.M. Group Statement Misinformation

SOURCE OF MISINFORMATION	Contravened endorsed procedure in this or related area	Contravened widely understood and accepted principles	Complied with endorsed procedure	Complied with widely understood and accepted principles	No clearly defined GAAP in this area
R.M.A.					
Accounting for debtors					
- inadequate provision		X			
R.M. Group					
Accounting for debtors - general					
- no provision prior to 1961		X			
- inadequate provision in 1961		X			
- provision charged to group rather than subsidiary		X			
- provision charged to unappropriated profits		X			
Accounting for hire purchase debtors					
- no/inadequate provision for bad debts		X			
- change in accounting for rental credits		X			
Failure to amortize tax loss goodwill	X				
Accounting for real estate					
- overcapitalization					X
- inconsistent capitalization		X			
- inconsistent presentation		X			
- inconsistent timing of profit recognition		X			
- arbitrary apportionment of costs					X
- timing of profit recognition				X[a]	
- revenue realization					
- goods not provided		X			
- contracts incomplete		X			
Accounting for pre-acquisition profits					
- included in current profit	X				
- writeback of previous provisions					X
Procuration fees - realized where no services provided		X			
	2	13	-	1	3

a. However, the particular circumstances rendered the general principle inappropriate.

profession should not be held responsible for this misinformation. Given the procedures for developing and defining accounting principles, it would be unreasonable to expect the profession to have established standards in all areas. Moreover, the profession had issued standards covering two of the three areas within the next decade. However, in the third area, the accounting for real estate developments, the profession has failed to remedy its lack of guidance.

Finally, in one case the misinformation resulted from the application of a generally accepted accounting principle which was rendered inappropriate by unusual circumstances. The individuals involved with the financial statements should be held responsible for this misinformation. In particular, the auditors were aware of these circumstances yet failed to comment on this issue in their report.

As far as disciplinary measures are concerned the accounting profession was well represented on the R.M.A. and R.M.H. board. More importantly, the government investigation showed that the management of R.M.A. and R.M.H. was dominated by O. J. O'Grady, a member of the accounting profession. In addition, the auditors of R.M.A. and R.M.H., Fuller, King and Co. were members of the I.C.A.A. and K. N. Wilkinson, a director of R.M.A. and the chief accountant of R.M.A. and R.M.H. was a member of the A.S.A. It can be concluded, therefore, that members of the accounting profession were extensively involved with R.M.A. and R.M.H. financial statement data. However, there is insufficient evidence to determine the extent of disciplinary proceedings instigated by the accounting profession against these members. In the Reid Murray era, the I.C.A.A. did not publish the names of members disciplined and the A.S.A. reported names in some disciplinary cases but not others. The only member reported in the journals was K. N. Wilkinson who was expelled from the A.S.A. because of his involvement with the R.M.A.

and/or R.M.H. accounts.

In concluding, the positive influence of accountants over the Reid Murray financial statement data should not be ignored. For example, in preparing their report on the 1961 accounts, the R.M.H. auditors wrote to auditors of subsidiaries, enquiring whether the accounting records had been properly kept, whether the provisions for doubtful debts were adequate, which method of calculating income yet to mature was used and the effect of any change in this method, whether the assets in the balance sheet were represented by true assets of real worth, whether there had been any material profit on intragroup sales and services, which method of depreciation was used and whether there had been any departure from consistency in accounting policies. Largely on the basis of the replies to these requests, the auditors wrote to the directors of R.M.H. who subsequently agreed to the $700,000 provision for doubtful debts in the 1960-61 accounts. Although, given the inappropriate treatment of this provision and the fact that many of the other matters for concern were not resolved, it may have been more useful if R.M.H.'s auditors had qualified their report. Also, R.M.A.'s auditors prevented the company from filing its 1961-62 accounts and, thus, prevented the presentation of financial statement data which may have induced more investor losses.

5.4 Conclusions

From the investors' viewpoint, the failure of R.M.A. in the early 1960s was significant. The book losses of shareholders and debenture holders have been estimated at approximately $41m. In addition, the debenture holders incurred substantial opportunity costs and losses in purchasing power from having their funds tied up over a considerable period. Even though they indicated some weaknesses, R.M.A.'s financial statement data were potentially misleading because they significantly overstated the value of the company's debtors and profits. Despite these overstatements, the auditors' reports attached to the R.M.A. accounts were not qualified. These findings, therefore, are consistent with the misinformation hypothesis. R.M.A.'s financial statement data misrepresented the company's results and financial position and, therefore, did not provide investors with a clear warning of the company's demise.

The misinformation in R.M.A.'s accounts resulted largely from the violation of generally accepted accounting principles and, as such, was primarily the responsibility of R.M.A.'s management and its accountants and auditors. Thus, the R.M.A. data do not support the responsibility hypothesis as individuals rather than the accounting profession were primarily responsible for the R.M.A. misinformation. However, several of these individuals were members of the accounting profession. The evidence is inconclusive but it is possible that the profession disciplined only one of its members, the company's accountant who was also a director, over the R.M.A. financial statement misinformation.

Part of the differences between the recorded value of R.M.A.'s debtors before and after failure probably resulted from the switch from going concern to liquidation based values, but there is insufficient evidence to conclude that the going concern assumption should have been dropped earlier. If adequate provision for doubtful debts had been made in the financial statements, this difference would have been much less significant.

In addition, since R.M.H. guaranteed eight of the nine R.M.A. debenture issues and since a significant part of R.M.A.'s assets were advanced to companies within the R.M. group at nominal interest rates, the financial statement data of the Reid Murray group were also relevant. The consolidated financial statement data of R.M.H. depicted the R.M. group as increasingly profitable prior to 1960-1961. The data for 1960-61 may have given some cause for concern but did not indicate that failure was imminent. In fact, the financial statement data of the R.M. group contained numerous sources of misinformation, and are therefore consistent with the misinformation hypothesis.

Most of the Reid Murray group financial statement misinformation occurred as a result of the violation of generally accepted accounting principles or, in one case, as a result of the inappropriate use of an accepted principle. The accountants and auditors involved with the R.M. group and the group's management therefore, must be held primarily responsible. Misinformation occurred in three areas where accepted accounting principles had not been defined. Given the nature of the process for developing accounting principles, the profession cannot be held responsible for this misinformation. In two of the three areas, the profession remedied this lack of principles within the next decade. However, in the third area, accounting for real estate developments, the profession still has not defined accepted principles more than twenty years later.

Thus, the R.M.H. data do not support the responsibility hypothesis as individuals rather than the accounting profession were primarily responsible for the R.M. group financial statement misinformation. Several of these individuals were members of the accounting profession. However, as in the R.M.A. case, the evidence regarding discipline is incomplete. The R.M.A. director/accountant, who was also the group accountant for R.M.H., was the only member against whom a disciplinary finding was reported in the profession's journals.

In brief, the evidence from the R.M.A. case study is consistent with the misinformation hypothesis but not the responsibility hypothesis. Individuals were primarily responsible for the financial statement misinformation. Several of these individuals were members of the accounting profession. However, there is insufficient evidence to determine whether the profession fulfilled its disciplinary responsibilities. There were some areas where accounting principles had not been developed and the profession can be criticized for its failure to subsequently delineate principles in one of these areas.

CHAPTER 6

LATEC INVESTMENTS LTD

In April 1953, Latec Investments Ltd. was incorporated as a proprietary company, to finance the hire purchase of motor vehicles in Newcastle and northern New South Wales. In December of the same year, Latec became a public company and subsequently developed interests in insurance, real estate, motor vehicle repairs, hotels and motels, and the provision of finance to business. From incorporation until 1960, Latec's net profit continually increased. It paid dividends of 15 per cent per annum and interest rates of up to 9 per cent per annum on debentures and 10 per cent per annum on deposits. Latec appeared to be a flourishing and dynamic group, with a promising future. In February 1961, it announced its largest half-yearly profit, and declared an interim dividend of 7½ per cent. Two months later the dividend was deferred and this caused a run on Latec deposits. Throughout 1961 Latec's liquidity position worsened and in September 1961, its board of directors was replaced. The new board reported a consolidated loss of $2.96m for 1960-61. In 1961-62, the group reported an interim profit of $133,450 but this was converted to a year end loss of $7.64m. No interest payments were made after 15 August 1962 and on 4 September 1962, Latec was placed into receivership by the trustee for the debenture holders.

This dramatic turnaround raised a number of questions. Did the affairs of Latec suddenly deteriorate in early 1961? Was the company in trouble well before 1961, with the situation being disguised in Latec's financial statements? The N.S.W. government ordered an investigation into Latec's affairs. Its findings suggested that there were aspects of Latec's financial statement data which were potentially misleading. This chapter analyses Latec's financial statement data to identify any misinformation, and determines the accounting profession's responsibility for this misinformation.

6.1 The Losses of Latec Investors

There were three main classes of Latec investors. They were shareholders, first mortgage debenture holders and depositors.[1] Table 6.1 shows the extent to which Latec relied on these various sources of funds. By 30 June 1962, Latec had issued share capital totalling $5.87m. At the end of 1959-60, Latec's last profitable year prior to receivership, the accounts showed that the group had reserves and unappropriated profits of $1.75m. According to the receiver's estimates, at 30 June 1963, Latec's entire shareholders' funds were lost. Rather than being liquidated, however, Latec continued to trade and this gave shareholders an opportunity to recover their losses. In 1977, on the resolution of a special meeting of shareholders, Latec wrote down its issued share capital by approximately 60 per cent and by 30 June 1979, this reduced share capital had been recovered.[2] Therefore, Latec's pre-receivership shareholders eventually lost 60 per cent, or $3.52m, of their contributed capital of $5.87m, as well as the pre-receivership reserves and unappropriated profits of $1.75m. These shareholders also incurred considerable losses from having their capital tied up in a non-earning capacity for a long time and from the decline in purchasing power over this period. It is not possible to quantify these losses.

[1] In addition, in 1955 Latec issued registered unsecured notes. However, these were redeemed in 1957, due to an infringement of the trust deed.

[2]

Pre receivership issued capital	$5.87m
Shares issued to unsecured creditors, under 1966 scheme of arrangement	$4.09m
Total issued capital, 1977	$9.96m

Agreed writedown, 1977, was $5.97m, which was approximately 60 per cent of $9.96m. Latec's annual report for 1978-79 announced that, for the first time in 18 years, retained earnings had moved from a debit to a credit balance. At this point, the remaining 40 per cent of pre-receivership share capital can be considered as recovered.

Table 6.1: Latec Investments Limited, Investors' Funds

Year Ended	New Share Capital Issued During the Period		Net Intake of Deposits During the Period		Net Intake of Debentures During the Period		Total Investor Funds
	$m	% of total	$m	% of total	$m	% of total	
Incorp							
- 30/6/53	0.08	100.0	-	0	-	0	0.08
30/6/54	0.27	96.4	0.01	3.6	-	0	0.28
30/6/55	0.70	78.7	0.19	21.3	-	0	0.89
30/6/56	-	0	0.54	100.0	-	0	0.54
30/6/57	-	0	1.45	100.0	-	0	1.45
30/6/58	-	0	2.99	100.0	-	0	2.99
30/6/59	0.98	21.6	3.56	78.4	-	0	4.54
30/6/60	1.54	11.6	8.63	65.2	3.06	23.2	13.23
30/6/61	1.90	51.6	(2.10)	(57.0)	3.88	105.4	3.68
30/6/62	0.40	(21.6)	(4.07)	220.0	1.82	(98.4)	(1.85)
	5.87	22.7	11.20	43.4	8.76	33.9	25.83

Source: Based on data drawn from New South Wales, Parliament [1965, p. 230]

Table 6.1 shows that, by 30 June 1962, Latec owed debenture holders $8.76m.[3] Debenture holders held a first mortgage over the assets of the holding company and all but three of Latec's 43 subsidiaries. The receiver estimated that the realizable value of the group's assets would be sufficient to repay debenture holders. By March 1968, the claims of debenture holders had been satisfied. A total of $11.07m had been paid out as principal, interest and receivership costs. At this date, the receiver, who had been

[3] Maturing deposits and debentures have been deducted in calculating these data, thus, the figures represent net loans outstanding. The table ignores debentures issued to the Commercial Banking Company to secure overdrafts. It takes account only of debentures issued to the investing public.

appointed on behalf of debenture holders, withdrew. The only losses Latec's debenture holders suffered were the forgone additional earnings which they could have made by putting their funds to more profitable uses and the decline in the purchasing power of principal and interest prior to their recovery. Given that the rate of interest on Latec debentures was relatively high for this period, the opportunity cost of having funds tied up in Latec is likely to have been insignificant.[4] Furthermore, given that the period between the appointment of the receiver and the full repayment of debenture debts was limited to five and a half years, and that repayments were spread over this period, the losses in purchasing power are also likely to have been relatively insignificant.

The depositors, who were unsecured creditors were less fortunate. As shown in Table 6.1, by 30 June 1962, depositors were owed $11.20m. At the date of receivership, Latec was unable to repay its unsecured creditors in full. In February 1965, a meeting of unsecured creditors approved a scheme of arrangement, accepting 92.68 cents in the dollar, to be satisfied by an issue of shares and debentures. The scheme was sanctioned by the Supreme Court of N.S.W. in April 1966. Depositors, therefore, immediately lost 7.32 per cent or $0.82m of their investment in Latec. The remaining $10.37m was repaid by a share issue covering 37.5 cents in the dollar and an interest free debenture issue covering the remaining 62.5 cents in the dollar. The total shares issued to depositors had a par value of approximately $3.89m.[5] The decision,

[4] For example, the maximum interest rates on Latec debentures ranged from 8 to 9 per cent. (See Latec Investments Ltd., *Prospectus, 16 December 1960*). By March 1968, the rate offered by competitors, such as F.C.A., on debentures for a similar term was 7 3/4 per cent, (see Finance Corporation of Australia Ltd., *Prospectus No. 28*).

[5] The total value, at par, of shares issued to unsecured creditors was $4.09m (see footnote 2). Approximately $0.20m of this related to other unsecured creditors.

in 1977, to write down issued share capital by 60 per cent, meant that depositors lost a further $2.33m. The debenture issue to depositors had a face value of approximately $6.48m. Twenty per cent of this issue was redeemed in 1969-70 and in 1971-72, and the remaining 60 per cent was redeemed in 1974-75. No interest was paid on these debentures. The identifiable losses of the Latec depositors were, therefore, approximately $3.15m, comprising the initial $0.82m write down according to the scheme of arrangement, and the subsequent $2.33m write down of shares, issued as part payment of the original debt. In addition, depositors incurred the opportunity cost of having $6.48m tied up, over a period of eight to thirteen years, in an arrangement which earned no return. They also incurred losses in the purchasing power of any funds eventually recovered.

To summarize, the collapse of Latec in the early 1960s caused losses to Latec's shareholders and depositors. At book value, these losses amounted to approximately $8.42m. They included unappropriated profits and reserves of $1.75m and contributed share capital of approximately $3.52m. Depositors lost approximately $3.15m. In addition, given the considerable period it took to recover the remainder of their initial investment, Latec's shareholders and depositors are likely to have incurred substantial losses, both in terms of earnings foregone and the decline in purchasing power on the funds eventually recovered. The debenture holders were repaid in full, although it is likely that they, too, incurred some losses of purchasing power and, possibly, some opportunity costs. In this situation, it is important to assess whether financial statement misinformation could have caused, or contributed to, these losses.

6.2 Testing the Misinformation Hypothesis for Latec

6.2 (i) The Relevant Period and the Relevant Data

The methodology proposed in Chapter 3 recognized that it may be necessary to limit the period of the case studies, particularly for some of the companies with long lives, because of the range of data which must be analysed. In Latec's case, however, since the period from incorporation until receivership spanned only ten years, it is feasible to analyse the financial statement data issued over this entire period. Chapter 3 also recognized that different sources of financial statement data are available to different classes of investors and it required an assessment of the sources ot data issued to the investors who actually lost funds in the company's failure. As discussed above, the losses associated with Latec's failure were largely incurred by shareholders and depositors. The losses of debenture holders were minimal. It is only necessary, therefore, to analyze the financial statement data available to the shareholders and depositors.

Latec's share issues were not accompanied by prospectuses. Thus, the annual report was probably the prime source of published accounting information for Latec's shareholders. Unfortunately Latec's annual reports are not available for the relevant period.[6] It is possible to derive most of Latec's audited financial statement data from the auditors' and investigating

[6] The Latec file held at the office of the Corporate Affairs Commission in N.S.W. (Latec's state of incorporation) does not contain annual reports issued prior to 1967. A Latec file is not held at the office of the Corporate Affairs Commission in S.A. Moreover, although still trading today, Latec Investments Ltd. is unable to provide copies of annual reports relating to the 1950s and early 1960s.

accountants' reports contained in the prospectuses.[7] However, it is not possible to determine whether any other accounting data were included in Latec's annual reports.

Usually, depositors are not provided with any specific sources of financial statement data but, in Latec's case, the issues of registered deposits, over the period 1955-56 to 1958-59, were accompanied by prospectuses.[8] In addition, as discussed in Chapter 3, audited financial statements and prospectuses are public documents and would have been available to depositors. It is necessary, therefore, to assess the state of affairs, from the depositors' perspective, according to both Latec's audited financial statements and its prospectuses.

Latec's first prospectus contained an auditors' report, which included information on net profit before tax over the previous three years, dividends, a balance sheet and estimates of interest and tangible asset cover for the proposed issue. Subsequent prospectuses included an investigating accountants' report, as well as an auditors' report. The latter was confined to a statement of past net profit after tax, paid up capital and dividends. The bulk of the financial statement data was contained in the investigating accountants' reports, which included information on previous net profit before tax, dividends, a balance sheet (for the group and also, from September 1959, for the holding company) adjusted for the effects of the proposed issue, and estimates of interest and tangible asset cover. Any other accounting

[7] Both these reports were based on Latec's audited financial statements. The data contained in the investigating accountants' reports were adjusted for the effects of proposed issues but the assumptions underlying these adjustments, and their effects, were set out in the reports.

[8] Latec Investments Ltd., Prospectuses dated 19 November 1956, 20 November 1957, 16 February 1959 and 23 September 1959.

information in the prospectuses tended to be drawn from the investigating accountants' reports or the auditors' reports. For example, the chairman's report quoted net profit data from the auditors' reports and tangible asset backing was quoted from the investigating accountants' reports.

6.2 (ii) Latec's Condition According to Its Financial Statement Data

6.2 (ii)(a) The shareholders' perspective

Table 6.2 shows the picture of Latec's profitability and security, made available to shareholders, through the group's audited financial statement data. It shows that from incorporation to 30 June 1960, Latec was generally highly profitable. The growth in net profit after tax was high, increasing by less than 30 per cent in only two years over this period. However, this growth was also erratic, ranging from an increase of 424.37 per cent, in 1953-54, to an increase of 3.00 per cent in 1957-58. It is not unusual to have an initial period of erratic growth, followed by more stable rates of growth, for successful newly established companies. Latec's substantial and erratic growth in net profit may have given some cause for concern. Alternatively, it could have been interpreted as a growth pattern not unusual for a company in its early stages of development.

Moreover, the rate of return on shareholders' funds was high, but reasonably stable. Over the period to 30 June 1960, the return on shareholders' funds did not fall below 15 per cent per annum and, from 1955-56 to 1958-59, it was approximately 20 per cent per annum.[9] It decreased significantly to 16.34 per cent, in 1959-60, but this still compared very favourably with the 9 per cent being paid on debentures.[10] Latec's return on

[9] Even this minimum rate of return of 15 per cent is an understatement given that it was based on closing rather than average shareholders' funds (see Table 6.2, note 3).

[10] The Latec prospectus dated 16 December 1960 offered interest rates of 5 per cent to 9 per cent.

Table 6.2: Latec's Profitability and Security, Shareholders' Perspective.[1]

Year Ended 30 June	Consolidated Net Profit ($000)	% Change in Profit over Previous Year	% Return on S.H.F.	% Dividend Rate	Net Asset Backing per 50¢ Share (cents)	Debt Ratio
Incorporation to 30/6/53	1.79	-	n.a.	10	n.a.	n.a.
1954	47.56	+424.37[2]	n.a.	15	n.a.	n.a.
1955	176.70	+271.53	15.74[3]	15	53.08	0.53
1956	234.19	+32.53	20.24	15	56.72	0.56
1957	281.38	+20.15	22.46	15	62.59	0.70
1958	289.83	+3.00	20.99	15	68.88	0.81
1959	400.35	+38.13	19.80	15	63.86	0.81
1960	646.26	+61.42	16.34	15	74.04	0.83
1961	(2965.46)	-558.86	n.a.	0	n.a.	n.a.
1962	(7544.88)	-154.42	n.a.	0	0	1.15

[1] This table presents audited consolidated financial statement data.

[2] The 1953 base has been adjusted to an annual equivalent.

[3] Since S.H.F. data were not available for 30/6/54, this figure is based on closing, rather than average, S.H.F.

its shareholders' funds, therefore, included a substantial premium for the additional risks associated with equity, compared to debt, capital. "Standard" rates of return on shareholders' funds over this period are available only for A.G.C. Table 3.3 shows that, from 1952-53 to 1959-60, A.G.C.'s return on shareholders' funds varied from 7.50 per cent, in 1959-60, to 20.21 per cent, in 1953-54. In each year, apart from 1954-55, A.G.C.'s return on shareholders' funds was well below Latec's rate of return. The margin varied from 10.42 per cent in 1958-59 to 4.57 per cent in 1955-56. Thus, compared to the rates offered on its debentures and to the rate of return earned by one of its major, successful, competitors, Latec appeared to be very profitable.

The dividend rate of 15 per cent per annum, from 1954-55, would have confirmed this view and probably made the Latec shares an attractive opportunity for investors seeking dividend income, as well as capital gains. Although this dividend rate was matched by A.G.C.'s dividend rate over this period, Tables 3.2 and 3.3 show that it exceeded average industry and B.F.C. rates in subsequent periods, by a substantial margin. Thus, compared to the "standards", established in Chapter 3, Latec's dividend rate also suggested that the company was highly profitable.

The asset backing for Latec's shares appeared to be sound, ranging from 53.08 cents per 50 cent share at 30 June 1955, to 74.04 cents, at 30 June 1960. Over this period, asset backing increased in each year, except in 1958-59, when it decreased by 5.02 cents per share. Industry average asset backing data are not available but Table 3.3 shows that Latec's asset backing was well below that of A.G.C., which ranged from $1.02 to $1.11 per 50 cent share over this period. On the other hand, B.F.C.'s asset backing, in the following decade, was generally much lower, ranging from approximately 43 cents to 63 cents per 50 cent share. There is no reason to expect these data to be influenced by temporal factors, other than general economic conditions.

The debt ratios also cast some doubt on the security of Latec shares. Prior to the difficulties in 1962, Latec's debt ratio ranged from 0.53 at 30 June 1955, to 0.83 at 30 June 1960. In the three years when Latec had substantially increased its share capital, from 1958 to 1960, the debt ratio was 0.81 or greater. The increases in share capital combined with the increasing debt ratio suggests that, from 1958 onwards, Latec was absorbing very large amounts of capital. These increases in capital were consistent with rapid growth. Latec's debt ratio can also be compared with that of other firms in the industry. Table 3.3 shows that over the corresponding period, A.G.C.'s debt ratio ranged from 0.71 to 0.80. Early in the period, A.G.C.'s debt ratio exceeded that for Latec by a substantial margin but from 1958 onwards, Latec's debt ratio exceeded that for A.G.C. by between 11 and 14 per cent. B.F.C.'s debt ratio in 1961, the year following Latec's collapse, was lower than that for Latec in 1960 but equal to it in 1958 and 1959. Industry ratios, available from 1963-64, were higher, although the changes in economic climate which occurred between the late 1950s and the mid-1960s, limit the value of any comparison of debt ratios over successive periods. The evidence suggests, however, that by the late 1950s, Latec shares were less secure than those of at least one of its competitors.

6.2 (ii)(b) The depositors' perspective

Four issues of registered deposits were made between 1956 and 1959. The interest rates ranged from 6 per cent to 10 per cent per annum and were considerably higher than those offered on risk free securities over this period.[11] Given the usual relationship between risk and return, the relatively high rates of interest on Latec deposits should have caused potential subscribers some concern. If the depositors had looked to Latec's financial statement data, they would have found more cause for concern. Table 6.3 shows the picture of Latec's profitability and security made available to depositors through the audited financial statements and prospectuses. According to the methodology developed in Chapter 3, the rate of return on assets, interest cover, debt ratio and current ratio are good indicators of investment profitability and security from the depositors' viewpoint. In Latec's case, these ratios should be calculated for the holding company rather than the group, since the depositors were unsecured creditors. However, data limitations prevent the calculation of some of these ratios. It has been necessary to rely on the prospectuses for both the audited financial statement data and the investigating accountants' data.[12] The prospectuses did not disclose interest expenses and, therefore, it has not been possible to calculate the return on assets earned by Latec. Instead, the prospectuses featured consolidated profits before tax as an indicator of Latec's profitability. These figures are included in Table 6.3, although their relevance to depositors can be questioned since they related to group rather than holding company performance and they included the effects of leverage.

Latec's consolidated profit before tax followed a similar pattern to profit after tax, which was shown in Table 6.2 Its growth was high but erratic. Changes over the previous period ranged from an increase of 539.02 per cent to a decrease of 5.16 per cent, although, prior to 30 June 1960, the increase in pre-tax profit over the previous period fell below 20 per cent only once and below approximately 40 per cent only twice.

[11] The first two issues offered interest rates from 8 per cent per annum for six months to 10 per cent per annum for three years or more. The third and fourth issues reduced the rate for six months to 6 per cent per annum. Examples of the rates offered on relatively risk free securities include the Sydney Water Board loans and the Melbourne and Metropolitan Board of Works loans, both of which offered rates of 5 1/4 per cent per annum, in 1959, for terms ranging from 7 to 25 years.

[12] See footnotes 6 and 7, in this chapter.

Table 6.3: Latec's Profitability and Security, Depositors' Perspective

Year ended	Consolidated profit before tax $000	Change in profit over previous period (%)	Interest Cover for Deposits	Tangible Asset Cover for Deposits	Debt Ratio		Current Ratio	
					Inv. Acctants Report	Audited Accounts	Inv. Acctants Report	Audited Accounts
Incorp'n 30/6/53	2.39	-	-	-	n.a.	n.a.	n.a.	n.a.
30/6/54	66.33	+539.02[1]	-	-	n.a.	n.a.	n.a.	n.a.
30/6/55	277.74	+318.72	-	-	n.a.	0.53	n.a.	1.87
30/6/56	388.26	+39.79	21.55	1.76	n.a.	n.a.	n.a.	n.a.
30/6/57	467.42	+20.39	25.97	1.42	n.a.	n.a.	n.a.	n.a.
30/6/58	443.29	-5.16	24.63	1.32	0.81	0.80	1.14	1.16
30/6/59	640.21	+44.42	7.11	1.23	0.86	0.85	1.09	1.11
30/6/60	1031.90	+61.18	-	-	0.85	0.84	1.05	1.05

Notes:

1. The 1953 base has been adjusted to an annual equivalent.

Despite the non-disclosure of interest expenses, the prospectuses for the issues of registered deposits did include estimates of the interest cover available for the proposed issues. The estimated interest cover, shown in Table 6.3, ranged from 25.97 times for 1956-57, to 7.11 times for 1958-59. This cover is well above the industry, A.G.C. and B.F.C. "standards", shown in Tables 3.2 and 3.4.[13]

The investigating accountants' reports also estimated asset cover for registered deposits. Table 6.3 shows that this cover ranged from $1.76 per one dollar subscribed for the first issue, to $1.23 for the final issue. Estimated asset cover declined continuously from the first to the fourth issue, although potential depositors may have been reassured by the fact that, at this time, Latec had no major secured creditors.

Depositors may have used debt ratios as an additional indicator of their investment security. Table 6.3 shows the debt ratios for the holding company according to the audited financial statement data and the investigating accountants' data. The data were available in the investigating accountants' reports only from 1958. The data from the audited accounts were available for 1955 and from 1958. These data show that the debt ratio for the holding company increased significantly from 0.53 at 30 June 1955, to 0.80 at 30 June 1958. It increased further to 0.85 in 1959 and 0.84 in 1960. The ratios based on the investigating accountants' data over this period are marginally higher because of the inclusion of the effects of proposed issues. A comparison with Table 3.3 shows that the Latec holding company's debt ratio from 1958 was considerably higher than A.G.C.'s debt ratio over the same

[13] Industry, A.G.C. and B.F.C. "standards" were not available until 1963-64, 1961-62 and 1962-63, respectively. Tables 3.2 and 3.4 show that the level of interest cover has tended to decline slightly over time, but Latec's interest cover exceeded the "standards" by a very large margin.

period. Industry average and B.F.C. ratios are not available over the corresponding period, but the holding company debt ratios in 1959 and 1960 exceeded B.F.C. ratios in 1961, 1962 and 1963. These data suggest that, from 1958, the Latec holding company was highly geared.

In addition, depositors may have used the company's current ratio as an indicator of liquidity. The audited financial statement data necessary to calculate the holding company's current ratios also were available only for 1955 and 1958, 1959 and 1960. The current ratio declined significantly from 1.87, at 30 June 1955, to 1.16 at 30 June 1958. It declined further to 1.11 in 1959 and 1.05 in 1960. The ratios based on the investigating accountants' data, which were available from 1958, were marginally lower in both 1958 and 1959, because of the inclusion of the effects of proposed issues. In comparison, Table 3.4 shows that A.G.C.'s current ratios over the corresponding period were significantly higher. Industry average and B.F.C. ratios are not available over this period although B.F.C.'s current ratios in the following period also exceeded the Latec ratios by a substantial margin. The evidence suggests that, from the depositors' perspective, Latec's liquidity was probably unsatisfactory.

To summarize, from the shareholders' perspective, the financial statements showed Latec as a highly profitable firm, both in terms of the rate of growth of net profit and the rate of return of shareholders' funds. With a dividend rate of 15 per cent per annum, Latec shares offered the opportunity for current income, as well as capital gain. Share security, in terms of asset backing and the debt ratio, was less satisfactory, although no worse than at least one other firm in the industry. From the depositors' perspective, the group seemed very profitable and potential subscribers were assured of very high interest cover. Tangible asset cover seemed adequate.

However, there were a number of factors which should have given Latec investors some cause for concern. The rate of growth in net profit was erratic. The rate of return on shareholders' funds decreased significantly in 1959-60. Asset backing per share was well below that of one of Latec's major competitors. From 1958, the group's debt ratio was higher than that of the same competitor and, from 1959, the holding company debt ratio was even higher. The levels of both debt and equity capital increased substantially from 1958. Interest rates on registered deposits were very high and according to the current ratios, liquidity was tight. The asset cover available for each subsequent issue of registered deposits was lower than tor previous issues. Nevertheless, even by 1960, there was no indication that failure was imminent.

6.2 (iii) Latec's Financial Statement Misinformation

The government investigation which followed Latec's failure concluded that Latec's audited financial statements were misleading primarily because of the accounting for bad debts, interest rebates on repossessed hire purchase goods and the provision for unearned hiring charges.

Latec made no provision for doubtful debts. Bad debts were written off as recognized, but recognition was deferred until every method of recovery had been exhausted. According to the government inspectors, Latec's management took deliberate steps to delay the recognition of bad debts. For example, they rewrote many defaulted floor plan advances on hire purchase vehicle stocks, as business loans.[14] They delayed the repossession ot goods sold under hire purchase, despite clear default by the hirers. This ensured an

[14] Floor plan advances consisted of short-term finance to car dealers for stocks of vehicles held (i.e. on the floor) for sale. When a vehicle was sold the loan on that vehicle was repaid and a new loan would be made to finance the acquisition of a replacement vehicle for sale.

interval of several years from default until the actual write-off, with no provision in the interim. The inspectors concluded that Latec's accounting for bad debts resulted in an overstatement of profits and assets from 1953-54 to 1960-61.[15] The effects of this inappropriate treatment became apparent in the accounts for 1961 and 1962. Prepared by the new board of directors, these accounts wrote off bad debts of $3.83m and $5.32m respectively, most of which were incurred in earlier years. In their investigation, the inspectors examined each of these write-offs and determined the year in which they should have been made. They classified debtors who had not made any payment for at least six months, as doubtful. Given that practically all debtors were liable for monthly repayments, this approach was conservative.

The effect of this reclassification on consolidated net profits is shown in Table 6.4. From 1954-55 until 1957-58, Latec's accounting for bad debts caused significant overstatement of profits. The percentage by which profits were overstated during this period increased from 9.4 per cent, in 1954-55, to 729.0 per cent, in 1957-58. Substantial overstatement continued in 1958-59 and 1959-60, when apparent losses were reported as profits. With the appointment of the new board, debts were reviewed and, over 1961 and 1962, bad debts which had accumulated from earlier years were written off. This caused losses for 1960-61 and 1961-62 to be overstated by 13.5 per cent and 55.2 per cent, respectively. Latec's accounting for bad debts, therefore, caused profits to be overstated from 1954-55 to 1959-60. The value of the asset, debtors, was correspondingly overstated.

Latec's hire purchase agreements provided for interest rebates on repossession. However, the inspectors found that rebates were not recorded when repossessions were made. Under the new management, these rebates were

[15] New South Wales, Parliament [1965, p. 142].

Table 6.4: Latec's Overstatement of Profit Due to Accounting for Bad Debts (in $000)

Year Ended	Bad Debts Expense: the Accts	Bad Debts Expenses: the Inspectors	Profit Before Tax: the Accts	Profit Before Tax: the Inspectors	Overstatement (Understatement) of Profit/Loss	% Overstatement of Profit (Loss)
30/6/54	-	0.77	66.33	65.56	0.77	1.2
30/6/55	-	23.92	277.74	253.82	23.92	9.4
30/6/56	2.58	104.38	388.27	286.47	101.80	35.5
30/6/57	3.78	283.35	467.42	187.85	279.57	148.8
30/6/58	4.15	393.97	443.29	53.47	389.82	729.0
30/6/59	79.09	1059.86	640.21	(340.56)	980.77	287.9
30/6/60	256.36	2513.36	1031.90	(1225.10)	2257.00	184.2
30/6/61	3834.29	3492.91	(2863.93)	(2522.55)	(341.38)	(13.5)
30/6/62	5324.47	2689.96	(7408.60)	(4774.09)	(2634.51)	(55.2)

Source: Based on data drawn from New South Wales, Parliament [1965, p. 142] brought to account in 1961-62. The inspectors estimated that this caused the loss for 1961-62 to be overstated by $360,080. Profits from 1954-55 to 1960-61 had been overstated by this amount. The most significant distortions occurred in 1958-59, 1959-60 and 1960-61, when it was estimated that profit was overstated by $65,610, $129,780 and $112,000, respectively.[16] The value of the asset, debtors was also overstated.

Latec's accounting for unearned hiring charges was also potentially misleading. The inspectors found that Latec provided for unearned hiring charges on hire purchase contracts on an arbitrary basis. Over the period 1952-53 to 1961-62, unearned hiring charges varied between 12.4 per cent and 20.3 per cent of gross hire purchase debtors.[17] Unable to obtain evidence of the factors considered in setting these figures, the inspectors concluded that

> "it is not unreasonable to say that the method employed left some leeway to fix the provision according to the amount of profit directors wanted to show"[18]

The inspectors calculated the provision for unearned hiring charges for 1959 and 1960, using the I.C.A.A. approved "Rule of 78", after adjusting income for the bad debts and rebates identified above. They estimated that Latec had under-provided for unearned income, according to the "Rule of 78", by $120,350 in 1958-59, and by $280,880 in 1959-60.[19] The appropriate provisions for earlier years were not calculated, but the 1959 and 1960 figures show that Latec's accounting for unearned income resulted in significant overstatement of both profits and assets. Table 6.5 shows the effect of Latec's inappropriate accounting for bad debts, hire purchase rebates and unearned

[16] New South Wales, Parliament [1965, p.143].

[17] New South Wales, Parliament [1965, p.144].

[18] New South Wales, Parliament [1965, p.145].

[19] New South Wales, Parliament [1965, p. 144]

Table 6.5: Latec's Corrected Profit (Loss) and Debtors, 1959 and 1960 (in 000)

	1959	1960
Net Profit before tax, audited accounts	640.21	1031.90
Overstatement due to accounting for		
Bad debts	980.77	2257.00
Rebates	65.61	129.78
Unearned income	120.35	280.88
Corrected net loss	(526.52)	(1635.76)
Debtors (including cash on hand and deposits)		
As per audited accounts	11218.61	23873.47
Adustments due to inappropriate accounting	1166.73	2667.66
Corrected Debtors	10051.88	21205.81

Source: Based on data drawn from New South Wales, Parliament [1965, pp. 142-148]

income on the group's results and financial position for 1959 and 1960. Net profit before tax and the asset, debtors, were overstated by $1.17m, for the year ended 30 June 1959, and by $2.67m, for the year ended 30 June 1960.

Apart from these major infractions, the inspectors found that, over the period 1955-56 to 1960-61, the profit on some intercompany transactions had not been eliminated, in the preparation of the consolidated accounts. As a result consolidated assets and profits were overstated by a total of $21,100.[20] In addition, between 1955-56 and 1959-60, the company accumulated a credit of $66,910, relating to refunds of insurance premiums on account of hirers. At 30 June 1960, these refunds were brought into income as credits to hiring charges. They should have been credited to hirers. Simultaneously, Latec wrote off an equivalent amount as bad debts, to avoid the increase in profits.[21]

[20] New South Wales, Parliament [1965, p. 148].

[21] New South Wales, Parliament [1965, p. 149].

Another weakness of Latec's published accounts was that they did not record the company's liability to pay underwriting fees, even though, in 1960, the group's chairman and managing director had agreed that Latec would pay the underwriters, Parker and Stewart, $100,000 consisting of $20,000 at that time, and $20,000 per annum for the next four years.[22] The inspectors argued that the accounts should have recorded the full liability and that the liability or at least a substantial part of it, should have been charged against profits, as the period covered by the borrowings had already expired in many cases.[23] Liabilities were understated and profits were overstated, but the inspectors did not attempt to estimate how the accounts for each year were affected. Finally, in 1960, the Commissioner of Taxation disallowed a reserve claimed by one of Latec's subsidiaries and, thus, increased tax payable by $109,000. The Commissioner agreed to accept payment over 1960, 1961 and 1962. This was not recognized in the 1960 group accounts, resulting in an overstatement of profit and understatement of liabilities. Some provision was made in 1961 and the underprovision was fully adjusted in the 1962 accounts.[24]

The evidence led the inspectors to conclude that, prior to 1961-62

> "... the balance sheets and profit and loss accounts of various (Latec) companies were false and the consolidated balance sheets and profit and loss accounts were also false."[25]

In conclusion, the government inspectors considered that Latec's audited financial statements significantly overstated the group's profits and assets from at least 1953-54 to 1959-60, and, in some cases in 1960-61. The most

[22] *Ibid.*

[23] *Ibid.*

[24] *Ibid.*

[25] New South Wales, Parliament [1965, p. 150].

serious overstatements occurred with debtors. In the Reid Murray case, it was possible to substantiate the findings of the government investigation, by considering the asset writedowns included in the receivers' statement of affairs. In Latec's case, however, the management changed hands in 1960-61, more than two years before the receivers were appointed. Over 1960-61 and 1961-62, the new management attempted to correct the misinformation. The substantial write offs of bad debts, over this period, reflected this policy. Indeed, by the time the receivers were appointed, on 30 September 1962, the realizable value of Latec's debtors was only $0.02m lower than its book value, of $20.11m. The valuations in the statement of affairs suggest that, by 30 June 1962, the most significant source of Latec's financial statement misinformation, debtors, had been corrected.

Although the receivers' estimate of the value of debtors approximated the book value, their estimate of the value of total assets was $4.28m lower than the book value of $25.34m.[26] Most of this difference related to Latec's investments in subsidiaries, which were recorded at "nil value" in the statement of affairs. Nearly all of the subsidiaries had guaranteed Latec's debenture issues and the receivers considered that this contingent liability made their value uncertain. The receivers acknowledged that probably there would be some surplus after all debenture commitments had been met, which meant that the shares in the subsidiaries would have some value, but they were unable to estimate this value. The writedown clearly resulted from the receivers' abandonment of the going concern assumption in valuing the subsidiaries. However, there is no clear evidence that the going concern assumption should have been dropped earlier and that the financial statements, issued prior to receivership, should have taken account of the contingent

[26] Latec Investments Ltd. (Receiver Appointed), Statement of Affairs, as at 30 September 1962.

liability. Indeed, by the time the receiver was appointed Latec's management had changed hands. The new management had made a number of write-offs to correct the effects of previous inappropriate accounting procedures. The receiver allowed Latec to continue trading and the current asset values in the statement of affairs actually coincided closely with the values in the financial statements.

In their examination of Latec's prospectuses, the inspectors commented on the significance of the inaccurate audited financial statement data. In their view,

> "The principal falsity in the prospectuses was in overstating the profits and assets of the Company and the consolidated profits and assets of the Group in respect of each of the financial years 1957, 1958, 1959 and 1960 ... Undoubtedly the prospectuses, particularly in the latter years, did not tell the whole truth..."[27]

The inspectors considered that Latec's prospectuses were important because they were used not only to raise public borrowings, but also as the basis of several takeovers, which had the effect of circumventing investigations by vendor companies. The inspectors were particularly critical of the investigating accountants' reports in Latec's prospectuses. These reports were based on the audited financial statements and embodied their inaccuracies. The inspectors criticized the investigating accountants for failing to verify and for giving credence to, these inaccurate data. In their view,

> "The public assumes that 'Report of Investigating Accountants' means that there has been an adequate investigation of a company's affairs. If this is not the case the report ought to state directly that no investigation has been made and that the audited accounts have been accepted. Going further, we do not consider it is in the public interest that investigating accountants should fail to carry out such tests as will satisfy them that the state of

[27] New South Wales, Parliament [1965, p. 152].

affairs is as shown in the audited statements."[28]

This criticism seems a little harsh, since the investigating accountants' reports included a statement that the balance sheet data prior to adjustment were "as taken from the Audited Balance Sheets". However, the records of past profits were not accompanied by a similar caveat.

The inspectors failed to comment that the way in which the investigating accountants used the audited financial statement data was also potentially misleading. For example, although the investigating accountants' reports contained insufficient information to enable the calculation of interest cover, they quoted estimates of interest cover for each proposed issue of deposits, notes and debentures. These estimates were based on consolidated net profit before tax divided by the estimated interest expense associated with the issue. This information was potentially misleading for four reasons. First, the calculation assumed no oversubscription. Each prospectus stated that Latec reserved the right to accept oversubscriptions and this right was, in fact, exercised. For example, on 19 November 1956, 20 November 1957 and 2 February 1959 Latec issued prospectuses for registered deposits with a face value of $200,000. The issue on 23 September 1959 had a face value of $1.0m. Yet, according to the inspectors' report, Latec's net intake of registered deposits over 1956-57, 1957-58, 1958-59 and 1959-60 was $1.27m, $2.98m, $3.6m and $8.58m, respectively.[29] These substantial oversubscriptions meant that the investigating accountants' estimates of the interest cover available for registered deposits were meaningless. Given Latec's history of oversubscribing issues, the investigating accountants' failure to allow for, or acknowledge the effects of, oversubscription can be considered negligent.

[28] New South Wales, Parliament [1965, p. 160].

[29] New South Wales, Parliament [1965, p. 230].

Second, even if the issues had not been oversubscribed, the investigating accountants' estimates of the interest expense associated with *each* issue were inconsistent. For example, the estimated interest expense for each deposit issue was based on an assumed average interest rate of 9 per cent per annum. Yet the interest rates on the first two issues ranged from 8 per cent to 10 per cent per annum, while the interest rates on the last two issues ranged from 6 per cent to 10 per cent per annum. Third, the estimates of interest cover assumed that the net profit before tax from the *previous* year was available to cover the interest expense of the proposed issue. Given that each issue was made during the year, rather than at the beginning, the full impact of the interest expense associated with the deposit issue in the previous year was not reflected in profit before tax for that year. This meant that the interest cover available for each *new* deposit issue was overstated.

Finally, the method of calculation also caused Latec's interest cover to be overstated. Interest cover is usually calculated by dividing the most recent figure for earnings before interest and tax by the interest expense incurred in that period. The investigating accountants' method of calculating interest cover for the proposed issue, by dividing earnings after interest but before tax by the expected interest expense associated with the proposed issue, produces a significantly higher estimate of interest cover. On the one hand, the method of calculation was disclosed in the investigating accountants' report. On the other hand, the usual reporting of interest cover would have provided more meaningful information and would have avoided the other three weaknesses, discussed above.[30] The investigating accountants' reports also provided estimates of the tangible asset cover available for the proposed debt issues. However, the effects of oversubscription also rendered these estimates meaningless.[31] In addition, from the depositors' viewpoint it would have been more appropriate to base any estimates of interest and asset cover on holding company, rather than consolidated, data.

To summarize, for several years prior to Latec's failure, the company's audited financial statement data significantly overstated profits and net assets. The distortion was largely due to the company's accounting for bad debts, hire purchase repossession rebates and provision for unearned hire purchase income. Less significant overstatements resulted from the failure to eliminate certain intercompany profits, the failure to recognize certain underwriting and tax liabilities and the accounting for refunds on hire purchase insurance premiums. In addition to reproducing these inaccuracies because of their uncritical acceptance of audited financial statement data, the investigating accountants' reports included potentially misleading estimates of the interest cover and asset cover for each of Latec's proposed debt issues.

[30] Although debenture holders' losses were minimal and, therefore, the quality of the accounting data, from their perspective, has not been considered, these criticisms apply to the investigating accountants' reports covering all debt issues. The overstatement of interest cover was particularly serious for the second and third debenture issues, which were made in the first half of 1960-61. For the second issue, profit before tax for 1959-60 would not have reflected the full impact of interest associated with the deposit issue which opened in September 1959, or of the interest associated with the first debenture issue, which opened in February 1960. In addition, for the third issue, profit before tax for 1959-60 completely omitted the interest impact of the second issue.

[31] In addition to the effects of oversubscription, the investigating accountants' estimates of asset cover available for debentures were misleading because they assumed that debenture funds would be used solely to acquire tangible assets. Part of Latec's debenture funds, however, was used to discharge unsecured liabilities. Indeed, the stated objects of the third debenture issue included the repayment of maturing deposits.

6.3 Testing the Responsibility Hypothesis for Latec

Having identified Latec's financial statement misinformation, it is necessary to determine the extent to which the accounting profession can be held responsible for these data. This responsibility can be determined in terms of the responsibility criteria set out in section 3.4(vi) of Chapter 3.

Latec's failure to make any provision for doubtful debts contravened generally accepted accounting principles. As discussed in the R.M.A. case study, the A.S.A. [1967] pronouncement, *The Valuation of Book Debts, Bad Debts and Provision for Doubtful Accounts*, stated that "the only acceptable basis" for reporting book debts was at their book value less an adequate provision for doubtful debts. Although the A.S.A. pronouncement was not issued until 1967, it promulgated principles which had been widely understood and accepted within the profession in the era of the Latec accounts.[32] The pronouncement also required

> "... that a debt should be written off when it is found to be bad (i.e., uncollectable) ..."[33]

Latec's policy of delaying the recognition of bad debts, therefore, also contravened generally accepted accounting principles. Even if it could be argued that the debts were not yet "bad", they were sufficiently "doubtful" to require some provision in the accounts.

In identifying the generally accepted accounting principles applicable in the U.S., Grady [1965] initially listed five broad objectives, which he derived from consideration of

[32] See, for example, Fitzgerald [1953, pp.74-80].

[33] Australian Society of Accountants [1967].

> "... the entire fulfilment of corporate fiduciary accountabilities to stockholders, creditors and others having bona fide interests."[34]

His accounting principles flowed from these objectives. Kenley [1970] modified Grady's objectives to fit the Australian accounting environment. The Australian objectives included

> "Objective 1. Account for sales, revenue, income, cost of sales, expenses, gains and losses in such a manner as to present fairly the results of operations for the period (or periods) of time covered.
>
> Objective 2. Account for assets invested in the enterprise by shareholders ... and creditors, in a meaningful manner, so that when considered with the liabilities of the business enterprise, including share capital and reserves, there will be a fair presentation of the financial position of the enterprise both at the beginning and the end of the period."[35]

Latec's policy of not recording interest rebates on hire purchase repossessions, which resulted in the overstatement of profit and debtors, therefore, contravened two of the basic objectives of accounting. Similarly the policy of not crediting insurance premium refunds to hirers, between 1955-56 and 1959-60, and the credit of these accumulated refunds to profit in 1959-60 contravened the basic objectives of accounting, identified by Kenley. As a result, Latec's accounting for both the hire purchase rebates and the insurance premium refunds contravened the matching principle. Although the Grady and Kenley studies were published after Latec's failure, the matching principle was a widely understood and accepted principle of accounting at the time that the Latec accounts were prepared.[36] Indeed, the credit of the refunds to profit also contravened the generally accepted realization

[34] Grady [1965, p. 55].

[35] Kenley [1970, p. 19].

[36] See, for example, Fitzgerald [1953, pp.26-28].

principle. As discussed in the R.M.A. case study, for revenue to be realized, goods or services must be provided. In this case, no service had been provided by Latec.

According to the government inspectors, the simultaneous write-off of bad debts, of an amount equal to the accumulated insurance refunds was made simply to get rid of this credit balance.[37] This bad debt write-off, therefore, also contravened the basic objectives of accounting and, as a result, the matching principle. These procedures defeated the purpose of financial statements and, although they reflected decisions by Latec's management, the individual accountants and auditors involved should have doubted their appropriateness.

Latec provided for unearned income on hire purchase contracts by applying an arbitrary percentage to gross hire purchase debtors. The percentage varied from year to year. Under the matching principle, the unearned interest income should have been spread according to the amount of hire purchase debts outstanding. Latec's arbitrary percentage apportionment did not achieve this end. The I.C.A.A. [1961] pronouncement, *Apportionment of Income of Hire Purchase and General Finance Companies*, recommended that the gross income arising from any form of finance contract should be apportioned, between current income and income yet to mature, by accounting methods consistent with the "Rule of 78". In most circumstances, apportionments based on the "Rule of 78" were consistent with the matching principle. This pronouncement was not issued until June 1961 but, according to its preamble, methods which complied with the "Rule of 78" were already used by leading hire purchase companies in Australia. While this suggested that there was some degree of acceptance for the "Rule of 78" prior to June 1961, it is doubtful whether there was any method of accounting for unearned income which could be considered as

[37] New South Wales, Parliament [1965, p. 149]

"generally accepted" in the era of the Latec accounts. For example, the *Statement on Accounting Practice No. 3, Accounting for Hire Purchase Transactions,* issued by the A.S.A. in 1958, stated that the "Rule of 78" was the "closest practicable approach" to recognizing hiring charges as earned, but it acknowledged that, in practice, several other methods of accounting for hiring charges were also used.[38] Indeed, by not recommending any specific method, the statement effectively condoned the use of these other methods, even though it recognized that

> "... the methods that are most commonly used are not always the best approximation for their circumstances ..."[39]

The apparent lack of clearly defined principles in accounting for unearned income is confirmed by the government inspectors' report, which, in 1965, noted that

> "The calculation of this future interest has always presented difficulty in finance companies with a large number of accounts and it is fair to say that, until a few years ago, some companies were not dealing with the problem on a scientific basis."[40]

Likewise an *A.S.A. Bulletin,* published in October 1965, noted that

> "practices in its (i.e. unearned income) calculation have been many and varied."[41]

Therefore, prior to 1961, the principles by which unearned income on hire purchase contracts should be brought to account were unclear. Although the government inspectors concluded that Latec's arbitrary method of accounting

[38] Australian Society of Accountants [1958, p.21].

[39] Australian Society of Accountants [1958, p. 26].

[40] New South Wales, Parliament [1965, p. 143].

[41] Australian Society of Accountants [1965a, p. 15].

for unearned income provided the opportunity to distort profit, they also found that, in this area,

"Latec was not too sure what should be done ..."[42]

Clearly, the profession was aware of the lack of defined principles in this area. It responded to this situation with the issue of I.C.A.A. pronouncements in 1960 and 1961.[43] Both of these pronouncements dealt with apportioning income yet to mature. The second pronouncement was more specific than the first with clear recommendations on appropriate principles. Perhaps because they were relevant only to hire purchase and finance companies, these pronouncements were not included in the I.C.A.A.'s series of Recommendations on Accounting Principles which were issue over this period. Moreover, they were not endorsed in the series of accounting standards issued subsequently. This may have limited their authority, although they were issued specifically as pronouncements of the General Council of the I.C.A.A.

Latec's failure to eliminate the profit on some intercompany transactions violated the I.C.A.A. *Recommendation on Accounting Principles, Disclosure of the Financial Position and Results of Subsidiary Companies.* This statement, which was issued in 1946, recommended that

> "The consolidated profit and loss account, or other information given as to the earnings of the group should disclose the aggregate results of the group for the period covered by the accounts, after eliminating the effect of inter-company transactions."[44]

Similarly, the A.S.A. *Statement on Accounting Practice No. 1, Notes on the Preparation of Consolidated Statements,* which was issued in 1956, had informed

[42] New South Wales, Parliament [1965, p. 144].

[43] Institute of Chartered Accountants in Australia [1960 and 1961].

[44] Institute of Chartered Accountants in Australia [1946e].

A.S.A. members that

> "A consolidated revenue statement results from the aggregation of the income and expense items of the companies constituting the group, after eliminating all inter-company trading ..."[45]

Latec's failure to eliminate profits on certain intercompany transactions, therefore, contravened accounting principles which had been clearly defined and widely circulated.

Misinformation also occurred because of Latec's failure to record the company's liability to pay underwriting fees and to charge part of these fees against profits, where the period covered by the borrowings had expired. Likewise, when the Commissioner for Taxation had disallowed a reserve claimed by a Latec subsidiary, the liability for the tax payable on this reserve should have been recorded in the subsidiary, and group, accounts. Latec's failure to record these liabilities contravened the third basic accounting objective identified by Kenley, which required an entity to

> "account for all known liabilities of the business enterprise in a meaningful manner in order that their summarization, considered together with the statement of assets and equity invested by shareholders, will fairly present the financial position of the enterprise at the beginning and end of the period."[46]

Similarly, the associated understatement of expenses contravened Kenley's first objective, discussed earlier, and the matching principle which follows from it.

Latec's investigating accountants' did not verify the group's audited financial statements, which formed the basis of their report. The I.C.A.A.'s *Recommendations on Accounting Principles, Accountants' Reports for*

[45] Australian Society of Accountants [1956].

[46] Kenley [1970, p. 19].

Prospectuses, required investigating accountants to accept full responsibility for the contents of their report and, therefore, to determine the extent to which the audited financial statements are reliable.[47] However, this recommendation was not issued until 1963 and, although it seems logical to require investigating accountants to verify their data, it is unclear whether this principle was generally accepted prior to this time. After all, the quality and content of the unqualified audited financial statements had already been attested to, by members of the accounting profession.

The I.C.A.A. recommendation on accountants' reports for prospectuses did not deal with the calculation of interest cover or asset cover. Indeed the evidence suggests that, at the time of the case study, the appropriate procedures in these areas had received little attention. For example, Fitzgerald [1949] made no mention of either of these ratios in his book, *Analysis and Interpretation of Financial and Operating Statements.* Even so, commonsense suggests that with the right to, and a history of, accepting significant oversubscriptions, any calculations based on the face value of issues would be meaningless. Likewise, in the estimation of interest cover, the application of the same average interest rate across issues offering different rates of interest is most unlikely to have been acceptable to the accounting profession. The investigating accountants' failure to take account of the full interest impact of previous debt issues in estimating interest cover also defied commonsense. Each of these weaknesses could have been avoided by calculating interest cover on the basis of earnings before interest and tax divided by interest expense, instead of earnings before tax divided by the expense of the proposed issue. Although no pronouncement had been made in this area, commonsense and conservatism should have suggested this approach to Latec's investigating accountants.

[47] Institute of Chartered Accountants in Australia [1963c].

Table 6.6 classifies Latec's financial statement misinformation according to whether it resulted from compliance with, violation of, or possibly a lack of, generally accepted accounting principles. This table shows that eleven of the thirteen sources of misinformation resulted from non-compliance with generally accepted accounting principles, although in ten of these eleven areas the principles had not been formalized. As far as the responsibility hypothesis is concerned, the failure to delineate princples in the other nine areas was not significant, since the principles were widely understood and accepted. The non-compliance was not disclosed in the financial statements or in the auditors' reports. The individuals involved with the preparation and audit of Latec's financial statement data and its management, therefore, can be held responsible.

A number of members of the accounting profession were involved with Latec's financial statements. Two of the directors, C. L. Cattell and R. A. Cattell, were former public accountants and Fellows of the A.S.A. According to the government investigation, the Cattells dominated Latec's internal and external management.[48] In addition, from 1959, one of the remaining four directors, A. C. Walters, was also a qualified accountant. R. A. Cattell was expelled from the A.S.A. on the grounds that he had

> "concurred in making, circulating and publishing a written statement which was false in certain material particulars regarding the net profits of Latec Investments Ltd. ..."[49]

[48] For example, the inspectors concluded that, "The destinies of the Company and its subsidiaries were, for all practical purposes from 1953 to 1961, in the hands of Leslie and Arthur Cattell, two brothers who were qualified accountants ..., and the rest of the Board in this period was virtually a rubber stamp. There was no restriction on the authority of the Cattells". New South Wales, Parliament [1965, p.219].

[49] *Australian Accountant*, July 1968, p.417.

Table 6.6: Responsibility for the Latec Financial Statement Misinformation

Source of Misinformation	Contravened endorsed procedure in this, or related, area	Contravened widely understood and accepted principles	Complied with endorsed procedure	Complied with widely understood and accepted principles	No clearly defined G.A.A.P. in this area
Overstatement of debtors					
- inadequate provision for doubtful debts		X			
- delayed recognition and write-off of bad debts		X			
Accounting for hire purchase contracts					
- failure to record rebates on repossessions		X			
- treatment of insurance refunds as profit instead of credits to hirers		X			
- expensing as bad debts amount equal to accumulated insurance refunds		X			
- arbitrary provision for unearned income					X
Failure to eliminate profit on intercompany transactions	X				
Underwriting fees					
- failure to record liability for fees		X			
- failure to expense fees at expiration of borrowing period		X			
Taxation					
- failure to record liability for certain disallowed reserves and, therefore to record the associated income tax expense		X			
Investigating accountants' reports					
- unquestioned acceptance of audited accounts					X
- calculation of interest cover		X[a]			
- calculation of asset cover		X[a]			
	1	10	-	-	2

a. Although the principles applicable to these calculations had not been promulgated, Latec's treatment of them was unrealistic and far from conservative, and, as such, is unlikely to have been acceptable to the accounting profession.

However, the A.S.A. did not report the names of any other members involved with the Latec accounts. Latec's auditors, Frank, Henry, Perry and Co., and the investigating accountants, G. A. Parkhill, Lemm and Bell, were members of the I.C.A.A., but it is impossible to tell whether any I.C.A.A. members were disciplined over the financial statement data produced by Latec.

Misinformation was produced in two areas where there were no clearly defined accounting principles. Given the nature of the process for developing accepted accounting principles, the profession cannot be held responsible for this misinformation. Indeed, in one of the areas the profession had defined principles just before Latec was placed into receivership and in the other area a pronouncement was issued just after the receivers were appointed.

Finally, the positive influence of accountants over Latec's financial statement data should not be ignored. For example, the auditors refused to sign the accounts for the first half of 1960-61 which announced Latec's largest ever profit, and they initiated action to correct the misinformation contained in these financial statements.[50] Although, on the other hand, the inspectors found that the auditors had expressed concern over Latec's accounts, as early as 1957.[51] Indeed, the inspectors suggested that, at least by 1959, the auditors should have investigated Latec's situation more thoroughly and should have qualified the accounts.[52] Had they done so Latec probably would have found raising capital a more difficult task.

[50] New South Wales, Parliament [1965, p. 200].

[51] New South Wales, Parliament [1965, p. 197].

[52] New South Wales, Parliament [1965, p. 200].

6.4 Conclusions

From the investors' viewpoint, the failure of Latec in the early 1960s was significant. In book values, the losses of shareholders and depositors amounted to more than $8m. In addition, Latec investors incurred substantial opportunity costs and losses of purchasing power, from having funds, which were eventually recovered, tied up over a considerable period. Latec's financial statement data suggested that, overall, the company's shares were a good investment, although by the late 1950s, there were some unfavourable signs. Latec's deposit issues offered attractive interest rates and appeared to have substantial interest cover and sufficient, although declining asset cover. However, the atypically high interest rates and, from 1958, the high debt ratios and low current ratios should have given Latec depositors some cause for concern. There were, therefore, indications that, in the long run, Latec may run into difficulties but it was not apparent that failure was imminent.

The evidence suggests that Latec's financial statement data were potentially misleading. In the years leading up to failure, Latec's accounts significantly overstated profits and net assets due to the accounting for bad debts, hire purchase repossession rebates and the provision for unearned hire purchase income. Less significant distortions occurred because of the accounting for refunds on hire purchase insurance, the failure to eliminate intercompany profits and the failure to recognize liabilities. The investigating accountants' reports embodied these weaknesses and, in addition, included potentially misleading estimates of interest and asset cover. These findings, therefore, are consistent with the misinformation hypothesis. Latec's financial statement data misrepresented the group's results and financial position and, therefore, did not provide investors with a clear warning of the group's demise.

There were some differences between the asset values in the statement of affairs and the asset values recorded in the financial statements prior to failure. These differences related to the value of Latec's subsidiaries and were caused by the recognition of the subsidiaries' liability to the debenture holders, upon appointment of the receivers. Prior to failure, this liability was contingent. Despite Latec's problems, there was no evidence to suggest that the liability should have been recognized earlier or that the going concern assumption should have been dropped. In fact, the appropriateness of the going concern assumption was not an important issue. The statement of affairs values, other than for the subsidiaries, coincided closely with the values in the financial statements.

Latec's financial statement misinformation resulted largely from the violation of generally accepted accounting principles and, as such, was primarily the responsibility of Latec's management and the accountants and auditors involved with Latec. The evidence on discipilinary measures taken by the profession is unclear. The A.S.A. reported disciplinary action against only one of its members over the Latec accounts although other members were involved. The action or inaction of the I.C.A.A. in this case cannot be determined. Misinformation occurred in two areas where it may not have been obvious which accounting principle was appropriate. The accounting profession cannot be held responsible for this situation. Moreover, in both areas these omissions were remedied rapidly. In conclusion, these findings, therefore, do not support the responsibility hypothesis.

CHAPTER 7

STANHILL DEVELOPMENT FINANCE LIMITED

Stanhill Development Finance Limited (S.D.F.) floated its only issues of shares and notes on 27 July 1960. Within five days they had been fully subscribed, for a total investment of $5.5m. Two years later, on 15 November 1962, S.D.F. defaulted on interest due to noteholders and their trustee obtained a judgement against the company for $4.22m, covering the outstanding principal and accrued interest. S.D.F. was unable to satisfy this judgement. In August 1963, a receiver was appointed on behalf of the noteholders and a government investigation was instigated. As a result of this investigation, in September 1964 it was recommended that S.D.F. be wound up. The report of the government investigation criticized S.D.F.'s financial statement data. This chapter identifies the sources of financial statement misinformation and determines responsibility for them.

7.1. The Losses of S.D.F. Investors

The two main classes of S.D.F. investors were shareholders and registered unsecured noteholders.[1] S.D.F.'s only issue of shares, on 1 August 1960, raised $1.5m. In May 1965, following the court order to wind up S.D.F., the receiver was appointed as liquidator. The liquidator's statement of affairs estimated that S.D.F.'s entire shareholders' funds had been lost.[2] It would

[1] In November 1960, $3.0m of debentures were issued to Clayton Development Pty. Ltd. Clayton's subscription was financed by a loan from S.D.F. Six months later, in May 1961, these debentures were redeemed. The government inspector concluded that the sole purpose of this transaction was to avoid the tax implications of the November 1960 credit squeeze. Given the nature and effects of this transaction, it is not necessary to consider debenture holders in this context.

[2] Stanhill Development Finance Ltd., Statement of Affairs, at 19 May 1965.

be wrong to assert, however, that S.D.F.'s failure resulted in losses to the investing public of $1.5m, since one-third of this share capital was contributed by the public company, Stanhill Consolidated Ltd. (S.C.L.) and was financed by a loan from S.D.F. to S.C.L. Eliminating the effects of this loan, S.D.F.'s loss of share capital raised directly from the investing public was, therefore, $1.0m. In addition, S.D.F.'s unappropriated profits, which peaked at $0.07m at 31 July 1961, were also lost.

S.D.F.'s major source of investors' funds was, however, its issue of eight year, registered, unsecured notes on 1 August 1960. This issue raised $4.0m from the investing public. The liquidator estimated that, at 19 May 1965, S.D.F. had a deficiency of $4.70m.[3] By this time unsecured creditors were owed $5.08m, of which $4.90m related to noteholders' principal and accrued interest. This meant that by 19 May 1965, S.D.F. noteholders had lost approximately $4.53m of principal and accrued interest. Moreover, this estimate understates the loss to S.D.F. noteholders due to the decline in the purchasing power of funds eventually recovered. It also ignores the opportunity cost of being unable to re-invest these funds, in the meantime, in more rewarding opportunities. It is difficult to quantify these losses.

To summarize, when S.D.F.'s liquidator was appointed, the investing public had lost approximately $5.60m. Shareholders had lost contributed share capital of $1.0m, and unappropriated profits. Noteholders had lost principal and accrued interest of approximately $4.53m. If the losses of purchasing power and the opportunity cost of investors being unable, in the interim, to re-invest their funds were included, these estimated losses would be greater.

[3] Stanhill Development Finance Ltd., Statement of Affairs, at 19 May 1965.

7.2 Testing the Misinformation Hypothesis for S.D.F.

7.2 (i) The Relevant Period and the Relevant Data

Since S.D.F. was put into receivership only three years after incorporation, there is no need to limit the period of this case study. The methodology proposed in Chapter 3 requires an assessment of the different sources of financial statement data which were relevant to the different classes of potential and existing investors. Potential subscribers to S.D.F.'s only share and note issues were provided with a prospectus. This was S.D.F.'s only prospectus. Since S.D.F. had just commenced operations at that time, it cannot be argued that financial statement data about S.D.F. misinformed the subscribers to these issues.[4] It is necessary, however, to consider the quality of any other accounting data contained in this prospectus. In addition, the financial statements in S.D.F.'s annual reports were distributed to existing shareholders and, although annual reports were not issued to noteholders, 85 per cent of the noteholders also held S.D.F. shares and therefore received annual reports.[5]

S.D.F. issued annual reports in 1961, 1962 and 1963. It has not been possible to obtain copies of the annual reports for 1962 and 1963.[6] However, the audited financial statement data for these years are available from the *Investment Service*f or!†xblv/ !a dlv Wydney Stock Exchange. The S.D.F. annual report for 1961 was extremely brief, consisting of a Directors' Report, a set

[4] The company was incorporated on 25 September 1959, as Stanhill Finance Corporation Ltd., but was inactive. On 22 June 1960 it was renamed Stanhill Development Finance Ltd. and commenced operations.

[5] Victoria, Parliament [1964, pp.79-80].

[6] The S.D.F. file held at the office of the Corporate Affairs Commission in Victoria (S.D.F.'s state of incorporation) does not contain the annual reports for 1962 and 1963, nor does the file held at the office of the Corporate Affairs Commission in South Australia.

of financial statements and an unqualified auditor's report. The Directors' Report quoted the reported net profit and the amount of interest receivable by S.D.F. but made no other use of financial statement data. However, it is not possible to determine whether any accounting information, other than the audited financial statements, was included in the annual reports for 1962 and 1963.

In the prospectus, the auditor's report simply stated that

> "1. The company was incorporated on 25th September, 1959.
> 2. No accounts have yet been prepared.
> 3. No dividends have been declared or paid."[7]

There were no financial statement data available about S.D.F. to influence the investment decision of the initial subscribers. The text of the prospectus, however, mentioned the security of the Stanhill group. For example, in his report, Stanley Korman, as chairman of directors, noted that

> "... the assets of the Group total nearly $60,000,000 and that there are over 40,000 holdings of shares, notes and debentures in the various companies...."[8]

The "group" included the well known public companies S.C.L., Factors Ltd. and Chevron Sydney Ltd., as well as several Korman family companies. Moreover, the prospectus attested to the quality of S.D.F.'s management on the grounds that the S.D.F. board was

> "... largely comprised of the directorate of Stanhill Companies, which are already on a substantial profit-earning basis..."[9]

[7] Stanhill Development Finance Ltd., *Prospectus*, 27 July 1960, p.12.

[8] Stanhill Development Finance Ltd., *Prospectus*, 27 July 1960, p.7. The Stanhill groups refers to the conglomerate of public and private companies, of which S.D.F. was a part, and which was effectively managed by Stanley Korman.

[9] Stanhill Development Finance Ltd., *Prospectus*, 27 July 1960, p.2.

In general, the prospectus implied that S.D.F. was a promising investment because of its association with the apparently successful Stanhill group. Indeed, existing investors in the Stanhill group were given priority in applying for S.D.F. notes and shares.[10] Ideally, the financial statements of the Stanhill group published prior to the prospectus, therefore, should be evaluated. In addition, a significant part of S.D.F.'s funds were advanced to various members of the Stanhill group, particularly S.C.L. These advances comprised a major part of S.D.F.'s assets. It is also desirable, therefore, to consider the financial statement data published by the Stanhill group, after S.D.F. had commenced operations. Unfortunately, since the "Stanhill group" was a group in a managerial sense, but not in a legal or accounting sense, it would be necessary to analyse the data of each company within the group. Such an approach is beyond the scope of this thesis. However, the Stanhill group was the subject of a government investigation and its findings about the group's financial statements are summarized later in this chapter.

7.2 (ii) S.D.F.'s Condition According to Its Financial Statement Data

S.D.F.'s financial statement data were contained in the company's annual reports for 1961, 1962 and 1963. However, a note to the 1961, 1962 and 1963 accounts warned investors of the doubtful value of the advances to S.D.F.'s major debtor, S.C.L. The book value of this account represented 78.87 per cent of the book value of S.D.F.'s total assets at 31 July 1961, 85.31 per cent at 31 July 1962 and 92.43 per cent at 31 July 1963. The doubtful nature of S.D.F.'s debtors was further accentuated in the financial statements, from 1961, which stated that interest due was only brought to account as

[10] Stanhill Development Finance Ltd., *Prospectus*, 27 July 1960, p.8.

received. The extremely doubtful value attached to S.D.F.'s assets render the calculation of S.D.F.'s rate of return on its assets, the return on shareholders funds, the net asset backing per share and the debt ratio pointless. Even the most naive of investors are unlikely to have bothered with such calculations. Therefore, Table 7.1 presents only net profit, dividend and interest cover data.

The net profit data showed that S.D.F. made substantial losses, in each year, except 1960-61 which was the first year of operations. S.D.F. paid only one dividend, which was the interim dividend of 4.17 per cent declared on 3 March 1961. Had this dividend rate been maintained, S.D.F.'s dividend rate would have been 8.33 per cent per annum. Industry averages are not available, but, in 1960-61, A.G.C.'s and B.F.C.'s dividend rates were 15 per cent and 4.17 per cent, respectively. The B.F.C. rate was atypical for the company because 1960-61 was its first year of operations. Over most of the 1960's, B.F.C. paid a dividend rate of 8.00 per cent per annum. S.D.F.'s dividend

Table 7.1 S.D.F.'s Profitability and Security, Shareholders' and Noteholders' Perspective

Year Ended 31 July	Net Profit (in $000)	% Change in profit over previous period	% Dividend Rate	Interest Cover
Incorp'n to 31/7/61[1]	129.33	-	4.17	1.51
1962	(663.05)	-612.68	-	-3.95
1963	(441.39)	133.43	-	-1.42

[1] This period actually covered 13 months. However, the note and share issues were made after the first month and S.D.F.'s trading activities were minimal during this period.

rate, therefore, appeared to be satisfactory for the first half of 1960-61, but not thereafter. The government investigation concluded that S.D.F. collapsed in the first half of 1960-61.[11] This was not evident from the dividend data. To determine whether it was evident from the other financial statement data, S.D.F.'s interim financial statements for 1960-61 should also be examined. Unfortunately, these statements are not available.[12]

In 1960-61, S.D.F. covered interest 1.51 times. Although interest cover "standards" are not available for 1960-61, a comparison with Table 3.4 shows that S.D.F.'s interest cover in 1960-61 was well below A.G.C.'s interest cover in 1961-62 but above B.F.C.'s interest cover for 1962-63 and most of the subsequent decade. An examination of the data in Tables 3.2 and 3.4 show that interest cover has tended to decrease over time. Nevertheless, compared to the B.F.C. interest cover in subsequent periods, S.D.F.'s interest cover for 1960-61 appears satisfactory. However, from 1961-62, it was negative and clearly unsatisfactory.

To summarize, S.D.F. floated its only issue of shares and notes before it commenced operations and, therefore, it cannot be argued that misleading accounting information about S.D.F. influenced the investment decision of initial subscribers. S.D.F.'s financial statement data, however, did have the potential to influence the decisions of investors in the secondary securities markets. From at least the end of its first year of operations, these data showed that S.D.F. shares and notes were an unattractive investment, since the notes to the accounts indicated that the value of the company's major asset,

[11] For example, as early as December 1960 S.D.F. was unable to raise temporary overdraft accommodation. See Victoria, Parliament [1964, p.25].

[12] They are not contained in the S.D.F. files held in either the Victorian or S.A. Corporate Affairs offices.

debtors, was indeterminate. From 1961-62, the data showed that the company had incurred substantial losses. In general, S.D.F.'s financial statements made it quite apparent that failure was imminent. Although S.D.F.'s accounts did indicate failure, it is necessary to determine whether there were any respects in which the financial statement data delayed or understated this warning.

7.2 (iii) S.D.F.'s Financial Statement Misinformation

Although S.D.F.'s financial statements for 1961 gave an indication of failure and the financial statements for 1962 and 1963 made failure apparent, there were aspects of these financial statements which were confusing, if not misleading. For example, the profit and loss statement for 1960-61 included a note, which stated that

> "In determining the profit for the period, income from interest has been taken to account to the extent that it has been received during the 13 months period to 31st July, 1961, and to 1st December, 1961."[13]

The 13 month period can be explained by the fact that S.D.F. commenced operations on 22 June 1960. This was not significant because the company was virtually inactive until the issue of the notes and shares on 2 August 1960. More importantly, this note suggests that rather than bringing interest income to account when due, it was only recorded when received. It seems that S.D.F. had adopted a cash rather than accrual method of accounting for interest income. In addition, it appears that S.D.F. had included, in the income for the year ended 31 July 1961, interest revenue received between 31 July and 1 December 1961.

[13] Stanhill Development Finance Ltd., *Annual Report, 1961*, p.3.

The balance sheet at 31 July 1961 included the following information.

Advances

Stanhill Consolidated Limited & Subsidiary Companies	($)
Principal maturing 31/12/61	147,116
Principal maturing 31/7/65	4,718,418
	4,865,534
Interest due at 31/7/61	339,428
	5,204,962
Less interest not yet received	151,952
	5,053,010
Other Companies	
Principal	116,208
Interest due at 31/7/61, since received	5,876
	122,084
Chevron Sydney Limited	
Interest due at 31/7/61	37,096
Less interest not yet received	37,096
	–

Source: Stanhill Development Finance Ltd., *Annual Report, 1961*, p.3.

These data suggest that between 31 July 1961 and 1 December 1961, S.D.F. received past interest due of $193,352.[14] According to the note to the profit and loss statement, this was treated as income for 1960-61. It accounted for approximately 86 per cent of S.D.F.'s profit before tax in 1960-61. Under the generally accepted principles of accrual based accounting, an asset, interest receivable, and income, interest revenue, should have been recorded when the

[14] Interest due at 31/7/61

From	S.C.L.	339,428
	Chevron Sydney	37,096
	Other	5,876
Total interest due at 31/7/61		382,400
Less interest not received by 1/12/61		
From	S.C.L.	151,952*
	Chevron Sydney	37,096
Interest received between 31/7/61 and 1/12/61		193,352

*Although it is unclear from the balance sheet whether this interest was not received by 31 July or 1 December 1961, it is clear from the inspector's report that this figure relates to interest due at 31 July but not received by 1 December 1961. See Victoria, Parliament [1964, p.56].

interest fell due. Where there was doubt about the collectability of the interest, this should have been recognized by a provision for, and/or a write off of, the doubtful debts. The switch to a cash basis of recognizing interest revenue effectively treated all interest due, but not received within the period, as irrecoverable. Moreover, having switched to cash based accounting, it was inconsistent to bring to account revenue received in the subsequent period. It should be noted, however, that although S.D.F.'s presentation of its profit and loss statement was confusing, it was conservative. Rather than recognizing as income the full interest due at 31 July 1961, of $382,400, only $193,352 was brought to account. Indeed, the accounting treatment, itself, should have warned investors of S.D.F.'s tenuous position. The decision not to record interest income until it was received, pointed to the doubtful security of debtors, which were S.D.F.'s major class of assets. The note to the balance sheet, which warned of the doubtful value of advances to S.C.L., should have substantiated this interpretation.

The combination of cash and accrual accounting and the inclusion of the effects of post-balance date transactions also complicated the interpretation of S.D.F.'s balance sheet, at 31 July 1961. Advances to S.C.L. included interest due from S.C.L. at 31 July 1961, of $339,428, less interest not yet received of $151,952. The wording of the balance sheet was ambiguous. The "interest not yet received" could have referred to interest outstanding at 31 July, when, in fact, it referred to interest outstanding at 1 December 1961 (see footnote 14). This implied that interest of $187,476 had been received from S.C.L. between 31 July and 1 December 1961. On the one hand, it was confusing to show this interest under "Advances", as it was no longer receivable. On the other hand, since it had been received after the balance date, to show it in the form in which it was received, or to which it had been converted, would have further distorted the description of S.D.F.'s financial position, at 31 July 1961. The receipt of the interest was a post-balance date event and its effects should not have been included in the balance sheet at 31 July 1961. This criticism applies equally to the asset "Advances: Other Companies" which included interest due at 31 July 1961, since received. No distortion arose with respect to interest due from Chevron Sydney, since none was received after the balance date.

Despite the confusing presentation of S.D.F.'s financial statements for 1961, these statements made it clear that the recoverability of S.D.F.'s major asset was in doubt. As such, it cannot be argued that these statements were seriously misleading. The financial statements for 1962 and 1963 made S.D.F.'s failure apparent, although the Sydney Stock Exchange's version of these statements are aggregated in such a way that it is not possible to identify whether the criticisms above applied to the accounts issued after 1961.

It is necessary to consider, however, whether the financial statements understated the extent of S.D.F.'s failure. Two statements of affairs were prepared for S.D.F., one on the appointment of the receiver in August 1963, and the other on the appointment of the liquidator, in May 1965. The August 1963 statement estimated that the realizable value of S.D.F.'s assets was $0.31m below their book value of $6.69m. Of this, $0.16m related to current assets with a book value of $6.52m. Such a difference is minor. However, approximately 94 per cent of the receiver's estimates of the realizable value of S.D.F.'s current assets related to advances to the Stanhill group companies, S.C.L., Stanhill Estates Pty. Ltd. and Stanhill Development Pty. Ltd.[15] These advances were only partly secured and the security consisted largely of a registered second mortgage over the Chevron Hilton Hotel, Sydney.

[15] Stanhill Development Finance Ltd., Statement of Affairs, August 1963.

They were not written down in the statement of affairs because

> "... the net amounts receivable by Stanhill Development Finance Ltd. ... cannot be assessed at this time ...."[16]

The receiver recognized that the recovery of $5.68m of the $6.10 Stanhill group debt was contingent on the sale of the Chevron Hilton Hotel realizing sufficient to discharge in full all prior charges, the second mortgage security held by S.D.F. and any unsecured debts. It also depended on S.C.L. being able to satisfy its debts in full. He concluded that, although the Statement of Affairs showed a surplus of $1.90m, subject to the realization of the Stanhill group debt at book value, the situation was more realistically shown as an estimated deficiency of $3.81m, subject to adjustment by the amount which might be recovered from the second mortgage over the hotel.[17]

In May 1965, the realizable value of the Stanhill group debt was estimated at $0.04m. The second mortgage over the Chevron Hilton Hotel, Sydney was then estimated to be virtually worthless. This meant that the estimated realizable value of the Stanhill group debt was $7.00m lower than its book value.[18] This write-down was the major source of the overall $7.30m difference between the book and realizable values of S.D.F.'s total assets.[19]

The notes to the receiver's statement of affairs, and the liquidator's statement of affairs, therefore, indicated a substantial difference between the book and realizable value of debtors, which was S.D.F.'s major class of assets. However, given that from as early as 1961, the notes to S.D.F.'s

[16] S.D.F., Statement of Affairs, Comments by Receiver, 6 December 1963.

[17] *Ibid.*

[18] This difference is greater than the total book value of the debt in August 1963, because of interest which had accrued since then.

[19] Stanhill Development Finance Ltd., Statement of Affairs, 19 May 1965.

financial statements stated that the value of the most significant of these advances could not be assessed, the receiver's and liquidator's statements cannot be regarded as evidence that S.D.F.'s financial statements were seriously misleading.[20] It could be argued that, under the circumstances, the going concern assumption was not appropriate and S.D.F.'s accounts should have been prepared on a liquidation basis. Indeed the government inspector argued that the note to the balance sheet should have included an estimate ot the extent to which these advances were irrecoverable or, at least, a warning that the realizable value of these advances was likely to be considerably less than their book value.[21] However, since the receiver was unable to obtain an estimate of the realizable value of the Stanhill group debt in August 1963, it is unrealistic to expect these data to have been included in earlier accounts. The note describing the value of the debt as indeterminate should have been adequate. All but the most naive of investors would have interpreted an indeterminate value as being a materially decreased value. The note would not have been warranted if the realizable value of these advances had been greater than, equal to, or slightly less than their book value.

To summarize, the evidence suggests that, from the first annual report, S.D.F.'s financial statements provided notice of the company's failure. These statements showed that, by the end of its first year of operations, S.D.F.'s fate was entirely dependent on another company of doubtful substance. Moreover, the statements showed that interest income due from this company and others within the Stanhill group was so doubtful that it was brought to account only when received. The only financial statement data which may have had the potential to mislead S.D.F. investors are the data produced by other companies within the Stanhill group.

[20] The financial statements stated that the value of advances to S.C.L. were indeterminate. At 31 July 1961, advances to S.C.L. and subsidiaries made up 97.03 per cent of the gross book value of S.D.F.'s advances.

[21] Victoria, Parliament [1964, p. 57].

7.2 (iv) The Stanhill Group's Financial Statement Misinformation

The prospectus accompanying the S.D.F. share and note issues depicted S.D.F. as part of the successful Stanhill group. Past financial statement data of the various companies in the group were used to develop the image of the Stanhill group as both profitable and secure, although the prospectus included only limited direct reference to these data. To determine whether the losses of S.D.F. investors can be attributed, in any way, to financial statement misinformation, it is necessary to evaluate the accounting reports of the Stanhill group issued prior to the release of this prospectus in August 1960. An evaluation of the Stanhill group financial statement data issued after August 1960, is also necessary, because S.D.F.'s major asset consisted of advances to the Stanhill group, in particular S.C.L.

As well as S.D.F., the government investigation into the affairs of the Stanhill group included the other major public companies, S.C.L., Factors Ltd. and Chevron Sydney Ltd., and the Korman family companies which significantly influenced the position of these public companies.[22] The inspector's major criticisms of the financial statement data of these companies are summarized below. Particular attention is paid to the accounts of S.C.L. and its subsidiaries, because of the significance of S.C.L. as S.D.F.'s major debtor.

7.2 (iv) (a) S.C.L.'s financial statement misinformation

S.C.L. was incorporated in 1955. From incorporation, it grew rapidly to become the holding company for more than seventy subsidiaries. Until 1960-61, S.C.L.'s financial statements depicted the group as an attractive investment

[22] These reports covered three volumes, Victoria, Parliament [1964, 1965-66 and 1967].

opportunity. Reported profit had grown rapidly and asset backing appeared to be sound. In July 1960, when S.D.F. was soliciting public monies partially on the basis of the Stanhill reputation, S.C.L. appeared to be the holding company of a very successful group. Yet, one year later, the same group reported a net loss of $0.62m and S.D.F.'s accounts warned that the value of its major asset, an advance to this group, was indeterminate. This failure raises two questions. Did failure occur entirely within 1960-61 or did earlier financial statement data disguise S.C.L.'s demise?

The government inspector's reports suggest that S.C.L. was failing well before 1961, but measures were taken to disguise this situation. One such measure was the creation of "profit puffing" transactions. For example, Stanhill Development Pty. Ltd., an S.C.L. subsidiary, was involved in "profit puffing" transactions during 1958 and 1959. These included land sales by Stanhill Development Pty. Ltd., to Factors Ltd. and Ceylon Bros. Pty. Ltd., at an extravagant price. The sale to Factors yielded trading profits of $121,600 in 1957-58, and $135,710 in 1958-59. Stanhill Development Pty. Ltd. had purchased this land only eight days prior to this transaction, for $54,000. By 31 July 1963, Factors had written down the land by $248,000.[23] After tax, the profit on this transaction accounted for just over 40 per cent of S.C.L.'s consolidated net profit in both 1958 and 1959. In June 1959, Stanhill Development Pty. Ltd. sold land to Ceylon Bros. Pty. Ltd., a company outside the Stanhill group. Ceylon's land purchase was financed by a loan from Factors. This transaction increased Stanhill Development's profit, and hence S.C.L.'s, profit for 1958-59 by $122,410. In early 1961, Dominion Pty. Ltd., a company within the Stanhill group, repurchased this land at the original

[23] Victoria, Parliament [1965-66, p.29 and 1967, p.19].

sale price, plus the cost of interest on the loan and a $10,000 profit for Ceylon Bros. The inspector concluded that the initial transaction

> "was engineered ... for the purpose of swelling the profits of S.C.L."[24]

S.C.L.'s "profit puffing" was not confined to real estate transactions. The S.C.L. accounts for 1958-59 also recorded a $58,000 commission paid to S.C.L. by Rockmans Pty. Ltd., a Factor's subsidiary, for its role in negotiating Rockman's takeover of K. and E. Rogers Pty. Ltd. Yet, the inspector found that S.C.L. had provided no such service and that this was simply a device to further increase S.C.L.'s profit for 1958-59.[25]

S.C.L.'s profit for 1959-60 was also overstated and its loss for 1960-61 was understated, because S.C.L. charged inflated architectural and management fees to Chevron Sydney Ltd. For example, the inspector found that S.C.L. had charged Chevron Sydney $1.13m for management services, which Chevron Sydney could have provided itself at little or no cost. The architect for Chevron Sydney was provided by S.C.L., at a much higher fee than if Chevron Sydney had hired its own architect. According to the inspector, the predominant purpose of these transactions was to increase S.C.L.'s profit. They increased S.C.L.'s profit for 1959-60 from $0.03m to the reported record $0.47m and decreased its loss for 1960-61 from $1.47m to $0.62m.[26] Had Chevron Sydney been recognized as an S.C.L. subsidiary, these management and architectural fees, which were recorded as revenue in S.C.L.'s accounts and capitalized in Chevron Sydney's accounts, would have been eliminated in the consolidated accounts. Legally, consolidation was warranted when the "parent" held either

[24] Victoria, Parliament [1965-66, p.31].

[25] Victoria, Parliament [1965-66, pp.37-39].

[26] Victoria, Parliament [1967, pp.112-120].

directly, or through a nominee, more than 50 per cent of the issued share capital of the "subsidiary". The records showed that, at 31 July 1960 and 1961, S.C.L. owned 49.17 per cent of Chevron Sydney's issued capital. However, the inspector found that, at 31 July 1960, S.C.L. actually owned more than 50 per cent of Chevron Sydney's shares. To disguise this situation, S.C.L. had transferred some of its Chevron Sydney shares to Factors Ltd. This transaction took place after 31 July 1960, but was back-dated. Chevron Sydney was also effectively an S.C.L. subsidiary at 31 July 1961, because of shares held by S.C.L.'s secretary and one of its directors, on its behalf.[27] In the words of the inspector,

> "My overall conclusion is that Chevron Sydney was at material times ... a subsidiary and that if this fact had been disclosed and the consequential legal obligations honoured the failure of Stanhill Consolidated Limited would have become apparent one year earlier than it did and the public would have been saved millions...."[28]

The S.C.L. accounts also embodied questionable asset revaluations. For example, on 30 June 1958, the directors of Stanhill Development Pty. Ltd. revalued some of its real estate from $267,990 to $563,070, with the credit being put to an account, "Unearned Increment on Unsold Sub-Divisional Land". The land had been purchased only a few months earlier. The revaluation was substantially below the market value estimated by a sworn valuer, dated the 27 June 1958, but the inspector believed that the valuer had not acted independently in arriving at this, and other, values. Moreover, since the land was part of Stanhill Development Pty. Ltd.'s trading stock, under generally accepted accounting principles, it should have been valued in the accounts at the lower of cost or market. The inspector concluded that the purpose of this entry was to increase tangible assets in the consolidated

[27] Victoria, Parliament [1967, pp.96-112].

[28] Victoria, Parliament [1967, p.96].

accounts and, thus, disguise the fact that S.C.L. was in breach of its debenture trust deed.[29] Another questionable revaluation was made on 30 October 1958, when S.C.L.'s board of directors resolved to increase the value of the shares of its wholly owned subsidiary Chevron Pty. Ltd., by $311,250, with the credit being written to an asset revaluation reserve.[30] This reserve was distributed subsequently as a bonus issue. S.C.L. made three bonus issues from its asset revaluation reserve between 1958 and 1960. These bonus issues contributed to S.C.L.'s reputation as a flourishing entity. The substantial write downs eventually required in S.C.L.'s accounts suggest that, in most cases, this reserve resulted from excessive valuations placed on the group's assets.

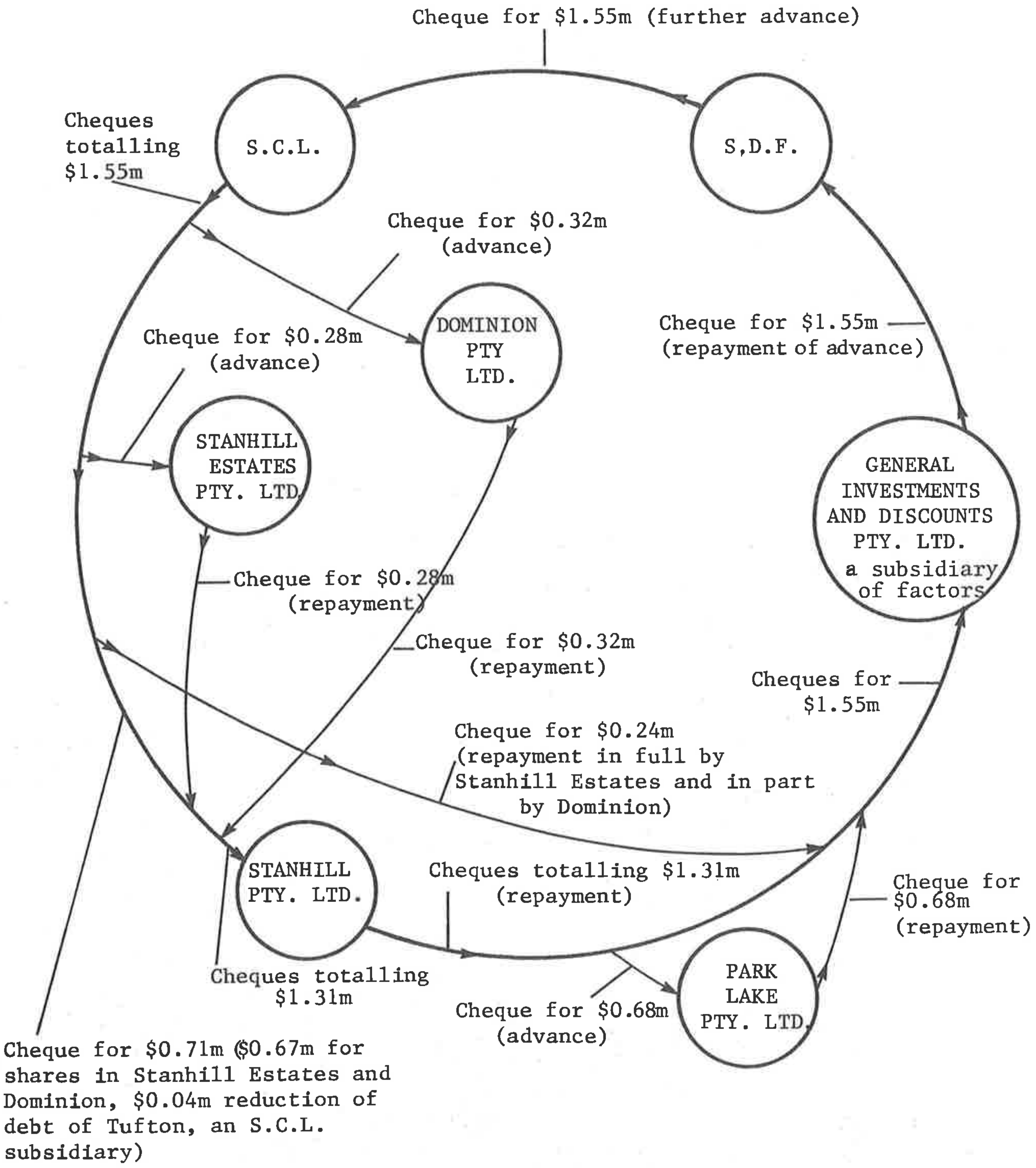
On 17 February 1961, various companies in the Stanhill group were involved in a "round robin" series of transactions. Through the simultaneous passing of cheques among Stanhill companies, various legal relationships were altered. The effect of these transactions is illustrated in Figure 7.1. The government investigation showed that the round robin was engineered solely for the benefit of two Korman family companies called Stanhill Pty. Ltd. and Parklake Pty. Ltd. It enabled these companies to realize in cash certain profits on real estate sales, to repay debts due to Factors and to rid themselves of further responsibility for real estate owned by the family companies Stanhill Estates Pty. Ltd. and Dominion Pty. Ltd.[31] From S.D.F.'s point of view, S.C.L. was substituted for Factors as a debtor owing $1.55m. S.C.L. took over Stanhill Estates and Dominion from the Korman private company, Stanhill Pty. Ltd. Stanhill Estates owed S.D.F. $1.30m. Therefore,

[29] Victoria, Parliament [1967, pp.29-30].

[30] Victoria, Parliament [1967, p.19].

[31] Victoria, Parliament [1967, p.121].

Figure 7.1 Stanhill Round Robin, 17 February 1961


Cheque for $1.55m (further advance)
S.C.L.
S,D.F.
Cheques totalling $1.55m
Cheque for $0.32m (advance)
DOMINION PTY LTD.
Cheque for $0.28m (advance)
Cheque for $1.55m (repayment of advance)
STANHILL ESTATES PTY. LTD.
GENERAL INVESTMENTS AND DISCOUNTS PTY. LTD. a subsidiary of factors
Cheque for $0.28m (repayment)
Cheque for $0.32m (repayment)
Cheques for $1.55m
Cheque for $0.24m (repayment in full by Stanhill Estates and in part by Dominion)
STANHILL PTY. LTD.
Cheques totalling $1.31m (repayment)
Cheque for $0.68m (repayment)
Cheques totalling $1.31m
PARK LAKE PTY. LTD.
Cheque for $0.68m (advance)
Cheque for $0.71m ($0.67m for shares in Stanhill Estates and Dominion, $0.04m reduction of debt of Tufton, an S.C.L. subsidiary)

Source: Victoria, Parliament [1967, p.120] as a result of the round robin, S.C.L.'s indebtedness to S.D.F. was increased from $1.68m to $4.53m. This was evident from S.D.F.'s next set of financial statements, as advances to S.C.L. and subsidiaries were disclosed separately in S.D.F.'s balance sheet. However, S.C.L.'s position was seriously weakened by the round robin and this was not evident from S.C.L.'s financial statements. The takeovers by S.C.L., of Stanhill Estates and Dominion, were supposedly based on the market value of the net tangible assets of these two companies, as determined by Ernest Fookes and Co., a firm of chartered accountants. These values were, however, significantly overstated.[32] For example, the net tangible assets of Stanhill Estates were valued at $707,370, after adding $877,040 to the book value of its real estate. The inspector concluded that

> "If the asset revaluations had not been made, the shares in Stanhill Estates which were worthless, would have appeared so."[33]

Dominion's "market" valuation was actually based on book values, at 31 December 1960, which were supposed to have been audited. Yet, Dominion's auditor's report was dated 25 May 1961, three months after the round robin, and the accounts were "so qualified as to be almost worthless".[34] Based on these accounts, S.C.L. paid $3.41 per 20 cent share, for a company which made a loss in 1960 of $23,410, and an average profit over the four years to 31 December 1960 of $1,600. In the round robin, therefore, S.C.L. paid $0.67m for the takeover of two virtually worthless companies, advanced these companies $0.60m and paid out a further $0.24 to meet their debts. These transactions were financed by a loan from S.D.F. In S.C.L.'s next set of financial statements, these acquisitions were not written down to their

[32] Victoria, Parliament [1967, pp.132-143].

[33] Victoria, Parliament [1967, p.141].

[34] Victoria, Parliament [1967, p.142].

realizable value nor was any provision for doubtful debts made against the advances to them.[35]

7.2 (iv) (b) Chevron Sydney's financial statement misinformation

The S.D.F. prospectus mentioned that Chevron Sydney Ltd. was part of the Stanhill group but since this company did not commence operations until 1959-60 and its first annual report was not available until after the S.D.F. prospectus was issued, it cannot be argued that Chevron Sydney's financial statement data were instrumental in attracting S.D.F. investors. However, from at least 1960-61, investments in, and advances to, Chevron Sydney accounted for a significant part of S.C.L.'s tangible assets.[36] S.C.L. was, in turn, S.D.F.'s major debtor. In addition, S.D.F. made substantial advances directly to Chevron Sydney. It is necessary, therefore, to evaluate Chevron Sydney's accounts.

Chevron Sydney was incorporated, according to its prospectus, to build a large modern hotel on a specific site in Sydney.[37] The inflated architectural and management fees charged by S.C.L. to Chevron Sydney were discussed above. These fees were capitalized in Chevron Sydney's accounts and therefore, inflated the company's asset values. Apart from these transactions

[35] S.C.L.'s consolidated balance sheet did include a note that subdivisional lands were recorded at cost, as in the directors' opinion, no accurate assessment of market value could be made. Although this should have warned investors that the value of the group's real estate may have been overstated, it gave no indication of the extent of the overstatement.

[36] At 31 July 1961 and 1962, advances to and investments in Chevron Sydney constituted 23.49 per cent and 26.79 per cent, respectively, of S.C.L.'s tangible assets. Prior to 1961, Chevron Sydney investments were not disclosed separately in S.C.L.'s accounts. By 31 July 1963, Chevron Sydney was in receivership and it was estimated that S.C.L. would not recover any of its advances to and investment in this company.

[37] Chevron Sydney Ltd., *Prospectus*, August 1959.

organized by S.C.L., Chevron Sydney entered into a number of transactions on its own behalf, which significantly distorted its reported results and financial position. For example, it used the money raised by its prospectus, to acquire a number of development properties, at extravagant prices. To disguise these "ultra vires" purchases in its 1960 accounts, entries were made on 29 July 1960, two days before balance date, to record the sale by Chevron Sydney of twenty-seven properties to Somerton Development Pty. Ltd. Somerton Development was formed in April 1960, with a share capital of $4. On 29 July 1960, it was made a wholly owned subsidiary of Stanhill Estates, which was at this time a Korman family company. The purchase price paid by Somerton Development for these properties was the price payable by Chevron Sydney to the original vendors, plus all costs incurred by Chevron Sydney in acquiring and holding the properties. The monies owing by Somerton Development were shown as "Sundry Debtors" in Chevron Sydney's 1960 accounts. Although Chevron Sydney had contracted to sell these properties, it continued to use them in 1961, to raise money either by mortgage or sale. On 14 September 1961, the contracts of sale were rescinded and the book entries were reversed, backdated to the year ended 31 July 1961.[38] Other "ultra vires" properties were disposed of through sales direct to Stanhill Estates in 1960. In this case, the money was lent to Stanhill Estates by S.D.F. but, once again, the inspector found evidence of backdated cheques and false minutes.[39]

7.2 (iv) (c) Factors' financial statement misinformation

Factors, another Stanhill public company, also manipulated its financial statements. For example, Factors was involved in some of S.C.L.'s "profit

[38] Victoria, Parliament [1967, pp.92-83].

[39] Victoria, Parliament [1967, pp.83-84].

puffing" transactions, discussed above. In addition, in April 1958, General Investments and Discounts Pty. Ltd. (G.I.D.), a money lending subsidiary of Factors which did not deal in real estate, purchased land and simultaneously resold it to Dominion, at a profit of $98,670. At the time, Dominion was a Korman family company. The inspector found that initially the purchase of this land had been arranged in Dominion's name but subsequently G.I.D. was substituted. G.I.D. then lent $1.0m, over a three year term, to Dominion and, by reducing the agreed interest rate of 8 per cent flat to 5.75 per cent, the interest charged on the loan was decreased by $98,670. The effect of these transactions was to increase G.I.D.'s profit for 1957-58, although at the expense of profits over the next three years. The profit from this transaction was not disclosed separately in the 1958 accounts, despite its atypical nature and the fact that it accounted for 87 per cent of G.I.D.'s profit before tax. The transaction increased Factors net profit before tax for 1957-58 by 94 per cent.[40]

(7.2) (iv) (d) The Stanhill Group's financial statement misinformation: a summary

To summarize, the evidence suggests that the financial statement data of some of the major public companies within the Stanhill group did not present a true and fair view of their state of affairs. Overall, investors in the Stanhill group lost more than $48m. The inspector concluded

> "The true significance of this loss lies not in its size, which is startling enough, but in the fact that by the use of these manoeuvres and manipulations ... the public was kept in complete ignorance of the 'Group's' losses for so long."[41]

[40] Victoria, Parliament [1965-66, pp.19-27]

[41] Victoria, Parliament [1967, p.169].

and

> ..."Nothing emerges to excuse the sharp practices in which the 'Group' engaged, or the dishonest way in which the public was deluded into believing that the 'Group' was earning substantial profits ... these directors were prepared to create the appearance of success by a process of manipulation of accounts, even if that involved misleading members of the public who were entitled to know the truth."[42]

The losses of S.D.F. investors were only a small part of the overall losses of the Stanhill group. However, if the financial statements of the other Stanhill companies had realistically reflected their results and financial position up to mid-1960, the S.D.F. share and notes issues might have failed, instead of being sold out in four days. The distortions to the accounts of companies within the Stanhill group, particularly S.C.L. and Chevron Sydney, for 1960 and 1961 were relevant because, if the actual state of affairs of these companies had been disclosed, S.D.F. could not have justified its advances to S.C.L. Alternatively, the reduction in the value of S.D.F.'s advances could have been estimated rather than being described as indeterminate, which would have provided S.D.F. investors with a more explicit warning of failure.

7.3 Testing the Responsibility Hypothesis for S.D.F

S.D.F.'s financial statement data were confusing, largely as a result of the violation of generally accepted accounting principles. However, the data, from the time of the first annual report, did provide a clear warning ot the company's failure and, therefore, it cannot be argued that the accounting profession was responsible for misinforming investors. If anything, the unusual treatment of S.D.F.'s financial statement data, for example, the combined cash-accrual basis of accounting, emphasized that S.D.F. was in

[42] Victoria, Parliament [1967, p.168].

difficulty. Yet, financial statement misinformation was produced by other companies within the Stanhill group. Given the role of these companies in launching S.D.F. and subsequently as direct or indirect S.D.F. debtors, it is necessary to determine the responsibility of the accounting profession for this misinformation. This responsibility can be determined on the basis of the responsibility criteria set out in Chapter 3, section 3.4(vi).

S.C.L.'s "profit puffing" transactions contravened the realization principle. As discussed in the earlier case studies, although no standard has dealt specifically with revenue realization, it was generally accepted that for revenue to be recognized, a transaction with an independent third party must have occurred, where goods have been provided, or services performed.[43] The accounting for each of the "profit puffing" transactions violated this principle. The purchasers were not independent of the vendor, S.C.L., as their management was significantly influenced by Stanley Korman. Indeed, Korman chaired the boards of the public companies S.C.L., S.D.F., Chevron Sydney and Factors, as well as most of the family companies. In addition, the boards of each of these companies were to a large extent common, with several positions being occupied by members of Korman's family. Moreover, in the Rockmans transaction no services were provided. Although the transactions were substantiated by documentary evidence, their significance and often their unusual nature should have led the individual accountants to query their validity.

The revenue recognized by S.C.L., from the inflated architectural and management fees charged to Chevron Sydney, also contravened the realization principle. Chevron Sydney was effectively controlled by S.C.L. Therefore, the realization test requiring a transaction with an independent third party

[43] See, for example, Fitzgerald [1953, p.27].

was not satisfied. These charges were capitalized in Chevron Sydney's accounts. Although not endorsed as an accounting standard until 1972, generally accepted accounting principles allowed the capitalization of outlays necessarily incurred in earning future revenue. According to Fitzgerald [1953, pp. 26-28], this principle was recognized at the time of the 1960s case studies. The architectural and management services may have been necessary to the development of the Chevron Hilton Hotel, but the capitalization of the fees charged by S.C.L. can be criticized on the grounds that they were much higher than necessary. Although supported by documentary evidence, the obviously close ties between S.C.L. and Chevron Sydney, should have cast doubt on these transactions.

The failure of S.C.L. to recognize Chevron Sydney as a subsidiary, despite its effective ownership of more than 50 per cent of the issued shares, resulted from deliberate attempts by S.C.L.'s management to disguise the parent-subsidiary relationship. The I.C.A.A. statement on accounting for subsidiaries, which was published in 1946, recommended consolidation

> "... where a company holds a direct or indirect controlling interest in another company ..."[44]

S.C.L.'s direct controlling interest in Chevron Sydney, at 31 July 1960, was disguised through the backdated transfer of shares to Factors Ltd. Its controlling interest, at 31 July 1961, was disguised through shares held by S.C.L.'s secretary and one of its directors, on its behalf. Given that S.C.L. held 49.17 per cent of Chevron Sydney's issued capital and given the apparently close relationship between S.C.L. and Factors, the individuals involved in the preparation and audit of the S.C.L. accounts should have suspected the S.C.L. - Chevron Sydney, parent-subsidiary relationship. In not

[44] Institute of Chartered Accountants in Australia [1946e].

recognizing this relationship, they violated the principles set out in the 1946 I.C.A.A. recommendation.[45]

Whilst the individual accountants can be criticized for not thoroughly investigating the relationship between S.C.L. and Chevron Sydney, under apparently questionable circumstances, there are aspects of the profession's treatment of the parent-subsidiary issue which can also be criticized. For example, the accounting profession has tended to emphasize the percentage of issued capital as the criterion for identifying subsidiaries. This criterion is somewhat artificial. In many cases, an associated company may be just as significant as a subsidiary. The profession has recently rectified this situation by issuing a standard on equity accounting. However, in the Stanhill era, equity accounting was not a generally accepted procedure.[46]

The revaluation of the development property held by the S.C.L. subsidiary, Stanhill Development Pty. Ltd. may have resulted from a lack of clearly defined principles in accounting for real estate developments. Generally accepted accounting principles at that time required stock-in-trade to be recorded at the lower of cost or market. Although real estate held by land development companies was, effectively, their stock-in-trade, there have been no pronouncements which specifically deal with the accounting for real estate held by development companies. Moreover, as discussed below, there were probably no clearly defined principles in the area of asset revaluations.

Likewise, the revaluation of the Chevron Sydney shares may have resulted from a lack of clearly defined principles. The I.C.A.A. recommendation on the form of the balance sheet published in 1946, required that investments in

[45] *Ibid*.

[46] Institute of Chartered Accountants/Australian Society of Accountants [1983b].

companies, including subsidiaries, be classified under the heading "investments", separate from current assets.[47] It was generally accepted that non-current assets, whether fixed or some other classification, should be recorded at cost. The revised recommendation, issued in 1963, also specifically excluded investments in subsidiaries from current assets.[48] At the time of the 1960s case studies, therefore, generally accepted accounting principles classified investments in subsidiaries as non-current assets, to be recorded at cost.

This interpretation was confirmed subsequently, in the *Statement on Accounting Practice, Treatment of Investments in Balance Sheets of Trading Companies,* which was published by the I.C.A.A. in 1970. The principle of recording investments in subsidiaries at cost was also substantiated subsequently by Kenley [1970, p.67]. Kenley's interpretation accords with the requirements of historic cost accounting. Non-current asset revaluations have, over time, become an accepted divergence from pure historic cost accounting, but were they a common practice in S.C.L.'s time?[49] On the one hand, Kenley [1970], in his *Statement of Australian Accounting Principles,* made no mention of asset revaluations. On the other hand, according to Chambers [1973], the revaluation of assets was a common practice. Although both of these works were written some time after S.C.L.'s failure, it is reasonable to suppose that, around that time, there were probably no clearly

[47] Institute of Chartered Accountants in Australia [1946a].

[48] Institute of Chartered Accountants in Australia [1963a].

[49] For example, the brief guide accompanying *AAS 10 Statement of Accounting Standards: Accounting for the Revaluation of Non-Current Assets,* published in 1981, stated that "revaluations have, in relatively recent years, become a normal feature of Australian financial statements" and the accounting standard, *AAS14 Statement of Accounting Standards: Equity Method of Accounting,* published in 1983, recommended the revaluation of investments in associated companies.

defined principles which dealt with asset revaluations. Indeed, the profession did not issue a standard on asset revaluations until 1981.

The failure of S.C.L.'s financial statements to reveal the detrimental effects of the 'round robin' can be attributed, at least in part, to accounting practices which were generally unacceptable to the profession. S.C.L.'s acquisition of Stanhill Estates and Dominion was supposedly based on independent estimates of the market value of the net tangible assets of these two companies. These valuations were drawn up and signed by P. Heseltine, a partner in the firm Ernest Fookes & Co., chartered accountants. Heseltine based the Stanhill Estates valuation on figures obtained from a licensed valuer and elsewhere. His calculations included subdividers' profits on some of the land, which accounted for up to 50 per cent of the valuation of the properties. Subdividers' profits were identified clearly in the original licensed valuer's report. They were unrealized and should have been omitted from Heseltine's calculations. In addition, Stanhill Estates had purchased land from Chevron Sydney, which Heseltine valued at Chevron Sydney's often extravagant, initial purchase price plus any other expenses associated with the properties.[50] Although Heseltine signed the report, the inspector argued that Eric Fookes, the senior partner in the firm responsible for the Stanhill Estates account and Brian McKenzie, the secretary of the Korman family companies, shared the responsibility. He concluded

> "I am unable to understand how experienced and competent chartered accountants such as Mr. McKenzie, Mr. Fookes and Mr. Heseltine could have honestly taken part in and lent their names to a share valuation such as this."[51]

[50] These valuations are discussed in Victoria, Parliament [1967, pp. 132-141].

[51] Victoria, Parliament [1967, p.141].

Dominion's shares were valued, according to Heseltine, on the basis of the company's audited accounts. There was no reason to expect the asset values in the audited accounts to approximate market values. Moreover, these accounts were subsequently qualified to the extent that Heseltine's valuations were meaningless. The valuation of companies for takeover is not an area where generally accepted accounting principles have been spelled out. Indeed, such reports are internal accounting reports and influence financial statements only indirectly. However, it is clear that Heseltine, Fookes and McKenzie were responsible for grossly inaccurate valuations which gave justification to an important part of the round robin conducted in February 1961. It is difficult to imagine that their approach would have been condoned by the accounting profession.

The actual recording of the Stanhill Estates and Dominion investments in S.C.L.'s financial statements, at their apparently independently determined values, complied with generally accepted accounting principles. Moreover, generally accepted accounting principles did not require S.C.L. to write down its investments in these subsidiaries. They were non-current assets and under generally accepted accounting principles, non-current assets are recorded at cost, which bears no necessary relationship to realizable value. However, it could be argued that, given the basic tenets of historic cost accounting, the informed financial statement user would not have expected the recorded values to be realizable. Thus, this information was not potentially misleading.

In the round robin, S.C.L. also advanced $0.60m to Stanhill Estates and Dominion. To comply with accepted accounting principles, S.C.L.'s accounts should have included a substantial provision for doubtful debts because of the state of affairs of these debtors. It is possible that the individual accountants and auditors involved with the S.C.L. accounts were unaware of the need for such a provision, because of the valuations discussed above. Nevertheless, it is probable that management, and in particular Korman, was aware of the need for some provision.

By 1960-61, S.C.L.'s viability was dependent on Chevron Sydney's performance. Responsibility for the overstatement of the value of Chevron Sydney's assets, because of the capitalization of extravagant charges by S.C.L., has been discussed above. Responsibility for Chevron Sydney's other financial statement misinformation can be determined on the following basis. The recording of the "fictitious" sale of the "ultra vires" properties to Somerton Development, in July 1960, contravened generally accepted accounting principles. Somerton Development was a Korman family company. Although legally independent of Chevron Sydney, Korman's control of both companies makes it doubtful whether the revenue should have been treated as realized. Chevron Sydney's continued use of the properties to raise money and the reversal of the sale in the next accounting period, substantiates this view. It seems that, in reality, the properties never changed hands. The individuals involved in the preparation and audit of Chevron Sydney's accounts can be held responsible for not properly applying the tests of revenue realization. Even a superficial examination of the circumstances surrounding the "sale" would have indicated the doubtful nature of this transaction. Moreover, even if it appeared that the revenue realization tests had been met, Chevron Sydney's failure to provide for the doubtful nature of the Somerton Development debt can be criticized, since Somerton Development had been formed only a few months earlier, with capital of $4. Revenue from the sale of other "ultra vires" properties to Stanhill Estates, in 1960, also did not satisfy the realization criteria. At that time, Stanhill Estates was a Korman family company and, as such, the independence of vendor and purchaser were doubtful. The existence of backdated cheques and minutes associated with this transaction should have confirmed this view.

The accounts of the other major public company in the Stanhill group, Factors, were potentially misleading for similar reasons. For example, the purchase and simultaneous sale of land by the non-real estate Factors subsidiary, G.I.D., to the Korman family company, Dominion, did not meet the revenue realization tests, because of Korman's effective control of both companies. The artificiality of this transaction was substantiated by the fact that interest, due from Dominion to G.I.D., was subsequently reduced by exactly the amount of profit which G.I.D. made on the sale.

To summarize, the only financial statement misinformation which could be associated with the failure of S.D.F. was published by companies within the Stanhill group, other than S.D.F. Table 7.2 classifies this misinformation according to whether it resulted from compliance with, the violation of, or, possibly, the lack of, generally accepted accounting principles. This table shows that eight of the ten sources of misinformation can be attributed to non-compliance with generally accepted accounting principles, although these principles had been endorsed by the profession in only one of these areas. As far as the responsibility hypothesis is concerned, the profession's failure to delineate principles in the other seven areas was not particularly significant since the principles in these areas were widely understood and accepted. The non-compliance was not disclosed and the auditors' reports on these accounts were not qualified. This misinformation was, therefore, primarily the responsibility of management and the individuals involved in the preparation and audit of the accounts of the various Stanhill companies.

In considering the role of the individuals, it should be noted that many of the potentially misleading aspects resulted directly from management's attempts to disguise the state of affairs within the Stanhill group. Moreover, unlike the earlier case studies, the Stanhill group's management was not influenced significantly by accountants. The government investigation

Table 7.2: Responsiblity for the Stanhill "Group's" Financial Statement Misinformation

Source of Misinformation	Contravened endorsed procedure in this or related area	Contravened widely understood and accepted principles	Complied with endorsed procedures	Complied with widely understood and accepted principles	No clearly defined G.A.A.P. in this area
S.C.L. Financial Statements					
- profit puffing transactions		X			
- revaluation of land in real estate subsidiary					X
- revaluation of shares in subsidiary					X
- overstatement of value Stanhill Estates and Dominion		X[a]			
- failure to provide for doubtful debts		X[b]			
- inflated architectural and management fees recorded as revenue		X			
- failure to recognize Chevron Sydney as S.C.L. subsidiary	X				
Chevron Sydney Financial Statements					
- sale of "ultra-vires" properties to Korman family companies		X			
- capitalization of inflated architectural and management fees		X			
Factors Financial Statements					
- real estate sales by non-real estate subsidiary to Korman family company		X			
	1	7	-	-	2

a. Although the principles applicable to valuations for takeovers had not been spelled out, it is most unlikely that the careless and incompetent manner in which these valuations were prepared, would have been acceptable to the profession.

b. Although a provision was warranted, there may have been insufficient evidence to determine the need for such a provision.

showed that the dominant decision maker within the group was Stanley Korman, who was an industrialist, not an accountant. The various boards of directors within the group were also reasonably free of accountants. Nevertheless, management's deliberate attempts to distort the financial statements of the various companies within the Stanhill group do not totally absolve the individual accountants involved in the preparation and more importantly the audit of these accounts. Many of the misleading transactions were of such significance to reported profit, so atypical or so obviously between interrelated parties that those accountants recording and auditing them should have questioned them. The auditors' task may have been complicated by the fact that the auditors of the various holding companies within the group were not necessarily the auditors of subsidiaries and they had limited access to subsidiary records but the doubtful nature of these transactions should have been apparent at the audit of subsidiary, if not the holding company, records.

Clearly, the profession had some responsibility to discipline members who were involved with the Stanhill accounts. Although the accounting profession had little representation in the management, the auditors of each of the major companies within the group were members of the I.C.A.A. Unfortunately it is impossible to tell whether the I.C.A.A. disciplined any of its members involved with the accounts of the various Stanhill companies. The extent to which A.S.A. members were involved is unclear. However, there is no record of any A.S.A. members being disciplined in connection with the accounts of the various Stanhill companies.

Misinformation was produced in two areas where there were no clearly defined accounting principles. Given the nature of the process of developing accepted accounting principles, the profession cannot be held responsible for this misinformation. However, it can be criticized over its responsiveness to the lack of principles in these two areas. In one area, accounting for aset revaluations, no pronouncement was issued until 1981. In the other area, accounting for real estate developments, as discussed earlier, there has been no pronouncement issued.

Finally, the positive influence of the Stanhill accountants should not be ignored. For example, S.D.F.'s failure was obvious from its first set of financial statements largely because of the note which warned of the indeterminate value of S.D.F.'s major asset. Apparently, this note was included at the insistence of S.D.F.'s auditors, Price Waterhouse and Co.[52] Indeed, the auditors' report emphasized the significance of this note.[53] In addition, in early 1962 the only chartered accountant on the board of S.C.L. insisted that an extraordinary meeting of shareholders be called, to consider voluntary liquidation. He had been appointed to the board in December 1961 and was forced to resign before the meeting, which was held on 5 April 1962. A set of unaudited financial statements, which showed no sign of insolvency, was tabled at that meeting. An approximate statement of affairs, drawn up by S.C.L.'s auditors at this accountant's request, just before his resignation, had shown a substantial deficiency and an estimated loss for the current year of more than $2m. The accountant attended the meeting in the body of the hall but was unable to convince the shareholders of the need for liquidation.[54] S.C.L.'s loss for 1961-62 was eventually recorded at $5.14m and, in January 1963, receivers were appointed by the trustee for S.C.L.'s debenture holders. At 31 July 1963, S.C.L.'s liabilities exceeded its assets by $11.81m.[55]

[52] Victoria, Parliament [1964, p.56].

[53] Stanhill Development Finance Ltd., *Annual Report 1961*, p.2.

[54] Victoria, Parliament [1964, p.67].

[55] S.C.L., Consolidated Profit and Loss Statement and Balance Sheet, 31 July 1963 (*Investment Service*, Sydney Stock Exchange).

7.4 Conclusions

S.D.F.'s failure was significant as it resulted in investor losses, measured in book values, of approximately $5.6m. In addition, S.D.F. investors incurred substantial losses of purchasing power and opportunity costs in having funds, which were eventually retrieved, tied up over a considerable period. The company's only issues of shares and notes were made before S.D.F. commenced operations. Moreover, from its first annual report, S.D.F.'s financial statement data showed that the company was in difficulty and that S.D.F.'s fate was largely dependent on the fate of S.C.L. It cannot be argued, therefore, that S.D.F.'s financial statement data misinformed investors. In this respect, therefore, the evidence does not support the misinformation hypothesis.

The liquidation value of S.D.F.'s assets was much lower than the value recorded in the financial statements. However, most of this difference was related to S.D.F.'s major asset, advances to S.C.L., and S.D.F.'s financial statements included a note which warned that the value of these advances was indeterminate. Although the book values were based on the going concern assumption, the note negated the effects of this assumption, at least for S.D.F.'s major asset.

However, the financial statement data of other companies within the Stanhill group were potentially misleading. These data were distorted by the effects of transactions which created profits, overstated asset values and ignored parent-subsidiary relationships. The financial statement misinformation of the Stanhill companies were relevant to S.D.F. investors in two ways. First, S.D.F. was floated partially on the basis of the favourable reputation of the Stanhill group. This reputation was dependent on the distortions to the financial statement data of the Stanhill companies, particularly of S.C.L. Second, S.D.F.'s major asset consisted of advances to S.C.L. If S.C.L.'s state of affairs had not been disguised, it is doubtful whether S.D.F., as a public company, could have justified advances of such magnitude to S.C.L. At least, S.D.F. investors, who acted through secondary securities markets, would have obtained an earlier and more accurate warning of the decline in the value of S.D.F.'s major asset. In this respect, therefore, the evidence is consistent with the misinformation hypothesis. The financial statement data misrepresented the results and financial position of various companies within the Stanhill group and these data may have misled S.D.F. investors.

The misinformation resulted largely from the violation of generally accepted accounting principles and, as such, was largely the responsibility ot management and the individual accountants involved in the preparation and audit of the accounts. The findings, therefore, do not support the responsibility hypothesis. There is insufficient evidence to determine whether the profession disciplined members involved with the financial statements of the various companies within the Stanhill group. Misinformation occurred in two areas where there were no clearly defined accounting principles. The accounting profession cannot be held responsible for this misinformation. However, it can be criticized for not subsequently defining the appropriate principles in these areas within a reasonable period of time.

CHAPTER 8

CAMBRIDGE CREDIT CORPORATION LTD

In March 1974, Cambridge Credit Corporation Ltd. issued a press release announcing its results for the first half of 1973-74. It reported a 99.8 per cent increase in net profit over the corresponding period in the previous year, and a return on ordinary share capital of 38.4 per cent.[1] On 16 September 1974, Cambridge issued a press release announcing the group's net profit for the year ended 30 June 1974. It reported an audited net profit of $3.06m, which was 33.2 per cent higher than the previous year, and a return on ordinary share capital of 29.2 per cent. In addition, it reported that, over the year, the corporation's tangible assets had increased from $170.55m to $213.05m. A final dividend of 7.5 per cent, payable by 31 October 1974, was declared, resulting in an annual dividend rate of 15 per cent.[2] These press releases, based on audited financial statements, depicted Cambridge as a profitable finance group offering attractive investment opportunities.

However, on 30 September 1974, fourteen days after its year-end profit announcement, Cambridge was put into receivership. The accounts for 1973-74 were eventually filed in February 1977. They showed a revised result of a loss of $70.44m. In a report which was attached to the accounts, Cambridge's directors attributed this turn around to the effects of receivership and, in particular, the forced sale of assets in a depressed economy. Receivership was, in turn, attributed to the economic policies of the Australian government and, in particular, wage increases over 1973 and 1974, the intervention in real estate markets, and the credit squeeze in the first half of 1974. In the words of the directors,

[1] New South Wales, Parliament [1976-77, pp. 15-16].

[2] *Ibid*.

> "With an uninterrupted record of 23 years of steadily increasing profits and continuing expansion, despite "stop" and "go" economic planning on the part of successive governments, the Directors were fully confident that the group would overcome the problems arising from difficult financial circumstances. However, the Directors failed to realize that a strong and virile economy would change almost overnight into one plagued by continuing two digit inflation rates, up to 5 per cent unemployment rate and interest rates so high as to destroy any incentive for the private sector of the economy to have any confidence ..."[3]

Despite the directors' explanation, Cambridge's sudden failure resulted in an investigation by the N.S.W. Corporate Affairs Commission. The findings of this investigation suggested that the financial statement data issued prior to failure were grossly inaccurate. This chapter assesses the losses of Cambridge investors and considers whether, prior to 1973-74, Cambridge was in fact the profitable group of companies described by its directors or whether it had experienced difficulties which were not disclosed in the group's financial statements. The responsibility for any financial statement misinformation is also considered.

8.1 The Losses of Cambridge Investors

Cambridge had four main classes of investors. They were ordinary shareholders, preference shareholders, debenture holders and unsecured noteholders. Table 8.1 shows the extent to which Cambridge relied on these various sources of funds, for the decade before receivership. During this time, the funds invested by shareholders, in the form of capital and premiums, increased from $3.39m to $13.07m, whilst funds borrowed through the issue of debentures and notes increased from $25.66m to $118.78m. In addition to share

[3] Cambridge Credit Corporation Ltd., *Annual Report, Year Ended 30 June 1974*, p. 4.

Table 8.1: Cambridge Credit Corporation Ltd., Investors' Funds (in $m)

At 30 June	Total Issued Preference	Share Capital Ordinary	Share Premium Reserve	Total Invested by Shareholders	Outstanding		Total Borrowed Funds
					Debentures	Notes	
1965	0.40	2.99	-	3.39	18.07	7.59	25.66
1966	0.40	2.99	-	3.39	19.91	6.53	26.44
1967	0.40	3.38	0.03	3.81	22.79	6.01	28.80
1968	1.00	3.70	0.11	4.81	27.51	5.98	33.49
1969	1.80	4.56	0.16	6.52	36.29	6.30	42.59
1970	1.80	7.06	0.31	9.17	46.52	10.69	57.21
1971	1.80	9.00	0.31	11.11	56.02	9.71	65.73
1972	2.80	9.00	0.31	12.11	66.35	12.18	78.53
1973	2.80	9.60	0.67	13.07	69.36	25.97	95.33
1974	2.80	9.60	0.67	13.07	84.84	33.94	118.78

Source: Cambridge Credit Corporation Ltd., *Annual Reports* 1965 to 1973 inclusive, and New South Wales, Parliament [1976-77, p. 356].

capital and premiums, the draft accounts for the year ended 30 June 1974 recorded unappropriated profits and reserves of $2.80m. Although Cambridge's affairs have not yet been finalized, the receivers have estimated that the entire shareholders' funds have been lost.[4]

A significant part of Cambridge's share capital was issued to companies closely associated with Cambridge's managing director, R.E.M. Hutcheson. These companies were not recognized as Cambridge subsidiaries. The inspectors of the N.S.W. Corporate Affairs Commission found that, over the period 30 June 1966 to 30 September 1974, the percentage of Cambridge's ordinary shares held by companies controlled by Hutcheson, ranged from 27.2 per cent at 30 June 1972 to 59.6 per cent at 31 December 1968.[5] Published financial statements are unlikely to have had much influence over the decisions by these companies to invest in Cambridge shares. If accounting data were relevant, then the management of these companies would have had access to internal accounting information. Based on the concept of effective control, the Corporate Affairs inspectors argued that these companies were, in reality, Cambridge subsidiaries. A set of "conglomerate" accounts which included these companies as a part of the Cambridge group, reduced issued share capital from $12.40m to $9.81m.[6]

The losses of shareholders who may have relied upon Cambridge's financial statement data, therefore, probably do not exceed the inspectors' estimates of the $9.81m share capital contributed by outsiders. The "conglomerate"

[4] New South Wales, Parliament [1976-77, p.19].

[5] New South Wales, Parliament [1979, p.291].

[6] The inspectors' estimates (see New South Wales, Parliament [1979, p. 293] were based on accounts at 30 June 1973. Although Cambridge made no further share issues after this date, this figure can only be used as an estimate.

accounts do not disclose separately the amount of share premiums contributed by outsiders. However, with a total share premium reserve of only $0.67m, outsider losses of share premiums can be considered insignificant. It is also difficult to determine the amount of unappropriated profits attributable to outsiders and subsequently lost in the Cambridge failure. According to the "conglomerate" accounts, by 30 June 1966 the group's reserves and unappropriated profits had already been eroded to a $0.67m deficiency.[7]

Table 8.1 shows that, on 30 June 1974, three months before receivership, debentures and notes payable were $84.84m and $33.94m, respectively. The "conglomerate" accounts prepared by the inspectors show that debenture and note funds were obtained almost entirely from outside investors.[8] By 30 September 1974, Cambridge owed $91.88m to debenture holders and $35.52m to unsecured noteholders.[9] Cambridge's receivers have estimated that the realization of the group's assets could take as long as ten years because of the heavy involvement in real estate.[10] However, initial estimates suggest that debenture holders may receive 55 to 80 cents in the dollar on their claims at 30 September 1974, and that noteholders will receive nothing.[11] On this basis, the noteholders' funds of $35.52m and debenture holders' funds of between $18.38m and $41.35m have been lost in the group's failure. In addition, whilst awaiting this recovery, debenture holders will incur substantial opportunity costs in earnings foregone on the retrievable element of their investment, as well as losses of purchasing power on these funds.

[7] New South Wales, Parliament [1979, p. 293].

[8] At 30 June 1973, the only elimination made to adjust debentures and notes for the effects of the Hutcheson conglomerate was a $0.02m elimination on debentures of $69.36m, (see New South Wales, Parliament [1979, p.293]).

[9] Cambridge Credit Corporation Ltd., Statement of Affairs, 30 September 1974.

[10] *Rydges*, March 1976, p.52.

[11] New South Wales, Parliament [1976-77, p.19].

To summarize, the collapse of Cambridge, in 1974, caused considerable losses to the company's shareholders, debenture holders and noteholders. Estimation of shareholder losses is complicated by the fact that a substantial proportion of the shares was held by companies closely associated with Cambridge. The losses of these companies are not relevant for this thesis,as it is unlikely that the decision to purchase Cambridge shares would have been influenced by published financial statement data. The shareholders outside the Hutcheson conglomerate lost a minimum of $9.81m contributed capital plus their share of unappropriated profits and reserves. Although Cambridge's assets are still being realized, it seems probable that noteholders have lost their entire investment of $35.52m, whilst debenture holders have lost between $18.38m and $41.35m. Moreover, these estimates ignore the opportunity costs and purchasing power losses on any funds eventually retrieved.

8.2 Testing the Misinformation Hypothesis for Cambridge

8.2 (i) The Relevant Period and the Relevant Data

Cambridge was incorporated in 1950, as Newcastle Acceptance Ltd. The company changed its name to Cambridge Credit Corportion Ltd. in 1955. Analysis of the financial statement data contained in Cambridge's annual reports and prospectuses, issued over the 24 years between incorporation and receivership, is beyond the scope of this thesis. Table 8.1 shows that Cambridge was especially active in seeking investors' funds from the mid-1960s.[12] The decade prior to receivership is, therefore, the relevant period for the Cambridge case study. The omission of data from earlier years is unlikely to be significant. Indeed, in its early years Cambridge was operated

[12] For example, funds invested by Cambridge's shareholders increased from $3.39m at 30 June 1965 to $13.07m at 30 June 1974. Funds invested by note and debenture holders increased from $25.66m to $118.78m over this period.

by Hutcheson as a family company. It was not granted official quotation on the Sydney and Newcastle stock exchanges until November 1957 and, on interstate stock exchanges until November 1960.[13]

According to the methodology developed in Chapter 3, different sources of financial statement data would have been available to the different classes of Cambridge investors and it is necessary, therefore, to analyse the data available from these different sources during the relevant period. Under the existing companies legislation, prospectuses were generally circulated to potential investors. Audited financial statements were circulated to existing shareholders, through an annual report, and were made available to existing debenture holders. Both prospectuses and audited financial statements were public documents, available on file at State companies offices.

Over the period 30 June 1965 to receivership, Cambridge made fourteen share issues.[14] However, six of these issues were made to existing shareholders and eight of them were private placements.[15] None of these share issues were accompanied by a prospectus, although the existing shareholders would have been provided with audited financial statements through annual reports. During the same period, Cambridge made nineteen issues of debentures and/or notes, each of which had its own prospectus.[16]

The format of these prospectuses changed little over time. They opened with a brief history of the company, which emphasized the growth in tangible assets and paid-up capital. Apart from these figures, the accounting

[13] New South Wales, Parliament [1976-77, p.20].

[14] New South Wales, Parliament [1976-77, p.284].

[15] *Ibid.*

[16] Cambridge Credit Corporation Ltd., *Prospectus Nos. 13 to 31.*

information in the prospectuses was largely confined to an auditors' report, which was issued by Cambridge's auditors, Fell and Starkey, chartered accountants, and signed by D.M. Purcell, partner-in-charge. This report included details of net profit before tax for the previous five years for Cambridge, for Cambridge and guarantors, and for the Cambridge group. From June 1970, net profit after tax was also disclosed and, from 1972, profits attributable to minority interests were identified separately. Where applicable, the auditors' report listed companies taken over during the year and stated any associated pre-acquisition results. Then followed details of the company's paid-up capital and dividend rate by share-class, over the last five years, and a statement of the assets and liabilities of the holding company and the group, as at the end of the most recent accounting period. The final section of the auditors' report calculated tangible assets subject to charge, based on the statement of assets and liabilities adjusted to include the amount of the proposed issue and allowing for the maximum amount of oversubscriptions. The amount which could be borrowed in accordance with debenture trust deed provisions was disclosed in the notes to the auditors' report, although no details of its calculation were given.

The format of Cambridge's annual reports also remained fairly constant over time. The first section consisted of the directors' report, which, prior to 1973, included details of consolidated net profit before tax and a number of other pieces of accounting information which were drawn from the consolidated accounts. The only accounting information presented in directors' reports prior to 1973, not reproduced directly from the audited financial statements, was the group's earning rate. The format of the directors' report was changed for the last annual report, issued in 1973. The accounting information in this report conformed with the requirements of s162a(2) of the *Uniform Companies Act (1961)* and included consolidatd net profit after tax, contributions by subsidiaries to this profit, details of subsidiaries acquired during the year, material transfers to and from provisions, the amount of debenture stock and notes issued and redeemed, shares issued, and dividends paid. The overall effects of this information had been embodied in the audited financial statements, although some additional details were provided in the directors' report. Audited financial statements, for both the holding company and the group, followed the directors' report. In addition, from 1971, a funds statement was also presented. The accounting information included in Cambridge's annual reports, therefore, consisted of the audited financial statements or data based on these statements.

8.2 (ii) Cambridge's Condition According to Its Financial Statement Data

8.2 (ii) (a) The shareholders' perspective

Table 8.2 summarizes the impressions which Cambridge shareholders would have obtained from the company's annual reports. It shows that the group reported substantial increases in net profit, excluding extraordinary items, in each year from 1967-68. During this period, the rate of increase in profit, over the previous year, fell below twenty per cent only once, and was above thirty per cent in four of the seven years. Also, the pattern of growth in Cambridge's reported profit during this period was reasonably stable. In each year, except from 1970-71 to 1972-73, the rate of growth in Cambridge's net profit improved, by a substantial margin.

Table 8.2: Cambridge's Profitability and Security, Shareholders' Perspective

Year ended 30th June	Consolidated Net Profit After Tax[1] ($m.)	Profit Change Over Previous Year (%)	Return on Av. Ord. S.H.F. (%)	Earning Rate (%)	Dividend Rate on Ord. Shares (%)	Net Asset Backing/ 50¢ Share (in $)		Debt Ratio
						Ord.	Pref.	
1965	0.47	+3.52	13.16	15.6	10.0	0.59	4.91	0.87
1966	0.46	-2.32	11.29	14.2	10.0	0.61	5.03	0.88
1967	0.47	+2.83	10.72	14.1	10.0	0.60	5.59	0.87
1968	0.56	+15.43	11.06	14.2	10.0	0.62	2.80	0.86
1969	0.69	+25.35	11.15	14.4	10.0	0.62	2.07	0.87
1970	0.96	+39.19	11.27	15.0	10.0	0.58	2.77	0.89
1971	1.33	+38.23	12.39	15.5	10.0	0.58	3.39	0.88
1972	1.65	+24.43	13.51	16.0	10.0	0.60	2.42	0.89
1973	2.19	+32.79	17.27	20.4[5]	10.0	0.48	2.15	0.91
1974[2]	3.13	+42.90[3]	21.74	29.2[5]	7.5[4]	0.58	2.48	0.93

[1] Excluding extraordinary items.

[2] Based on draft accounts prepared before receivership, reproduced in New South Wales, Parliament [1976-77, pp. 356-357].

[3] The 33.2 per cent increase in net profit reported in September 1974 was based on net profit including extraordinary items.

[4] The second half dividend of 7½ per cent, proposed in the draft accounts for 1973-74, was never paid.

[5] From 1973 earning rates were not disclosed in the Annual Reports, but they were published in the press releases which announced Cambridge's results for the year.

Measured in terms of returns on ordinary shareholders' funds, however, the trend in Cambridge's profitability was less favourable. The rate of return on shareholders' funds declined from 13.16 per cent to 10.72 per cent per annum from 1964-65 to 1966-67, and then increased only slightly over the next three years, from 11.06 per cent to 11.27 per cent per annum. It was not until the period from 1970-71 to 1973-74 that Cambridge's return on its shareholders' funds increased significantly, rising from 12.39 per cent to 21.74 per cent per annum. A comparison with Table 3.2 shows that, on a year by year basis, the return on Cambridge's shareholders' funds exceeded the industry average from 1964-65 to 1966-67 and from 1972-73 to 1973-74. A comparison with Table 3.3 shows that A.G.C.'s return on shareholders' funds exceeded Cambridge's in each year except 1972-73 and 1973-74, but B.F.C.'s return on shareholders' funds exceeded Cambridge's only in 1969-70 and 1970-71. To summarize, apart from 1972-73 and 1973-74, Cambridge was less profitable, in terms of returns on shareholders' funds, than A.G.C. Moreover, Cambridge was less profitable than the average firm in the industry and B.F.C. over the late 1960s and early 1970s. Apart from 1972-73 and 1973-74, therefore, Cambridge shares appeared to be a satisfactory, but not highly profitable, investment.

Table 8.2 also shows the earning rates quoted by Cambridge's directors, in the annual reports from 1965 to 1972, and in press releases for 1973 and 1974. The method of calculating these figures was not disclosed and, as discussed later, appears to have been inconsistent over time. Their meaning was also unclear although they were quoted as an indicator of profitability. In this context, the earning rates suggested that the company had experienced a decline in profitability from the mid-to-late 1960s, steady growth in profitability over the late 1960s and early 1970s, and substantial growth in profitability over 1972-73 and 1973-74. In each year, the quoted earning rates were higher than the rate of return on ordinary shareholders' funds.

In 1963-64, Cambridge decreased its annual dividend rate to 10 percent. Since it was first listed publicly, Cambridge had paid a dividend of 12.5 per cent per annum. The dividend rate of 10 per cent per annum was maintained from 1963-64 to 1972-73. In 1973-74, Cambridge proposed an annual dividend rate of 15 per cent but, with the appointment of the receiver in September 1974, shareholders only received the interim dividend of 7.5 per cent. Table 3.2 shows that industry average dividend rates for 1964-65 to 1973-74 ranged from a low of 9.65 per cent in 1968-69, to a high of 11.75 per cent in 1972-73. The industry dividend rate exceeded the Cambridge rate in six of the ten years, including four of the five years since 1969-70. Table 3.3 shows that over the corresponding period, A.G.C. maintained an annual dividend rate of 15 per cent. B.F.C.'s annual dividend rate over 1964-65 to 1973-74 averaged 10.05 per cent. It exceeded Cambridge's dividend rate in the last five of the ten years from 1964-65 to 1973-74. Thus, in terms of dividend rates, Cambridge shares also appeared to be a satisfactory but not highly attractive investment. From the early 1970s, the dividend rate was relatively low.

Table 8.2 shows the asset backing for Cambridge preference and ordinary shares. Preference shares were well covered at each balance date over the period from 1965 to 1974, with cover ranging from a maximum of $5.59 per 50 cent share in 1967, to a minimum of $2.07 in 1969. Even at this minimum, the asset backing for Cambridge's preference shares was more than four times greater than their par value. The asset backing available for ordinary shares was stable for most of the period. It ranged between 58 and 62 cents per 50 cent share in nine of the ten years between 1965 and 1974. In 1973, however, the asset backing for Cambridge ordinary shares fell to 48 cents per share, which was two cents below par. Industry average asset backing data are not available but Table 3.3 shows that, from 1965 to 1974, the asset backing for A.G.C. shares did not fall below 93 cents per 50 cent share. Over the same period, the asset backing available for B.F.C. shares increased from 58 cents per share in 1965, to 79 cents per share in 1974. The asset backing for B.F.C. shares exceeded that available for Cambridge ordinary shares for each year from 1967 to 1974. Thus, over the ten years from 1965 to 1974, the par value of Cambridge's ordinary shares was covered by tangible assets in all but one year. However, this backing was below that of Cambridge's competitors, particularly later in the decade.

Table 8.2 shows that over the decade, Cambridge's debt ratio ranged from a low of 0.86 in 1968, to a high of 0.93 in 1974. Apart from 1968, the debt ratio fluctuated between 0.87 and 0.89 from 1965 to 1972. In 1973 and 1974, Cambridge's debt ratio increased to 0.91 and 0.93, respectively. Table 3.2 shows that from 1965 to 1974 industry average debt ratios ranged from 0.84 to 0.88. Table 3.3 shows that over this period A.G.C.'s debt ratio also ranged from 0.84 to 0.88 and B.F.C.'s debt ratio ranged from 0.84 to 0.89. Cambridge's debt ratio exceeded the industry average and A.G.C.'s debt ratios in each of the ten years between 1965 and 1974. It also exceeded B.F.C.'s debt ratios in eight of the ten years, with the ratios of the two companies equal in the ninth year. Therefore, compared to the average firm in the industry and at least two of its competitors, Cambridge was highly geared and, in 1973 and 1974, its gearing was increasing.

8.2 (ii) (b) The debenture and note holders' perspective

Cambridge's audited financial statements may also have been relevant to the debenture and note holders. Table 8.3 presents the financial ratios of probable interest to debenture and note holders. These ratios have been based on the consolidated accounts because both the debenture and note issues were

Table 8.3 Cambridge's Profitability and Security, Debenture and Noteholders' Perspective from the Audited Financial Statements

Year Ended 30 June	Return on Assets (% p.a.)	Asset Cover For Debentures[1]	Interest Cover
1965	8.63	2.50	1.30
1966	8.58	2.28	1.30
1967	8.33	2.00	1.30
1968	8.45	1.49	1.33
1969	7.93	1.43	1.31
1970	7.43	1.51	1.37
1971	8.01	1.46	1.41
1972	7.86	1.45	1.43
1973	8.31	1.68	1.40
1974[2]	8.70	1.70	1.51

1. Asset cover = $\frac{\text{(Total tangible assets less secured mortgages)}}{\text{Debentures}}$

2. Based on draft accounts prepared before receivership, reproduced in New South Wales, Parliament [1976-77, pp. 356-359].

guaranteed by most of Cambridge's subsidiaries.[17] Table 8.3 shows that, over the decade to 1974, the profitability of the Cambridge group, in terms of its rate of return on assets, ranged from a low of 7.43 per cent in 1969-70, to a high of 8.70 per cent in 1973-74. In comparison, Table 3.2 shows that, over the corresponding period, the industry average rate of return on assets tended

[17] For example, at 31 December 1973, the Cambridge group had total assets with a book value of $196.73m, of which only $3.23m related to the assets of non-guarantor subsidiaries (Cambridge Credit Corporation Ltd., *Prospectus No. 31*). It should be noted that this prospectus included five subsidiaries as guarantors, when, in fact, they were not (see 8.2(iii)g and note 71). However, the fact remains that the bulk of Cambridge subsidiaries were guarantors.

to increase, varying from a low of 8.24 per cent in 1964-65, to a high of 9.68 per cent in 1973-74. The industry average rate of return on assets exceeded the rate of return earned by the Cambridge group in each year except 1964-65 and 1965-66. Table 3.4 shows that between 1964-65 and 1973-74, A.G.C.'s return on its assets varied from a low of 8.63 per cent to a high of 12.23 per cent and B.F.C.'s return on its assets varied from 8.60 per cent to 10.10 per cent. The rate of return on assets earned by the Cambridge group was lower than the rate of return earned by A.G.C. in nine of the ten years, and lower than the rate of return earned by B.F.C. in each of the ten years. In conclusion, over the period 1964-65 to 1973-74, Cambridge's profitability, in terms of the returns earned on its assets, appeared to be unsatisfactory. Apart from the early years, it was below the industry average and the rates earned by two of its competitors.

Cambridge's interest cover was also relatively low. Table 8.3 shows that, from 1964-65 to 1973-74, the group's interest cover ranged from a low of 1.30 times to a high of 1.51 times. In comparison, Table 3.2 shows that over the corresponding period, industry average interest cover ranged from 1.41 times to 1.62 times. Table 3.4 shows that for the same period, interest cover for A.G.C. ranged from 1.54 times to 1.83 times and interest cover for B.F.C. ranged from 1.44 times to 1.52 times. The interest cover for the Cambridge group was below the level of cover for the average firm in the industry and for B.F.C. in each year, except 1973-74, and was below the level of cover for A.G.C. in each year over the period.

The asset cover available for Cambridge debenture holders is shown in Table 8.3. At each balance date from 1965 to 1974, the cover for every dollar invested in Cambridge debentures ranged from a low of $1.43 to a high of $2.50. The average cover was $1.75. Tables 3.2 and 3.4 show that over the corresponding period, debenture cover within the industry averaged $1.95, ranging from a low of $1.82 to a high of $2.42, A.G.C.'s debenture cover averaged $1.77, ranging from a low of $1.58 to a high of $1.96, and B.F.C.'s debenture cover averaged $1.53, ranging from a low of $1.42 to a high of $1.79. Cambridge's debenture cover was lower than the industry average and A.G.C.'s cover, at each balance date from 1968. However, it was lower than B.F.C.'s debenture cover on only three of the ten balance dates in the period, and these occurred from 1971. These data show that, by the early 1970s Cambridge's debenture cover was below that of other firms in the industry.

The debt ratio provides an additional indicator of investment security for debenture and note holders. The debt ratios of the Cambridge group were shown in Table 8.2 and have been discussed with reference to the security of Cambridge's shares. They indicated that Cambridge was relatively highly geared, with gearing increasing in the two years prior to receivership.

In addition to the data available from the audited financial statements, potential debenture and note subscribers were issued with prospectuses, which contained auditors' reports based on annual or interim financial statements. Table 8.4 shows the ratios relevant to debenture and note subscribers, calculated from these statements. Despite the fact that the return on assets is one of the most useful measures of profitability for debenture and note holders, the prospectuses did not disclose the data necessary to calculate this rate of return. Instead, the prospectuses issued prior to 1974 simply disclosed profit before tax, whilst later prospectuses also disclosed profit after tax. Table 8.4 shows that overall, interim and annual profit before tax increased significantly between 1965 and 1973. For example, the reported profit for 1964-65 was $0.61m but by 1972-73, it had increased to $3.64m. The reported interim profit for the first half of 1965-66 was

Table 8.4 Cambridge's Profitability and Security, Debenture and Noteholders Perspective from the Prospectuses

Period Ended	Prospectus No.	Consol. Net Profit Before Tax ($m)	% Change Over Corresponding Period in Previous Yr.	Consol. Net Profit After Tax ($m)	% Change Over Corresp. Period in Previous Yr.	Asset Cover for Debentures	Debt Ratio	Limitations on Borrowing ($m)
30/6/65	13	0.61	-	n.s		2.30	0.90	1.76
31/12/65	14	0.36*	-	n.s		2.19	0.90	1.65
30/6/66	15	0.65	+6.55	n.s		2.12	0.90	0.75
31/12/66	16	0.37*	+2.78	n.s		2.02	0.90	0.93
30/6/67	17	0.68	+4.62	n.s		1.53	0.87	0.51
31/12/67	18	0.42*	+13.51	n.s		1.54	0.87	0.80
30/6/68	19	0.82	+20.59	n.s		1.49	0.86	0.90
31/12/68	20	0.52*	+23.81	n.s		1.45	0.86	1.73
30/6/69	21	0.97	+18.29	n.s		1.43	0.87	1.67
31/12/69	22	0.68*	+30.77	0.43*	-	1.42	0.87	4.35
30/6/70	23 & 24	1.50	+54.64	0.96	-	1.51	0.89	4.45
31/12/70	25	1.00	+45.59	0.67*	+55.81	1.49	0.89	2.76
30/6/71	26	2.29	+52.67	1.33	+38.54	1.46	0.88	5.33
31/12/71	27	1.44*	+45.45	0.80*	+19.40	1.43	0.88	2.03
30/6/72	28	2.67	+16.60	1.65	+24.06	1.45	0.89	n.s
31/12/72	29	1.75*	+21.53	0.99*	+23.75	1.58	0.89	n.s
30/6/73	30	3.64	+36.33	2.29	+38.79	1.68	0.91	8.38
31/12/73	31	3.76*	+114.86	1.97*	+98.99	1.68	0.91	19.90

* Denotes reported profit for first six months of the year
n.s = not stated

$0.36m and by the first half of 1973-74, interim profit had increased to $3.76m, which was higher than the profit for the previous financial year. The rate of increase in profit before tax over the previous corresponding period was, however, erratic. For example, prior to 1968, the rate of increase was less than 20 per cent. In 1968 and 1969, the growth rate increased to between 20 per cent and 30 per cent and in 1970 and 1971 it increased further to between 45 per cent and 55 per cent. The rate of growth in profit then decreased until the first half of 1973-74, when the reported profit before tax was more than double the result for the first half of the previous year. The after-tax profits, which were disclosed in the prospectuses issued from 1971, also showed significant increases over profit in the previous corresponding period. The lowest increase was 19.40 per cent, which was recorded for the first half of 1971-72. The strong profit growth reported in the prospectuses from the late 1960s should be contrasted with the relatively low rate of return on assets disclosed in Cambridge's audited accounts. Had these data been disclosed in the prospectuses, potential debenture and note subscribers would have been presented with a less attractive picture of Cambridge's profitability.

The asset cover available for debentures from 1968, according to the prospectus data, is similar to that calculated from the audited financial statements. However, the asset cover prior to 1968, based on the prospectus data, is significantly lower than the cover based on the audited financial statements because the two sources differed over the value of total tangible assets and debentures on issue. The reason for these differences is not apparent but both sources suggest that the asset cover for Cambridge debentures was unsatisfactory. The data from the audited financial statements also showed that Cambridge's interest cover was low. This information, which would have been relevant to debenture and note subscribers, was omitted from the prospectuses. The debt ratios from the two sources are consistent from 1967 and confirm that Cambridge was a firm with relatively high and increasing gearing. For no apparent reason, the total assets and liabilities recorded in the prospectuses differ from the audited financial statement data prior to 1967. However, the prospectus data result in higher debt ratios and should have served to emphasize the high leverage of the Cambridge group. The final column of Table 8.4 shows the amounts of further borrowing which could be undertaken within the limitations of the trust deed, according to the auditors' calculations. Despite the group's high gearing, for most of the period Cambridge was capable of borrowing at least an additional $1m, without infringing the trust deed. At 31 December 1973, the group would have been allowed to borrow an additional $19.90m.

To summarize, in the decade prior to receivership, Cambridge's audited financial statement data reported substantial increases in net profit, both before and after tax, each year from 1967-68. However, the rate of return earned on shareholders' funds from the late 1960s was below the rates earned by other firms in the industry. The company quoted substantial earning rates, which increased from 1966-67, but their basis of calculation was not disclosed. The company's dividend rate and asset backing per ordinary share, particularly from the early 1970s, were relatively low and its gearing was high. The rate of return earned by Cambridge on its assets was low, particularly from the late 1960s. Interest cover was also relatively low. However, the data necessary to calculate the return on assets and interest cover were not available to potential debenture and note subscribers, through the Cambridge prospectuses. The asset cover for Cambridge debentures was also low compared to that of other firms in the industry, although the auditors' calculations of borrowing limitations, disclosed in the prospectuses, suggested that ample borrowing capacity remained. On the one hand, therefore, the financial statement data, suggested that, over the ten years prior to receivership, Cambridge was not an attractive investment opportunity. On the other hand, however, Cambridge was apparently profitable and the data gave no indication that failure was imminent. Indeed, in the two years immediately prior to receivership, the data suggested significantly improved profitability and better asset cover for debentures. In the last year, interest cover also improved significantly.

8.2 (iii) Cambridge's Financial Statement Misinformation

Cambridge was placed into receivership on 30 September 1974. In February 1975, the Attorney-General of N.S.W. appointed the Corporate Affairs Commission to investigate the affairs of Cambridge under s170(1) of the *Uniform Companies Act (1961)*. The terms of appointment required an examination of the accounts underlying the profit announcements made in March and September 1974, and the auditors' reports included in the Cambridge prospectuses issued from June 1966.[18] The investigation, therefore, involved a detailed analysis of the financial statement data issued by Cambridge from 1966 to 1974. This investigation led to two reports, which were tabled in the N.S.W. Parliament.[19] The Corporate Affairs inspectors concluded that Cambridge's audited financial statement data, issued from June 1966, were false.[20] According to the inspectors, these data gave no warning that failure was imminent because of accounting practices, which were deliberately adopted to conceal the actual situation. The most significant of these practices are discussed below.

[18] New South Wales, Parliament [1979, pp. 14-15].

[19] See New South Wales, Parliament [1976-77 and 1979]. The second report referred to a third and final report. However, according to the N.S.W. Corporate Affairs Commission (conversation with Mr. A. Adams, 13 October 1983) it is most unlikely that this third report will be issued.

[20] New South Wales, Parliament [1979, p.277].

8.2 (iii) (a) Accounting for Front End Profits on Land Sales

The Cambridge group was heavily involved in the development and sale of real estate. This was a long term investment. However, to report profits in the short term, Cambridge sold undeveloped or partially developed land to joint ventures in which it retained a substantial equity interest. The transfer price on these sales included an element of development profit. The practice of developers who inflate profits on sales to joint ventures, by loading development profits into the transfer prices, is known as "front-ending".[21] In most cases, the front end profits on these transactions were recognized fully at the time of sale. In the Reid Murray case, the recognition of profit at the time of sale had resulted in criticisms because of doubts over whether such profits would be received eventually. In Cambridge's case, it was not unusual for the purchaser to pay in full within a relatively short period. The recognition of profit at the time of sale in these circumstances is less open to criticism.

The inspectors, however, were more concerned with the unrealized nature of the front end profits. Cambridge retained an interest in the property because of its significant equity interest in the purchaser. According to the inspectors, despite the separate legal identity of the joint venture purchasers, the only profit which should have been recognized by Cambridge is that share attributable to the interest acquired by outsiders.[22] Where Cambridge retained an interest in the property, because of its equity interest in the purchaser, the share of profit attributable to that interest should have been eliminated. Moreover, where Cambridge held more than a 50 per cent

[21] Australian Accounting Research Foundation [1982, p.31].

[22] New South Wales, Parliament [1976-77, p. 53].

interest in the purchaser, the entire unrealized profit should have been eliminated, in the group accounts, by consolidation procedures.[23] Yet Cambridge's group accounts included full front end profits with no allowance for its retained interest. The group was involved in real estate from the early 1960s, but it was only from 1970 that front end profits became a significant part of total profit.[24]

Table 8.5 lists property sales from July 1972 which involved front end profits and identifies the part of the profit which should have been eliminated because of Cambridge's retained interest in the property. These figures show that Cambridge overstated its profit before tax by $3.32m, $3.91m and $3.73m in the accounts at 30 June 1973, 31 December 1973 and 30 June 1974, respectively. These overstatements should be compared to Cambridge's audited total profits before tax over this period, which were $3.54m, $3.76m and $5.86m, respectively. Had the unrealized profits been excluded from the audited accounts, reported profits would have been significantly lower and the group's image, as depicted in these accounts, would probably have been significantly less attractive.

Land sales to subsidiaries involved Group Housing Pty. Ltd. and Loftus Properties Ltd. Group Housing was a triventure agreement, with 50 per cent of its issued capital held by Cambridge, and the remaining 50 per cent held between Intercapital Investments Pty. Ltd. (Intercapital) and Lewis Land Pty. Ltd., which were nominally independent of Cambridge. However, the inspectors concluded that Group Housing was a subsidiary of Cambridge.[25] Table 8.5 shows

[23] It could be argued, on the grounds of effective control, that joint ventures in which Cambridge owned less than a 50 percent interest should also have been treated as subsidiaries. The accounting for joint ventures is considered in more detail in section 8.2 (iii)(e).

[24] New South Wales, Parliament [1976-77, p. 52].

[25] New South Wales, Parliament [1976-77, pp. 76-105].

Table 8.5: Unrealized Front End Profits on Cambridge Land Sales

Sale(s) to	Amount Applicable to Cambridge's Interest ($m)	Accounts Affected, Period Ended
Camfin Holdings No. 1 Pty. Ltd.	0.96	30/6/73
Iron Bark Pty. Ltd.	0.66	"
Group Housing Pty. Ltd.	0.64	"
Calypso Pty. Ltd.	0.41	"
Chronos Pty. Ltd.	0.40	"
St. Alban's Park Pty. Ltd.	0.18	"
Arkena Pty. Ltd.	0.07	"
Total Year Ended 30/6/73	3.32	
Group Housing Pty. Ltd.	3.63	31/12/73
Loftus Properties Ltd.	0.28	"
Total Six Months Ended 31/12/73	3.91	
Group Housing Pty. Ltd.	1.62	30/6/74[1]
Meadow Lake Pty. Ltd.	1.50	"
Loftus Properties Ltd.	0.37	"
Camfin Holdings Pty. Ltd.	0.24[2]	"
Total Year Ended 30/6/74	3.73[3]	

Source: Based on data drawn from New South Wales, Parliament [1976-77, Sections 4-6].

[1] Refers to 1973-74 draft accounts.

[2] Adjustment to front end profit year ended 30/6/73.

[3] The total for the year ended 30/6/74 is less than the total for the six months ended 31/12/73 because of inconsistent accounting procedures applied over the half-year compared to the year.

that profits on Group Housing land sales, which should have been eliminated, amounted to $0.64m, $3.63m and $1.62m in the accounts at 30 June 1973, 31 December 1973, and 30 June 1974 respectively. The Group Housing profits were not eliminated because Cambridge's management contended that Group Housing was not a subsidiary. In contrast, Loftus Properties was not recognized as a subsidiary because of an oversight on the part of management and the auditors.[26] Table 8.5 shows that this oversight resulted in the overstatement of Cambridge group profits before tax by $0.28m for the six months ended 31 December 1973 and $0.37m for the year ended 30 June 1974.

Moreover, the unrealized front end profits included in the Cambridge accounts were determined on inconsistent bases. In most cases, the transactions were accounted for on an accural basis which recognized the full profit. However, when this method gave results inconsistent with budgeted profit, an alternative method was selected which produced results closer to budget. For example, in accounting for a land sale by the Cambridge joint venture, Burhead Timber Company Pty. Ltd. (Burhead), to Group Housing, the full profit of $3.37m was included in the results for the six months ended 31 December 1973. Yet for the year ended 30 June 1974, the same transaction was brought to account on a profit emerging basis, resulting in a recorded profit of $0.55m.[27] When asked to justify this approach, the group's chief accountant, Davis-Raiss, explained that

> "We ... would have seen (the) Burhead (transaction) which had $3 million (profit) ... and we would have decided if we took a tenth

[26] New South Wales, Parliament [1976-77, pp. 124-126].

[27] Cambridge's novel profit emerging method involved spreading profit evenly over the term of the sale.

> of that profit it would result in a substantial reduction in the overall profit."[28]

Furthermore, in the draft accounts for the six months to 31 December 1973, the Burhead profit had been calculated on a cash emerging basis, before being changed back to an accrual basis.[29] In contrast to the Burhead transaction, the profit on a sale to Group Housing, by the Cambridge joint venture, Sunderland Holdings Pty. Ltd. (Sunderland), was brought to account on a cash emerging basis for the six months ended 31 December 1973, and on an accrual basis for the year ended 30 June 1974. Under these procedures, the December 1973 accounts showed a profit of $0.25m on this transaction, whilst the June 1974 accounts showed a profit of $1.08m.[30] The Burhead and Sunderland deals were virtually identical and the inspectors could find no reason for their inconsistent treatment.

> "other than it was expedient to enable Cambridge to publish a group profit figure compatible with the pre-determined target set ..."[31]

The accounts did not disclose the methods used to calculate profits or the substantial amounts which the transactions contributed to group profit. The profit announcement based on the December 1973 accounts merely stated that the results had been arrived at in accordance with the Corporation's usual accounting practice.

[28] New South Wales, Parliament [1976-77, p.209]. The profit calculated on the profit emerging basis was, in fact, greater than one-tenth of the accrual based profit because of the inclusion of interest received.

[29] New South Wales, Parliament [1976-77, pp. 145-153 and 201-219]. Under the cash emerging method, the profit is recognized in proportion to the amount of cash received under the contract during the period, as a share of the total cash receivable from the sale.

[30] New South Wales, Parliament [1976-77, pp. 160-164 and 204-205].

[31] New South Wales, Parliament [1976-77, p. 164].

The Corporate Affairs inspectors concluded that Cambridge's accounting for front end profits on land sales reflected

> "... the complementary processes of determining profit targets ... and resolving the methods of accounting for profits at the end of any period to come within the range of such targets."[32]

8.2 (iii) (b) Accounting and Non-Accounting for Subsidiaries

The subsidiaries involved in front end land transactions were not the only companies omitted from Cambridge's group accounts. For example, Cambridge failed to recognize the real estate company Capital Realty Pty. Ltd. as a subsidiary. Acquired by Cambridge in August 1973, for $1.134m, Capital Realty had issued share capital of $4 and net tangible assets with a book value of $4,655. By 31 December 1973, Cambridge had paid $0.28m towards the acquisition costs of this company. In the group accounts this payment was included in the asset account, "Mortgages and Other Receivables". No reference was made to the acquisition of the company and its results were not included as part of the group's results. If it had been accounted for correctly, the consolidated accounts would have shown goodwill on consolidation of approximately $1.129m which was the difference between the acquisition cost of Capital Realty and its book value. This would have increased the goodwill reported in the December 1973 balance sheet by 33.5 per cent, from $3.37m to $4.50m.

On the 26 June 1974, Capital Realty revalued its assets to $2.0m, resulting in a surplus of $1.10m which was paid as a dividend to Cambridge, by way of a bonus issue. Capital Realty's only significant asset consisted of an option to purchase 2,490 acres of non-urban land twelve miles outside of Canberra. On 20 September 1974, four days after Cambridge's profit

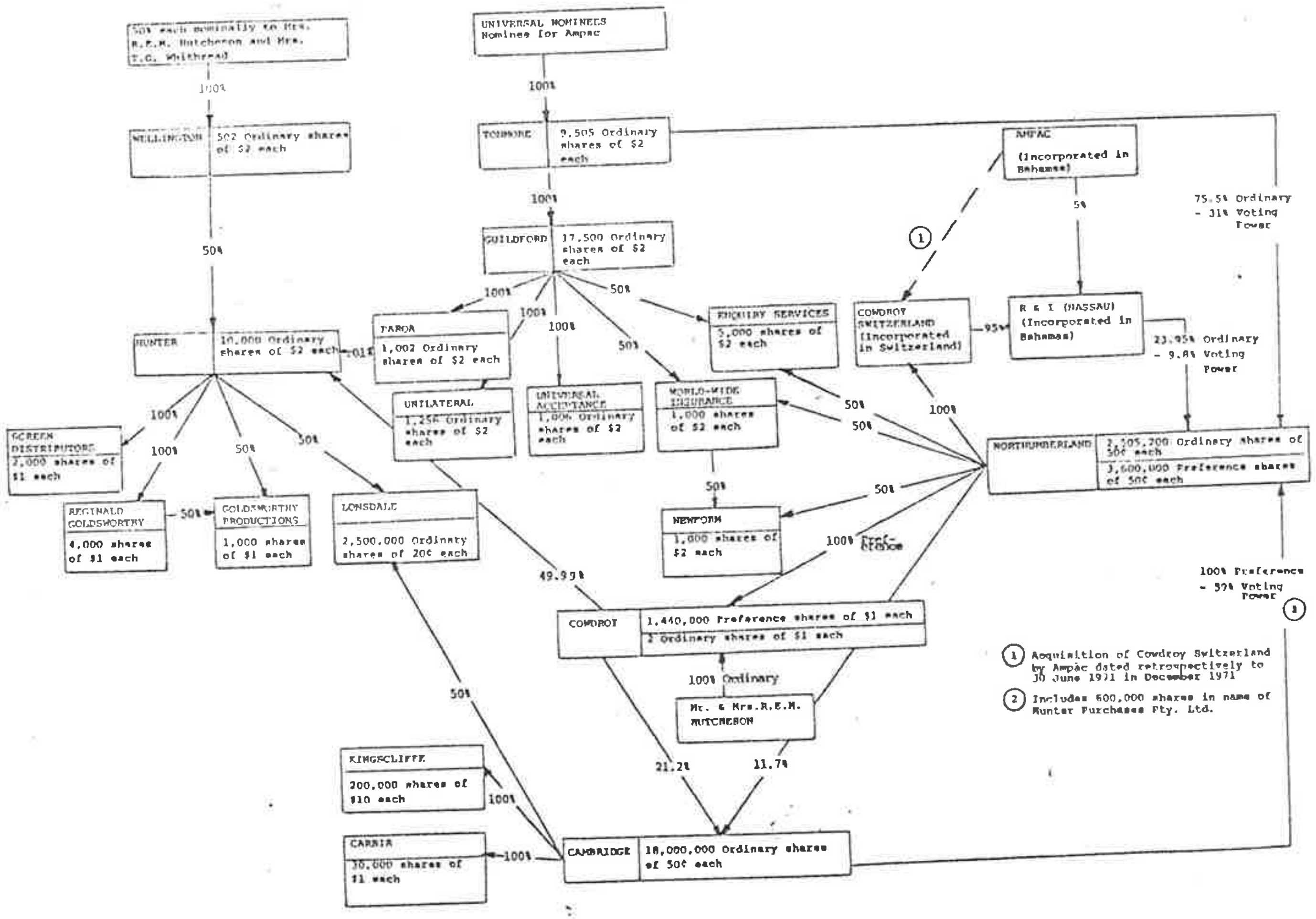
[32] New South Wales, Parliament [1976-77, p. 140].

announcement, Capital Realty decided not to purchase this land. Capital Realty had been recognized as a subsidiary in the June 1974 accounts. This decision meant that the group had to write back a mortgage liability of $0.85m, which was the share of the acquisition cost still outstanding, and write off a loss of $1.15m. The inspectors found evidence that the minutes of the meeting at which this decision was taken, had been falsely dated. They believed that the need for this write off was known before the profit announcement on 16 September 1974.[33] Thus, even though Capital Realty had been recognized as a Cambridge subsidiary in the June 1974 accounts, the failure to recognize the write off contributed to Cambridge's potentially misleading results.

The most significant subsidiaries which were not consolidated in the Cambridge group accounts, were the investment companies owned and/or controlled by Cambridge's managing director, R.E.M. Hutcheson. These companies included the public company, Northumberland Insurance Company Ltd. (Northumberland), and the proprietary companies Hunter Purchases Pty. Ltd. (Hunter), Wellington Court Holdings Pty. Ltd. (Wellington), Cowdroy Investments Pty. Ltd. (Cowdroy), Town and Country Pty. Ltd., Carbir Fishing Pty. Ltd. (Carbir) and Austral Family Homes Pty. Ltd. (Austral). Figure 8.1 describes the relationships of the various companies within the Hutcheson conglomerate, at 30 June 1971. This diagram excludes Austral which was a joint venture company in which Cambridge became involved in 1967. Austral was wholly owned by Cambridge by 30 June 1968 but was not recognized as a Cambridge subsidiary until 30 June 1970. It also excludes Town and Country which was effectively controlled by Cambridge from the late 1960s but was not treated as a Cambridge subsidiary.

[33] For details of Capital Realty transactions, see New South Wales, Parliament [1979, pp. 128-139].

Figure 8.1: Hutcheson Conglomerate at 30 June, 1971


50% each nominally to Mrs. R.E.M. Hutcheson and Mrs. T.G. Whithread
100%
WELLINGTON
502 Ordinary shares of $2 each
50%
HUNTER
10,000 Ordinary shares of $2 each
.01%
100%
SCREEN DISTRIBUTORS
2,000 shares of $1 each
100%
50%
50%
REGINALD GOLDSWORTHY
4,000 shares of $1 each
50%
GOLDSWORTHY PRODUCTIONS
1,000 shares of $1 each
LONSDALE
2,500,000 Ordinary shares of 20¢ each
UNIVERSAL NOMINEES
Nominee for Ampac
100%
TORMORE
9,505 Ordinary shares of $2 each
100%
GUILDFORD
17,500 Ordinary shares of $2 each
100%
100%
100%
50%
50%
PAROA
1,002 Ordinary shares of $2 each
UNILATERAL
1,256 Ordinary shares of $2 each
UNIVERSAL ACCEPTANCE
1,006 Ordinary shares of $2 each
WORLD-WIDE INSURANCE
1,000 shares of $2 each
ENQUIRY SERVICES
5,000 shares of $2 each
50%
NEWFORM
1,000 shares of $2 each
AMPAC
(Incorporated in Bahamas)
1
5%
COWDROY SWITZERLAND (Incorporated in Switzerland)
95%
R & I (NASSAU) (Incorporated in Bahamas)
75.5% Ordinary - 31% Voting Power
23.95% Ordinary - 9.8% Voting Power
50%
50%
100%
50%
100% Preference
NORTHUMBERLAND
2,305,200 Ordinary shares of 50¢ each
3,600,000 Preference shares of 50¢ each
100% Preference - 59% Voting Power
2
49.99%
COWDROY
1,440,000 Preference shares of $1 each
2 Ordinary shares of $1 each
100% Ordinary
Mr. & Mrs.R.E.M. HUTCHESON
50%
21.21%
11.7%
KINGSCLIFFE
200,000 shares of $10 each
100%
CARBRIA
30,000 shares of $1 each
100%
CAMBRIDGE
18,000,000 Ordinary shares of 50¢ each
1 Acquisition of Cowdroy Switzerland by Ampac dated retrospectively to 30 June 1971 in December 1971
2 Includes 600,000 shares in name of Hunter Purchases Pty. Ltd.

Source: New South Wales, Parliament [1979, p.289]

Cambridge recognized subsidiary status only when it directly held more than 50 per cent of the voting shares. It made extensive use of nominee shareholders and, in determining subsidiary relationships, it focused on "legal" form, rather than the "substance" of Hutcheson controlled ownership and management. Indeed, the inspectors even found evidence of changes to company structures and beneficial ownership, which had been made solely to avoid the recognition of Cambridge subsidiaries.[34]

For example, the inspectors found that, on the basis of effective control, Northumberland was a Cambridge subsidiary from April 1971 because of the voting rights attached to preference shares on the non-payment of preference dividends. Cambridge attempted to avoid the recognition of Northumberland's subsidiary status by transferring part of its holding to Wellington, which was another Hutcheson company. However, this transfer was financed by a Cambridge loan and the inspectors concluded that the beneficial ownership of these shares remained with Cambridge.[35]

In terms of effective control, Hunter was also a Cambridge subsidiary as it was managed and wholly financed by Cambridge.[36] Similarly, the inspectors made a case for the recognition of the Hutcheson controlled Wellington, Cowdroy, Town and Country, Carbir, and Austral as Cambridge subsidiaries.[37] Overall, the Hutcheson conglomerate had incurred large losses over a considerable period. It had survived largely because of the substantial public borrowings by Cambridge. The failure to recognize these companies as subsidiaries enabled Cambridge to continue to borrow from the public without

[34] New South Wales, Parliament [1979, p.20].

[35] New South Wales, Parliament [1979, pp. 61-64].

[36] New South Wales, Parliament [1979, p.29].

[37] New South Wales, Parliament [1979, pp. 27, 59-61, 249-251 and 255-256].

disclosing the extent or nature of these losses.

Northumberland can be used to illustrate the type of accounting practices adopted by the Hutcheson controlled companies and to demonstrate their significance to the Cambridge group. Northumberland was incorporated in 1955, to provide insurance to Cambridge customers. In later years, it was used to hold Cambridge shares, to support the market and to ensure that control ot Cambridge did not slip from the Hutcheson conglomerate. The company also allowed Cambridge to minimize its provision for doubtful debts. Cambridge insured its debts with Northumberland and instead of providing for doubtful debts, it recorded assets such as claims or potential claims against Northumberland, despite doubts about the recoverablity of these claims.

By the late 1960s, Northumberland was unprofitble.[38] Its results for the year ended 31 December 1970 were apparently so unpalatable to management that these accounts were abandonned in favour of accounts for the eighteen month period to 30 June 1971. The results for this eighteen month period were better than the results for the previous year, but this improvement was achieved at Cambridge's expense. On 25 June 1971, Cambridge purchased almost the entire issued capital of a company called Kingsclitfe Forests Pty. Ltd. (Kingscliffe). According to the Cambridge accounts, these shares cost $2.0m. The purchase price of the shares was actually $0.90m, with an additional $1.10m being credited to Northumberland, as commission on this transaction. The inspectors found no evidence of work done by Northumberland to justify the commission. This transaction reduced Northumberland's loss, for the eighteen months ended 30 June 1971, to $0.41m. The discarded accounts, for the twelve months ended 31 December 1970, had shown a loss of more than $1m. Because of the transaction, the cost of Cambridge's assets at

[38] The history of Northumberland is discussed in New South Wales, Parliament [1976-77, pp. 40-42] and [1979, pp. 30-45, 61-146].

30 June 1971, was overstated by $1.10m.[39] In 1971-72, further income was diverted to Northumberland, on the basis of purchases of Kingscliffe shares by Cambridge. On this occasion, Cambridge paid a $2.25m "commission" to Hunter, $0.23m of which was passed on to Northumberland. Northumberland recorded this commission as "Claims Recovery on Indemnity Claims". Neither Hunter nor Northumberland did any work in connection with this transaction. As a result of this transaction, the cost of Cambridge's assets was overstated by a further $2.25m.[40] In addition, to improve its position in 1973, Northumberland revalued its holdings of Cambridge shares by $0.54m, which was used to partially offset some of its other losses. The revaluation was $0.10m above market value.[41]

Despite the undisclosed diversion of $1.33m of Cambridge funds to Northumberland over 1971 and 1972, a Cambridge management report, filed in January 1974, concluded that Northumberland was insolvent and totally dependent on Cambridge funds for its survival. According to this report, Northumberland's insolvency was not reflected in its accounts because of inconsistent asset revaluations, such as the revaluation of Cambridge shares discussed above, inadequate provision for doubtful debts and questionable estimates of outstanding claims. The report estimated that Northumberland's 1973 accounts overstated assets and understated liabilities by $6.3m.[42]

To alleviate Northumberland's situation, in May 1974 Cambridge credited Northumberland with $1.15m as a procuration fee, for the transfer of Kingscliffe shares from Wellington to Cambridge. According to the inspectors,

[39] New South Wales, Parliament [1979, pp. 24-25 and 69-86].

[40] New South Wales, Parliament [1979, pp. 86-87].

[41] New South Wales, Parliament [1979, pp. 134-135].

[42] New South Wales, Parliament [1979, pp. 25 and 99-100].

this payment was based on a falsified agreement between Wellington and Northumberland. Northumberland's accounts processed the fee as a "Claims Adjustment". In the Cambridge accounts, it was initially capitalized as part of the cost of Kingscliffe shares but since these were already over-valued, it was subsequently transferred as a debit to the income account "Interest Received", and then, after audit, it was transferred to "Commissions Paid".[43]

Thus, over the period 1971 to 1974, Cambridge funds of $2.48m were diverted to Northumberland, with no commercial justification and without disclosure in the Cambridge accounts. This resulted in an overstatement of Cambridge assets, by $1.33m, and an understatement of its 1973-74 profit before tax, by $1.15m. If Cambridge had recognized Hunter and Northumberland as subsidiaires, the effects of these transactions would have been eliminated in the group accounts.

The omission of various other Hutcheson companies also had a significant effect on the Cambridge group accounts. For example, Hunter was established in the mid-1960s to take over the hire purchase bad debts of the Cambridge branch in Brisbane, thus avoiding their disclosure in Cambridge's financial statements. By December 1973, Hunter, financed by Cambridge, had incurred losses of approximately $7.55m, largely because of leasing and hire purchase bad debts and inappropriate investments in film companies and listed shares. Even though Hunter was not recognized as a subsidiary, these losses were effectively passed on to Cambridge. They were put through the Cambridge accounts, at 30 June 1972 or thereafter. However, they were never disclosed separately in those accounts.[44] Many of the accounting practices used to

[43] New South Wales, Parliament [1979, pp. 102-118].

[44] The history of Hunter is discussed in New South Wales, Parliament [1976-77, pp. 43-45 and 1979, pp. 30-45 and 150-247].

disguise Hunter's losses were similar to those adopted by Northumberland. For example, Cambridge paid fictitious commissions to Hunter on share and land purchases. Profits on the sale of shares by Cambridge were diverted to Hunter. Advances to Hunter were written off against "Interest Received", without disclosure. In addition, Hunter's investments were purchased by Cambridge at inflated values and subsequently written down without disclosure.[45]

Wellington's function was to receive loans from Cambridge and forward them to Cowdroy and Northumberland, largely for the purchase of Cambridge shares. This enabled Cambridge to disguise its support of Cowdroy and Northumberland and, thus, avoid the consequences of s67 of the *Uniform Companies Act (1961)* which prohibited companies financing the purchase of their own shares. Cowdroy was used to buy shares in Cambridge after Northumberland's holding became so large that further purchases would have resulted in an obvious parent-subsidiary relationship.[46]

Cambridge also advanced funds to the Hutcheson dominated companies, Town and Country and Carbir. Both of these companies were insolvent and in the year ended 30 June 1972, Cambridge wrote-off advances to them by debiting the income account "Interest Received", without separate disclosure in the accounts. In addition, Cambridge diverted rebates, granted on a purchase of shares, to Carbir and Austral.[47] At this time, Austral was recognized as a Cambridge subsidiary and, therefore, the rebate resulted in an overstatement of Cambridge group profit as well as assets.

[45] New South Wales, Parliament [1979, p.162].

[46] The function of Wellington and Cowdroy are discussed in New South Wales, Parliament [1976-77, pp. 42-45 and 1979, pp. 56-61 and 120-146].

[47] New South Wales, Parliament [1979, pp. 261-262].

Even when the Cambridge accounts did recognize subsidiaries, questionable practices were followed. For example, no provision was made to reduce goodwill associated with the acquisition of unprofitable subsidiaries or subsidiaries with a deficiency of net assets, until the 1974 accounts.[48] In accounting for advances to a joint venture subsidiary in 1972, Cambridge eliminated bad debts of $0.60m by capitalizing this irrecoverable debt as an interest free loan.[49] In addition, in calculating group profit to 31 December 1973, Cambridge capitalized interest on a joint venture project twice, which overstated the asset and interest income by $0.04m.[50]

8.2 (iii) (c) The Combined Effects of Cambridge's Accounting for Land Sales and Subsidiaries

Table 8.6 shows the combined effects, over the period 1967 to 1973, of Cambridge's failure to eliminate unrealized front end profits on real estate, its failure to recognize companies within the Hutcheson conglomerate as part of the Cambridge group, and the effects of inappropriate accounting for various other Cambridge subsidiaries. This table shows that, by 30 June 1973, Cambridge's shareholders' funds had been overstated by $11.62m. At each balance date from 1967 to 1973, shareholders' funds were overstated, because of the overstatement of assets and/or profits. The most serious distortion occurred in 1971, when shareholders' funds were overstated by $4.80m. However, each year from 1967 to 1970 the overstatements exceeded $1 million, and in 1972 and 1973 they were not less than $0.5 million.

The inclusion of unrealized profits on front end land sales contributed $3.32m to the overstatement of Cambridge's shareholders' funds and the

[48] New South Wales, Parliament [1979, p.298].

[49] New South Wales, Parliament [1976-77, pp. 70-71].

[50] New South Wales, Parliament [1976-77, p.168].

Table 8.6: Distortions to the Cambridge Accounts Due to Unrealized Profits on Land Sales, the Omission of Hutcheson Companies and the Inappropriate Accounting for Recognized Subsidiaries. ($m)

	Year Ended 30/6/67	30/6/68	30/6/69	30/6/70	30/6/71	30/6/72	30/6/73	Total
(a) Front End Profits							(3.32)	(3.32)
(b) Effects of Omision of Northumberland								
Profits (losses), Northumberland.	-	0.01	0.02	(0.01)	(0.41)	(0.32)	(0.20)	(0.91)
Prov'n to write down Northumberland's investments in shares and bonds to market value and to write off intangibles.		0.03	(0.15)	0.07	(0.04)	(0.02)	0.12	0.01
Prov'n against Northumberland's investment in loss making companies.		0.07	(0.07)	(0.12)	(0.73)	0.05	0.01	(0.79)
Elimination on revaluation of Cambridge shares held by Northumberland.							(0.54)	(0.54)
Overstatement of Kingscliffe shares.					(1.10)	(0.23)		(1.33)
Under(over) statement of group S.H.F. due to omission of Northumberland		0.11	(0.20)	(0.06)	(2.28)	(0.52)	(0.61)	(3.56)
(c) Effects of Omission of Hunter								
Profits (losses), Hunter accts.	(0.33)	(1.29)	(0.81)	0.98	(0.05)	0.91	0.15	(0.44)
Prov'n to decrease share investments to to market value.				(1.37)	(1.94)	1.18	2.13	-
Prov'n to decrease film company investments to value in 1973-74 Cambridge accounts.		(0.23)	(0.51)	(0.59)	(0.15)	(0.09)	1.20	(0.37)
Hunter losses written off by Cambridge.							1.34	1.34
Overstatement of Kingscliffe shares.						(2.02)		(2.02)
Overstatement Burleigh Garden land.							(0.48)	(0.48)
Under(over) statement of group S.H.F. due to omission of Hunter	(0.33)	(1.52)	(1.32)	(0.98)	(2.14)	(0.02)	4.34	(1.97)

Table 8.6: Distortions to the Cambridge Accounts Due to Unrealized Profits on Land Sales, the Omission of Hutcheson Companies and the Inappropriate Accounting for Recognized Subsidiaries. ($m) (Contd.)

	Year Ended 30/6/67	30/6/68	30/6/69	30/6/70	30/6/71	30/6/72	30/6/73	Total
(d) Other Distortions								
Profits (losses), Wellington & Cowdroy.				0.01	(0.01)	(0.10)	0.02	(0.08)
Elimination of premiums paid for Cambridge shares.		(0.16)	(0.12)	0.17	(0.45)	(0.17)	(0.10)	(0.83)
Provision to write-off advances to Carbir & Town & Country - to extent recognized in Cambridge 1971-72 accounts.		(0.19)	(0.25)	(0.20)	0.09	0.55		-
Provision to eliminate mark-up on Surfers shares.				(0.28)				(0.28)
Provision to reduce goodwill on consolidation - to the extent recognized in June 1974 draft accounts.							(0.88)	(0.88)
Elimination of bad debts capitalized as interest free loans to joint ventures.						(0.60)		(0.60)
Hutcheson private family group profits (losses) during the period.	(0.05)	(0.05)	(0.04)	-	(0.01)	-	0.05	(0.10)
Under(over) statement of group S.H.F. due to other distortions	(0.05)	(0.40)	(0.41)	(0.30)	(0.38)	(0.32)	(0.91)	(2.77)
Total Under(Over) Statement of Group S.H.F.	(0.38)	(1.81)	(1.93)	(1.34)	(4.80)	(0.86)	(0.50)	(11.62)

Source: Based on data contained in Annexure 6B, New South Wales, Parliament [1979, pp. 294 to 300] and Table 8.5

omission of Northumberland from the Cambridge group contributed $3.56m. The most important distortion associated with the omission of Northumberland resulted from the fictitious commissions on Kingscliffe shares. By 30 June 1973, the omission of Hunter contributed $1.97m to the overstatement of shareholders' funds, with the most important distortion also resulting from fictitious commissions on Kingscliffe shares. Most of Hunters' losses were, however, passed on to Cambridge and written off, without disclosure, in the Cambridge accounts for 1973. The overstatement of shareholders' funds due to the omission of Hunter was, therefore, higher prior to 1973. For example, by 30 June 1972 it had amounted to $6.31m. Prior to 1973, the most important distortions associated with the omission of Hunter resulted from the overstatement of the value of its investments. The omission of other Hutcheson companies from the group and inappropriate accounting for recognized subsidiaries caused shareholders' funds to be overstated by $2.77m, by 30 June 1973. The most important of these distortions resulted from the failure to reduce goodwill on the consolidation of unprofitable subsidiaries and the failure to eliminate premiums on the sale of Cambridge shares to various Hutcheson companies. Group shareholders' funds, at 30 June 1973, were reported as $15.57m. The $11.62m adjustment implies that they should have been reported as $3.95m.

8.2 (iii) (d) A Further Estimate of Cambridge's Financial Statement Misinformation.

The inspectors also estimated the overstatement of Cambridge's assets, apart from the distortions due to the non-consolidation of other companies within the Hutcheson conglomerate. Their calculations are presented in Table 8.7. This table differs from Table 8.6 in three ways. First, it covers a longer period, as it includes the accounts for 30 June 1966 and 31 December

Table 8.7: Overstatement of Cambridge Profits, Shareholders' Funds and Assets ($m)

Year Ended 30 June	'66	'67	'68	'69	'70	'71	'72	'73	6 mths 31/12/73	Total
Amount Due From Hunter										
1) Accum'd & Subseq. losses	1.04	0.33	1.29	0.81	(0.98)	0.05	(0.91)	(0.15)		1.46
2) Issued capital & increases			(0.02)							(0.02)
3) Overstatement of investment in listed shares					1.37	1.94	(1.18)	(2.13)		-
4) Overstatement of investment in film companies			0.23	0.51	0.59	0.15		(1.20)	(0.28)	-
5) Assets not taken up by Cambridge									0.17	0.17
6) Amts written off by Cambridge								(1.34)	(0.27)	(1.61)
	1.04	0.33	1.50*	1.32	0.98*	2.14	(2.09)	(4.82)	(0.38)	-
Amount Due From Carbir and Town and Country			0.19	0.25	0.20	(0.09)	(0.55)			-
Mark Up Over Cost:- Kingscliffe, Surfers shares and Burleigh Garden land					0.28	1.10	2.25	0.48		4.11
Other Distortions										
Bad Debt-Cap'd as int. free loan							0.60			0.60
Front End Profits								3.32	3.91	7.23
Overstated Subsid Share Costs								0.88		0.88
" Interest Income									0.04	0.04
Overstatement of Profit	1.04	0.33	1.68	1.57	1.45	3.15	0.21	(0.14)	3.57	12.86
Cum. " " SHF	1.04	1.37	3.05	4.62	6.07	9.22	9.43	9.29	12.86	12.86

Source: New South Wales, Parliament [1979, pp. 330-331].
* Denotes rounding error of $0.01m.

1973. Second, it ignores the effects of the non-consolidation of Hutcheson dominated companies within the group. And finally, it ignores the further write-down of Hunter film investments which was recognized in the 1974 draft accounts and incorporated in Table 8.6. Using this approach, the inspectors estimated that, by 31 December 1973, Cambridge's shareholders' funds had been overstated in the group's published accounts by $12.86m. The inclusion of the 1966 and December 1973 accounts contributed $4.61m to this estimate. The most significant distortion occurred in 1971, when Cambridge's accounting practices apparently resulted in an overstatement of profits of $3.15m. Overall, front end profits were the most significant source of distortion. They inflated shareholders' funds by $7.23m, of which $3.91m was included in profit for the six months ended December 1973. The overstatement of the cost of investments by $4.11m was also an important cause of the inflated shareholders' funds. According to the Cambridge balance sheet at 31 December 1973, the group had shareholders' funds of $16.69m. The adjustments identified above would have reduced the group's shareholders' funds to $3.83m.

8.2 (iii) (e) Other Sources of Cambridge's Financial Statement Misinformation

The group's accounting for debtors also contributed to the misleading nature of the Cambridge accounts. The companies within the Hutcheson conglomerate became increasingly unprofitable and increasingly indebted to Cambridge. If these companies had been recognized as part of the Cambridge group, the inter-company loans would have been eliminated in the consolidated financial statements. Instead, they were shown as part of the asset debtors. Some of these debts were eventually written off by Cambridge without disclosure. Prior to these write offs and even after them, advances to Hutcheson companies were an important part of the group's assets. Given the virtual insolvency of the debtors, the Cambridge accounts at least should have provided for default. Cambridge's total provision for bad debts increased from $50,000 at 30 June 1966, to $700,000 at 30 June 1973.[51] Over the period March 1966 to September 1974, Cambridge advanced at least $15.32m to the "independent" Hutcheson companies. In comparison, the increase of $650,000 in the provision for bad debts over this period seems relatively insignificant. However, by September 1974 $10.43m of this debt had been treated as lost.[52] Cambridge removed these debts from its accounts by making undisclosed write-offs (often as a debit to "Interest Received") and by appropriating income, rebates and discounts. If adequate provision for doubtful debts had been made and bad debts written off at the appropriate time, Cambridge's debtors would not have been overstated and these unusual accounting procedures would have been unnecessary.

Between 30 June 1969 and 31 December 1973, amounts owing to third parties by joint ventures for which Cambridge, as registered proprietor, was primarily liable, were recorded by Cambridge as an asset, "Mortgages and Other Receivables" and as a liability "Secured Borrowings, Mortgages". By 31 December 1973, joint venture debts of $24.20m had been recorded in this way.[53] The inspectors argued that, although it was appropriate to recognize Cambridge's liability for these debts, it was inappropriate to record the associated "asset" as receivable. In their opinion, the asset which should have been recorded was "Development Projects", that is

> "the cost of Cambridge's interest in the subject land if and when called upon to meet the mortgage commitment ..."[54]

[51] New South Wales, Parliament [1979, p.149].

[52] New South Wales, Parliament [1979, p.120].

[53] New South Wales, Parliament [1976-77, pp. 38-39].

[54] *Ibid.*

The "receivables" classification enabled Cambridge to include these amounts in liquid assets, as defined by the debenture trust deed and, thus, to enhance its borrowing capacity.

Advances from Cambridge to the joint ventures were also included in "Mortgages and Other Receivables". At 30 June 1974, $98.10m of the total "Mortgages and Receivables" of $116.29m had been advanced to joint ventures in which there was no significant outside equity investment, but over which there existed $102m in prior ranking charges. The format of these joint ventures varied considerably. A small part of the advances were made to joint ventures wholly owned by Cambridge. The inspectors argued that the appropriate asset to record in this case was "Development Projects". Most of the advances, however, were made to joint ventures which had not been finally structured, or to unincorporated joint ventures in which Cambridge generally held an equity interest of at least 50 per cent, or to incorporated joint ventures over which Cambridge generally had effective, if not nominal, control.[55] The inspectors argued that the incorporated joint ventures should have been treated as subsidiaries. They also argued that advances to the unstructured and unincorporated joint ventures, at least to an extent proportional to Cambridge's ownership, was either not an advance or an advance to Cambridge itself. The treatment of loans to joint ventures on this basis at 30 June 1974, would have decreased the asset "Mortgages and Other Receivables" by $98.10m and increased the asset "Development Projects - Joint Ventures" by $204.51m.[56] However, development projects, unlike receivables, were not classified as liquid assets and did not influence Cambridge's borrowing capacity.

[55] New South Wales, Parliament [1976-77, pp.198-199 and pp. 249-253].

[56] New South Wales, Parliament [1976-77, pp. 198-199].

Other sources of misinformation occurred in the 1974 draft accounts. These included the failure to make any provision for losses on a \$1.5m investment in the shares of the insolvent Northumberland, on a \$4.91m debt outstanding from Wellington, and on the \$1.10m invested in Capital Realty.[57] In addition, the accounts charged \$1.07m to the profit and loss appropriation account, to eliminate goodwill on consolidation. The inspectors argued that this should have been brought to account as an extraordinary item, in calculating Cambridge's result for the year.[58] Although the draft accounts for 1974 were never published, the profit announcement, in September 1974, was based on these accounts.

One other aspect of Cambridge's accounting data which can be criticized is the "earning rates", which were shown in Table 8.2. Although emphasized in the annual reports and in press releases, the earning rate was not defined and appears to have been calculated on different bases at different times. For example, the earning rates quoted for 1964-66, 1967-69, and 1971-72 were, in fact, the rate of return on ordinary issued share capital, apparently calculated from net profit after tax and preference dividends divided by average ordinary share capital. However, the earning rates quoted for 1966-67 and 1969-71 appear to have excluded the effects of proposed final preference dividends. The earning rate quoted for 1972-73 was significantly higher than the return on ordinary share capital and there is no apparent explanation for this difference. The quoted earning rates, therefore, can be considered a source of misinformation because of the failure to explain their calculation and the apparent inconsistency in their calculation over time.

[57] New South Wales, Parliament [1979, p.45].

[58] New South Wales, Parliament [1976-77, p.199].

8.2 (iii) (f) The Asset Values: Evidence from the Statement of Affairs

The inspectors' estimates of the overstatement in shareholders' funds are considerably lower than the receiver's estimates of the losses of Cambridge investors. The initial statement of affairs as at 30 September 1974, prepared by Cambridge directors, showed no overall deficiency, although it did include substantial writedowns.[59] For example, it showed debtors with a realizable value $16.38m below their book value. Joint venture debtors accounted for $13.16m of this difference.[60] The realizable value of advances due from subsidiaries was estimated to be $2.71m below book valuc.[61] Under generally accepted accounting principles, these current assets should have been recorded in the accounts, at their expected realizable value. However, the directors attributed the writedowns largely to the circumstances of receivership. Moreover, the writedowns were largely offset by interests in joint ventures, which were not recorded in the Cambridge accounts but had a realizable value of $24.65m in the statement of affairs.[62]

The asset values in the statement of affairs suggested that both debenture holders and noteholders would be paid in full. However, the receiver qualified the statement of affairs values on two grounds. First, a large part of the group's assets were subject to prior charges to mortgagees. The mortgagees could exercise their rights of sale or foreclosure, with little regard to Cambridge's equity. Second, the group's land had an estimated gross value of $310m. If the land realized less than 90

[59] Cambridge Credit Corporation Ltd., Statement of Affairs, 30 September 1974.

[60] Statement of Affairs, *op. cit.*. Schedule B.

[61] Statement of Affairs, *op. cit.*, Schedule C.

[62] *Ibid.*

per cent of the directors' valuation the surplus shown in the statement of affairs would be eliminated. Indeed, the receiver believed that the realization of such large amounts of land would probably affect the market.[63] He concluded

> "... I am highly doubtful that the assumption made by the Directors in reaching their values that "real estate would be sold as far as possible in an appropriate market at an appropriate time", will be borne out by subsequent events.
>
> The present economic climate makes it difficult to realise substantial parts of the Group's assets at other than depressed values."[64]

He warned of a possible deficiency which placed doubt on the full recovery of debenture holders' claims.

By 8 February 1977, the receiver estimated that debenture holders might recover between 55 cents and 80 cents in the dollar, on their claims at 30 September 1974.[65] This implied losses on the realization of assets of between approximately $77m and $100m.[66] It has not been possible to obtain details of these losses.[67] However, as most of the total book value of Cambridge's assets related to current assets, much of these losses must reflect current

[63] Statement of Affairs, *op. cit.*, accompanying letter from the receiver, pp.5-6.

[64] *Ibid.*

[65] New South Wales, Parliament [1976-77, p.19].

[66] Debenture holder losses have been estimated, earlier in this chapter, at between $18.38m and $41.35m. In addition according to the Statement of Affairs, at 30 September 1974, unsecured creditors were owed $42.64m and the book value of shareholders' funds was $16.12m.

[67] No documentation relating to the announcement on 8 February 1977 was included in the Cambridge file held by the South Australian Corporate Affairs Commission. In addition, *all* documentation relating to the Corporate Affairs investigation has been removed from the Cambridge file held by the Corporate Affairs Commission in New South Wales, Cambridge's state of incorporation.

assets with realizable values significantly below their book value.

It cannot be concluded, however, that these book values were necessarily overstated. The differences may simply reflect the effects of switching from going concern to liquidation based accounts and forced sales in depressed markets. Differences between current asset values in pre-receivership accounts and in the statement of affairs can only be construed as misinformation where it can be shown that the going concern assumption was no longer appropriate. It is extremely difficult to assess the point at which the going concern assumption should be dropped. The decision rests with management, although, in attesting to the truth and fairness of the accounts, the auditor must also assess its appropriateness. The Corporate Affairs investigation showed that Cambridge's board of directors was confident to the very end that the group would survive.[68] However, there was sufficient evidence for the auditors to question the appropriateness of the going concern assumption well before receivership. For example, the Corporate Affairs investigation showed that the auditors had doubts about the unrealized front end profits.[69] In addition, since they also audited the other major companies within the Hutcheson conglomerate, they should have been aware of the effective subsidiary and insolvent status of many of Cambridge's debtors. If these factors had been taken into account, it would have been apparent that the terms of the debenture trust deed had been violated and, therefore, that Cambridge's continued existence was uncertain.

8.2 (iii) (g) The Misinformation in the Prospectuses

The misinformation in the audited financial statements also affected the

[68] New South Wales, Parliament [1979, p.19].

[69] New South Wales, Parliament [1976-77, pp.55-69].

data in Cambridge's prospectuses. One of the most crucial aspects of the prospectus reports was the calculation of Cambridge's borrowing capacity in accordance with the terms of the trust deed. The debenture trust deed limited borrowing to the lesser of three-quarters of the value of liquid assets or five times the value of shareholders' funds.[70] For all but the last issue, the limit was based on five times shareholders' funds.[71] However, it has been shown that, from at least 1966, Cambridge's audited accounts seriously overstated shareholders' funds. Ignoring the complex issue of the non-consolidation of the "independent" Hutcheson companies, Table 8.8 shows the effect of the overstatement of shareholders' funds on Cambridge's borrowing capacity between September 1966 and May 1974. This table shows that Cambridge's borrowing was in excess of its capacity, as defined by the debenture trust deed, from 1966. The amount by which Cambridge exceeded its capacity varied from $4.43m in 1966 to $63.86m in 1974.

The 1974 issue was, in fact, based on three-quarters of liquid assets. In November and December 1973, Cambridge revalued its real estate holdings by $84m, which resulted in a net surplus of approximately $37m after providing for future tax. The effects of this revaluation were not included in account balances at 31 December 1973, but details were included in the notes to the accounts.[72] The auditors concurred with Cambridge's point of view that, since notes are part of accounts, the financial consequences of this revaluation should be incorporated in shareholders' funds for the purpose of calculating borrowing capacity. If the revaluation had not been taken into account,

[70] Cambridge Credit Corporation Ltd., Debenture Trust Deed, clauses 7 and 22(h).

[71] New South Wales, Parliament [1979, p.52].

[72] Cambridge Credit Corporation Ltd., Notes on and Forming Part of Accounts for the Six Months Ended 31 December 1973, note 11.

Table 8.8: Violation of Cambridge's Borrowing Capacity ($m)

Prospectus No.	Date	Overstatement of SHF	Adjusted Cambridge SHF	SHFx5	Debentures Issued	Excess Borrowing
15	21/9/66	1.04	3.10	15.48	19.91	4.43
17	2/10/67	1.37	3.25	16.27	22.59	6.32
19	1/10/68	3.05	2.63	13.15	27.51	14.36
21	10/10/69	4.62	2.97	14.87	36.29	21.42
24	6/11/70	6.07	4.13	20.65	46.53	25.88
26	1/11/71	9.22	3.05	15.23	56.02	40.79
28	20/11/72	9.43	4.23	21.13	66.35	45.22
30	12/11/73	9.29	6.23	31.28	69.36	38.08
31	6/5/74	12.86	2.68	13.39	77.25	63.86

Source: Based on data contained in Annexure 10, New South Wales, Parliament [1979, pp. 330-331].

Cambridge would have been without borrowing capacity in 1974. When the revaluation was included, the borrowing limit was determined by three-quarters of liquid assets. The Corporate Affairs inspectors concluded that the main purpose of the real estate revaluation was to allow Cambridge to continue to borrow.[73]

Moreover, the Corporate Affairs investigation showed that liquid assets, at 31 December 1973, were overstated by $49.05m because of the inclusion of the following items, which should have been excluded under the terms of the trust deed:

[73] The calculation of borrowing limits, in *Prospectus No. 31*, for the debenture issue made in 1974, is discussed in New South Wales, Parliament [1976-77, pp. 226-251].

	$m
Stock	0.68
Shares in listed companies held by guarantors	0.73
Mortgages and other receivables of all non-guarantor companies	0.11
Five non-guarantor subsidiaries shown as guarantors (excluding the effects of noted above)	2.60
Advances to ventures 100% Cambridge owned	3.32
Advances to joint ventures not finally structured	17.41
Amounts owing by joint ventures on first mortgage to outside financiers or unpaid vendors	24.20
	$ 49.05

Source: New South Wales, Parliament [1976-77, p.279]

It should be noted that, for the last prospectus, a reduction of liquid assets of $26m would have left Cambridge without any further debenture borrowing capacity.

8.2 (iii) (h) Cambridge's Financial Statement Misinformation, A Summary

From at least June 1966, Cambridge's accounts significantly overstated profits, assets and shareholders' funds. One of the major causes of distortion was the accounting for front end profits on land sales. Cambridge not only failed to eliminate the share of profit attributable to its retained interest in real estate sold, but it also accounted for individual front end profits on an inconsistent basis. The Corporate Affairs inspectors suggested that Cambridge's reported results were strongly influenced by management's preconceived notion of budgeted profit for each period. These results were achieved largely through the inconsistent accounting for front end profits on land sales.

The overstatement of the value of assets, shares and real estate was another major source of distortion in the Cambridge accounts. These overstatements often arose through the addition of commissions and procuration fees on the acquisition of such assets. The commissions and procuration fees were paid to Cambridge debtors, which were otherwise insolvent. The Corporate Affairs investigation showed that no services had been provided in exchange for the commissions and procuration fees. The assets should have been recorded at their "true" cost, net of any such charges. On at least one occasion, these fictitious charges were expensed, thus causing Cambridge's profit to be understated. Cambridge also alleviated the position of some of its insolvent debtors by acquiring their shares or their assets at inflated prices. Generally, it made no provision for losses on these acquisitions. Moreover, the Corporate Affairs inspectors concluded that these debtors were Cambridge subsidiaries because they were effectively controlled by Cambridge's chief executive, R.E.M. Hutcheson. If the group accounts had reflected this situation, the distortions due to these transactions would have been eliminated.

At least the insolvency of these debtors should have been recognized in the Cambridge accounts, by an adequate provision for doubtful debts and the write off of irrecoverable debts. Instead, the group took deliberate steps to avoid the disclosure of the substantial bad debts due, both from within and beyond the Hutcheson conglomerate. Initially, "non-Hutcheson" debts were disguised through assignment to, or insurance by, closely related Hutcheson companies. Moreover, when the recognition of bad debts due from the Hutcheson companies could be deferred no longer, Cambridge tended to disguise these write offs, by debiting them against the income account, "Interest Received", rather than disclosing them as bad debts. In some cases, Cambridge had incurred these debts to disguise its own position. For example, it lent money to various Hutcheson companies solely to finance the purchase of its own shares. In addition to its major debtors, there were other companies, also controlled by Hutcheson, which Cambridge failed to recognize as subsidiaries. Overall, the omission of the Hutcheson controlled subsidiares allowed the group to hide both the nature and unprofitability of its business.

Other sources of Cambridge's financial statement misinformation included the revaluation of subsidiaries, the failure to take account of a post balance date event, the inappropriate accounting for goodwill associated with insolvent subsidiaries, the inappropriate accounting for transactions with joint ventures, the revaluation of real estate and the misclassification of liquid assets. Probably the most significant aspect of Cambridge's financial statement misinformation, from an investor's point of view, was the fact that it enabled the group to continue to borrow when it was, from at least June 1966, without further borrowing capacity. In this respect, it is clear that financial statement misinformation contributed substantially to investor losses.

Finally, although these factors caused significant overstatement of Cambridge's assets, particularly current assets, they in no way account for the vast differences between the book and realizable value of Cambridge's assets, which has become apparent since receivership. In the absence of evidence to the contrary, it seems that a large part of these differences may simply reflect the effects of the change from going concern to liquidation based accounting. The evidence suggests that the going concern assumption should have been dropped some time before receivership.

8.3 Testing the Responsibility Hypothesis for Cambridge

The responsibility for Cambridge's financial statement misinformation can be assessed in terms of the responsibility criteria set out in section 3.4(vi) of Chapter 3. There were at least 20 reasons for Cambridge's financial statement misinformation. These included

1. The failure to eliminate unrealized profits on land sales.
2. The use of inconsistent procedures in accounting for land sales.
3. The failure to recognize subsidiaries.
4. The revaluation of shares held in a real estate subsidiary.
5. The failure to take account of a post balance date event.
6. The payment of fictitious commissions and procuration fees on the purchase of assets.
7. The diversion of profits on the sale of shares.
8. The overstatement of the acquisition cost of investments.
9. The recording of debtors acquired at a cost greater than realizable value.
10. The disguised write off of bad debts.
11. The inadequate provision for bad debts.
12. The failure to provide for losses on investments in insolvent companies.
13. The capitalization of interest twice.
14. The failure to amortize goodwill associated with insolvent subsidiaries.
15. The amortization of goodwill against unappropriated profits.
16. The accounting for joint venture loans from outsiders.
17. The accounting for advances to wholly owned and incorporated joint venture.
18. The accounting for advances to unincorporated and unstructured joint ventures.
19. The revaluation of real estate.
20. The incorrect calculation of liquid assets.

The accounting profession's responsibility for each of these aspects can be determined on the following bases.

1. The inclusion of unrealized profits on land sales

From 1970, Cambridge's reported results included significant profits on the sale of land to joint development ventures in which Cambridge held a substantial equity interest. The basic issue is whether it was appropriate to recognize this profit. There has been no accounting standard dealing specifically with accounting for real estate development, although the profession has issued two publications in this area. The A.S.A. published a *Society Bulletin* on accounting for land development projects in 1967 and the A.A.R.F. published a discussion paper on accounting for real estate development in 1982.[74] Therefore, at the time the Cambridge accounts were prepared, the only guidance available was the *Society Bulletin* and the generally accepted principles relevant to accounting for any transaction. The *Society Bulletin* dealt largely with the management, rather than the financial, aspects of accounting for land development. It did not consider the problem of common equity interests between vendor and purchaser. However, as discussed in the earlier case studies, under generally accepted accounting principles, for revenue to be realized by the vendor, the purchaser must be an independent third party. Although the joint venture purchasers had separate legal identities, they were in effect controlled by Cambridge. In these circumstances, Cambridge had some influence over the price paid by the purchaser. The recognition of profits on these sales, therefore, contravened generally accepted accounting principles. The A.A.R.F. discussion paper [1982, p.31] outlined two views on how front end profits should be treated:

> "- that the transaction is either at arm's length or it is not (if the former, the developer is entitled to recognize the full profit; if the latter, the full profit should be written back);

[74] Australian Society of Accountants [1967a] and Australian Accounting Research Foundation [1982].

> - that the developer should recognize the proportion of the profit applicable to the outside equity in the joint venture, and should write back the proportion applicable to its own equity."

Arm's length transactions were defined as those where the vendor was unable to influence the transaction price.[75] This was not the case for the Cambridge front end profits. Thus, under the principles identified in the A.A.R.F. discussion paper, either all of the profit or the proportion applicable to Cambridge's interest should have been eliminated.

Although the relevance of the realization principle to accounting for real estate development was not spelled out by the profession until 1982, the individual accountants involved in the preparation and audit of the Cambridge accounts, should have known that their practices violated the realization principle. Indeed, there is some evidence that the auditors, Fell and Starkey (now Ernst and Whinney), other than D.M. Purcell who was the partner in charge, were concerned by the Cambridge procedure. For example, in October 1972, King, a Sydney partner, and Brown, a Brisbane partner, commented in writing that Cambridge's accounting for front end profits contravened generally accepted accounting principles. King wanted a note to the accounts disclosing that the profits were considered to have been fully realized, despite a retained interest by Cambridge. His suggestion was not adopted in the 1972 accounts. In November 1972, Jupp, Fell and Starkey's National Partner in Charge of Audit and Accounting, rejected unequivocally Cambridge's technique of accounting for front end profits. However, apart from a note to the 1973 accounts which consisted of a weakened version of the disclosure proposed by King, no further action was taken by Fell and Starkey.[76]

[75] Australian Accounting Research Foundation [1982, p.31].

[76] New South Wales, Parliament [1976-77, pp. 55-69].

2. The use of inconsistent procedures in accounting for land sales

Cambridge accounted for the front end profits on different land sales on different bases. In November 1973, the I.C.A.A. issued an accounting standard on the disclosure of accounting methods, which acknowledged consistency as one of the basic concepts underlying all financial reporting.[77] When re-issued in 1977, this standard defined consistency in terms of consistency in accounting policies from one period to another and between items of a similar nature.[78] Although this standard was issued after the receivers were appointed to Cambridge, it formalized an accounting principle which was widely understood and accepted.

Another basic concept of accounting, the diversity convention, recognizes that different accounting procedures may be appropriate in different entities, in accounting for apparently similar items, because of different underlying circumstances. However, in the Cambridge case, the Corporate Affairs inspectors found that different procedures were used to record transactions which appeared to have similar characteristics. More importantly, the investigation found that different procedures were used to record the same transactions in different accounting periods. The consistency convention does not prohibit changes in accounting principles between periods, where they are warranted by changed circumstances. In Cambridge's case, however, procedures were apparently changed to achieve budgeted profit. In this aspect, therefore, Cambridge's financial statements violated one of the basic concepts of accounting.

[77] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1973e].

[78] Institute of Chartered Accountants in Australia/Australian Soceity of Accountants [1977].

3. The failure to recognize subsidiaries

Cambridge's failure to recognize as subsidiaries, various companies over which it had effective control, also contravened generally accepted accounting principles. This affected the group's accounting for joint ventures as well as for other companies within the Hutcheson conglomerate. The principles governing the recognition of subsidiaries were discussed in the S.D.F. case study. As early as 1946, the profession recommended the recognition of subsidiaries, and hence consolidation, wherever a company held a direct or indirect controlling interest in another company.[79] In addition, a *Society Bulletin*, published in 1968, defined a subsidiary as a company controlled by a holding company, through share ownership. However, the bulletin also recognized

> "A good case might also be made for the inclusion in a consolidation of an associated company whose operations are integrated with those of the group and which is effectively controlled by the holding company otherwise than through ownership of issued equity shares."[80]

In addition, under s.6 of the *Uniform Companies Act, 1961*, a company was deemed a subsidiary where the investor company controlled the composition of the board of the investee, or controlled more than half of its voting shares or held more than half of its issued capital. Furthermore, the definition in s.6 covered the situation where shares in the investee were held by a nominee of the investor.

Thus, by 1968, it was clear that the law and the accounting profession interpreted control as meaning effective control. Yet, Cambridge's

[79] It should be noted that the 1946 pronouncement was not endorsed as an accounting standard in the early 1970s. However, the principles, spelled out in this pronouncement, remained relevant.

[80] Australian Society of Accountants, [1968, p.19].

accountants and auditors interpreted control in the nominal sense of share ownership. Subsidiaries were only recognized where Cambridge, itself, held more than fifty per cent of the issued shares with voting rights attached. In some cases, when this criterion was met, subsidiary status was overlooked. In other cases, it was deliberately concealed. Hutcheson and Davis-Raiss apparently initiated these manipulations which disregarded generally accepted accounting principles. Purcell should have been aware of the failure to recognize the subsidiaries in which Cambridge held more than fifty per cent of the capital. In addition, he should have been aware of the effective control over many of the other companies within the Hutcheson conglomerate, since Fell and Starkey were also the auditors of the most significant of these companies. However, it should be acknowledged that although the profession had defined subsidiaries in terms of effective control, it had made little effort to operationalize this concept. The profession did not endorse the 1946 recommendation, with its concept of effective control, as an accounting standard in the early 1970s. In practice, the identification of subsidiaries solely on the basis of share ownership was widespread.[81] This situation was not remedied until 1983 when *AAS14*, the standard on equity accounting, was issued.

4. The revaluation of shares held in a real estate subsidiary

The revaluation of Capital Realty in the draft accounts for 30 June 1974, occurred in an area where the appropriate principles may have been unclear. Capital Realty was a land development company. Its major asset consisted of an option to purchase development land near Canberra. It may have been unclear

[81] This problem was resolved, to some extent, with the issue of a standard on equity accounting in 1983, which was based on the concept of "significant influence" over the investee. (See Institute of Chartered Accountants in Australia/Australian Society of Accountants [1983].)

whether this asset should have been classified as current or non-current. On the one hand, the Cambridge group was heavily involved in real estate development and, under these circumstances, it could be argued that real estate related assets should have been treated as part of the group's stock-in-trade. On the other hand, there were no clearly defined accounting principles which dealt specifically with accounting for real estate development and the appropriate classification of an option to purchase real estate simply may not have been apparent. If the option had been classified as a current asset, under generally accepted accounting principles it should have been recorded at the lower of cost or net realizable value. If the option had been classified as non-current, a revaluation may have been appropriate, although the accepted principles in accounting for revaluations had not been defined. As discussed in earlier case studies, an accounting standard on revaluations was not issued until 1981 and no standard has been issued on real estate developments. However, the case for this revaluation is questionable because the evidence suggests that, by the time Cambridge's preliminary results were announced, the directors had decided not to purchase the land and the option was worthless.

5. The failure to take account of a post balance date event

Capital Realty's revaluation was reversed, probably after 30 June 1974 but before the record profit announcement based on the 1973-74 accounts. The reversal required the write-off of a $1.15m loss and the recognition of a liability of $0.85m. The first pronouncement to deal with post-balance date events was not issued by the accounting profession until 1978.[82] This standard dealt with the accounting for events occurring after balance date,

[82] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1978c].

but prior to the completion of the financial statements. It required disclosure of certain post balance date events. For example, where an event elucidated or revealed conditions existing at balance date, its effects were to be included in the financial statements. In addition, where the failure to disclose an event resulted in misleading statements, the event was to be disclosed in a note to be the financial statements. Cambridge's draft accounts for 1973-74, which were presumably finalized around the time of the press release, therefore, contravened this accounting standard. However, at the time the accounts were prepared, no such standard existed and the principles applicable to this area had not been spelled out.

6. The payment of fictitious commissions and procuration fees on the purchase of assets

The addition of fictitious commissions and procuration fees to the cost of shares and land purchased by Cambridge violated the first two basic objectives of accounting, identified by Kenley [1970, p.19]. In most cases, these costs were capitalized as part of the cost of the assets, although, in at least one case, they were expensed against current profit. On each occasion no services had been provided. The recording of these "transactions" ensured either that Cambridge's recorded profit did _not_ "fairly present the results of operations for the period" or that assets were _not_ accounted for "in a meaningful manner", to provide "a fair presentation of the financial position of the enterprise".

More specifically, in the Cambridge era, generally accepted accounting principles required investments in shares, as non-current assets, to be recorded at acquisition cost.[83] The inclusion of fictitious charges overstated the cost of shares purchased by Cambridge, and, therefore, contravened generally accepted accounting principles. As far as land is concerned, generally accepted accounting principles required that land acquired for development and resale should be classified as trading stock, and recorded at the lower of cost or market value. The commission paid by Cambridge on the purchase of land from a third party, should not have been recorded as part of the cost of this land since no services had been received in exchange for the commission.

The "procuration fee" recorded on the purchase of Kingscliffe shares, which was paid to Northumberland and expensed by Cambridge, also constituted a violation of generally accepted accounting principles, because Northumberland provided no services in return for the fee. The accounting profession has made no pronouncement which deals specifically with the recognition of expenses. However, under generally accepted accounting principles, an expense is incurred when resources are used up in the production of revenue.[84] The procuration fee used up resources, but was unrelated to the production of revenue.

7. The diversion of profits on the sale of shares

The diversion to Hunter of profit on the sale of shares owned by Cambridge also violated generally accepted accounting principles. The gain on the sale of the shares was understated by Cambridge because it recorded commission expenses even though services had not been performed by Hunter.

[83] The generally accepted accounting principles relevant to accounting for investments in shares were discussed in the S.D.F. case study.

[84] Henderson and Peirson [1975, pp.77].

The accounting for this transaction clearly violated Kenley's first basic objective of accounting.

8. The overstatement of the acquisition costs of investments

Cambridge purchased most of Hunter's unprofitable investments. The shares were transferred at book value, which was greater than market value, simply to reduce Hunter's debt to Cambridge as much as possible.[85] As discussed above, investments in shares, as non-current assets, should be recorded at acquisition cost. However, the payment of greater than market value for shares which could have been obtained at market value, suggests that the transaction lacked commercial validity and, therefore, that the cost had been overstated.

9. The recording of debtors at a cost greater than their realizable value

Cambridge paid more than the realizable value for debtors purchased from Hunter and recorded the debtors at their acquisition cost. Under generally accepted accounting principles, the debtors should have been recorded at their expected realizable value.[86]

10. The disguised write off of bad debts

Cambridge subsequently wrote off most of the Hunter debts without disclosure. In addition, it disguised the write-off of sizeable debts due from various Hutcheson controlled companies, by debiting accounts such as "Interest Received". On one occasion, it capitalized a bad debt as an

[85] New South Wales, Parliament [1979, pp. 212-216].

[86] The principles relevant to accounting for debtors were discussed in the 1960s case studies.

interest free loan. There was no accounting standard which dealt with bad debts but this treatment contravened the generally accepted accounting principles, set out in the A.S.A. pronouncement on bad debts, which required that

> "The actual writing off of bad debts should always be made against the provision for doubtful debts or directly charged to profit and loss account where the provision, if any, is inadequate.[87]

Cambridge management justified the debits to "Interest Received" on the grounds that they were reversals of interest previously charged, but the inspectors found no evidence to support this claim.[88]

11. The inadequate provision for bad debts

Despite these write offs, the various insolvent Hutcheson companies became increasingly indebted to Cambridge which made inadequate provision for default by these and other debtors. Indeed, it used Hutcheson companies to disguise its need to increase the provision for bad debts. The inadequate provision for bad debts contravened generally accepted accounting principles. As discussed in the 1960s case studies, accepted accounting principles required that debtors be recorded at their realizable value, with adequate provision for doubtful debts. During 1977 and 1978, the trustee for the debenture holders instigated a number of court actions against the Cambridge auditors and directors, although only those against the auditors have been pursued. The trustees have charged that, amongst other things, Fell and Starkey did not warn them of the inadequate provision for doubtful debts made by Cambridge and its subsidiaries. On 27 June 1983, the Supreme Court of

[87] Australian Society of Accountants [1967].

[88] New South Wales, Parliament [1979, p.273].

N.S.W. found that Purcell, as auditor, had failed to act with reasonable prudence in his audit of the 1971 accounts, in not requiring provisions for debts due from various companies controlled by Hutcheson. On 17 September 1983, the court ruled that although the auditors had committed a breach of duty, they were not liable for damages because it had not been shown that the auditors' negligence caused the debenture holders' losses. In March 1985, this decision was reversed and the Supreme Court of New South Wales awarded damages of $145m against the partners of Fell and Starkey.[89]

12. The failure to provide for losses on investments in insolvent companies

By 30 June 1974, Cambridge held Northumberland shares with a book value of $1.5m. In the Cambridge era, where investments in shares were intended to be held continuously, generally accepted accounting principles required that they should be recorded at cost. However, given Northumberland's insolvent condition, some provision for loss should have been included in Cambridge's accounts. Under these circumstances, the non-current "held continuously" classification becomes inappropriate, and the investment should have been written down to its realizable value.

13. The capitalization of interest twice

The capitalization of interest on a joint venture twice violated the second basic objective of accounting, identified by Kenley [1970, p.19], which

[89] *Adelaide Advertiser*, 13 September 1983 and *Business Review Weekly* 10-16 September, 1983 discuss the original decision. For details of the decision against the auditors see *Australian Financial Review*, 26 March 1985. In addition to this action, in March 1985 the N.S.W. Attorney General laid charges against Purcell and the four directors, for conspiracy to cheat and defraud investors and possible investors.

required assets to be reported in a way which provided a fair presentation of the entity's financial position.

14. The failure to amortize goodwill associated with insolvent subsidiaries

The inclusion, in the balance sheet at 30 June 1973, of $0.88m goodwill on consolidation, which related to unprofitable and/or insolvent subsidiaries, overstated the assets of the Cambridge group. Under generally accepted accounting principles, the goodwill should have been amortized as it became exhausted by the passage of time.[90] The Corporate Affairs investigation showed that these subsidiaries had no potential value at 30 June 1973 and therefore, the goodwill associated with their acquisition should have been written off.[91]

15. The amortization of goodwill against unappropriated profits

The goodwill associated with insolvent subsidiaries was, in fact, amortized in the draft accounts for 30 June 1974. However, this amortization also contravened generally accepted accounting principles. First, its deferment until 1974 contravened the matching principle, although having been omitted in 1973, it was better recognized in 1974 than not at all. Second, the write-off was made by debiting the profit and loss appropriation account. The standard on profit and loss statements issued in December 1973 required all charges, including prior adjustments, to be put through the

[90] The principles relevant to accounting for the amortization of goodwill were discussed in the R.M.A. case study. The 1947 recommendation dealing with amortization was superseded in 1970 and, again, in 1974. However, both of these subsequent versions confirm that the goodwill should have been amortized. In addition, the exposure draft on accounting for goodwill, issued in 1983, requires the amortization of goodwill over the time during which benefits are expected to arise. See Australian Accounting Standards Board [1983].

[91] New South Wales, Parliament [1979, p.298].

profit and loss statement, either as part of operating profit or, in certain circumstances, as extraordinary items.[92]

16. The accounting for joint venture loans from outsiders

Cambridge included in the asset "Mortgages and Other Receivables" loans by third parties to development ventures in which it held a primary interest. The loans were in no way receivable by Cambridge and the fact that Cambridge recognized the liability for these loans does not justify this treatment. Cambridge was the registered proprietor of these ventures and was primarily liable for their debts. As such, Cambridge effectively owned a part of the development ventures and it should have recorded the cost, or if lower, the realizable value of its share of the assets of the ventures, under the classification, "Development Ventures". The second basic objective of accounting, identified by Kenley [1970, p.19], was to account for assets in a meaningful manner and Cambridge's treatment of joint venture loans from third parties did not satisfy this objective. More specifically, the revised I.C.A.A. pronouncement on balance sheets, issued in 1963 and reissued in 1970, recognized that

> "A true and fair view implies appropriate classification and grouping of items ...[93]

Although not accorded the status of an accounting standard in the 1970s, this recommendation confirmed generally accepted accounting principles.

The accounting for joint ventures was an exceedingly complex area, in which the profession had not defined any specific accounting principles.

[92] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1973d].

[93] Institute of Chartered Accountants in Australia [1963a] and [1970g].

Indeed, one cannot help but suspect that the joint venture form of business organization was attractive to Cambridge because of its "off-balance sheet" characteristics and its scope for the manipulation of reported results and financial position. However, in this case Cambridge's procedures violated the most basic principles of accounting.

17. The accounting for advances to wholly owned and incorporated joint ventures

The inclusion, within "Mortgages and Other Receivables", of advances from Cambridge to certain development ventures also contravened generally accepted accounting principles. Many of the ventures were wholly owned by Cambridge or were incorporated ventures in which Cambridge effectively held a greater than 50 per cent interest. Under the generally accepted accounting principles discussed earlier, these ventures should have been treated as subsidiaries, with the advances eliminated in the group accounts and the assets of the ventures recorded as "Development Ventures".

18. The accounting for advances to unincorporated and unstructured joint ventures.

The inspectors also argued for the elimination of advances to the unincorporated and unstructured joint ventures in which Cambridge held a substantial interest, at least to an extent proportionate to Cambridge's interest. They claimed that, from Cambridge's viewpoint, the "advances" to these unincorporated joint ventures, or at least a substantial part of them, constituted advances to Cambridge itself. This interpretation is substantiated by Davies [1983], in his book *Unincorporated Joint Ventures, Accounting and Auditing Implications*. According to Davies [1983, p.11]

> "In its financial statements ... each participant should substitute for these cumulative contributions its proportionate share of ... each of the assets and liabilities of the joint venture."

However, Davies published his work in 1983 because of the lack of clearly defined principles in this area, which he attributed partially to the wide variety of ways in which investments in an unincorporated joint venture can be legally structured. The profession remedied this situation in October 1985 with its issue of a standard on accounting for joint ventures. On the one hand, it is possible that Cambridge was unsure of the appropriate method of accounting for its investments in unincoprporated joint ventures. On the other hand, it is also possible that Cambridge deliberately chose the joint venture format which gave it the opportunity to present its investments in the most favourable light, especially from the point of view of the debenture trust deed. Certainly, the existence of joint ventures with no final structure suggests that Cambridge sought a flexible approach in accounting for joint ventures.

19. The revaluation of real estate

Cambridge's revaluation of real estate in the December 1973 accounts was particularly significant from the investors' viewpoint, because of its influence over the company's borrowing capacity in 1974. The revaluation was not included in the balance sheet, but in the notes to the accounts. It related to real estate held for development which should have been treated as trading stock and valued at the lower of cost or market. However, as discussed in the S.D.F. case study there have been no pronouncements which specifically deal with accounting for real estate held by development companies and, in 1974, there were no clearly defined principles in the area of asset revaluations. As such, the revaluation was made in an area where there was a lack of clearly defined accepted accounting principles. It is no less significant because of its inclusion in the notes, rather than the body of the accounts, as evidenced by the fact that the auditors' adopted the revalued amounts in their calculation of Cambridge's borrowing limits.

20. The incorrect calculation of liquid assets

The real estate revaluations allowed the borrowing limits for Cambridge's last prospectus to be based on liquid assets rather than shareholders' funds. Liquid assets were calculated to include, as part of "Mortgages and Other Receivables", loans from third parties and from Cambridge itself, to development ventures in which Cambridge had a substantial interest. As discussed above, this treatment violated generally accepted accounting principles. Also, the inclusion of stock, shares held by guarantors and the assets of five non-guarantor subsidiaries within liquid assets violated the terms of the trust deed. Cambridge's principal accounting officer, Davis-Raiss, calculated liquid assets and shareholders' funds, although the calculation of the borrowing limits was presented in prospectuses in the name of the auditor, Purcell.[94] Subject to one minor correction, Purcell did not scrutinize Davis-Raiss' calculations. The I.C.A.A. prcnouncement issued in 1963, entitled *Accountants' Reports for Prospectuses*, did not deal with the calculation of borrowing limits. Indeed, there has been no pronouncement issued by the profession, in this area. However, there is little doubt that the performance of both Davis-Raiss and Purcell would have been below the standard expected by the profession. As the Corporate Affairs inspectors concluded

> "... the auditors were not alert to the way in which Cambridge was dealing with the borrowing limitations in seeking to make a further

[94] New South Wales, Parliament [1976-77, p.245].

> issue of debentures and they did not sufficiently apprise the trustee, or ultimately the lending public of this."[95]

Table 8.9 classifies Cambridge's financial statement misinformation according to whether it resulted from compliance with, the violation of, or possibly the lack of generally accepted accounting principles. It shows that 16 of the 20 sources of misinformation resulted from the violation of generally accepted accounting principles, although the profession had specifically endorsed procedures in only 5 of these areas. As far as the responsibility hypothesis is concerned, the lack of endorsed procedures in the other 11 areas was not particularly significant because the principles in these areas were well understood and accepted. The non-compliance in these 16 areas was not disclosed in the financial statements or the auditors' reports. It can be concluded, therefore, that Cambridge's management and the individual accountants and auditors involved with the group's financial statement data were primarily responsible for the financial statement misinformation. Thus, the evidence does not support the responsibility hypothesis.

In assessing the responsibility of the individuals involved, it should be noted that Cambridge's managing director, R.E.M. Hutcheson, was an associate of the A.S.A.[96] The Corporate Affairs investigation showed that Hutcheson dominated Cambridge's management. From September 1970, Cambridge's principal accounting officer, E. R. Davis-Raiss, who was an associate of the I.C.A.A., was also a director. Davis-Raiss had been the group accountant and assistant secretary since 1960, and company secretary since 1962. The Corporate Affairs investigation found that Davis-Raiss was largely responsible for the

[95] New South Wales, Parliament [1976-77, p.226].

[96] Hutcheson's and Davis-Raiss' accounting qualifications were shown in the list of directors, published in both the prospectuses and annual reports.

Table 8.9 Responsibility for the the Cambridge Financial Statement Misinformation

Source of Misinformation	Contravened endorsed procedure in this or related area	Contravened widely understood and accepted principles	Complied with endorsed procedure	Complied with widely understood and accepted principles	No clearly defined GAAP in this area
1. Front end land sales - unrealized profits		X			
2. - inconsistent procedures		X			
3. Failure to recognize subsidiaries		X[a]			
4. Revaluation of shares held in a real estate subsidiary					X
5. The failure to take account of a post balance date event					X
6. Payment of fictitious commissions and procuration fees on the purchase of assets, and the associated overstatement of the cost of these assets or expenses.		X			
7. Diversion of profit on the sale of assets.		X			
8. Overstatement of acquisition cost of investments in shares.		X			
9. Recording of acquired debtors at greater than realizable value.	X				
10. Bad and doubtful debts - disguised write-off against other accounts	X				
11. - inadequate provision	X				
12. Failure to provide for losses on investments in insolvent companies.		X			
13. Capitalization of interest twice.		X			
14. Failure to amortize goodwill associated with insolvent subsidiaries.	X				
15. Amortization of goodwill against unappropriated profits.	X				
16. Joint ventures - accounting for loans due to outside financiers		X[a]			
17. - accounting for advances to wholly owned or incorporated ventures		X			
18. - accounting for advances to unstructured and unincorporated ventures					X
19. Revaluation of real estate.					X
20. Incorrect calculation of liquid assets		X[b]			
	5	11	-	-	4

Notes:

a. Although covered by a pronouncement issued by the profession, by the early 1970s this pronouncement was not endorsed as an accounting standard.

b. Generally accepted accounting principles have not been promulgated in this area. However, the individual accountants involved with this matter showed a standard of care which would have been unacceptable to the profession.

accounting practices adopted by Cambridge. Hutcheson was aware of the practices devised by Davis-Raiss and, in many cases, also played a significant part in developing them.[97] Hutcheson's and Davis-Raiss' responsibility for the financial statement misinformation is emphasized by the fact that for most of its existence the Cambridge board had only four members. The remaining two had no accounting knowledge. Prior to their appointment, one had been a butcher and the other, an insurance clerk. In addition, Cambridge's auditors, Fell and Starkey, were a firm of chartered accountants. The partner-in-charge, D. M. Purcell, was a member of the I.C.A.A. By the time the deficiencies in the Cambridge accounts became apparent, the journals of the I.C.A.A. and the A.S.A. published the names of most members against whom serious disciplinary charges were proven. Yet there is no record in the journals of the I.C.A.A. or A.S.A. of any member involved with the Cambridge accounts being disciplined. (It is possible, however, that disciplinary proceedings may still be instigated. As the Cambridge case was still before the courts in 1985, it may yet reach the investigation committees of the I.C.A.A. and/or A.S.A.)

Four of the twenty sources of misinformation occurred in areas where there were no clearly defined accounting principles. Given the nature of the process of developing accepted accounting princples, the profession cannot be held responsible for this misinformation. It has covered the lack of principles with the issue of standards in the areas of accounting for revaluations, post-balance date events and joint ventures. These standards were issued within a reasonable period of time as the inadequacies in

[97] The roles of Cambridge's directors in management, and their responsibility for accounting matters are discussed in New South Wales, Parliament [1976-77, pp.22-25]. The inspectors found that Hutcheson was responsible for the overall structure of the conglomerate whilst he left the detail of the structure to Davis-Raiss (see New South Wales, Parliament [1979, p.22]).

Cambridge's financial statement data did not become apparent until the release of the reports of the government inspectors in the late 1970s. However, the misinformation also involved development real estate and, once again, the accounting profession can be criticized for not issuing a standard in this area.

8.4 Conclusions

From the viewpoint of investors, Cambridge's failure was significant as it resulted in losses, measured in book values, of at least $64m and possibly as much as $87m. In addition, Cambridge investors have incurred and continue to incur substantial losses in purchasing power and opportunity costs in having funds, which eventually may be recovered, tied up over a considerable period.

Despite impressive profit reports in the two years immediately prior to receivership, Cambridge's financial statement data generally showed that the group was not a particularly attractive investment opportunity for investors in shares, debentures or notes. However, the data gave no hint that failure was imminent. Indeed, the financial statement data implied that investments in Cambridge were adequately covered and that Cambridge still had substantial borrowing capacity.

The evidence presented in this chapter shows that, from at least 1966, Cambridge's financial statements significantly overstated profits, assets and shareholders' funds. This, in turn, enabled Cambridge to continue to borrow, when, in fact, under the terms of the debenture trust deed, the company was without further borrowing capacity. Financial statement misinformation, therefore, contributed substantially to the losses of Cambridge investors. These findings are consistent with the misinformation hypothesis. Cambridge's financial statement data misrepresented the group's results and financial position and, therefore, did not provide investors with a clear warning of the group's demise.

The overstatement of assets and shareholders' funds in the Cambridge accounts was significantly less than the write-downs eventually recognized by the receivers. Although some of the write-downs related to current asets which should have been recorded at realizable value, it is likely that a substantial part of them resulted from the change from going concern to liquidation based accounting. The auditors should have doubted Cambridge's viability, particularly because of its large advances to a series of unprofitable companies, and the implications of these doubtful debts for the group's borrowing capacity. There was probably sufficient evidence to indicate that the going concern assumption was inappropriate for Cambridge's later pre-collapse accounts. The failure to drop this assumption provides further support for the misinformation hypothesis.

Cambridge's misinformation resulted largely from the violation of generally accepted accounting principles and, as such, was primarily the responsibility of management and the individuals involved with the preparation and audit of Cambridge's financial statement data. The profession, however, may be criticized for not yet disciplining members involved with the Cambridge financial statements. Misinformation occurred in four areas where there were no clearly defined accounting principles. The accounting profession cannot be held responsible for this misinformation. It has subsequently issued standards which define the accepted principles in three of these areas. However, the lack of principles in the area of accounting for real estate was a serious deficiency in the Cambridge case and the profession should be criticized for not issuing a standard in this area. In conclusion, the findings are not consistent with the responsibility hypothesis, although they do indicate that the accounting profession has failed to meet certain responsibilities in the areas of discipline and standard setting.

CHAPTER 9

ASSOCIATED SECURITIES LIMITED

In February 1979, Associated Securities Limited (A.S.L.) went into receivership, after reporting a loss of $3.5m for the half-year to 31 December 1978. The company had operated since 1926 and, despite substantial losses during the depression years, had grown to be one of Australia's major finance companies.[1] From the early 1960s, the Royal Bank of Scotland had been one of A.S.L.'s major shareholders. In late 1976, Ansett Transport Industries (A.T.I.) bought out the Royal Bank of Scotland and purchased further shares on the open market, to make an effective "takeover" of A.S.L.[2] Investors appeared to hold A.S.L. in high regard. Its last issue of debentures, which was withdrawn two weeks before receivership, attracted over $20m.[3] Since receivership, A.S.L.'s first charge debenture holders have been repaid in full. Second charge debenture holders may recover most of their principal but not accrued interest, and depositors and shareholders are likely to suffer substantial losses.[4] A.S.L.'s failure raises a number of questions. Why did the public invest $20m in a company which was about to collapse? Did the affairs of A.S.L. suddenly deteriorate from late 1978, or were subscribers to the last debenture issue, and possibly other A.S.L. investors, misled about the company's performance and financial condition? Did the investor losses

[1] The history of A.S.L. can be traced through various issues of the Sydney Stock Exchange publications, *Investment Service and National Times*, 10 March 1979, pp. 22-25 and 27.

[2] In December 1976, A.T.I. acquired 48.4 per cent of A.S.L.'s share capital (*The Bulletin*, 20 February 1979, p.20). Given the distribution of A.S.L.'s remaining issued share capital, this constituted a takeover, in all but the strict legal sense.

[3] *The Bulletin*, 20 February 1979, p.21.

[4] *Adelaide Advertiser*, 14 September 1982, p.18 and 17 February 1984, p.12.

result from the forced sale of the group's assets, following receivership, or were the losses actually incurred prior to receivership, but not disclosed in the group's financial statements? The directors attributed these losses to the effects of receivership, which they alleged had

> "... substantially negated the underlying going concern assumptions upon which previous financial statements had been prepared, which recognized the orderly realization of assets and the liquidation of liabilities in the ordinary course of business."[5]

This chapter assesses the losses of A.S.L. investors and considers whether the company's financial statement data were potentially misleading and, if so, the extent to which the accounting profession can be held responsible.

9.1 The Losses of A.S.L. Investors

At receivership, A.S.L. had five main classes of investors. They were ordinary shareholders, preference shareholders, depositors and first and second charge debenture holders. Table 9.1 traces the growth in funds invested in A.S.L. over the two decades prior to receivership. During this time, ordinary share capital increased from $2.69m to $25.03m. This growth occurred mainly over the late 1960s and early 1970s. Preference shares were not issued until 1977-78 and accounted for the $10m increase in issued capital from that time. This capital was subscribed by A.T.I. following its "takeover" of A.S.L. in late 1976. Share premiums also grew significantly over the period, from $3.26m to $9.32m, with major increases occurring in the late 1960s and early 1970s. A.S.L.'s affairs have not yet been finalized, but at receivership, the consolidated statement of affairs showed an estimated deficiency of $12.04m.[6] This implied that the entire $44.35m subscribed by

[5] Associated Securities Ltd, *Annual Report 1979*, Directors Report, p.2.

[6] Associated Securities Ltd., Statement of Affairs, at 8 February 1979.

Table 9.1: Funds Invested in A.S.L. (in $m)

At 30 June	Issued share capital	Share premium reserve	Share-holders' invest-ment[1]	Debentures		Term deposits[2]
				First charge	Second charge	
1960	2.69	3.26	5.95	7.83	-	12.53
1961	2.69	3.26	5.95	13.65	-	15.87
1962	3.36	2.59	5.95	19.01	-	17.69
1963	3.36	2.59	5.95	28.61	-	18.82
1964	4.81	3.93	8.74	32.29	-	20.02
1965	4.81	3.93	8.74	40.17	-	17.45
1966	4.81	3.93	8.74	46.12	-	15.54
1967	6.02	5.14	11.16	55.45	-	19.95
1968	9.03	8.15	17.18	68.64	-	26.51
1969	9.03	8.15	17.18	83.04	-	34.11
1970	12.07	11.19	23.26	97.34	-	35.36
1971	13.98	10.09	24.07	126.41	-	30.44
1972	19.00	15.10	34.10	146.39	-	17.19
1973	21.41	12.81	34.22	166.09	54.13	32.38
1974	25.03	9.32	34.35	188.08	57.46	35.06
1975	25.03	9.32	34.35	161.15	43.59	18.39
1976	25.03	9.32	34.35	153.47	33.26	11.47
1977	25.03	9.32	34.35	132.52	26.49	19.43
1978	32.03[3]	9.32	41.35	165.81	23.84	27.62
8/2/79	35.03[4]	9.32	44.35	191.86	41.22	14.79

Source: Based on data drawn from Associated Securities Ltd, Audited Financial Statements, Years ended 30 June 1960 to 30 June 1978, and the Statement of Affairs, at 8 February 1979.

Notes:

[1] Shareholders investment comprises paid up capital plus premiums.

[2] Prior to 30/6/72 includes unsecured notes.

[3] Includes $7.00m preference shares.

[4] Includes $10.00m preference shares.

shareholders and, as well as any unappropriated profits, had been lost.[7] At receivership, unappropriated profits were negligible, although they had been as high as $20.81m, at 30 June 1975.[8]

The growth of first charge debentures issued over these two decades was also substantial. Table 9.1 shows that they increased from $7.83m to $191.86m at receivership. The trust deed covering these first charge debentures was regarded as one of the most restrictive in the finance industry.[9] By 30 June 1982, A.S.L.'s first charge debenture holders had recovered their entire principal plus accrued interest.[10]

Second charge debentures were first issued in 1972-73 and by 30 June 1973, $54.13m had been invested in these debentures. According to the statement of affairs, amounts owing to second charge debenture holders totalled $41.22m. The realizable value of the group's assets was estimated to be sufficient to cover second charge debenture debts, at the date of receivership. These estimates allowed for a deficiency of $6.90m on debts owed by the group's finance subsidiary, Associated Securities Finance Ltd. (A.S.F.).[11] Subsequent reports indicate that the sale of A.S.F. resulted in a deficiency on the A.S.F. debt of approximately $18m. This would reduce the estimated surplus available to repay second charge debenture holders to

[7] It was reported in the *National Times*, 10 March 1979, p.27, that A.S.L.'s preference share capital of $10m, which was subscribed entirely by A.T.I. during 1978, was paid into a trust account and will be repaid. However, this was not evident from the 1979 accounts.

[8] Associated Securities Ltd, *Annual Report, 1975*.

[9] *The Bulletin*, 3 April 1976 p.33. According to the Trust Deed, Cl. 8(2), A.S.L.'s first charge debenture borrowing was limited to the lesser of two thirds of tangible assets, excluding unearned income, or five times shareholders' funds.

[10] *Adelaide Advertiser*, 14 September 1982, p.18.

[11] Associated Securities Ltd., Statement of Affairs, 8 February 1979, Schedule B.

approximately $37.39m, which implies a shortfall of approximately $3.83m.[12] Moreover, between the appointment of the receiver and 30 June 1982, when first charge debenture holders were paid out, interest of $31.74m had accrued on these debentures.[13] On the basis of the statement of affairs valuations, adjusted for the actual value of the A.S.F. debt and accrued interest on first charge debentures, second charge debenture holders could expect to lose approximately $35.57m of their principal.[14] However, the realizable values of assets other than the A.S.F. debt appear to have been understated. In February 1984, the trustee for the debenture holders announced that second charge debenture holders could recover between 80 cents and 100 cents in the dollar on outstanding principal.[15] This implied maximum losses of principal of approximately $8.24m. By September 1983, payouts to A.S.L.'s second charge debenture holders amounted to $16.45m.[16]

Apart from losses of principal, A.S.L.'s debenture holders have also incurred an opportunity cost in having funds, which may have been earning a return below that of alternative investment opportunities, tied up for an

[12] *Australian Financial Review*, 5 February 1980, reported an estimated deficiency in the A.S.F. debt of $17m. The 1979-80 accounts included a $19m provision for doubtful debts against the receivables of a related company, subsequently disposed of. Presumably this write-off relates to A.S.F.

[13] Total payments to first charge debenture holders amounted to $223.6m (*Adelaide Advertiser*, 14 September 1982, p.18). Amounts due, at receivership, were $191.86m.

[14]

	$m
Surplus available for second charge debentures, Statement of Affairs	$48.49
Plus estimated loss on realization of A.S.F., Statement of Affairs	6.90
Less actual loss on realization of A.S.F., approx	(18.00)
Less accrued interest, first charge debentures	(31.74)
Adjusted surplus available for second charge debentures	5.65
Less principal due to second charge debenture holders	41.22
Loss of second charge debenture principal	(35.57)

[15] *Adelaide Advertiser*, 17 February 1984, p.12.

[16] *Adelaide Advertiser*, 21 June 1983, p.22 and 27 September 1983, p.18.

extended period. They have also incurred losses in purchasing power on those funds. For first charge debenture holders, this opportunity cost was probably insignificant. It involved an enforced investment between February 1979 and June 1982, at below market interest rates.[17] However, the terms of some first charge debentures had extended beyond 1982 and would not normally have been retrieved any earlier. In addition, the principal repayments and accrued interest were spread over a 40 month period to 30 June 1982. Similarly, with the recovery of principal and accrued interest spread over less than three and a half years, the losses of purchasing power suffered by first charge debenture holders were probably relatively insignificant. The costs to second charge debenture holders both in terms of earnings foregone and lost purchasing power, however, are likely to be higher. Second charge debentures were generally issued for shorter terms than first charge debentures and, therefore, would normally have been retrieved earlier than under receivership. In addition, second charge debenture holders did not start to recover their principal until 30 June 1983. Further recoveries may take some time and it is most unlikely that any interest will be paid.

Table 9.1 shows that funds raised through term deposits grew erratically to $14.79m at receivership. According to the statement of affairs, the realizable value of A.S.L.'s assets was sufficient for depositors to recover approximately 39 cents in the dollar. However, subsequent estimates suggest that A.S.L. depositors are unlikely to recover any of their investment. Even if the remaining assets are liquidated at greater than their current estimated realizable value, any surplus is likely to be fully absorbed by interest

[17] A.S.L. offered interest rates as high as 13.5 per cent on first and second charge debentures. (see *Prospectus No 34*). By 1982 market rates were considerably higher than this. For example, in April 1982, Esanda, the A.N.Z. finance subsidiary, offered debenture interest rates of up to 16 per cent.

accruing on second charge debentures.

To summarize, the evidence suggests that A.S.L.'s failure will result in investor losses of between $80m and $88m. These include $44.35m invested by shareholders, including A.T.I., and $14.79m invested by term depositors. They also include unappropriated profits of $20.81m which were lost by A.S.L. over the last few years prior to receivership. In addition, they include estimates of the losses of principal by second charge debenture holders which have ranged from nothing to $8.24m. Moreover, the above estimates ignore the losses incurred by second charge debenture holders from earnings forgone on, and the decline in purchasing power of, any principal eventually recovered.

9.2 Testing the Misinformation Hypothesis for A.S.L.

9.2 (i) The Relevant Period and the Relevant Data

In Chapter 3, the relevant period for analysis was defined as the time during which the company was most active in seeking the investors' funds which were lost in the company's failure. A.S.L. was incorporated in 1926 but Table 9.1 shows that it was not active in seeking investor funds until the late 1960s. It seems probable, therefore, that the financial statement data issued from the late 1960s would have been the published accounting information most relevant to the investors caught in the collapse of A.S.L. Most of the investors' funds lost in A.S.L.'s failure were contributed since the late 1960s. Second charge debentures were not issued until the early 1970s. Although term deposits were accepted before the late 1960s, these were generally a short to medium term investment. It is unlikely that the term deposits lost in 1979 were subscribed before the late 1960s. Some of A.S.L.'s shareholders, who lost in the collapse, may have made their investment decision before the late 1960s. However, most of the share capital was issued subsequently.

The relevant data were defined as the financial statement data which may have influenced the investors who lost in the company's failure. A.S.L.'s shareholders, term depositors and second charge debenture holders suffered significant losses. The shareholders' likely perspective of A.S.L.'s condition can be determined by considering the data in the company's annual reports. Prospectus data are not relevant because share issues were not accompanied by prospectuses. Instead, share capital was raised through rights issues to existing shareholders, bonus issues from share premium reserves, staff issues and private placements. Moreover, the annual report data were not relevant to all of the share issues. For example, the $7.45m raised through bonus issues reflected a decision by management rather than investors, although investors had initially contributed the share premiums converted to bonus shares.[18] In addition, it is probable that A.T.I.'s decision to take up $10m of preference shares, following its acquisition of A.S.L., was based on privileged information rather than external accounting data. Similarly, it is possible that staff and private investor groups may have had access to private information, which could have lessened their reliance on publicly available financial statement data. However, existing shareholders had access to annual reports which may have influenced their decision to take up more shares. Furthermore, potential private investors and staff groups had access to annual reports as public documents.

A.S.L.'s annual reports for 1968 and 1969 consisted of a directors' report, consolidated and holding company financial statements and a five year

[18] Details of bonus issues from share premium reserves are included in the Notes to the Audited Financial Statements, for 1970-71, 1972-73 and 1973-74.

summary of progress. The directors' report contained financial statement data such as consolidated profit, the level of gross receivables, provisions for losses and reserves, and dividend payments. These data were drawn directly from the financial statements. The five year summary was identical to that presented in prospectuses over this period and contained information drawn directly from the audited financial statements. No comment can be made on the accounting content of the annual reports issued after 1969, because they are not available.[19] However, it has been possible to obtain copies of A.S.L.'s audited profit and loss statements and balance sheets and it is probable that these were the primary source of accounting information in the annual reports.

As discussed in Chapter 3, potential debenture subscribers are provided with prospectuses and existing debenture holders have access to audited financial statements. Second charge debentures were not issued until 1972-73. The accounting information available to these investors can be assessed from A.S.L.'s prospectuses and audited financial statements issued after that date. A.S.L.'s term depositors were not provided with either prospectuses or audited financial statements but as public documents, both were available to them. Given the nature of this form of investment, it is unlikely that many depositors would have sought financial statement data. It is possible, however, that a few institutional depositors were influenced by financial statement data. It is necessary, therefore, to assess the accounting information relevant to depositors in A.S.L.'s prospectuses and audited financial statements.

Between 30 June 1968 and receivership, A.S.L. issued twenty-two debenture prospectuses.[20] Although the format of these prospectuses varied, each made

[19] These reports were not contained in the files held by the Corporate Affairs Commission in either South Australia or in New South Wales, A.S.L.'s state of incorporation.

[20] Associated Securities Ltd, *Prospectus Nos 16 to 37*. Prior to November 1972, these prospectuses also covered the issue of unsecured notes.

considerable use of accounting data. For example, the prospectuses issued between August 1967 and March 1969 included a "Summary of Group Progress", which presented data based on the group's audited accounts from the previous five years.[21] It included a breakdown of assets into classes, (eg purchase and loan agreements, real estate mortgages, lease agreements, secured contracts and development projects), and details of borrowed funds, subscribed capital, reserves, profits after tax, as well as per share figures for earnings, dividends and asset backing.

The prospectuses also included a "Report from the Chairman", which emphasized the growth in assets, consolidated net profit and earning rate. These figures were drawn from financial statement data contained in the "Report of Chartered Accountants", which followed the chairman's report. The accountants' report included details of consolidated profits, paid up capital and dividend rates, over the past five years, and a statement of both parent company and group assets and liabilities, as at the end of the previous accounting period. It also included estimates of the company's borrowing limit, calculated in accordance with the trust deed, and of assets secured under the trust deed. These reports were prepared by Spry, Walker and Co., who were A.S.I.'s auditors during this period. The prospectuses issued from September 1969 to May 1974 also made use of accounting data.[22] The major differences between these and the earlier prospectuses were that the chairman's report was omitted and, from 1971, the chartered accountants' report was renamed the auditors' report.[23] Despite the change in title, the format of the accountants' report remained unchanged.

[21] Associated Securities Ltd, *Prospectus Nos 14 to 17*.

[22] Associated Securities Ltd, *Prospectus Nos 18 to 28*.

[23] Associated Securities Ltd, *Prospectus Nos 22 to 37*.

After May 1974, the emphasis on accounting data in the prospectuses changed.[24] The summary of progress was excluded and details of A.S.L.'s "business mix" and asset cover for debentures were added. The business mix information consisted of a breakdown of the group's assets into gross accounts receivable, development projects and commercial finance. The auditors' report no longer disclosed borrowing limits but did include some additional information, such as profit from operations, before and after tax, for the previous five years for A.S.L., for A.S.L. and guarantors, and for the A.S.L. group. Details of abnormal and extraordinary items were also given and profits were restated to take account of the prior period effects of changes in tax rates and changes in accounting policies. In other respects, the auditors' reports were similar to the earlier Spry, Walker and Co. reports, although the firm had now become part of Touche Ross and Co.[25] In addition, from March 1977, the A.S.L. prospectuses included a directors' statement which disclosed trading profit, income tax and abnormal and extraordinary items.[26] These data differed from the income data presented in the auditors' prospectus reports because of the prior period adjustments.

In brief, although the prospectuses made extensive use of accounting data and although their format changed considerably over time, the accounting information included in these prospectuses was based on either the accountant's reports in the prospectuses or the audited financial statements. An analysis of the data from these two sources should therefore indicate the perspective available to A.S.L.'s investors from the group's published accounting information.

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[24] Associated Securities Ltd, *Prospectus Nos 29 to 37*.

[25] Spry, Walker and Co. became part of Touche Ross and Co. in 1974-75.

[26] Associated Securities Ltd, *Prospectus Nos 34 to 37*.

9.2 (ii) A.S.L.'s Condition According to Its Financial Statement Data

9.2 (ii) (a) The Shareholders' Perspective

Table 9.2 summarizes the impressions of profitability and security which shareholders would have gained from A.S.L.'s consolidated financial statements. Between 1967-68 and 1972-73, after-tax profit grew steadily by around 20 to 22 per cent per annum, except in 1967-68 and 1971-72, when it grew by closer to 30 per cent. In 1973-74, the rate of growth in profit decreased to approximately 16 per cent and in 1974-75 profit was 66 per cent lower than in the previous year. In each year from 1975-76 through to receivership, A.S.L. reported a consolidated net loss, although in its last year, 1977-78, the loss was reduced to $0.16m.

The rate of return on ordinary shareholders' funds varied little over the period 1967-68 to 1972-73, ranging from a low of 12.06 per cent per annum in 1968-69, to a high of 12.98 per cent per annum in 1971-72. In 1973-74, the rate of return increased to 13.82 per cent per annum. From 1974-75, however, A.S.L.'s return on ordinary shareholders' funds declined sharply, to a minimum of -39.09 per cent per annum, in 1976-77. Comparing these rates of return to the "standard" rates presented in Tables 3.2 and 3.3, A.S.L.'s rate of return on its shareholders' funds was relatively low. In 10 of the 11 years considered, A.S.L.'s rate of return was lower than the industry average return on shareholders' funds. Furthermore, the rate of return earned by A.S.L. on its shareholders' funds was lower than the rate of return earned by A.G.C. in each of the 11 years and lower than the rate of return earned by B.F.C. in each year from 1970-71. From 1974-75, there was no doubt that A.S.L. was experiencing severe profitability problems.

A.S.L.'s dividend data also confirmed the difficulties from 1974-75. Table 9.2 shows that between 1967-68 and 1973-74 A.S.L. paid dividends of 16 per cent per annum on ordinary share capital. A comparison with Tables 3.2 and 3.3 shows that this exceeded the industry average and B.F.C. dividend rates over the period. It also exceeded the A.G.C. dividend rate in 6 of the 7 years over this period.[27] However, A.S.L. decreased its dividend rate in 1974-75, to 10 per cent per annum and in 1975-76, to 8 per cent per annum. From 1976-77, no dividends were paid. The A.S.L. dividend rate in 1974-75 exceeded the industry average dividend for that year, but it was below the A.G.C. and B.F.C. rates. From 1975-76, A.S.L.'s dividend rate was lower than the industry average, A.G.C. and B.F.C. rates. Thus, in terms of dividend rates, A.S.L. shares appeared to be a relatively attractive investment from 1967-68 to 1973-74, but not thereafter.

Table 9.2 shows that between 1968 and 1973, A.S.L.'s asset backing generally fluctuated between $1.21 and $1.23 per 50 cent ordinary share, although in 1969 and 1970 it increased to $1.27 per share. From 1974, however, asset backing per share declined and by 30 June 1978, it had fallen to 67 cents per share. Industry average asset backing figures are not available but Table 3.3 shows that over the corresponding period A.G.C.'s asset backing per share exceeded that for A.S.L. from 1972. On the other hand, B.F.C.'s asset backing per share was higher than A.S.L.'s only in 1977 and 1978. In terms of asset backing, therefore, until 1973 A.S.L.'s shares appeared to be sound. From 1974 to 1976, they were reasonably well covered but, by 1977, the asset cover, whilst still above par value, was relatively low.

[27] Table 3.3 shows that, in each year between 1967-68 and 1977-78, except 1972-73, A.G.C.'s dividend rate was 15 per cent per annum. The dividend rate in 1972-73 was 18.75 per cent.

Table 9.2: A.S.L.'s Profitability and Security, Shareholders' Perspective

Year ended 30th June	Consolidated Net Profit after tax[1] ($m)	% profit change over previous period	Return on av. ord. S.H.F.(%)[1]	% Dividend Rate (ord.shares)	Net asset backing per 50c share($)	Debt Ratio
1968	2.24	+27.27	12.20	16.0	1.21	0.82
1969	2.70	+20.54	12.06	16.0	1.27	0.85
1970	3.31	+22.59	12.35	16.0	1.27	0.82
1971	4.03	+21.75	12.48	16.0	1.21	0.83
1972	5.24	+30.02	12.98	16.0	1.23	0.82
1973	6.37	+21.56	12.94	16.0	1.21	0.84
1974	7.38	+15.86	13.82	16.0	1.10	0.85
1975	2.51	-65.99	4.55	10.0	1.07	0.83
1976	(5.42)	-315.94	(10.25)	8.0	0.99	0.82
1977	(16.63)	-206.83	(39.09)	0	0.68	0.85
1978	(0.16)	+99.04	(4.62)	0	0.67	0.85

Source: Associated Securities Ltd, Audited Financial Statements, Years ended 30 June 1968 to 30 June 1978.

Notes:
1 Excluding extraordinary items.

The debt ratio provides an additional indicator of investment security. Table 9.2 shows that A.S.L.'s debt ratio was reasonably stable, varying from 0.82 to 0.85. A comparison with Tables 3.2 and 3.3 shows that A.S.L.'s debt ratios were lower than the industry, A.G.C. and B.F.C. debt ratios in each year except 1969 when A.G.C. and A.S.L. both had debt ratios of 0.85. These data suggest that A.S.L. had relatively low gearing. It is interesting to note, however, that A.S.L.'s debt ratios were at their maximum of 0.85 in three of the five years prior to receivership. Before then, the debt ratio had reached 0.85 on only one occasion.

The financial statement data, issued over the period 1968 to 1978, indicated that A.S.L. shares were a relatively unattractive investment. Indeed, there is some evidence to suggest that a significant number of A.S.L. shareholders were aware of the group's weaknesses from as early as 1973. For example, A.S.L. share prices decreased significantly in September 1973 and again in September 1974. However, it is difficult to interpret these data without comparing them to movements in the share market as a whole. Moreover, even if A.S.L. share prices did fall relative to the market this does not indicate that there were *no* shareholders who were misinformed by A.S.L.'s financial statement data. It is tempting to argue that A.S.L.'s accounts provided ample warning of failure for sophisticated investors and that any "misinformation" was the result of the inability of "naive" investors to interpret financial statement data. However, when the share market columnists in the financial press write positively of A.S.L.'s prospects (see for example *Rydges*, September 1976, p.39) it is difficult to accept this argument. The fact remains that, according to A.S.L.'s accounts the asset backing per share appeared sound, especially over the late 1960s and early 1970s, and, for a finance company, the group had low gearing. At least some investors, who were not necessarily naive, believed that A.S.L. shares were a reasonable investment.

9.2 (ii) (b) The Debenture Holders' Perspective

Table 9.3 shows financial ratios relevant to second charge debenture holders, calculated from the audited financial statements, for the period 1973 to 1978. Second charge debentures were first issued in 1972-73. These ratios are based on the consolidated accounts, because the second charge debentures were guaranteed by most of A.S.L.'s subsidiaries.[28] In addition to these ratios, debenture holders may have been influenced by reported net profits, as shown in Table 9.2 and discussed above.

The rate of return on average total assets provides a measure of profitability for debenture holders. Table 9.3 shows that A.S.L.'s return on its assets increased from 9.92 per cent in 1972-73 to 10.12 per cent in 1973-74, but over the next three years it declined to such an extent that by 1976-77, the group effectively earned no return at all. In 1977-78, some recovery occurred, with the group reporting a return of 8.49 per cent on its average total assets. In comparison, Tables 3.2 and 3.4 show that A.S.L.'s rate of return on assets was higher than the industry average, A.G.C. and B.F.C. rates in 1972-73 and 1973-74, but lower in the four years between 1974-75 and 1977-78. Thus, from the second charge debenture holders' perspective, A.S.L. appeared to be relatively profitable prior to 1974-75. However, from then onwards it was clearly unprofitable.

The level of debenture security is indicated by asset cover. Table 9.3 shows that the asset cover available for A.S.L.'s second charge debentures increased from $2.99 per $1 of debenture funds in 1973, to $4.90 in 1978. A comparison with Table 3.2 and 3.4 shows that A.S.L.'s second charge debenture cover was higher than the industry average, A.G.C. and B.F.C. cover, in each of the 6 years.[29] The debt ratio is also a useful indicator of investment security for debenture holders. A.S.L.'s debt ratios, according to its

[28] For example, at 30 June 1978, the A.S.L. group had total assets with a book value of $285.05m, of which only $7.68m related to assets of non-guarantor subsidiaries. (See Associated Securities Ltd., *Prospectus No. 37*, p.12).

[29] The value of this comparison is weakened by the fact that the industry data do not distinguish between first and second charge debentures, and A.G.C. and B.F.C. only issued first charge debentures.

Table 9.3: A.S.L.'s Profitability and Security, Second Charge Debenture Holders' Perspective from the Audited Accounts

Year Ended 30th June	Return on Assets[1] (% pa)	Asset cover for Second Charge Debentures[2]	Interest Cover
1973	9.92	2.99	1.70
1974	10.12	3.18	1.59
1975	8.36	3.55	1.13
1976	5.48	3.75	0.75
1977	0.60	3.88	0.09
1978	8.49	4.90	1.01

Source: Associated Securities Ltd, Audited Financial Statements, Years ended 30 June 1968 to 30 June 1978.

Notes: 1 Excludes extra-ordinary items.

2 Asset cover = (Tangible assets - first charge debentures)/second charge debentures.

audited accounts, were shown in Table 9.2 and considered in relation to share security. Compared to the average firm in the industry, A.G.C. and B.F.C., A.S.L. had relatively low debt ratios, which suggested that A.S.L. debentures were a relatively secure investment.

In contrast to the estimates of asset cover and debt ratios, the interest cover data raised some doubts about the security of A.S.L. debentures, particularly in the latter part of the period. Table 9.3 shows that between 1972-73 and 1976-77, interest cover declined continuously, from 1.70 to 0.09 times, and in 1977-78, A.S.L.'s earnings before interest and tax were just sufficient to cover the group's interest expense. A comparison with Tables 3.2 and 3.4 shows that A.S.L.'s interest cover was below the industry average and B.F.C. cover in each year except 1972-73 and 1973-74, and it was below the A.G.C. cover in each year except 1973-74. Thus, A.S.L.'s interest cover was relatively low after 1973-74.

Each debenture issue was accompanied by a prospectus. The prospectus, therefore, can be considered the prime source of information for prospective debenture subscribers. Table 9.4 presents the data relevant to second charge debenture holders, calculated from the prospectus financial statements. The prospectus auditors' reports placed considerable emphasis on group profits, both before and after tax. The rate of growth in A.S.L.'s consolidated profit before tax, over profit in the previous corresponding period, decreased significantly during 1972-73 and 1973-74. From the first half of 1974-75, pre-tax profit declined. In each period from the first half of 1975-76 until receivership, A.S.L. reported losses. The small losses in 1977-78 were a considerable improvement over the results for the previous two years. Table 9.4 shows that A.S.L.'s profit after tax exhibited a similar pattern to pre-tax profits. The only significant difference between the pattern of profits before and after tax, is that the decline in growth in profit after tax did not occur until the year ended 30 June 1974, compared to the first half of 1973-74 for profit before tax. Also this decrease was less marked in profit after tax.

It is interesting to note that prior to 1974-75, the consolidated profits reported in the audited accounts, which were shown in Table 9.2, were the same as the profits reported in the prospectuses. However, from 1974-75, the auditors adjusted the prospectus data to incorporate the prior period effects of changes in income tax rates and in some of A.S.L.'s accounting policies. The apparent purpose of these adjustments was to enable a comparison of profits over time. A comparison of the after-tax profits in the audited accounts, as shown in Table 9.2, with the after-tax profits disclosed in the prospectuses, as shown in Table 9.4, indicates that these adjustments altered profits by between 4 and 6 per cent. Prior period adjustments, therefore,

Table 9.4: A.S.L.'s Profitability and Security, Second Charge Debenture Holders' Perspective from the Prospectuses

Period Ended	Prosp. No.	Consolid. Net Profit before tax ($m)	Change in profit over correspond. period in previous yr (%)	Consolid. Net Profit after tax ($m)	Change in profit over corresponding period in previous yr (%)	Group Return on Assets[1] (%)	Asset Cover for Second Charge Debentures	Debt Ratio	Interest Cover
31/12/72	26	6.38	+39.00	3.34	+27.97	10.58	2.93	0.82	1.80
30/6/73	27	11.94	+24.12	6.37	+21.56	9.92	2.99	0.84	1.70
31/12/73	28	7.31	+14.58	4.17	+24.85	n.a.	2.60	0.85	n.a.
30/6/74	30	13.17	+10.30	7.38	+15.86	n.a.	3.16	0.85	n.a.
31/12/74	31	1.23	-83.17	0.83	-80.10	n.a.	3.19	0.84	n.a.
30/6/75	32	3.39	-74.26	2.36	-68.02	n.a.	3.55	0.83	n.a.
31/12/75	33	(7.04)	-672.36	(3.89)	-568.67	n.a.	3.40	0.83	n.a.
30/6/76	34	(5.30)	-256.34	(5.65)	-339.41	n.a.	n.a.	n.a.	n.a.
31/12/76	34	(16.12)	-128.98	(16.45)	-322.88	n.a.	3.46	0.86	n.a.
30/6/77	35	(15.42)	-190.94	(15.87)	-180.88	n.a.	3.67	0.85	n.a.
31/12/77	36	(0.60)	+96.28	(0.62)	+96.23	n.a.	4.25	0.86	n.a.
30/6/78	37	(0.56)	+99.64	(0.82)	+94.83	n.a.	5.67	0.85	n.a.

Source: Associated Securities Ltd, *Prospectus Nos 16 to 37*.

Note: 1. Converted to a per annum equivalent.
n.a. = not available

were apparently only of marginal significance. The significance of these prior period adjustments will be reconsidered in more detail later in this chapter.

Table 9.4 shows the rate of return on assets earned by the A.S.L. group for the first half of 1972-73 and for the full year based on the prospectus data. The rate of return for the full year is the same as that shown in Table 9.3, which was calculated from the audited accounts. The interim rate of return, which was not available in the annual reports, differed little from the full year rate. The rate of return on assets earned by A.S.L. during this year was higher than the industry average, and that for A.G.C. and B.F.C. The analysis of the audited accounts showed that A.S.L.'s rate of return on its assets became relatively unsatisfactory only after 1973-74. Perhaps it is significant that the data necessary to calculate A.S.L.'s return on its assets were not disclosed in the prospectuses issued from March 1974.

Table 9.4 shows the asset cover per dollar of funds invested in second charge debentures, based on the prospectus data. In general terms, these data coincide closely with the data from the audited accounts, presented in Table 9.3. Table 9.3 showed that A.S.L.'s second charge debenture cover was above the industry average, A.G.C. and B.F.C. cover, throughout the relevant period.[30]

[30] The most significant difference between the asset cover estimates based on the two different data sources occurred at 30 June 1978. The prospectus estimate significantly overstated the cover available, because of its failure to include first charge debentures of $25m, which had been issued to secure bills of exchange received by A.S.L. However, although these debentures were not included in the prospectus statement of assets and liabilities, they were disclosed in the notes attached. Even allowing for these debentures, the debenture cover at 30 June 1978 remained relatively high.

Table 9.4 shows A.S.L.'s debt ratios based on the prospectus data. The ratios calculated for the end of each year coincide closely with the ratios which were calculated from the audited accounts. In addition, the debt ratios at the interim balance dates are similar to the debt ratios calculated at year-end. Thus, the prospectus debt ratios confirmed that, for a finance company, A.S.L. was relatively low geared. A.S.L. debentures appeared a secure investment opportunity.

Table 9.4 also shows estimates of A.S.L.'s interest cover for the first half of 1972-73 and for the full year, based on the prospectus data. The full year estimate is the same as that calculated from the audited accounts, which exceeded the industry average and B.F.C. cover, but was lower than the A.G.C. cover. The estimate of interim interest cover was higher than for the full year, although a comparison with Table 3.4 shows that it was still below the year-end estimate of A.G.C.'s cover. Table 9.3 showed, however, that from 1974-75, A.S.L.'s interest cover was relatively low. It may be significant that from this time A.S.L.'s prospectuses did not include the data necessary to calculate interest cover, which is an important measure of investment security for debenture holders.

9.2 (ii) (c) The Depositors' Perspective

Table 9.5 presents the financial ratios relevant to depositors, calculated from data contained in A.S.L.'s audited accounts and prospectuses. These ratios are based on the holding company accounts because term deposits, although partially secured, were not guaranteed by A.S.L. subsidiaries. Table 9.5 shows the return on assets earned by A.S.L. between 1967-68 and 1977-78, based on data drawn from the audited holding company accounts. The prospectuses did not include the data needed to calculate the holding company's rate of return on its assets. Although not addressed to potential depositors, the prospectuses issued prior to November 1972 covered issues of unsecured notes, as well as debentures. The holding company's rate of return would have provided useful information for noteholders, as unsecured creditors. The holding company's return on its assets increased steadily to reach a maximum of 10.14 per cent, in 1971-72. From 1972-73, however, the rate of return fluctuated. Compared to the rates of return shown in Tables 3.2 and 3.4, the rates of return on assets earned by the A.S.L. holding company were relatively low. The industry average rates were higher in 7 of the 11 years, including the 6 years from 1972-73. The A.G.C. and B.F.C. rates were also higher in 7 of the 11 years, including the years from 1971-72 for A.G.C., and from 1974-75 for B.F.C. These data should have indicated to depositors that from the early 1970s, A.S.L. was relatively unprofitable.

Holding company interest cover data were also available only from the audited accounts. Table 9.5 shows that from 1967-68 to 1971-72, A.S.L.'s interest cover fluctuated around 1.6 times. From 1972-73, however, the holding company's interest cover declined. It reached a minimum of 0.09 times, in 1976-77. In comparison to the "standard" interest cover estimates shown in Tables 3.2 and 3.4, the holding company's interest cover, particularly from the early 1970s, was relatively low. It was lower than A.G.C.'s cover in each of the 11 years and lower than the industry average cover in 7 of the years, including the last 6 years from 1972-73. It was also lower than B.F.C.'s interest cover from 1973-74.

Table 9.5 shows estimates of the holding company's current ratios. Despite the relatively low interest cover, the current ratios did not suggest that the holding company was facing severe liquidity constraints. The data necessary to calculate current ratios were contained in both the audited accounts for year-end estimates, and the prospectuses for interim and year-end estimates. Between 30 June 1968 and 30 June 1973, the holding company's

Table 9.5: A.S.L.'s Profitability and Security, Depositors' Perspective from the Audited Accounts and Prospectuses

Period ended	Prospectus No.	Annual Report	Return on Assets (%) in Annual Report	Interest Cover in Annual Report	Current Ratio		Debt Ratio	
					in Annual Report	in Prospectus	in Annual Report	in Prospectus
30/6/68	16	1968	8.84	1.61	3.23	3.23	0.82	0.82
31/12/68	17					2.71		0.84
30/6/69	18	1969	9.13	1.63	3.00	3.00	0.85	0.85
31/12/69	20					2.99		0.83
30/6/70	21	1970	9.39	1.64	3.15	3.15	0.82	0.82
31/12/70	22					2.98		0.83
30/6/71	23	1971	9.79	1.64	2.66	2.66	0.83	0.83
31/12/71	24					2.49		0.85
30/6/72	25	1972	10.14	1.59	2.62	2.62	0.82	0.82
31/12/72	26					2.89		0.83
30/6/73	27	1973	8.96	1.52	2.63	2.63	0.84	0.84
31/12/73	28					2.26		0.86
30/6/74	30	1974	9.07	1.26	2.40	2.40	0.85	0.85
31/12/74	31					2.80		0.84
30/6/75	32	1975	10.05	1.14	2.83	2.83	0.83	0.83
31/12/75	33					n.a.		0.83
30/6/76		1976	7.64	0.89	2.48	n.a.	0.82	n.a.
31/12/76	34					2.36		0.86
30/6/77	35	1977	0.71	0.09	2.22	2.22	0.85	0.85
31/12/77	36					3.03		0.85
30/6/78	37	1978	9.79	1.07	3.82	3.82	0.85	0.85

Sources: Associated Securities Ltd, *Prospectus Nos 16 to 37* and Audited Financial Statements, Years ended 30 June 1968 to 30 June 1978.

current liabilities generally were covered by current assets, by 2.5 to 3 times. Between 31 December 1973 and 31 December 1977, A.S.L.'s current ratio fluctuated a little more widely, between 2.2 and 3. The current ratio at 30 June 1978, of 3.89, was considerably higher than at any other balance date during this period. A comparison with Table 3.2, shows that A.S.L.'s current ratios exceeded the industry average in each year between 1967-1968 and 1977-78. They also exceeded the current ratios, shown in Table 3.4, in all but three years for A.G.C. and in all but two years for B.F.C. Whilst A.S.L.'s interest cover was relatively low, the company's relatively high current ratios may have reassured any depositors who were concerned about the security of interest payments.

However, in A.S.L.'s case, the current ratio is not a good indicator of liquidity because a large part of the company's current assets consisted of advances to subsidiary and associated companies heavily involved in real estate. Although these advances were at call and, therefore, technically receivable, they were tied up in real estate development and unlikely to be easily liquidated. A better indicator of A.S.L.'s liquidity and solvency can be obtained by comparing the group's receivables and payables within one year. Unfortunately, A.S.L.'s receivables and payables data are not available in a comparable format for all years since 1968. However Table 9.6 compares the receivables and payables maturing within one year at 30 June 1971, 1974 and 1978. These data indicate that by 1974, A.S.L. was experiencing significant liquidity problems. To remain solvent, it had to roll over its maturing liabilities and/or generate funds from its real estate developments. Thus, although not apparent from the holding company current ratios, A.S.L.'s financial statements contained evidence of liquidity problems, from at least 1974.

Table 9.6: A.S.L.'s Receivables and Payables Within One Year ($m)

	Receivables[1]	Payables[2]	Difference
1971	91.59	73.95	17.64
1974	158.09	162.30	-4.21
1978	101.54	95.34	+6.20

Notes:

1. Receivables maturing within one year, including interest.
2. Payables includes payables maturing within one year (excluding interest), interest payable within one year and unpaid purchase consideration for development projects.

On the other hand, the holding company's debt ratios suggested that A.S.L. still had some borrowing capacity. The debt ratios were fairly stable, varying at year-end between 0.82 and 0.85, and at interim balance dates between 0.82 and 0.86. In comparison with the debt ratios shown in Tables 3.2 and 3.3, the holding company's debt ratio was lower than the industry average and B.F.C. debt ratios in each year, and lower than A.G.C.'s debt ratio in all but two years when the ratios of the two companies were equal.

9.2 (ii) (d) The Investors' Perspective, A Summary

To summarize, the financial statement data, issued over the period 1968 to 1978, indicated that A.S.L. shares were a relatively unattractive investment. Consolidated net profit after tax grew steadily prior to 1973-74, but the rate of return on shareholders' funds, even over this period, was relatively low. From 1974-75, it was clear that A.S.L. was experiencing severe profitability problems. In the late 1960s and early 1970s A.S.L. paid a relatively attractive dividend rate but from 1974-75 the dividend rate was low.

From the second charge debenture holders' point of view, A.S.L. appeared profitable prior to the mid 1970s, but not thereafter. Profit before tax, which was shown in the prospectus auditors' reports, grew until 1973-74, but then declined. From 1974-75, A.S.L.'s rate of return on its assets and interest cover was low. The A.S.L. prospectuses, a prime source of information for prospective debenture subscribers, did not contain the data necessary to calculate the group's rate of return of its assets, or its interest cover, from 1973-74. Despite the group's poor profits from 1974-75, A.S.L.'s second charge debentures appeared to be a relatively secure investment. They had sound asset backing and the group had low gearing.

From the depositors' point of view, the profitability of the holding company and its interest cover were low from the early 1970s. Moreover, an analysis of the group's maturing receivables and liabilities indicated serious liquidity problems. However, gearing was relatively low.

9.2 (iii) A.S.L.'s Financial Statement Misinformation

The above analysis suggests that A.S.L.'s financial statement data gave clear indications of profitability and liquidity problems for at least three and a half years before receivership. However, the loss incurred in 1977-78 was much lower than in the previous two years. It was not apparent that failure was imminent. It is necessary, therefore, to consider whether A.S.L.'s financial statement data were potentially misleading, or whether events subsequent to 30 June 1978 precipitated the failure of A.S.L.

9.2 (iii) (a) Changes in A.S.L.'s Accounting Policy

During the 1970s, A.S.L. made six major changes to its accounting policy. These changes hampered intertemporal comparisons of A.S.L.'s results over the crucial years leading up to receivership. Where the fact that a change had been made was disclosed in the notes to the accounts, it cannot be argued that the changes themselves caused misinformation, since their disclosure made it apparent that intertemporal comparisons were inappropriate. Nevertheless, where a change allowed A.S.L. to improve its reported results and defer the disclosure of some of the problems it was experiencing and where there was no justification for such a change, it could be argued that the reported improvement was potentially misleading for investors. However, where the financial effects of the change were disclosed in the notes to the accounts, investors should have been able to adjust the reported results for the effects of the change. It is necessary, therefore, to examine the extent of the disclosure of A.S.L.'s changes in accounting policy, the reasons for the changes and their effects on the group's reported results.

9.2 (iii) (a) (1) The Financial Effects of the Changes on Policy, in the Year of the Change

Table 9.7 identifies the changes, their financial effect, whether this effect was disclosed and the reasons given for the change. It shows that all six changes were disclosed in the audited accounts. It also shows that three of the six changes resulted in a significant improvement in A.S.L.'s reported results, in the year of introduction. A fourth change improved the group's retained earnings, although it significantly decreased income for the year. The remaining two changes significantly worsened A.S.L.'s reported results.

9.2 (iii) (a) (2) The Reasons for A.S.L.'s Changes in Policy

Where the changes are warranted by circumstances, it could be argued that they resulted in better measures of profit. Table 9.7 shows that the reason for change was disclosed in only one case, where the change in tax effect accounting was explained by a change in accounting standards. In the notes to

Table 9.7: A.S.L.'s Changes in Accounting Policies

Date of Change	Discarded Policy	New Policy	Effect in Year of Change	Effect of Change Disclosed			Reason for Change
				Audited Accounts	Prospectus-Prior Period Adjustments	Prospectus Other	
1973-74	Interest on funds invested in development projects expensed as incurred.	Interest on funds invested in development projects capitalized.	Increased group profit after tax by $1.02m or approximately 14 per cent.	Yes	No	Yes	Not disclosed, although management subsequently stated that the value of the group's real estate was well in excess of its cost.[1]
1974-75	Non-interest borrow-costs expensed as incurred.	Non-interest borrow-costs capitalized and amortized over the term of the borrowings.	Increased group profit before tax by $0.39m or approximately 12 per cent.	Yes	No	Yes	Not disclosed.

contd./

Table 9.7 continued

1975-76	Unrealized exchange gains and losses on foreign currency obligations not brought to account.	Unrealized exchange gains and losses on foreign currency obligations amortized over the residual terms of the borrowings to which they related.	Exchange losses of $1.6m amortized which accounted for approximately 29 per cent of the group's net loss before tax	Yes	Yes	-	Not disclosed.
1975-76	Future income tax benefits arising from investments in tax loss companies carried forward to future accounting periods with a corresponding decrease in the losses shown.	Income tax benefits arising from investments in tax loss companies brought to account at the time of recoupment.	Retained earnings credited by $1.54m. Increased after tax loss by $3m from $2.4m to $5.4m.	Yes[1]	Yes, but combined with effects of changes in tax rates.	-	Change recommended by the accounting profession.
1976-77	Unrealized exchange gains and losses on foreign currency amortized over the residual terms of the borrowings to which they relate.	Unrealized exchange gains and losses on foreign currency recognized in the year of the exchange rate change.	Exchange losses of $3.25m were recorded, which account for approximately 19 per cent of the group's net loss before tax.	Effects combined with the effects of the change of policy in the previous year.		-	Not disclosed.

Table 9.7 continued

1977-78	Group's income included its share of subsidiary profits and dividends from associated companies.	Equity accounting adopted. Group's income included its share of profits from subsidiary and associated companies.	Converted a group net loss before tax of $0.68m to a profit of $0.11m. Of the profit of $0.79m brought to account, $0.67m related to profits earned in prior periods and was shown as an abnormal item.	Yes	Yes	-	Not disclosed.

Source: Associated Securities Limited, Audited Financial Statements, 1973-74 to 1977-78, and *Prospectus, Nos. 28 to 37.*

Note 1: *The Bulletin*, 6 July 1974, p. 53.

Note 1. The financial effects of this change were disclosed in the Directors' report rather than the notes to the accounts.

the accounts for 1975-76, it was stated that the company's policy on accounting for tax losses

> "has been reconsidered and changed in the light of the recent statement by the Accounting Bodies, supported by general commercial opinion."[31]

The first Australian accounting standard dealing with tax effect accounting was issued in October 1974.[32] It was amended in August 1976, with the changes becoming operative for any accounting period ending on or after 30 June 1976.[33] The 1976 standard altered the criteria for recording future income tax benefits associated with losses carried forward. The 1974 standard had recognized tax loss benefits, where there was a reasonable expectation that the company would derive sufficient future assessable income to realize the benefit of the deductions for the loss. The 1976 standard, however, required that

> "A future income tax benefit ... should only be carried forward as an asset where realization of the benefit can be regarded as being assured beyond any reasonable doubt ... In the case of companies which incur losses, doubt can be expected to exist as to the realization of any future income tax benefit and in these cases an asset should not be brought to account or carried forward unless virtual certainty exists as to the realization of the benefit."[34]

A.S.L.'s decision to remove future income tax benefits from its balance sheet was appropriate, because it resulted from a change in generally accepted accounting principles.

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[31] Associated Securities Ltd, Notes to the Audited Financial Statements, 1975-76, Note le.

[32] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1974c].

[33] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1976].

[34] *Ibid.*

The failure to disclose the reasons for the other changes in accounting policy makes it difficult to determine whether these changes were appropriate. The decision to capitalize rather than expense interest on development projects increased reported profit. The generally accepted accounting principles relevant to this decision were discussed in the R.M.A. case study. As early as 1966, an A.S.A. report had recommended the capitalization of interest costs on development projects, provided that the book value of the projects remained less than their estimated realizable value.[35] An accounting standard on expenditure carried forward was issued in 1972.[36] It allowed capitalization where the expenditure contributed to the future earning capability and gave rise to an asset which was reasonably expected to realize its book value. The A.S.L. interest capitalization policy was introduced at a time when the Australian property market was collapsing. The subsequent writedowns of development projects cast some doubt on the appropriateness of this policy, particularly in later years. However, there is no conclusive evidence to suggest that the 1973-74 book value of the development projects exceeded their realizable value. There is some evidence to suggest that these book values may have been overstated in subsequent years, but the appropriateness of A.S.L.'s real estate valuations is a separate issue, which is discussed below.

The expenditure carried forward standard also allowed the capitalization of expenditure which contributed to the future earning capability and was reasonably expected to be covered by future revenue. Therefore, A.S.L.'s capitalization of non-interest borrowing costs also complied with this standard, as long as A.S.L. expected its revenue from borrowing to cover these

[35] Australian Society of Accountants [1966].

[36] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1976].

costs. Indeed, Kenley [1970, p.70] confirmed that non-interest borrowing costs could be capitalized. There is no evidence to suggest that this change in policy was inappropriate.

The changes to amortizing unrealized foreign exchange losses and subsequently to recognizing the full unrealized gains or losses were not covered by an accounting standard or recommendation. Both practices complied with the conservatism convention. An exposure draft on accounting for foreign currency transactions had been issued in 1973 and a second exposure draft was issued in June 1979.[37] The existence of this second exposure draft, and a third exposure draft issued in 1983, suggests that accounting for foreign currency transactions is a complex and controversial area.[38] At the time A.S.L. made these changes in policy, there were no clearly defined principles in these areas. Indeed, a survey in 1978, of the published accounts of 100 companies in Australia, found that in relation to foreign currency translation,

> "the most significant feature to emerge, apart from the diversity of accounting methods, was the fact that quite a number of the companies had changed method from the previous year."[39]

A.S.L.'s changes in its accounting for its foreign currency losses could be viewed as an attempt to adopt the most appropriate treatment in an area neglected by the accounting profession. The lack of defined principles in this area was remedied in October 1985 with the issue of *AAS20, Foreign Currency Translation*.

[37] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1973c]. Australian Accounting Research Foundation [1979].

[38] Australian Accounting Research Foundation [1983].

[39] *Australian Financial Review*, 20 December 1978.

No reason was given for A.S.L.'s adoption of equity accounting in 1977-78. Exposure drafts on equity accounting had been issued in 1971 and 1973.[40] These drafts lapsed and a third exposure draft was issued in July 1979.[41] The standard on equity accounting was finally issued in 1983.[42] At the time that A.S.L. adopted equity accounting, it had not been recommended, although the issue of the third exposure draft shortly afterwards, suggests that there was some support for equity accounting within the profession. Indeed, as early as 1975, 16 of the 100 largest companies in Australia were already using equity accounting.[43] It is possible that A.S.L. may have considered the introduction of equity accounting appropriate in 1977-78. The adoption of the equity accounting standard by the accounting profession in 1983 indicates that most accountants would also consider A.S.L.'s use of equity accounting appropriate.

Finally, in assessing the appropriateness of A.S.L.'s changes in accounting policy, it is important to consider the context in which they were made. Table 9.7 showed that three of the six changes permitted some improvement in A.S.L.'s reported results. By the mid-1970s, A.S.L. was experiencing difficulties and these changes in policy enabled it to defer recognition of, if not disguise, the extent of these difficulties. There is no conclusive evidence that any of the changes were inappropriate However, it is possible that some of the changes reflected "creative accounting". When

[40] Australian Society of Accountants [1971]. This was subsequently adopted as an exposure draft, in late 1973, by the I.C.A.A., see Institute of Chartered Accountants in Australia/Australian Society of Accountants [1973b].

[41] Australian Accounting Research Foundation [1979b].

[42] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1983].

[43] Pratt [1977, p.80].

questioned over the appropriateness of some of A.S.L.'s changes in accounting policy, the group's chief executive acknowledged that

> "You take a conservative view in the years you can afford it.... But in the bad years you take the fat from under the table. There's nothing wrong with that."[44]

9.2 (iii) (a) (3) Eliminating the Financial Effects of the Changes in Policy for Intertemporal Comparisons

The financial effects of the six changes were disclosed, although in two cases they were not disclosed properly. First, the effect of the change in tax effect accounting on the profit and loss statement was not disclosed in the accounts. However, it was disclosed in the directors' report. This omission was not particularly significant because s162a of the *Uniform Companies Act, 1961* required the directors' report to be attached to the financial statements. Second, the effect of the change to full recognition of unrealized foreign exchange gains and losses was combined with the effect of the earlier change to amortizing unrealized exchange gains and losses. However, since the amortization of exchange gains and losses had only been introduced in the previous year, the disclosure of the combined effects of the changes in policy over the two years provided a better basis for comparison with results for the years prior to the changes than if the effect of changing from amortization to full recognition had been disclosed.

Generally, the disclosure of the financial effects of the changes in accounting policy enabled comparison of results and/or financial position with the preceding year. In most cases, however, it did not enable comparison between subsequent years, when the "new" policy was followed, and previous years, when the "old" policy had applied. Comparisons of profit before tax

[44] *Australian Financial Review*, 15 September 1975, p.2.

over a number of years were possible only when the change in policy resulted in an item which was recorded separately in subsequent accounts. For example, the amortized foreign exchange gains and losses were a separate item in the profit and loss account and they could be eliminated to enable comparisons with accounts from the pre-amortization era. Generally, the changes affected existing accounts. Therefore, most of the changes made any intertemporal comparisons of the group's published results difficult, although their disclosure made it apparent that such comparisons were not appropriate.

However, the prospectus reports attempted to present A.S.L.'s results in a form which could be compared over a number of years, by making prior period adjustments for some of the changes in accounting policy. Table 9.7 shows that prior period adustments were made for only four of the six changes, although details of the financial effects of the other two changes were also included in the reports. A comparison of reported profit from the audited accounts, as shown in Table 9.2, with the prior period adjusted profit from the prospectuses, as shown in Table 9.4, indicated that prior period adjustments were a relatively insignificant part of reported profit. In this respect, however, the data, in Table 9.4 were incomplete. They consisted of the profit for the most recent year, as reported in the various prospectuses. The prior period effects of changes in accounting policy made during that year had been removed but were not incorporated in the results of prior years which were drawn from previous prospectuses. This meant that where there were changes in accounting policy, the results for the year could not be compared directly with the results of previous years which were drawn from previous prospectuses.

Any meaningful comparison required adjustments to the earlier results for the effects removed from current results. These adjustments are incorporated in Table 9.8, which compares A.S.L.'s audited results to its results adjusted for all identified prior period effects from 1974. The table shows that the adjustments in the 1974, 1975 and 1976 prospectuses, which consisted of the prior period effects of tax rate changes, were relatively insignificant. The adjustments in the 1977 prospectuses consisted of the prior period effects of changes in tax rates, and of the changes in A.S.L.'s accounting for future income tax benefits and foreign currency obligations. These adjustments had a significant impact on the reported profit for 1973-74, which was increased by approximately 21 per cent, and for 1974-75, which was decreased by approximately 120 per cent. The adjustments in the 1978 prospectuses consisted of the adjustments made in the 1977 prospectuses and the prior period effects of the adoption of equity accounting. They had a significant impact. Reported profit tor 1973-74 was increased by approximately 21 per cent. For 1974-75, it was decreased by approximately 115 per cent, and for 1977-78, it was decreased by approximately 412 per cent. It should be remembered, however, that the prior period effects of the adoption of equity accounting were disclosed as an abnormal item, in A.S.L.'s audited accounts.

The data in Table 9.8 support the view that intertemporal comparisons of A.S.L.'s audited results were of limited value because of changes in accounting policy and tax rates. For example, the final column of Table 9.8 shows that had the accounting policies applied in 1977-78 been used consistently over time, the profit for 1973-74 would have been approximately 21 per cent larger than reported; the profit for 1974-75 would have been reported as a loss; and the loss reported for 1977-78 would have been more than four times greater than the audited loss. Moreover, the prior period data understated the distortions to intertemporal comparisons because they incorporated the etfects of only four ot the six changes made.

Table 9.9 identifies the individual sources of the prior period adjustments included in A.S.L.'s last prospectus, which incorporated the

Table 9.8: Prior Period Adjustments to A.S.L.'s Audited Results

Year ended 30 June	Audited Results	Adjusted Results, 1974 & 1975 Prospectuses		Adjusted Results, 1976 Prospectuses		Adjusted Results, 1977 Prospectuses		Adjusted Results, 1978 Prospectuses	
	(after tax) $m	$m	% diff	$m	% diff	$m	% diff	$m	% diff
1969	2.70	2.70	0						
1970	3.31	3.09	-6.34						
1971	4.03	4.03	0	4.03	0				
1972	5.24	5.24	0	5.24	0	5.66	+8.02		
1973	6.37	6.37	0	6.37	0	5.83	-8.48	6.20	-2.67
1974	7.38	7.62	+3.25	7.62	+3.25	8.93	+21.00	8.95	+21.27
1975	2.51			2.36	-5.98	(0.51)	-120.32	(0.38)	-115.14
1976	(5.42)					(5.65)	-4.24	(5.61)	-3.51
1977	(16.63)					(15.87)	+4.57	(15.76)	+5.23
1978	(0.16)							(0.82)	-412.50

Source: Associated Securities Ltd, *Prospectus, Nos 28 to 37.*

Table 9.9 Sources of A.S.L.'s Prior Period Adjustments

Year ended 30 June	1974	1975	1976	1977	1978
Audited Profit (loss) from operations, before tax, (in $m)	13.17	3.39	(5.60)	(16.72)	0.11
+/(-) Prior period adjustments for:-					
i) Foreign currency obligations	1.31	(2.89)	0.31	1.30	-
ii) Equity accounting	0.03	0.13	0.04	0.10	(0.67)
Total adjustment	1.34	(2.76)	0.35	1.40	(0.67)
Adjusted profit (loss) before tax	14.51	0.63	(5.25)	(15.32)	(0.56)
Income tax expense	5.79	0.88	0.18	(0.09)	0.27
+/- Prior period adjustment	(0.24)	0.12	0.54	0.54	-
Adjusted income tax expense	5.55	1.00	0.36	0.45	0.27
Adjusted profit/loss from operations after tax	8.96	(0.37)	(5.61)	(15.77)	(0.83)
Profit/(loss) from operations after tax (as per audited accs)	7.38	2.51	(5.42)	(16.63)	(0.16)
Difference	1.58	(2.88)	(0.19)	0.86	(0.67)

Source: Associated Securities Ltd, *Prospectus, Nos. 34 to 37.*

effects of the four changes in accounting policy. This table shows that the most significant effects resulted from the changes in accounting for foreign currency obligations, in 1975-76 and 1976-77. The foreign currency adjustment for 1974-75 decreased the reported profit before tax, of $3.39m, by $2.89m. The prior period effects of equity accounting were insignificant in absolute terms, although the decrease of $0.67m, in 1977-78, was relatively significant because of the low reported profit before tax in that year. The prior period adjustments to the income tax expense, which included the effects of changed tax rates and changes in tax effect accounting, were relatively insignificant in all years. This confirms that the major effects of the prior period adjustments to A.S.L.'s reported results came from changes in accounting policy rather than from changes in tax rates.

Whilst the data from the prospectuses substantiates the view that intertemporal comparisons of A.S.L.'s reported results were of limited value, the fact remains that the prospectuses adjustments enabled a comparison of A.S.L.'s results over time, either through the prior period adjustments or other information. Prospectuses are public documents. Thus, the information necessary to make intertemporal comparisons of A.S.L.'s results was publicly available. Under these circumstances, the lack of intemporal comparability of A.S.L.'s financial statements cannot be considered a major misinformation issue.

9.2 (iii) (a) (4) The Relevance of A.S.L.'s Changes in Policy to the Misinformation Hypothesis

To summarize, A.S.L. made six major changes in its accounting policies in the years leading up to receivership. These changes were disclosed in the notes to the accounts and their effects were disclosed in the notes to the accounts or, in one case, in the directors' report. The changes hampered any intertemporal comparisons of A.S.L.'s reported results over the crucial years leading up to receivership. However, as far as the misinformation hypothesis is concerned, the incomparability of A.S.L.'s reported results over time is not significant for two reasons. First, the fact that the changes were disclosed should have made it apparent that intertemporal comparisons of results were inappropriate. Second, the prospectuses, which were freely available, contained the data necessary to convert the reported results to a comparable form.

The reasons for only one of the six changes in policy were disclosed in the accounts. This change, in tax effect accounting, was caused by a change in accounting standards and was appropriate. The reasons for the remaining five changes were not disclosed although there is no conclusive evidence that they were inappropriate to the circumstances. It cannot be concluded, therefore, that the financial statement data produced as a result of these changes were potentially misleading. Three of the five unexplained changes allowed A.S.L. to improve its reported results in troubled times and A.S.L.'s management openly admitted to introducing favourable changes in unfavourable times. Nevertheless, the fact remains that since the financial effects of the changes were disclosed in the year of the change, any attempt to artifically improve the company's profit should have been apparent to investors.

It can be concluded, therefore, that A.S.L.'s frequent changes in accounting policy should not have been a major cause of financial statement misinformation for astute investors. It is possible that naive investors may have attempted inappropriate intertemporal comparisons of reported results or may have been unaware of the improvement in reported results caused by some of the changes. However, it is unreasonable to criticize the financial statement data on the grounds that they were misinterpreted by unsophisticated users. Preparing financial statements for unsophisticated users would be an extremely onerous task.

9.2 (iii) (b) *Statex* Adjustments to A.S.L.'s Reported Results

An alternative assessment of the distortions to A.S.L.'s reported results has been made in *Statex,* the investment service published by the Sydney Stock Exchange. *Statex* usually reproduces the reported results of the companies listed on the exchange, although it occasionally adjusts them for any "inconsistencies". *Statex* adjusted A.S.L.'s audited profit each year from 1974-75 to 1977-78. These adjustments are summarized in Table 9.10. According to *Statex,* over the four years to 30 June 1978, A.S.L. overstated its profit or understated its losses by a total of $5.3m. In each year, profit was overstated or losses were understated by a material amount. The largest adjustment occurred in 1974-75, when *Statex* converted A.S.L.'s reported profit, after-tax, of $2.51m, to a loss of $0.22m. This adjustment was particularly illuminating, as it showed A.S.L. as a loss company one year before this was evident from the audited accounts.

Apart from the foreign exchange gains in 1974-75 and the capital gain which resulted from the introduction of equity accounting in 1977-78, the *Statex* adjustments reflected a more conservative approach to determining profit rather than adjustments for the effects of A.S.L.'s inconsistent accounting policies. For example, for 1974-75 and 1975-76, *Statex* removed the profit on repurchase of debentures. A.S.L. had consistently redeemed debentures prior to maturity before 1974-75.[45] However, during 1974-75 and 1975-76, the group was able to do this at a discount, which resulted in a profit for the group. A.S.L. had not changed its accounting for debenture redemptions, but *Statex* eliminated these profits because they were abnormally

[45] Associated Securities Ltd, Notes to Audited Financial Statements, 1974-75, Note 1.

Table 9.10: *Statex* Adjustments to A.S.L.'s Reported Profits (in $m)

Year ended 30 June	Operating profit (loss), per audited accounts	*Statex* profit (loss)	Adjustment	Reasons for adjustments
1975	2.51	(0.22)	(2.73)	Profit on repurchase of debentures, Profit on foreign currency transactions, Over-provision for tax in previous years, Other tax adjustments
1976	(5.42)	(6.60)	(1.18)	Profit on repurchase of debentures, Provision for doubtful debts in previous yrs
1977	(16.63)	(17.90)	(1.27)	Special loss provisions written back. Overprovision for tax in previous years
1978	(0.16)	(0.28)	(0.12)	Recognition of capital gain
Total	(19.70)	(25.00)	(5.30)	

Source: *Australian Financial Review*, 12 Feb 1979, p.2.

large. *Statex* also removed the effects of the changes in tax rates in 1974-75 and 1976-77, but made no adjustment for the change in tax effect accounting in 1975-76. For 1975-76 and 1976-77, *Statex* adjusted the audited results for the effects of reversals of provisions for doubtful debts and special losses which were made in previous years. Presumably *Statex* justified these eliminations on the grounds that they were not part of the group's current profits.

The *Statex* adjustments do not provide any significant evidence of misinformation. Whilst it is true that the elements identified by *Statex* had hampered any direct comparison of A.S.L.'s operating profit over time, the notes to the accounts usually provided sufficient detail to enable the identification of these elements. It can be argued, therefore, that the accounts and the notes to the accounts were sufficiently detailed to prevent these atypical elements from misleading informed financial statement users.

9.2(iii)(c) Inaccurate Reports of Interim Results

It is possible that A.S.L. misled investors through the non-disclosure of atypical profit items in the announcement of its interim results. For example, for the six months ended 31 December 1974, A.S.L. reported a net profit after tax of $1.09m. At the time, the composition of the profit was not disclosed, although reports in several newspapers suggested that it included a $0.20m gain on foreign currency transactions.[46] Six months later, in a preliminary report to the Sydney Stock Exchange, A.S.L. reported a net profit after tax of $2.51m, for the year ended 30 June 1975. Again, the composition of profit was not disclosed. The Sydney Stock Exchange then requested details of any foreign currency gains and tax write backs and A.S.L. replied that the year's net profit included foreign currency gains of $1.09m and $0.36m from the overprovision for tax in the previous year. Since foreign currency gains for the first half-year had been estimated at $0.20m, this information suggested that in the second half of 1974-75 foreign currency gains accounted for $0.89m of the net profit of $1.42m. It appeared that A.S.L.'s operating performance in the second half of the year had declined materially. This issue was pursued by Cedric James, a journalist with *The Bulletin*.

[46] *The Bulletin*, 23 August 1975, pp. 63-64, discusses this situation.

> "When I suggested to company officials that in view of reports that the first half-year's result included only $200,000 of foreign exchange, the profit experience in the second half had shown a big deterioration, they decided to be more forthcoming on the breakdown with the purpose of re-assuring me that there had been a marked improvement in earnings in the second half."[47]

A.S.L. provided James with the break down of net profit shown in Table 9.11. Trading profit in the first half-year was only $17,000, in the reported profit of $1.09m. According to Table 9.11, foreign currency gains for the first half-year were $1.2m, rather than the $0.20m reported by the financial press. James commented

> "The company was somewhat less than frank about the makeup of the poor (first) half-yearly result and reports in several newspapers that the outcome included $200,000 in gains on currency transactions were left uncorrected."[48]

However, in this situation, it cannot be argued that the potentially misleading announcement of interim results was caused by financial statement misinformation. There is no evidence that the interim financial statements contained any misinformation. It was a management decision not to release detailed interim results and not to correct misinformation which resulted from speculation in the financial press.

9.2 (iii) (d) A.S.L.'s Asset Valuations

A.S.L.'s statement of affairs showed that, at receivership, the realizable value of the group's assets was $50.54m lower than their total book value of $292.56m.[49] This difference may simply reflect differences between going-concern and liquidation values. The major sources of the discrepancy

[47] *Ibid*.

[48] *Ibid*

[49] Associated Securities Ltd., Statement of Affairs, 8 February 1979.

Table 9.11: Breakdown of A.S.L.'s Profit in 1974-75 ($m)

	Six months ended 31 Dec '74	Six months ended 30 June '75	Year ended 30 June '75
Profit on trading	0.017	1.356	1.373
+ Foreign currency gain	1.200	0.784	1.984
Pre-tax profit	1.217	2.140	3.357
- Tax (after write back of previous over provisions)	0.142	0.637	0.880[1]
Net profit after tax	1.075	1.503	2.477
+ Write back of losses attributable to outside shareholders	0.015	0.015	0.030
Reported result	1.090	1.518	2.507

Source: *The Bulletin*, 23 August 1975, pp.63-64

*Note:*1 Not disclosed in the article, assumed to be the only source of difference between the stated pre-tax and post-tax profits. It should be noted that this estimate is $0.101m less than the sum of the tax provisions for the two half-years, as disclosed by A.S.L.

between book and realizable values were sundry debtors, which had a book value of $234.69m and a realizable value of $214.75m, and stock, which had a book value of $46.20m and a realizable value of $16.11m. Real estate mortgages accounted for most of the deficiency between the book and realizable value of debtors. These included loans to development projects, for which the control and responsibility for future development had passed to A.S.L. because of default in payment of interest and/or principal. According to A.S.L.'s directors, the writedowns in the statement of affairs were necessary, since

> "Because of Receivership, there is now doubt as to whether financing facilities will be available to allow these default accounts to be developed and marketed as originally planned ... Values have therefore been ascribed to these securities on an

earlier sale basis, in their 'as is' condition."[50]

Similarly, the asset 'stock' consisted of real estate in the form of development projects. In the statement of affairs, the directors made the following comments about the realizable value of these projects,

> "The properties ... consist mainly of areas acquired for development over varying periods, ranging up to 15 years ... with the projects being assessed on a going concern basis, which contemplated the realization of assets and the liquidation of liabilities in the ordinary course of business. Realization on this basis was dependent on availability of funds to enable the development, sale and financing of projects over the period mentioned.
>
> The appointment of a Receiver has changed the ability of the Company to develop and sell projects as originally envisaged and, for the purposes of this Statement, values have now been ascribed on an earlier sale basis."[51]

Thus, according to A.S.L.'s directors, the balance sheet valuations for debtors and stock were realistic, with the discrepancy between these valuations and those in the statement of affairs reflecting the switch from going concern to liquidation based accounts.

Current assets are those reasonably expected to be realized within the normal operating cycle of the business. In the case of real estate and real estate related assets, that cycle can extend over a number of years. It is possible, therefore, that the discrepancies between the book and realizable values of A.S.L.'s development projects and mortgages over real estate did reflect the interruption of the group's operating cycle. In this case, the values in the pre-receivership balance sheets could not be considered misinformation. However, when A.S.L.'s receiver was asked if he agreed with repeated statements by the directors that receivership had affected the

[50] Statement of Affairs, *op. cit.*, Note, 2.

[51] Statement of Affairs, *op. cit.* Note 5.

valuation of the company's property, he replied

> "I don't necessarily agree. Trying to place values on real estate is a pretty interesting operation."[52]

Clearly, the valuation of real estate related assets is a major issue with regard to A.S.L.'s financial statement misinformation. There is little concrete evidence to assess the appropriateness of the asset valuations in A.S.L.'s financial statements. The accounts for 1975-76 and 1976-77 included provisions for possible losses on mortgage loans of \$2.70m and \$2.0m respectively. The creation of these provisions, however, does not necessarily mean that real estate debtors were previously overstated. As far as the development projects are concerned, from 1 July 1973 the group capitalized interest on funds invested in these projects. The introduction of this policy was justified on the grounds that the current value of A.S.L.'s development projects was well in excess of cost. Yet two years later, in the accounts for 1975-76, A.S.L. charged against profit, provisions and allowances of \$4.45m for possible diminution in the value of development projects. At that time, the notes to the accounts included the comment that

> "Although significant uncertainties currently exist in the economy and sections of the real estate market, your directors believe these provisions and allowances are adequate".[53]

Despite this assurance, the 1976-77 accounts included further provisions of \$8.00m against development project valuations. These accounts were issued after the A.T.I. takeover and the provisions were said to reflect A.T.I's determination to reduce A.S.L.'s property holdings.[54] According to the A.S.L.

[52] *Australian Financial Review*, 5 April 1979, p.38.

[53] Associated Securities Ltd, Notes to the Audited Financial Statements, 1975-76, Note 4.

[54] See *The National Times*, 10-15 January 1977, p.39.

directors, the write-downs would not have been required if the properties

> "had been held and developed in the longer term in the ordinary course of business."[55]

Were A.S.L.'s property valuations excessive, or did the writedowns reflect changing management and market conditions? The decline of property markets over 1973-74 combined with the substantial writedowns in 1975-76 suggest that A.S.L.'s property related assets may have been overvalued, at least during 1973-74 and 1974-75. Whether the subsequent writedowns, in 1975-76 and on receivership, reflected overvaluation or resulted from forced sale is difficult to say. There are some hints of overvaluation. For example, in January 1977, it was reported, in the *National Times*, that

> "Much of A.S.L.'s broad acres ... cannot be developed due to government zoning and planning regulations and its value is nowhere near its original cost.[56]

The article claimed that, for example, the current market value of A.S.L.'s holding at Werribee, in Victoria, was less than half its original cost. In addition, in 1979, it was reported that much of A.S.L.'s land in Victoria, which had been purchased for residential development, in fact, had

> "little hope of residential rezoning in this century, if ever."[57]

It is unclear, however, whether A.S.L. had already allowed for these situations in its provisions.

Moreover, there is evidence that on at least one occasion A.S.L. deliberately overstated the value of its real estate related debtors. In

[55] Associated Securities Ltd., Directors Report, Year ended 30 June 1977.

[56] *The National Times*, 15 January 1977, p.39.

[57] *The National Times*, 10 March 1979, p.23.

December 1977, A.S.L. sold land to a joint venture of virtually no substance. The transaction lacked commercial reality in that a deposit of only $50,000 was required on land with a selling price of $1.6m.[58] No provision was made for the doubtful nature of this receivable. The profit recorded at the time of the transaction was $300,000 but the joint venturer was unable to make subsequent payments. This transaction was not publicized until after receivership, but, as noted then,

> "A.S.L. would have been better off to have kept the land, but then it would not have been able to report a profit for the December 1977 half-year. One can only wonder if other deals of this sort were arranged."[59]

More importantly, during 1978, Australian Guarantee Corporation (A.G.C.) investigated A.S.L. with view to a takeover. A.G.C. estimated that writedowns of $40m to $50m were required on A.S.L.'s property and property loans. It offered to buy A.S.L., if the group sold its "bad" property to its 'parent'. A.T.I. refused on the grounds that it was not in the interests of its own shareholders. A.S.L. then called in Hooker Corporation Ltd. to examine its property values. Hooker recommended writedowns of at least $30m.[60]

In brief, the valuations assigned to A.S.L.'s development projects and related receivables are the major issue as far as financial statement misinformation is concerned. The valuation of development projects and related receivables is a complex issue. It is generally accepted that development property should be valued at the lower of cost or net realizable value. The value of property debtors may also be influenced by estimates of the net realizable value of properties available as security. However, net

[58] *The National Times*, 10 March 1979, pp.22-27.

[59] *Ibid*.

[60] *Ibid*.

realizable value is difficult to determine. It requires some assumptions to be made about the period over which properties are to be realized and some predictions to be made about events within and beyond the organization during that period. Nevertheless, the available evidence suggests that the values of A.S.L.'s development ventures and probably its property loans, were overstated in the accounts in the years leading up to receivership. It is difficult to determine the magnitude of this overstatement. It seems unlikely, however, that it accounted for the entire difference between the book and realizable value of A.S.L.'s current assets, after receivership. No doubt, some of the difference reflected the switch from going concern to liquidation based asset values. A.S.L.'s accounts cannot be criticized for maintaining the going concern assumption in the period leading up to receivership because the group's existence was virtually assured as long as it had the support of A.T.I. This support was withdrawn immediately prior to receivership.

9.2 (iii) (e) A.S.L.'s Financial Statement Misinformation, A Summary

To summarize, there were aspects of A.S.L.'s financial statement data which were probably misleading. The changes in the group's accounting policies, from the early 1970s, hampered any intertemporal comparisons of A.S.L.'s results, over the crucial years leading up to receivership. More importantly, some of the changes allowed the group to improve its reported results and defer the disclosure of the problems it was experiencing. However, the various sources of financial statement data enabled a comparison of A.S.L.'s results over time and enabled the identification of any profit improvements at least in the year of change. It is concluded, therefore, that the changes did not result in any significant financial statement misinformation, at least for financially literate investors.

The major issue in evaluating A.S.L.'s financial statement data is the valuations assigned to group's development projects and related receivables. In the period leading up to receivership, development projects and related receivables accounted for a significant part of A.LS.L.'s assets. The valuation of development property and related assets is complex and involves some subjectivity. Nevertheless, there is some evidence to suggest that A.S.L.'s financial statements significantly overstated the value of these assets. It is most unlikely, however, that this overstatement accounted entirely for the writedowns estimated by A.S.L.'s receivers. Some of these writedowns can be attributed to the switch from a going concern to a liquidation basis of valuation. There is no evidence to suggest that A.S.L. should have dropped the going concern assumption any earlier.

9.3 Testing the Responsibility Hypothesis for A.S.L.

The accounting profession's responsibility for A.S.L.'s financial statement misinformation can be determined in terms of the responsibility criteria set out in section 3.4(vi) of Chapter 3. The only clear evidence of misinformation relates to that the values of development projects and property debtors which were overstated. As discussed in earlier case studies, the accepted principles relevant to accounting for real estate development have not been defined. However, the generally accepted accounting principles in related areas required A.S.L. to record development projects at the lower of cost or net realizable value. This principle had been specified by the profession from as early as 1948.[61] It was confirmed in the 1976 accounting standard on inventories.[62] According to the notes to its accounts, A.S.L.

[61] Institute of Chartered Accountants in Australia [1948].

[62] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1976c].

complied with these principles.[63] Development projects were carried at the lower of cost or "assessed net realizable value", where

> "assessed net realizable value is based on regular management valuations performed by qualified valuers."[64]

Cost included holding charges (including the capitalized interest, discussed above) provided that cost was less than realizable value. It would seem, therefore, that accountants had the responsibility for recording the costs of development projects and for calculating the net realizable values of development projects. The net realizable value of a project would have been equal to its estimated market value less any estimated future costs associated with the project prior to realization. Qualified valuers, not accountants, had the responsibility for estimating market values. If book values were overstated, the accountants could be held responsible only where there was some evidence that they had not recorded the capitalized or future costs properly or where they had not written down the book value when costs of a development property exceeded its realizable value. The individuals involved in the preparation of A.S.L.'s accounts could not be held responsible, however, for overstated book values which resulted from overstated market values. There is no evidence to suggest that the capitalized or future costs of A.S.L.'s development projects had not been recorded properly nor that the lower of cost of net realizable value rule, quoted in the notes to the accounts, had not been applied. Thus, there is no evidence to suggest that the individuals involved in the preparation of A.S.L.'s accounts should be considered responsible for any overstatement of the book value of its

[63] See, for example, Associated Securities Ltd., Notes to and Forming Part of the Balance Sheet and Statement of Profit and Loss, as at 30 June, 1976, Note 1b.

[64] *Ibid.*

development projects. Moreover, whilst the auditors were responsible for attesting to the truth and fairness of A.S.L.'s financial statements, there is no evidence to suggest that they should be considered responsible for any overstatement of the value of the development projects. After all, the values were based on information provided by qualified valuers.

As far as property debtors are concerned, the 1967 A.S.A. pronouncement on bad debts required adequate provision for doubtful debts.[65] A.S.L.'s accounts, from 1975-76, did include substantial provisions for doubtful property debtors. The question is whether the ultimate inadequacy of these provisions can be attributed to poor judgement or to a deliberate violation of generally accepted accounting principles. The notes to the accounts gave no details of the valuation of property debtors. However, the valuation of property debtors probably would have depended on the valuation of the underlying security of the debtors which, in turn, is likely to have consisted largely of development real estate. Thus, responsibility for the overstatement of property debtors probably rested more with valuers than with accountants.

Finally, as far as individual responsibility is concerned, it should be noted that although there is no conclusive evidence to implicate the individual accountants involved with A.S.L. over the inflated asset values, such evidence is unlikely to be available to an external observer. The earlier case study companies had been the subject of a government investigation which resulted in detailed reports on some of their accounting procedures. There was no government investigation into the affairs of A.S.L. This may have been because the various state Corporate Affairs bodies found no grounds to suggest that an investigation was warranted. However,

[65] Australian Society of Accountants [1967].

without such an investigation or access to internal information, it is impossible to determine whether A.S.L. followed its stated policies and, therefore, complied with accepted accounting principles. Perhaps it should be concluded that there is no substantive evidence to suggest that accountants were responsible for the overstatement of A.S.L.,'s asset values but that it would be very difficult to prove that they were responsible, even in part, for this misinformation without access to the details of A.S.L.'s accounting procedures.

As far as the responsibility of the accounting profession is concerned, with no conclusive evidence against individual members, it is difficult to criticize the profession as a whole. However, the profession can be criticized for failing to define principles in the complex and controversial area of accounting for real estate development. Although the prime responsibility for the overstatement of the value of A.S.L.'s development projects and probably property debtors appears to rest with valuers rather than accountants, clearly defined principles in this area may have been useful in instructing valuers on the basis of valuation or in evaluating their estimates of realizable value.

9.4 Conclusions

From the investor's point of view, A.S.L.'s failure was significant. Although the affairs of the group have not been finalized, it seems that its failure will probably result in losses of invested funds of between $80m and $88m. Moreover, these estimates ignore the probably substantial losses incurred by second charge debenture holders from earnings foregone on, and the decline in purchasing power of, any principal eventually recovered. A.S.L.'s financial statement data issued over the period 1968 to 1978, did not depict the group as a particularly attractive investment opportunity. It was clear from at least 1974-75 that A.S.L. was experiencing profitability and liquidity problems. However, the data suggested that funds invested in A.S.L. were reasonably secure and there was no indication that failure was imminent.

The evidence suggests that the major source of misinformation in A.S.L.'s accounts was the overstated value of some of the group's current assets. The existence of significantly overstated current asset values is consistent with the misinformation hypothesis. A.S.L. produced financial statement data which misrepresented its financial position and, therefore, did not provide at least some investors with a clear warning of the extent of the group's demise. However, it is unlikely that these overstatements accounted entirely for the investor losses. Part of these losses can be attributed to the differences between liquidation and going concern based asset values. There is no evidence to suggest that A.S.L. should have dropped the going concern assumption prior to receivership.

The overstatement of current aset values contravenes accepted accounting principles and, therefore, normally would be considered the responsibility of the individuals involved in the preparation and audit of the accounts. However, in A.S.L.'s case, the overstatement relates to the value of development projects and property debtors. Assuming that A.S.L. adopted the procedures described in the notes to its accounts, the overstatement of the value of the development projects and probably property debtors was likely to have been the responsibility of qualified valuers rather than accountants. Thus, the evidence in A.S.L.'s case is not consistent with the responsibility hypothesis. It should be noted, though, that the misinformation occurred in that troublesome area, accounting for real estate development, and the accounting profession can be criticized for not delineating the appropriate principles in this area.

Finally, the lack of support for the responsibility hypothesis should be interpreted in the light of the quality ot the evidence. The lack ot evidence against the individuals involved with A.S.L.'s accounts may reflect the lack of access to inside information about the accounting procedures embodied in those accounts.

CHAPTER 10

FINANCE CORPORATION OF AUSTRALIA LIMITED

Finance Corporation of Australia was incorporated as a private company in South Australia in December 1954. In March 1955, it was converted to a public company, in which the Bank of Adelaide held 40 per cent of the share capital. In 1969, the Bank of Adelaide acquired the remainder of F.C.A.'s issued capital. By this time, F.C.A. had a number of subsidiaries. The company was begun to finance the purchase of motor vehicles, domestic appliances, farming equipment and industrial machinery, and was expanded subsequently to include real estate finance, motor vehicle distribution, pastoral and property ventures.[1] Although F.C.A. had experienced a decline in profitability over the late 1970's, it had a reputation as a sound and reasonably successful finance company and had contributed significantly to the Bank of Adelaide's profitability. For example, over the five years from 1973-74 to 1977-78, F.C.A.'s net profit averaged 71.23 per cent of the Bank of Adelaide's consolidated net profit. During this period, F.C.A.'s contribution to the Bank's profit had declined from 85.23 per cent in 1973-74, to 61.45 per cent in 1977-78, but with a net profit of $4.21m in 1977-78, F.C.A. appeared to be sound.[2]

Nevertheless, by May 1979 the F.C.A. group had collapsed. The collapse was accompanied by asset writedowns which absorbed most of the company's

[1] The history of F.C.A. has been traced through data contained in the group's annual reports, issued over the period 1955 to 1979.

[2] These percentages are based on net profit, excluding extraordinary items and minority interests. The comparability of F.C.A. and Bank of Adelaide profits is weakened by the fact that the two groups have different balance dates. Moreover, it should be noted that these percentages have ignored the possibility of intercompany eliminations between F.C.A. and Bank of Adelaide accounts.

shareholders' funds and which required an injection of between $40m and $60m additional capital. Unlike the other corporate failures considered in this thesis, F.C.A.'s failure did not result in a breach of its debenture trust deed, nor did it result in receivership. However, because of F.C.A.'s failure the Reserve Bank of Australia insisted that the Bank of Adelaide merge with another Australian trading bank. F.C.A. still trades today as a subsidiary of the Australian and New Zealand Banking Group (hereafter the A.N.Z.).

In February 1979, one week after A.S.L. went into receivership, F.C.A. released its results for the first half of 1978-79, which showed a downturn in profitability. At about the same time, F.C.A. closed its 54th debenture issue, which had raised more than $40m over the previous five months[3] and had increased the company's debt almost to the trust deed limit.[4] F.C.A. was due to make debenture repayments of $20m in April, and was anxious to issue its 55th prospectus. However, the Corporate Affairs Commissions in South Australia and New South Wales asked F.C.A. to justify certain current asset values in the proposed prospectus. F.C.A. was unable to satisfy the Corporate Affairs Commissions and was forced to defer the issue of its 55th prospectus. The April debenture repayments were made from F.C.A.'s standby facility, which had to be repaid within 180 days. The adverse publicity surrounding these events caused investors to lose confidence in F.C.A. and resulted in the company's inability to attract new and retain existing deposits. For example, over the first three months of 1979, the net outflow of funds to F.C.A.'s lenders at call or on short term deposit was $44m. In

[3] Finance Corporation of Australia Ltd, Directors' Report for six months ended 31 December 1978.

[4] Finance Corporation of Australia Ltd, Trust Deed, Clause 7, limited debenture borrowing to the lesser of 80 per cent of current assets or six times shareholders' funds.

the following three months the net outflow amounted to almost $40m.[5] F.C.A. could not cover these outflows. It had fully drawn its standby reserve of $10m from the Bank of Adelaide, and the Reserve Bank instructed the Bank of Adelaide not to inject further funds into its ailing finance subsidiary. By this time, even if the issue of asset valuation had been resolved satisfactorily and the 55th prospectus issued, public confidence in F.C.A. was so low that the issue would have been unlikely to succeed. F.C.A. had run out of money.[6]

The Bank of Adelaide's directors unsuccessfully attempted a number of rescue bids. Finally, a consortium of five Australian trading banks from the Australian Banking Association (hereafter the A.B.A.) and the Commonwealth Trading Bank of Australia provided the Bank of Adelaide with a subordinated loan of $50 m, initially drawn to $30 m. In addition, the Reserve Bank provided the Bank of Adelaide with a specific liquidity facility of $25m, initially drawn to $10m. The Bank of Adelaide then subscribed additional capital to F.C.A., in the form of 30m fully paid redeemable preference shares with a par value of $1 and 25m redeemable preference shares paid to 10 cents. In addition, the Bank paid in full the existing uncalled liability of 75 cents per share on 8m ordinary shares. Thus, the Bank of Adelaide contributed $38.5m additional share capital to F.C.A. The A.B.A./Reserve Bank assistance was conditional upon the Bank of Adelaide merging with another Australian Bank but only the A.N.Z. put forward a satisfactory merger proposal. Eventually this proposal was accepted by Bank of Adelaide shareholders, despite attempts by a group of objecting shareholders to have the South Australian Supreme Court put the offer aside.

[5] Finance Corporation of Australia Ltd, Directors' Report for fifteen months ended 30 September 1979.

[6] The difficulties faced by F.C.A. during early 1979 are summarized in South Australia in the Supreme Court [1979, pp.8-38].

This group of shareholders based their objections, in part, upon a claim that the writedowns of F.C.A.'s assets underlying the A.N.Z. offer were excessive, and that the value of F.C.A. and the Bank of Adelaide were understated. The Supreme Court was not required to judge these claims, as, on the day that the A.N.Z. offer was due to expire, the objecting shareholders withdrew their legal challenge, after consideration of

> "certain entirely new information about the position of F.C.A. and the Bank of Adelaide."[7]

The content of this new information was not disclosed.

The purpose of this chapter is to assess whether F.C.A.'s financial statement data, published in the years preceding its collapse, could have misled investors and contributed to their losses. The rejection of the 55th prospectus, which was based on F.C.A.'s audited accounts, and the asset writedowns made prior to the Bank of Adelaide/A.N.Z. merger suggest that current asset values in these accounts may have been overstated. Alternatively, the writedowns may have been due to the adverse circumstances which arose in early 1979. These circumstances created severe liquidity problems for the F.C.A. group, which may have necessitated a change in the basis of valuation of the group's assets. It is also possible that the extent of the financial statement misinformation has been exaggerated because of the overstatement of the required writedowns. This chapter also considers the responsibility of the accounting profession for any financial statement misinformation produced by F.C.A.

[7] *Australian Financial Review*, 3 December 1979.

10.1 The Losses of F.C.A. Investors

Prior to failure, F.C.A. had three main classes of investors. They were shareholders, debenture holders and depositors. Table 10.1 shows the funds which each of these groups contributed to F.C.A., from incorporation until 31 December 1978, which was the interim balance date immediately preceding the group's failure. In addition to contributed capital of $35m, shareholders' funds on 31 December 1978 included reserves and unappropriated profits of $17.26m. The audited balance sheet dated 30 September 1979, showed shareholders' funds totalling $51.39m made up of the $35m contributed capital, the $38.5m "rescue capital" provided by the A.B.A. consortium and the Reserve Bank, and a deficiency of $22.11m. Between 31 December 1978 and 30 September 1979, therefore, F.C.A.'s shareholders' funds had decreased by approximately $39m. Reserves and unappropriated profits of $17.26m and contributed capital of $22.11m had been lost. The major cause of the capital losses were asset write-offs and writedowns of $44.62m. During the year ended 30 September 1979, the Bank of Adelaide's consolidated shareholders' funds decreased by $38.16m, or 53 per cent. F.C.A.'s failure was responsible for this decline.[8]

Table 10.1 shows that the other classes of F.C.A. investors provided significantly more funds than shareholders. For example, at 31 December 1978, F.C.A.'s liability to debenture holders and depositors was $341.73m and $110.09m respectively. F.C.A.'s debenture borrowings grew rapidly from incorporation, with particularly large increases occurring in the late 1960s and early 1970s. They continued to grow until 31 December 1978, although at a slower rate over the mid-to-late 1970s. Money borrowed on deposit also grew

[8] The full extent of the $44.62m writedowns was not reflected in the decline in F.C.A.'s or the Bank's consolidated shareholders' funds because the profit from other sources in 1978-79, partially offset the writedowns.

Table 10.1: Funds Invested in F.C.A. (in $m)

Year ended 30 June	Share capital	Debentures	Deposits
1955	0.20	–	0.26
1956	1.00	2.84	0.27
1957	n.a.	n.a.	n.a.
1958	n.a.	n.a.	n.a.
1959	1.75	8.97	4.85
1960	2.50	14.44	9.67
1961	3.25	17.14	10.62
1962	3.75	23.35	14.22
1963	4.51	29.73	15.34
1964	5.51	38.86	16.72
1965	6.42	45.96	17.09
1966	7.52	56.91	11.32
1967	8.03	63.74	11.02
1968	9.03	73.04	15.30
1969	11.54	88.02	23.40
1970	13.79	109.55	31.87
1971	22.75	144.67	30.90
1972	22.75	173.97	43.83
1973	28.40	209.73	57.97
1974	32.80	287.99	60.60
1975	32.80	285.59	64.43
1976	32.80	310.59	65.29
1977	35.00	334.21	110.72
1978	35.00	337.02	98.55
31/12/78	35.00	341.73	110.09

Source: Finance Corporation of Australia Ltd, *Annual Report, years ended 30 June 1955 to 30 June 1978* and Interim Balance Sheet, six months ended 31 December, 1978.

materially, but more erratically than debenture borrowings. The decline in the rate of growth in debenture borrowings in the late 1970s, was partly offset by higher levels of deposits. Early estimates of the asset writedowns required by F.C.A. exceeded shareholders' funds, with the implication that the group's creditors would suffer losses. However, the writedowns made eventually, as shown in the accounts at 30 September 1979, absorbed all retained earnings and only part of paid-up capital. Therefore, none of F.C.A.'s debt capital was lost in the company's collapse.

To summarize, F.C.A.'s depositors and debenture holders lost nothing. As F.C.A. was wholly owned by the Bank of Adelaide, it was the Bank's shareholders who were subjected to loss. At book value, this loss was approximately $39m.

10.2 Testing the Misinformation Hypothesis for F.C.A.

10.2(i) The Relevant Period and the Relevant Data

The methodology developed in Chapter 3 requires an assessment of the financial statement data which were available to the investors who suffered losses in F.C.A.'s failure. The only investor losses were those of the shareholders of the Bank of Adelaide. Given the access which the Bank would have had to F.C.A.'s internal accounting data, it could be argued that F.C.A.'s *published* financial statement data were probably of little relevance to the Bank's decisions to invest in F.C.A. However, F.C.A.'s internal accounting information was available to the Bank of Adelaide's management but not to its shareholders. The Bank's management made the decisions to invest in F.C.A., but the Bank's shareholders had the opportunity to buy or sell Bank shares and, thus, effectively ratify or reject management's decisions. The most accessible accounting information about F.C.A. which was available to Bank shareholders, was the Bank's consolidated financial statements, which embodied F.C.A.'s financial statements. Details of the effects of transactions between the Bank and F.C.A. are not available and it is not possible to identify the eliminations in the Bank's consolidated accounts. Despite this problem, an analysis of the profits, assets and liabilities, disclosed in F.C.A.'s audited financial statements, should give a reasonable indication of the accounting information about F.C.A. which was available to Bank of Adelaide shareholders.

The methodology developed in Chapter 3 identified the dividend rate as one of the key indicators of profitability from the shareholders' point of view. In F.C.A.'s case, however, dividends were paid to the Bank of Adelaide and not to its shareholders and the Bank's consolidated accounts would have eliminated the effects of dividend payments. Assuming the Bank's consolidated accounts were the prime source of accounting information for Bank shareholders, F.C.A.'s dividend rate is, therefore, unlikely to have been considered by Bank shareholders. The methodology developed in Chapter 3 also identified net profit as potentially relevant to investment decisions. Although Bank of Adelaide shareholders were not presented with F.C.A.'s annual reports and prospectuses, information about F.C.A.'s net profit may still have had an influence over their decision to invest in the Bank, particularly as F.C.A. made a large contribution to the Bank's consolidated net profit. The other indicators of the profitability and security of share investments, identified in Chapter 3, remain appropriate.

In Chapter 3, the relevant period was identified as the period during which the company was most active in seeking investors' funds, particularly those lost in the company's failure. F.C.A. was incorporated in 1955 and it was wholly owned by the Bank of Adelaide from 1969. Table 10.1 showed that from 1969 until 1978, F.C.A.'s contributed capital increased from $11.54m to $35m. Thus, although F.C.A. existed for twenty-five years prior to its collapse, it seems appropriate to concentrate upon the period between 30 June 1968, which was the balance date immediately prior to the Bank of Adelaide takeover, and 31 December 1978, which was the interim balance date immediately prior to F.C.A.'s collapse.

10.2(ii) F.C.A.'s Condition according to Its Financial Statement Data

Table 10.2 shows the key indicators of the profitability and security of an investment in F.C.A. shares, for the period 30 June 1968 to 31 December 1978. The net profit data show that F.C.A. was profitable for the entire period, although profit was variable. Consolidated net profit grew erratically until 1973-74. Over this period, profit growth seemed to follow a three year cycle, with one year of low growth followed by two years of high growth. For example, in 1967-68 profit grew by 7.69 per cent and then in 1968-69 and 1969-70 it grew by 30.52 per cent and 26.87 per cent respectively. In 1970-71 the growth rate dropped back to 15.69 per cent but then in each of 1971-72 and 1972-73, the growth rate was greater than 30 per cent. In 1973-74 the growth in net profit dropped back to 11.93 per cent but two years of high growth did not follow. From 1974-75 to 1978-79, profit generally decreased in each period. The only exception was 1975-76 when profit increased but this increase was insufficient to achieve the level of profit reported two years earlier. If the fall in profit recorded in the first half of 1978-79 was maintained for the full year, profit would have been almost 66 per cent less than in the previous year. As discussed earlier, creditors' reaction to this substantial decline in profit contributed to the final collapse of F.C.A.

The rate of return on shareholders' funds earned by F.C.A. in the early part of the period appears to have been reasonably stable. From 1967-68 to 1971-72, the return on shareholders' funds fluctuated between 11.51 per cent

Table 10.2: F.C.A.'s Profitability and Security, The Bank of Adelaide's Shareholders' Perspective

Period ended	Net Profit after tax $m[1]	Change in net profit over previous yr (%)	Return on shareholders funds[1](%)	Net tangible asset backing per $1.00 share[2]	Debt Ratio
30/6/68	1.54	+7.69	12.15	1.50	0.87
30/6/69	2.01	+30.52	13.15	1.31	0.87
30/6/70	2.55	+26.87	13.63	1.27	0.88
30/6/71	2.95	+15.69	11.51	1.10	0.85
30/6/72	4.10	+38.98	13.02	1.15	0.87
30/6/73	5.45	+32.93	15.01	1.26	0.87
30/6/74	6.10	+11.93	13.92	1.18	0.88
30/6/75	4.81	-21.15	10.09	1.19	0.88
30/6/76	5.34	+11.02	10.92	1.22	0.89
30/6/77	4.36	-18.35	8.60	1.25	0.90
30/6/78	4.21	-3.44	8.09	1.26	0.90
31/12/78	0.72	-65.80[3]	1.37	1.28	0.90

Source: Finance Corporation of Australia Ltd, *Annual Report, Years ended 30 June 1968 to 30 June 1978* and *Interim Report, six months ended 31 December 1978*.

1. Net profit and return on shareholders' funds exclude extraordinary items.
2. Future income tax benefits treated as intangible.
3. Adjusted to an annual equivalent basis.

and 13.63 per cent per annum. In 1972-73, it rose to 15.01 per cent before falling to 13.92 per cent in 1973-74. However, after 1973-74, F.C.A.'s return on its shareholders' funds declined sharply and in the first half of 1978-79, F.C.A. earned a return on shareholders' funds of only 1.37 per cent. Comparing F.C.A.'s rate of return on shareholders' funds with the industry average shown in Table 3.2, F.C.A. earned a higher rate of return in 7 of the 11 years. Even in the period from 1974-75 to 1977-78, when F.C.A.'s return on its shareholders' funds declined, it was higher than the industry average in each year except 1975-76. By 1978-79, however, the industry average rate of return was 7.39 per cent per annum, whilst F.C.A.'s rate of return in the first half of that year was only 1.37 per cent. Thus, the return on shareholders' funds data, when compared to industry average rates of return, did not indicate profitability problems until 1978-79, although in making these comparisons, it must be remembered that the poor results of both F.C.A. and A.S.L. from the mid-1970s, are likely to have had a substantial effect on the industry averages.[9] Table 3.3 shows the rates of return on shareholders' funds earned by A.G.C. and B.F.C. over the corresponding period. F.C.A.'s rate of return on its shareholders' funds was lower than for A.G.C. in each year over the relevant period, except for 1973-74, and it was lower than for B.F.C. in each year from 1971-72, except for 1972-73. Thus, although F.C.A.'s return on shareholders' funds prior to 1978-79 was generally higher than the industry average rates, it was generally lower than the rates earned by two of its major competitors, from at least 1971-72.

[9] The industry data, over most of this period, included finance companies with outstandings in various forms of finance agreements of $0.5m or more. F.C.A. and A.S.L., had finance agreements many times greater than this by the mid-1970s and, therefore, are likely to have had a strong influence over industry averages.

The level of security available for F.C.A. shares was also relatively low. At 30 June 1968, the net asset backing per $1 share was $1.50. Apart from this initial year, F.C.A.'s asset backing fluctuated from a low of $1.10 per share to a high of $1.31 per share. Industry average asset backing data are not available, but F.C.A.'s asset backing was lower than that for A.G.C. over the period and lower than that for B.F.C. at each balance date from 1971.[10]

F.C.A.'s debt ratio also seems to have been relatively unattractive. Prior to 1976, F.C.A.'s debt ratio was stable, generally varying between 0.87 and 0.88. At 30 June 1976, F.C.A.'s debt ratio had increased to 0.89, and on subsequent balance dates it was 0.90. Over the corresponding period, the industry average debt ratios, shown in Table 3.2, were lower than F.C.A.'s debt ratios for six of the eleven years and were equal for another three years. A.G.C.'s debt ratios over the corresponding period, shown in Table 3.3, were lower than F.C.A.'s for nine of the eleven years and were equal for the other two years. B.F.C.'s debt ratios, also shown in Table 3.3, were lower than F.C.A.'s for five of the eleven years and equal for two of the other years. From 1976, F.C.A. was higher geared than the average firm in the industry and than A.G.C. and B.F.C.

To summarize, F.C.A.'s financial statement data showed that the group had experienced profitability problems from 1974-75. F.C.A.'s return on shareholders' funds was lower than that of two of its major competitors from the early 1970s, although it was higher than the industry average. The security available for F.C.A. shares was also relatively unattractive. The asset backing per share was relatively low and, from 1976, the group's debt ratio was relatively high.

[10] Table 3.3 shows the asset backing available for A.G.C. and B.F.C. shares, although allowance must be made for the fact that A.G.C. and B.F.C. shares had a par value of 50 cents.

10.2(iii) F.C.A.'s Financial Statement Misinformation

The above analysis suggests that F.C.A.'s financial statement data indicated that, from the mid-1970s, F.C.A. shares were not a particularly attractive investment. However, the data gave little indication that failure was imminent. It is necessary to consider, therefore, whether F.C.A.'s failure occurred only because of the series of adverse circumstances which arose in early 1979, or whether F.C.A.'s accounts disguised the extent of the group's problems prior to 1979.

Asset valuation was a major issue in the F.C.A. collapse. The 55th prospectus was deferred because of Corporate Affairs Commission queries over current asset values. This deferment contributed to F.C.A.'s liquidity problems. In addition, according to the Chairman of the Bank of Adelaide, speculation in the media over the value of F.C.A.'s development ventures resulted in a decline in investor confidence and an outflow of the company's short term funds, which compounded the liquidity problems.[11] Under generally accepted accounting principles, F.C.A.'s development ventures should have been valued at the lower of cost or realizable value. According to the notes to F.C.A.'s pre-collapse accounts, these principles had been applied.[12] To prove that F.C.A.'s audited financial statement data were potentially misleading it is necessary, therefore, to establish the extent to which the book value of the current assets was overstated and whether any overstatement reflected inaccuracies in previous accounts or a subsequent decline in realizable values.

[11] Letter from Chairman, Bank of Adelaide, to shareholders, 29 August 1979.

[12] See, for example, Finance Corporation of Australia Ltd., Notes to the Audited Financial Statements, for the year ended 30 June 1978, Note 1(d).

10.2(iii)(a) Estimates of the Overstatement of the Value of F.C.A.'s Current Assets

The evidence about F.C.A.'s asset values is controversial. The writedowns in F.C.A.'s audited accounts of 30 September 1979, represent the company's final estimate of the overstatement. However, unlike the other case studies where only one estimate of realizable values was available, several other estimates of the required writedowns have been made. The first estimate was provided by an F.C.A. working party which reviewed the value of the group's development ventures. At 31 March 1979, they recommended that the book value of F.C.A.'s development ventures should be written down by $30m, comprising approximately $28m for development land and $2.0m for property finance loans.[13] The proposed land writedowns were based on the lower of book value and estimated realizable value. The estimates of realizable value were provided by the F.C.A. branches responsible for the development properties. They were based on realization over a two to three year period in the *existing condition* and on the assumption that finance would be provided on reasonable terms to purchasers.[14] Previous book values had also been based on the lower of cost and net realizable value, but realization assumed the sale of *fully developed* land in the ordinary course of business. F.C.A.'s management claimed that liquidity problems prevented further development and warranted the change in the basis of valuation. According to them, the writedowns simply reflected this change, as there were fewer purchasers for broad acres

[13] South Australia in the Supreme Court [1979, pp.38-41]. The working party actually estimated the land writedown at $27.067m. This was subsequently rounded up to $28m.

[14] Letter from Chairman, Bank of Adelaide, to shareholders, 29 August 1979.

or partially developed land than for developed land and the market value for such land was substantially lower.[15]

A second estimate of F.C.A.'s asset writedowns was provided by the Bank of New South Wales.[16] On 22 March 1979, the Bank of Adelaide commissioned Sir Norman Young, a prominent Adelaide businessman, to undertake merger negotiations with the Bank of New South Wales. On 26 April 1979, the Bank of New South Wales proposed a scheme of arrangement with the Bank of Adelaide, which was based on F.C.A. writedowns of $58m. Details of the writedowns were not released, except that they applied principally to land held for development, as well as to F.C.A.'s lending portfolio.[17] F.C.A. directors considered the writedowns to be overstated and attributed them to a 'fire-sale' basis of valuation. However, the Bank of New South Wales claimed that the basis of valuation was similar to that used in the earlier F.C.A. estimates.[18] Whilst the basis of valuation may have been the same, the perspective was probably different, as the larger the F.C.A. writedowns, the lower the cost of the proposed merger with the Bank of Adelaide. The offer was rejected by Bank of Adelaide directors.

Sir Norman Young then sought out alternative rescue proposals. He based his negotiations on a net asset backing of $1.48 per Bank of Adelaide share.[19] Prior to F.C.A.'s collapse, Bank of Adelaide shares had a net asset backing of between $2.20 and $2.25. With 31.505m shares outstanding, the backing of $1.48 implied Bank of Adelaide asset losses of $23.47m, which

[15] *Ibid.*

[16] Now Westpac Banking Corporation Ltd.

[17] South Australia in the Supreme Court [1979, p.12].

[18] South Australia in the Supreme Court [1979, p.15].

[19] *The Adelaide Advertiser*, 9 November 1979, p.7.

presumably reflected F.C.A. writedowns of this amount.[20] These writedowns were substantially lower than the initial F.C.A. estimates, and those implicit in the Bank of New South Wales offer. In the Supreme Court inquiry into the proposed A.N.Z. merger, Sir Arthur Rymill, chairman of the Bank of Adelaide, was questioned over this valuation. He claimed that the asset backing of $1.48 was pitched as high as possible, as a starting point for any merger negotiations.[21] For example, it included some allowance for the future income tax benefits associated with the F.C.A. writedowns. Whilst the basis of this valuation was not disclosed, it was clearly in F.C.A.'s interest to have writedowns as low as possible. Young was unsuccessful in his attempt to solicit offers at, or near, $1.48 per share and this suggests that the market had little confidence in writedowns as low as $23.47m.

A third estimate of the writedowns was obtained on 17 May 1979, when F.C.A. commissioned Richard Ellis, Sallman and Seward Pty Ltd. (hereafter Ellis & Co.) to provide an independent valuation of its development properties, based on realization over a two to three year period. Ellis & Co. estimated property writedowns, at 25 May 1979, of $30.75m on a cash sale basis, or $28.14m on a terms basis.[22] These writedowns were similar to the initial F.C.A. estimates for development land and $27.25m less than the total writedowns recommended by the Bank of New South Wales.

Meanwhile, the Reserve Bank/A.B.A. consortium agreed to lend $60m to the Bank of Adelaide. This offer was based on a study by a working group appointed by the consortium, which had recommended writedowns of $58m to F.C.A.'s assets. The Bank was advised that the writedowns should include asset writedowns of $30m and a general provision for contingencies of $28m,

[20] Based on an average net asset backing per share of $2.225.

[21] *The Adelaide Advertiser*, 9 November 1979, p.7.

[22] South Australia in the Supreme Court [1979, p.32].

which would cover other losses as they occurred.[23] However, the Bank was not provided with any details of the specific writedowns required, nor of the basis on which they had been estimated. It was not until the Supreme Court inquiry in November 1979, that the A.B.A. disclosed the following breakdown.

Recommended Writedowns

	$m
Diminution in value of land development ventures	44.0
Bad debts and provision for doubtful debts	7.0
Allowance for performance bonds	3.0
Termination of joint ventures	4.0
	$58.0m

Source: South Australia in the Supreme Court [1979, p.148]

By November 1979, the A.B.A. had recognized that the initial estimate of $58m was excessive, because the writedown of the allowance for performance bonds and termination of joint ventures was no longer warranted, given the subscription of further F.C.A. capital and the likely acceptance of the Bank of Adelaide/A.N.Z. merger.

On 29 August 1979, the Bank of Adelaide sent details of the proposed A.N.Z. merger to its shareholders.[24] An independent evaluation of the proposed scheme, by Chartered Accountants, A. N. Powell, self-employed, and A. Hilton of Coopers and Lybrand, was included. Despite their access to

> "management and independent reports on F.C.A.'s investment in land development projects,"

[23] Letter from Chairman, Bank of Adelaide, to shareholders, 29 August 1979.

[24] *Ibid.*

and

> "discussion with senior officers and the auditors of the Bank of Adelaide",[25]

Powell and Hilton made no attempt to estimate the asset writedowns required. They simply quoted the Bank's net asset backing as shown on its last balance date and told the Bank's shareholders that

> "this figure will have to be adjusted to take account of the provision for future losses in respect of land held for development. No decision has yet been made by the Board of Directors of F.C.A. as to either their basis of valuation of such assets or their method of development or disposal. However, provision of either $30m or $58m for future losses or reduction in the value of these assets would reduce the net asset backing as at 30th September 1978 to $1.20 and $0.31 per share respectively."[26]

It is difficult to understand how Powell and Hilton could recommend the scheme as "fair and commercially reasonably in all circumstances", when they made no estimate of F.C.A.'s asset writedowns.

The A.N.Z. offer consisted of 15 A.N.Z. shares for 44 Bank of Adelaide shares. At the time of the offer, A.N.Z. shares were selling for around $4.00, putting a valuation of approximately $1.36 per share on the Bank of Adelaide.[27] Taking the Bank's pre-collapse asset backing of between $2.20 and $2.25, the A.N.Z. offer apparently involved writedowns of approximately $27.25m.[28] However, it is not possible to determine the A.N.Z.'s estimate of F.C.A.'s asset writedowns from its offer for the Bank of Adelaide, as the offer is likely to have included a component of goodwill, covering factors such as the value of the Bank of Adelaide's banking licence and the economies

[25] *Ibid.*

[26] *Ibid.*

[27] South Australia in the Supreme Court [1979, p.35].

[28] Based on an average asset backing of $2.225 per Bank of Adelaide share.

of scale resulting from the merger. It is likely, therefore, that the A.N.Z.'s estimate of F.C.A.'s writedowns was greater than $27.25m.

On 27 September 1979, the Bank of Adelaide again wrote to its shareholders, recommending acceptance of the A.N.Z. offer.[29] F.C.A.'s draft accounts, for the year ended 30 June 1979, were attached. They included a $41.41m provision for the diminution in the value of development ventures, a $3.55m provision for doubtful debts and a $2.25m write-off of bad debts. The total write-offs and provisions of $47.21m contrasted sharply with the initial F.C.A. estimate of $30m, although that estimate had related only to development ventures and property loans. The Bank's shareholders were informed that the development venture writedowns were based on a detailed study made by a working committee, consisting of representatives of the A.B.A. consortium and F.C.A. By this time, control of F.C.A. had vested in the A.B.A. consortium. According to the letter, the writedowns were based on

> "the estimated current market values of each of F.C.A.'s ventures on the basis of their present undeveloped or partially developed condition. In addition, where sales were estimated to occur beyond three months, the Working Committee discounted the estimated current market value of such development ventures to allow for a return of 15 per cent per annum up to the estimated date of sale ...
>
> Whether the amount of the provision ... is too large or too small will only become apparent as the land is sold."[30]

The provision for doubtful debts was said to cover loans

> "where their recovery was considered to be in any doubt."[31]

More details of the changes in F.C.A.'s approach to valuing its development ventures and debtors at 30 June 1979, were presented to the

[29] Letter from Chairman, Bank of Adelaide, to shareholders, 27 September 1979.

[30] *Ibid*.

[31] *Ibid*

Supreme Court inquiry, by the partner-in-charge of F.C.A.'s audit, John Bishop, of Peat Marwick Mitchell and Co.[32] Prior to the 30 June 1979, F.C.A.'s development property was valued at the lower of cost or net realizable value. Cost consisted of acquisition, development and holding costs. Holding costs included an amount for "past unrecouped interest", which was the lower of the estimated cost of money to F.C.A. and 9.5 per cent per annum on the cash invested in the property from its date of acquisition to balance date. Realizable value was calculated on the basis of the estimated selling value of the property less the estimated selling expenses, less the estimated future cost of bringing the property into a saleable condition and less the estimated "future unrecouped interest" which was 9.5 per cent per annum on the estimated cash investment in the property from the balance date to the time when this cash investment was expected to be recovered. Bishop gave no explanation for setting F.C.A.'s maximum cost of funds at 9.5 per cent per annum, which was critical to the calculation of both historic cost and realizable value. Whilst a 9.5 per cent per annum ceiling may have reflected conservatism in the calculation of cost, it had the opposite effect on the calculation of realizable value.

Having calculated the cost and net realizable value of a property on this basis, F.C.A. applied the following rules to determine book value:

1. If the net realizable value was greater than the historic cost, including capitalized costs, the value of the property was recorded at historic cost.

[32] South Australia in the Supreme Court, [1979, pp.76-112].

2. If the net realizable value was less than the historic cost the value of the property was written down by that part of unrecouped interest capitalized in the past but not covered by net realizable value.

3. If the net realizable value was less than the historic cost, after the write-off of all past unrecouped interest, the value of the property was recorded at net realizable value, after adding back sufficient future unrecouped interest to cover the amount by which historic cost less past unrecouped interest exceeded net realizable value.

4. If the net realizable value plus future unrecouped interest was less than the historic cost less past unrecouped interest, the value of the property was written down by the amount of the capital loss.

It seems, therefore, that prior to 1979, F.C.A. capitalized past unrecouped interest on profitable ventures, but omitted the deduction of future unrecouped interest in the calculation of the realizable values of unprofitable properties. This approach improved the net realizable values of unprofitable properties. [ie. properties covered by rules (3) and (4).] The increased net realizable values for the unprofitable properties resulted in increased book values. However properties covered by Rule (4) were written down by the amount of the capital loss and, therefore, valuations made under this rule remained very conservative. On this issue, the A.A.R.F. [1982, p.18] stated

> "... there are two basic points of view on the extent to which anticipated future holding costs should be deducted (from NRV)
>
> i) that they should be deducted only to the extent that they will be capitalised to the project, ignoring any that will be written off as incurred,
>
> ii) that the total anticipated holding costs until the estimated date of sale should be deducted, whether they will be capitalised or not.

> The first view in effect regards future holding costs that will be written off as period costs rather than project costs ...
>
> On the second view, holding costs are a real cost of a project regardless of the capitalisation policy that happens to be adopted. Therefore, to the extent that they are ignored where they would have the effect of reducing net realisable values below book values, the recognition of a loss is being deferred. Accordingly, it is argued that to ignore holding costs would be acceptable only when they are not material."

The method used to calculate the realizable value of development ventures in F.C.A.'s pre-collapse accounts was consistent with the first view.

Bishop justified the omission of future unrecouped interest charges from net realizable value, when this value was below a property's historic cost, net of capitalized interest, on the grounds that

> "clearly the company was not going to make either a profit, nor even an interest earning on its investment in that property the way the future estimated realizable values looked, and therefore it took the view that it should view that particular venture as one which it must get out of on the best possible terms, and, if it was not clearly earning any interest or profit up to date, it was felt inappropriate to value it on a basis that required it to earn an interest or a profit in the future ..."[33]

Bishop's argument has some merit. The deduction of future unrecouped interest in calculating the net realizable value of unprofitable properties would have amounted to recording a loss in the current period so that future costs could be capitalized. On these grounds, therefore, it seems that F.C.A.'s rules for valuing of development ventures were appropriate.

With reference to F.C.A.'s loans against development properties, Bishop explained that the pre-collapse accounts recorded the loans at the lower of their carrying value and the estimated value of the net assets of the borrower which were available as security. Carrying value included outstanding

[33] South Australia in the Supreme Court [1979, p.80].

principal plus accrued interest. Where the carrying value of a loan was less than its estimated underlying security, the loan was recorded at its carrying value. Where the underlying security was less than the carrying value, the loan was written down to the value of the security.

Some of Bishop's evidence on the method of valuing F.C.A.'s development land and loans in the 30 June 1979 draft accounts has been suppressed.[34] However, for development land, it seems that the lower of cost or net realizable value rule was still applied, but that cost and net realizable value were determined on a more conservative basis. Initially, an estimate of the market value of each property was made, on the basis of disposal within two to three years, in its present undeveloped or partially developed condition. In each case, market value was based on the lower of the branch estimates which were used by the working party in March 1979 and the valuations provided by Ellis & Co. in May 1979. Realizable value was then estimated on the basis of market value less any estimated selling, management and development costs. Development costs were charged where work had already commenced, or where F.C.A. was legally committed to a development programme. Where it was considered that realization would take place over a period of more than three months, the realizable values were discounted to their present value at a rate of 15 per cent per annum. Then, the lower of cost or realizable value rule was applied on an individual property basis, by comparing this discounted realizable value with book value as recorded in previous F.C.A. accounts. In the 30 June 1979 draft accounts, development loans were recorded at the lower of carrying value and the realizable value of the property over which the loan had been granted. This realizable value was

[34] For example, the evidence on development venture valuations was recorded in the Supreme Court report on pp.76-105, of which pp.86-87, 90-96 and 101-104 were suppressed.

calculated by the same method used for F.C.A.'s own development land, and included discounting the estimated future realizations to their present value at a rate of 15 per cent per annum.

F.C.A. also changed its method of valuing ordinary receivables in the draft accounts at 30 June 1979.[35] Previously, if a debt was thought to be bad or doubtful it was written off. There was no separate provision for doubtful debts. At 30 June 1979, more stringent criteria were introduced in assessing doubtful debts. All debts judged as bad or possibly bad were written off. Debts classified as doubtful and possibly good were included in a provision for doubtful debts, to the full extent of the debt. In addition, new criteria were introduced for "non-accrual" loans. Loans were classified as non-accrual where there was doubt over the receipt of payments, on a continuing basis, until the principal was recovered. Previously, F.C.A. made no provision for default on non-accrual loans, provided that the estimated value of the underlying security covered the value of the loan. Interest due which was doubtful, was omitted from the accounts. At 30 June 1979, non accrual loans were assessed on the personal covenant of the debtor. Where it was considered that the debtor would be unable to pay interst as it fell due, the loan was written down to the *present* value of the underlying security, using a discount rate of 15 per cent per annum. The value of the underlying security was discounted even though in the long run it might have been sufficient to meet the whole of the outstanding liability for both principal and interest. If the present value of the security was greater than the value of the loan, no writedown was made.

[35] Part of the evidence presented to the Supreme Court inquiry concerning the writedown of debtors has been suppressed. The remaining evidence, therefore, is not entirely clear. However, the evidence available, combined with the notes to F.C.A.'s 1978 accounts, confirm the following interpretation.

The final estimate of the writedowns, which was eventually accepted by F.C.A., consisted of the writedowns shown in F.C.A.'s audited financial statements for the fifteen months ended 30 September 1979. (The balance date was extended by three months, so that the balance dates for F.C.A. and the Bank of Adelaide coincided). These accounts were filed in December 1979, by which time F.C.A. was a subsidiary of the A.N.Z. They included charges of $44.62m against consolidated net profit for the writedown or write-off of assets. The $44.62m was composed of a $38.03m provision for the diminution in the value of development ventures, a $1.45m provision for doubtful debts and a write off of bad debts of $5.14m. The charge of $38.03m for the diminished value of development ventures included a $28.57m increase in the provision for losses against development land and an $8.51m provision for losses against development loans, with the remaining $0.96m presumably reflecting development land written off. According to the notes to these accounts, development land was valued on the basis of sale in its present undeveloped or partially developed condition, except where F.C.A. was legally committed to development or where work had already commenced. The land was valued at the lower of cost or estimated present realizable value. Cost included development costs, plus interest and holding costs capitalized before 1 January 1979. Present realizable values, presumably of both development land and loans, allowed for the time value of money by discounting the projected cash flows by a rate "considered prudent by the Board".[36]

It appears, therefore, that the method of valuing development ventures in the draft accounts at 30 June 1979, was maintained in the audited accounts for the fifteen months ended 30 September 1979. Indeed, in evidence to the Supreme Court inquiry, Bishop stated that

[36] Finance Corporation of Australia Ltd, Notes to Audited Financial Statements, fifteen months ended 30 September 1979.

> "he was not aware of any change in procedure between the end of June and September 30."[37]

However, the notes to the September accounts did not disclose whether the realizable value of development land was based on the F.C.A. estimates at 31 March 1979, the Ellis & Co. estimates at 25 May 1979, or some other source. In addition, they did not disclose the discount rate applied in estimating present realizable values. As far as debtors are concerned, the notes to the September 1979 accounts stated that bad debts were written off, that adequate provision was made for doubtful debts, and that provisions and write-offs were made for non-accrual loans where the estimated present realizable value of the underlying security was less than the principal.[38] This approach appears the same as that adopted in the June draft accounts, although once again the present value discount rate was not disclosed.

10.2(iii)(b) Evaluation of the Estimated Writedowns of F.C.A.'s Current Assets

Table 10.3 summarizes the various estimates of the writedowns required by F.C.A. The estimates based on the decline in the Bank of Adelaide's asset backing have been excluded because of some doubtful aspects in their calculation. For example, the valuation used by the Bank in its early merger negotiations was optimistic and the value underlying the A.N.Z. merger offer probably included a component of goodwill.

Table 10.3 shows that the estimates of the writedowns required by F.C.A. varied from $30m at 31 March 1979, to $58m at 30 April 1979. The estimated

[37] *The Adelaide Advertiser*, 14 November 1979.

[38] Finance Corporation of Australia Ltd, Notes to audited financial statements, fifteen months ended 30 September 1979.

Table 10.3: Comparison of the Estimates of the F.C.A. Writedowns (in $m)

	Initial F.C.A.	Bank of N.S.W.	Richard Ellis & Co.	A.B.A.	F.C.A. accounts, year ended 30 June 1979	F.C.A. accounts, 15 months ended 30 September 1979
Date to which estimate applies	31 March 1979	April 1979	25 May 1979	30 April 1979	30 June 1979	30 September 1979
1. Writedown of						0.96 write-off
Development land	28.0	n.d.	28.14	n.d.	n.d.	28.57 addition to provision
Development loans	2.0	n.d.	n.a.	n.d.	n.d.	8.51
Total development ventures	30.0			44.0	41.41	38.03
2. Provision/write off of						
Doubtful debts	n.a.	n.d.	n.a.'	n.d.	3.55	1.45
Bad debts	n.a.	n.d.	n.a.	n.d.	2.25	5.14
Total ordinary receivables				7.0	5.80	6.59
3. Other write-offs						
Termination of joint ventures	n.a.	n.d.	n.a.	3.0	–	–
Allowance for performance bonds	n.a.	n.d.	n.a.	4.0	–	–
Total write-downs	30.0	58.0	28.14	58.0	47.21	44.62
Method of valuation						
Development land	Lower of existing bk values & NRV NRV based on F.C.A. branch estimates. Realization in 2 to 3 years in undev'd/partially dev. condition. Inconsistent treatment of unrecouped int.	Sale in an orderly way within 2 to 3 years	Realization on cash basis in 2 to 3 yrs in undev'd or partially dev'd condition		Lower of existing bk value & NRV. NRV based on lwr of branch estimates & Ellis valuations. Realization in 2 to 3 yrs, in undev'd or partially dev'd condition Realizable values discounted to PV at 15% p.a.	Lower of book value or NRV Realization in undev'd or partially dev'd condition. Realizable values discounted to PV at a rate "prudent in the current year"
Development loans	Lower of carrying value & net assets of borrower	n.d.	n.a. - undertook land valuations only		Lower of carrying value & value of security property. Realizable value discounted to PV at 15% p.a.	Lower of carrying value & value of security property. Realizable value discounted to PV at a rate "prudent in the current yr"
Other assets	Covered development ventures only	n.d.	n.a.	Termination of joint ventures considered inevitable. No details of calculation of bad/doubtful debts	More stringent criteria in classification of ordinary rec'bls Non-accrual loans written down to value of underlying security, discounted to PV at 15% p.a.	Non-accrual loans written down to value of underlying security discounted to PV at undisclosed rate.
Gross Book Value of Assets						
Development Land	n.a.	n.d.	n.d.	n.d.	n.d.	45.88
Development Loans	n.a.	n.d.	n.a.	n.d.	n.d.	17.49
Total Development Ventures				77	71.71	63.37
Ordinary Receivables	n.a.	n.d.	n.a.	n.d.	371.03	345.43
Notes						
n.a. - not applicable						
n.d. - not disclosed						

write-downs at 30 June 1979 and 30 September 1979 were higher than the March estimates but lower than the April estimates. On the other hand, the estimated writedowns at 25 May 1979 were slightly lower than the March estimates. It is necessary to determine which, if any, of these writedowns provides a reasonable estimate of the extent to which F.C.A.'s asset values were overstated.

Several problems arise in comparing and evaluating these estimates of the F.C.A. writedowns. First, the estimates were made at different dates over the six months from 31 March to 30 September 1979, and, therefore, applied to different stocks of land, loans and receivables. Second, the estimates related to different assets and were not presented in a comparable form. For example, some of the estimates were confined to development ventures, while others also included ordinary debtors. Moreover, with respect to development ventures, some applied just to development land, some applied to land and loans combined, and some were split between development land and development loans. Third, the estimates made by F.C.A. may have been influenced by different management, because by mid-1979 control of F.C.A. had passed to the A.B.A. consortium and by December 1979 it had passed to the A.N.Z. Finally, the different estimates were based on different methods of asset valuation.

The estimates at 31 March 1979, made by the initial F.C.A. working party, applied only to development land and loans. Those at 25 May 1979, made Ellis & Co, applied only to development land. As far as development land is concerned, these two estimates appear to be reasonably consistent, although the stock of land in May was probably slightly lower than in March.[39] The

[39] F.C.A.'s investment in development ventures appears to have declined throughout 1979, At 31 December 1978, the gross book value of this asset was $81.75m (land $49.0m, loans $32.75m). At 30 April 1979, its gross book value was $77m (breakdown not available). At 30 June 1979, its gross book value was $71.71m (breakdown not available) and at 30 September 1979, its gross book value was $63.37m (land $45.88m, loans $17.49m).

estimates were much lower than the writedown of development ventures in the June draft accounts. The June estimate, like the March estimate applied to development loans as well as land, although these two components were not disclosed separately. The failure to consider the writedown of ordinary receivables at 31 March and at 25 May 1979, may possibly mean that, at these times, F.C.A. considered the value of this asset appropriate.

The Bank of New South Wales estimate, made during April 1979, and the A.B.A. estimate at 30 April 1979 were identical, at $58m. The A.B.A. subsequently reconciled its estimate to the writedowns in the June draft accounts. It explained the $10.79m difference on four main grounds.[40] First, by the time the June accounts were prepared, F.C.A.'s continued existence was virtually certain, so there was no need to make the $7m provision for the termination of joint ventures and various performance bonds. Second, the circumstances existing at the time that the A.B.A. estimate was made, required that the support from the A.B.A. was both adequate and provided in a single step. Third, there was more limited time for the calculation of the A.B.A. estimate. Finally, between 30 April and 30 June 1979, the book value of F.C.A.'s development ventures decreased and over this period F.C.A. had continued to review its doubtful debts. The A.B.A. implied that its writedown, which was consistent with the Bank of New South Wales writedown, was also consistent with the writedowns in the draft accounts at 30 June 1979, with the June estimates being the most accurate simply because of the passage of time.

However, the peculiar circumstances surrounding these three consistent estimates cast some doubt on their independence. A detailed breakdown of the writedowns estimated by the Bank of New South Wales was never disclosed. The

[40] South Australia in the Supreme Court [1979, pp.146-150].

composition of the A.B.A. estimate was not disclosed until requested by the South Australian Supreme Court, in November 1979. By this time, several months had elapsed and F.C.A.'s draft accounts, at 30 June 1979, had been released. The Bank of New South Wales was a member of the A.B.A. consortium and it is likely that the estimate of the writedowns made by the Bank of New South Wales influenced the estimate made by the A.B.A. Furthermore, by the time the June accounts were prepared, control of F.C.A. had passed to the A.B.A. consortium. In these circumstances, the consistency of these estimates cannot be taken as evidence of their accuracy.

The estimates of the development venture writedowns made by the March F.C.A. working party, which were consistent with the Ellis & Co. valuations, were $11.4lm lower than the estimates in the June draft accounts. This difference is not surprising, because of two significant differences in their bases of valuation. First, the June estimates were based on the lower of the March F.C.A. working party and Ellis & Co. valuations, which would have increased the required writedown. Second, and more importantly, the discounting of estimated realizable values to their present value in the June accounts would have increased the writedown.[41] Indeed it has been estimated that the present value discounting accounted for approximately $6.3m of the development venture writedowns at 30 June 1979.[42]

To argue that these present value based writedowns were more accurate than the earlier writedowns, it is necessary to show that present value discounting was a more appropriate method of valuation. At the Supreme Court

[41] Present value discounting must result in a lower net realizable value than that calculated under normal historic cost accounting. It is more likely, therefore, that realizable value will be below cost and thus increase the writedown required overall.

[42] South Australia in the Supreme Court [1979, p.117].

inquiry, counsel for the objecting shareholders argued that the present value method overstated the development venture writedowns, since it deducted a future profit component. The Bank of Adelaide's investment advisers, Schroder, Darling and Company Ltd. also questioned the appropriateness of this technique.[43]

Present value discounting does not fall within the gambit of the generally accepted principles of historic cost accounting. However, according to the A.A.R.F. [1982] discussion paper on accounting for real estate development, the discounting of development ventures to their present realizable value may be appropriate. The A.A.R.F. [1982, p.18] recognized that the accepted practice of valuing property at net realizable value *in the ordinary course of business* includes an element of unrealized profit. It could be argued that property should be valued at the lower of cost or net realizable value in its existing condition rather than in its developed state. The existing state value would not take account of planned developments and, therefore, would not include any unrealized profit expected from that development. In contrast, the "ordinary course of business value" includes the effects of planned development. According to the A.A.R.F. [1982, p.20],

> "Valuing property in its existing state theoretically involves discounting its net realizable value in the ordinary course of business for risk and profit, to arrive at its present value."

This seems to have been the approach used by F.C.A. in its June 1979 accounts. On the one hand, therefore, F.C.A.'s valuation of its development ventures at 31 March 1979 and the Ellis & Co. valuations at 25 May 1979, and the valuations in the accounts prior to 1979, accorded with accepted

[43] *Ibid.*

practice. On the other hand, the valuation in the June 1979 accounts accorded with the "existing state view". Although it was not then an accepted accounting practice, it cannot be argued that this existing state view was inappropriate. It should be noted, however, that valuations derived under this view are strongly influenced by the choice of discount rate, and even though the present value method may have been appropriate, F.C.A.'s discount rate was not necessarily so.

Present value discounting also influenced the writedowns of ordinary receivables included in the June 1979 accounts. The security underlying non-accrual loans was assessed on the basis of present realizable value, regardless of the fact that the security might have been sufficient in the long-run to meet the whole of the outstanding liability for principal and interest. Whilst the circumstances may have warranted present value discounting of development ventures, there is no evidence to suggest that a similar case can be made for valuing the various forms of security underlying non-accrual loans. In his report, the Master of the Supreme Court described F.C.A.'s valuation of its non-accrual loans as "ultra-conservative".[44]

The auditors' attitude towards F.C.A.'s present value discounting was variable. At one point, Bishop acknowledged that, as far as the auditors were concerned,

> "We had not conveyed our reaction to the proposed 15 per cent arrangement to the company, but I think they understood it was causing us some difficulty."[45]

On another occasion, he told the Supreme Court inquiry that

[44] South Australia in the Supreme Court [1979, p.110].

[45] *The Adelaide Advertiser*, 13 November 1979, p.9.

> "... the present value deduction was not in accordance with standard accounting procedures, but it was not abnormal and it was appropriate to the circumstances."[46]

Also, he told the inquiry that the auditors were

> "... of the opinion that the board has adopted conservative accounting policies which are appropriate to the group's circumstances and that the abnormal provisions for diminution in value of ventures and doubtful debts raised in accordance with those policies have been properly arrived at."[47]

Certainly, the auditor's report on accounts at 30 September 1979, which were prepared on the same basis as the June accounts, contained no qualification with regard to the adoption of present value accounting.

Apart from the issue of present value accounting, counsel for the objecting shareholders argued that the writedowns of the development ventures were overstated because, although the cash inflows associated with the properties had been discounted, the outflows such as selling, management and development costs had been deducted in full.[48] To the extent that this had occurred, the present values of F.C.A.'s development ventures were understated. The dissident shareholders also objected to the provision, in full, for every debt which was considered in any way doubtful. They argued that since the debts which were classified as doubtful and possibly bad were written off completely, it would have been sufficient to provide for only part, say half, of the debts which were classified as doubtful and possibly good. Although the fraction of one half may not have been appropriate, there seems to be some merit in this view. In the accounts prior to 1979, F.C.A. had written off all bad and doubtful debts. However, the size of the writedowns suggests that much more stringent criteria were applied in

[46] *The Adelaide Advertiser*, 13 November 1979.

[47] *The Adelaide Advertiser*, 9 November 1979.

[48] South Australia in the Supreme Court [1979, pp.125-126].

classifying doubtful debts in the 1979 accounts. Under these circumstances, the write off of all doubtful and possibly bad debts combined with the provision in full, for all doubtful and possibly good debts appears excessive.

In addition, the objecting shareholders claimed that there were two other respects in which F.C.A.'s June 1979 accounts were misleading.[49] First, the $2.78m provision for contingencies built up prior to 1978-79 should have been written back through the profit and loss account, because of the stringent basis on which the realizable value of F.C.A.'s assets had been assessed. This argument ignores the possibility that F.C.A.'s management may have been aware of problem areas, other than development ventures and debtors. Second, they argued that F.C.A.'s continued existence was virtually certain, given the additional capital subscribed by the Bank of Adelaide, and thus, it was appropriate to recognize the future income tax benefits associated with the asset writedowns in the June 1979 accounts. Whilst these benefits, totalling $18.17m, would be available to a future owner, F.C.A.'s continued existence was dependent on the A.N.Z. merger. Since the merger had yet to be approved by the Supreme Court and no viable alternative to this merger existed, the omission of these future income tax benefits is understandable.

To summarize, the A.B.A. reconciliation of its recommended writedowns with those included in the draft accounts at 30 June 1979, implied that the June writedowns were appropriate. However, the evidence suggests that the June writedowns may have been overstated. The adoption of present value discounting significantly increased the size of the writedown of development ventures. This method was most unusual, although there is some evidence to suggest that it may have been appropriate to the circumstances. The failure to discount the cash outflows associated with development ventures, however,

[49] South Australia in the Supreme Court [1979, pp.118-119].

was not appropriate. This would have resulted in an understatement of the present realizable value of development ventures and, hence, possibly an overstatement of the required writedown. For ordinary receivables, the introduction of more stringent criteria for identifying doubtful debts combined with the provision in full, for all doubtful but possibly good debts seems excessive, especially since all doubtful but possibly bad debts were written off. In addition, the present value discounting of the security underlying non-accrual loans was questionable.

Table 10.3 shows that the total writedowns at 30 September 1979 were $14.62m higher than the writedowns estimated by the F.C.A. working party at 31 March 1979. The writedown of development land at 30 September 1979 closely matched the estimate at 31 March 1979, although it was probably based on a slightly lower stock of land. However, the September estimate of development loan writedowns was more than four times greater than the March estimate, despite being based on a much lower stock of loans.[50] In addition, the September writedowns, unlike the March estimate, included a substantial write-off of, and provision against, ordinary receivables.

Table 10.3 also shows that F.C.A.'s writedowns at 30 September 1979 were $2.59m lower than at 30 June 1979. Given that the same accounting methods were apparently used in both sets of accounts, the difference can not be due

[50] The March estimates were based on development ventures with a total gross book value between $77m, at 30 April 1979, and $80m,, at 31 December 1978. Assuming the decline between December and April was spread evenly over the period, the gross book value of development ventures at 31 March can be estimated at $77.75m. Applying the proportions of land and loans as at 31 December 1978, the gross value of F.C.A.'s development land and loans at 31 March can be estimated at approximately $47.50m and $30.25m, respectively. Thus, the land writedowns at 31 March represented 59 per cent of the gross value, whilst, at 30 September they represented 64 per cent. More importantly the loan writedowns at 31 March and 30 September represented approximately 7 per cent and 49 per cent of gross value, respectively.

to a change in method, although it may reflect a change in the present value discount rate which was not disclosed in the September accounts. Another possible explanation for the lower writedown is the difference in the gross book values of the assets written down. The book value of F.C.A.'s development ventures at 30 September 1979 was 11.63 per cent lower than at 30 June 1979, whilst the writedown was 8.16 per cent lower. These differences seem reasonably consistent. However, the book value of F.C.A.'s principal outstandings at 30 September 1979 was 6.90 per cent lower than at 30 June 1979, yet the combined provision for, and write-off of, bad debts was 13.62 per cent higher. This difference may simply reflect additional information about the viability of debtors obtained since the June accounts were prepared, or it may reflect the fact that the A.N.Z. had an even more stringent attitude towards debtors than the A.B.A./F.C.A. management.

It has been shown that the value of the development ventures and ordinary receivables in the 30 June 1979 draft accounts were determined on a more stringent basis than in earlier accounts or in earlier estimates of the required writedowns. The values in the final accounts at 30 September 1979, particularly of ordinary receivables, appear to have been determined on an even more stringent basis. The accounts issued after 1979 suggest that the basis of valuation in the September 1979 accounts was too stringent. Table 10.4 shows that the bad debts recognized by F.C.A. from 30 September 1979 increased significantly. This increase is not surprising given the more stringent policy applied from that time. However, Table 10.4 shows that from 1980 bad debt recoveries also increased significantly. In 1980, 1982 and 1983 recoveries amounted to approximately 50 per cent of bad debts recognized and, in 1981, recoveries amounted to more than 100 per cent of the bad debts recognized. In contrast, prior to 1980, recoveries tended to be approximately 10 per cent of bad debts recognized. Bad debt recoveries result from an overstatement of bad debts in previous periods. The very high level of recoveries following the bad debts policy adopted in September 1979, suggests that this policy resulted in an overstatement of debtor writedowns. This policy was first introduced in the June 1979 draft accounts. Even though the policy appears to have been applied more stringently in the September accounts, it is likely that it also caused some overstatement of debtor writedowns in the June accounts.

The evidence in Table 10.4 also indicates that the provision for diminution in the value of development ventures, at 30 September 1979, was significantly overstated. At 30 June 1978, F.C.A.'s accounts included a provision for diminution of the value of development ventures of $0.81m. At 30 September 1979, this provision was increased to $37.88m. From 1980, no further additions were made to this provision. The notes to the accounts issued from 1980 disclosed profit from sales of development ventures, accompanied by a footnote which stated that these profits were

> "After part reversal of previously created provision for diminution in value"

The amount of the reversals were also disclosed. Table 10.4 shows that these reversals amounted to $23.65m, by 30 September 1983. Whilst these reversals may reflect the recovery of real estate markets between 1979 and 1983, it is more likely that they reflect an overstatement of the writedown of development ventures in F.C.A.'s 1979 accounts.

To summarize, there were a number of different estimates of the overstatement of F.C.A.'s current assets. These estimates ranged from approximately $30m to $58m, although their comparability is limited by the different dates to which they refer, the different assets on which they focused, their different bases of calculation and the different managements for which they were derived. The early estimates of writedowns of about $30m related only to development ventures and were derived for F.C.A.'s original management. No writedowns of ordinary receivables were recommended, although it is unclear whether this was because they were not considered or were thought to be unnecessary. The writedowns ultimately accepted by F.C.A. totalled $44.62m and covered both development ventures and ordinary receivables. However, the reversals included in subsequent accounts suggest that these writedowns were probably too high. The writedowns in the June draft accounts probably were similarly overstated, as they were calculated on the same basis. The methods by which the Bank of New South Wales and A.B.A. writedowns were derived were never disclosed, but the reconciliation between the A.B.A. writedown and the writedown in the June accounts, suggests that they were also significantly overstated.

It is possible, of course, that the June writedowns were set at the figure necessary to achieve the A.N.Z. - Bank of Adelaide merger. When the June accounts were prepared, control of F.C.A. had passed to the A.B.A. consortium, of which the A.N.Z. was a member. Moreover, by this time, the Reserve Bank had ordered the Bank of Adelaide to merge with another Australian trading bank and the A.N.Z. offer was the only one available. When the September accounts were prepared, F.C.A. was an A.N.Z. subsidiary.

In conclusion, there seems to have been general agreement that the value of F.C.A.'s development ventures was overstated. The extent ot the overstatement was in dispute. In addition, the A.B.A. consortium and the A.N.Z. agreed that the value of F.C.A.'s ordinary receivables was overstated, but the evidence suggests that both the A.N.Z. and the A.B.A. overstated the writedowns required. It is not clear whether F.C.A.'s original management considered that the value of ordinary receivables was overstated.

Table 10.4: Recoveries and Reversals in the F.C.A. Accounts ($m)

Period ended	Bad debts on accounts receivable	Bad debts recovered	Reversal of development venture provision
30/6/76	0.91	0.13	-
30/6/77	1.14	0.08	-
30/6/78	1.26	0.12	-
30/9/79	5.71	0.57	-
30/9/80	2.98	1.66	14.07
30/9/81	1.51	1.55	4.63
30/9/82	2.29	1.21	2.51
30/9/83	2.84	1.39	2.44

Source: Finance Corporation of Australia Ltd., Notes to Audited Financial Statements, 1976 to 1983.

10.2(iii)(c) Conclusions about F.C.A.'s Current Asset Values

The evidence presented above suggests that, by 1979, the value of F.C.A.'s development ventures was overstated by an uncertain amount and that the value of F.C.A.'s ordinary receivables also may have been overstated. To show that the accounts issued by F.C.A. prior to its collapse were potentially misleading, it is necessary to show that these overstatements existed prior to 1979 and that they were not simply the result of adverse circumstances which arose during 1979.

Initially, F.C.A.'s management recognized the need for some development venture writedowns, although they maintained that the writedowns were largely the result of liquidity problems which arose in early 1979. However, there is some evidence that the value of F.C.A.'s development ventures was overstated prior to 1979. In particular, the queries from the Corporate Affairs Commissions over development venture values actually preceded the group's liquidity problems. The Australian real estate market collapsed in the early 1970s and some finance companies failed because of their involvement in real estate. Others, such as Industrial Acceptance Corporation Ltd. and Commercial and General Acceptance Ltd., made substantial real estate writedowns and only survived because of support from their parent companies. Yet F.C.A.'s accounts prior to 1979, included no specific provision for development venture writedowns and only a small general provision for contingencies.[51] F.C.A.'s method of calculating the book values of some of its development ventures was conservative and it is possible, therefore, that no writedowns were required prior to 1979. However, there had been a major decline in property markets during the 1970s and it is also possible that F.C.A.'s accounts had not recognized the effects of this decline on development property values. Certainly, the Corporate Affairs Commissions held this view.

There is no doubt that part of the writedown resulted from a change from going concern to liquidiation based values for F.C.A.'s development ventures. The various estimates of the writedowns were based on the sale of development properties in their *existing* condition over a two to three year period. In contrast, the development venture values in the pre-collapse accounts allowed for realization in a *developed* condition over a longer period. Liquidity problems prevented the development and realization of the properties over the normal course of business and necessitated this change in

[51] The $0.81m provision for the writedown of development ventures at 30 June 1978, discussed elsewhere, was disclosed in the September 1979 accounts, but not in the 1978 accounts. Presumably the non-disclosure of this provision in 1978, and possibly in earlier years, reflected its immateriality.

the basis of valuation. There is, however, no evidence to suggest that the going concern assumption underlying the pre-collapse accounts was inappropriate. F.C.A.'s management should have been aware that development venture values were overstated in the pre-collapse accounts but they could not have anticipated the extent of the liquidity problems which arose in early 1979.

If any writedowns of receivables were warranted, it is unlikely that these would have resulted simply from events in 1979. Liquidity problems may have forced F.C.A. to seek higher returns and higher risk debtors with consequential higher default rates, but there is no evidence of this. Therefore, any writedowns of ordinary receivables which were warranted are likely to have reflected overstated values in the pre-collapse accounts.

Although not directly relevant to the misinformation hypothesis, it could be argued that the financial statement data issued by F.C.A. *after* its collapse misled investors. The letter from the Bank of Adelaide directors to shareholders, recommending the proposed A.N.Z. merger, included a copy of the F.C.A.'s draft accounts at 30 June 1979. It is probable that these accounts overstated the required writedowns for both development ventures and ordinary receivables. At a meeting following the circulation of this letter, Bank of Adelaide shareholders approved the proposed A.N.Z. merger, which embodied substantial writedowns of F.C.A. assets and, hence, losses to Bank of Adelaide shareholders. It could be argued, therefore, that inaccurate financial statement data published after, rather than before, F.C.A.'s failure, caused or contributed to investor losses.

10.3 Testing the Responsibility Hypothesis for F.C.A.

F.C.A.'s pre-collapse accounts were probably misleading because of the overstatement of the value of development ventures and, possibly, ordinary receivables. The responsibility of the accounting profession for this misinformation can be determined on the basis of the responsibility criteria set out in Chapter 3, part 3.4(vi). In addition, it is probable that the post-collapse accounts of 30 June 1979 misled investors. The final accounts of 30 September 1979, were prepared on a similar basis and contained similar misinformation. However, this thesis is concerned only with financial statement data issued prior to failure and this possibility is not pursued.

The difficulties which arise in valuing development properties were discussed in the A.S.L. case study. No accounting standard has been developed in this area but generally accepted accounting principles require development ventures to be treated as a part of trading stock and valued at the lower of cost or net realizable value. This principle has been repeatedly endorsed by the profession from at least 1948. According to the notes to F.C.A.'s pre-collapse accounts and evidence given by Bishop, this principle had been followed consistently by F.C.A. Thus, the fault presumably lay with the estimates of cost and/or realizable value. Market value estimates were more the responsibility of valuers than accountants. However, the calculations of realizable value, based on those estimates, and the calculations of cost for reporting purposes were the responsibility of accountants.

The general rules used by F.C.A.'s accountants to calculate the cost and realizable value of development ventures in the pre-collapse accounts appear to have been appropriate. A property's book value was recorded at cost, including capitalized holding and development costs, provided that the capitalization did not increase cost above net realizable value.

Capitalization, under these circumstances, complies with generally accepted accounting principles. Holding costs included "past unrecouped interest", which was the lower of 9.5 per cent per annum and the estimated interest cost to F.C.A., on the money invested in the property. The accounting principles relating to capitalization, discussed in earlier chapters, generally referred to interest expenses actually incurred and paid to third parties. At the time that F.C.A. applied its policy, there was no professional pronouncement which dealt specifically with the capitalization of a notional cost of funds available to an entity. However, in its discussion paper the A.A.R.F. (1982, p.11) subsequently confirmed that

> "Where a developer has a central pool of funds ... the cost of all funds ... may be averaged and allocated to projects in proportion to the amount of capital invested in each."

Thus, F.C.A.'s capitalization of the past unrecouped interest, as the cost of funds available to the company, seems to have been appropriate. The 9.5 per cent per annum ceiling was consistent with the conservatism convention, but there is insufficient information to determine whether this was an appropriate limit.

Realizable value was based on estimates of market value less selling expenses, future development costs and future unrecouped interest. Future unrecouped interest was estimated at 9.5 per cent per annum on future investments in the property. Whilst the 9.5 per cent per annum ceiling was a conservative approach in estimating cost, it may have had the opposite effect on the estimation of net realizable value. However, the selection of this rate can only be criticized where there were clear indications at the time, that it was inappropriate and the evidence in this area is unclear.[52]

In brief, an examination of the method used by F.C.A.'s accountants to value its development properties provides no grounds for criticism. The overstatement of realizable values may have resulted from optimistic estimates of the market value of the development ventures. In this case, accountants cannot be held responsible.

The value of ordinary receivables also may have been overstated in F.C.A.'s pre-collapse accounts. As discussed in earlier chapters, generally accepted accounting principles require that debtors be shown at expected realizable value, with bad debts written off and with an adequate provision for doubtful debts. These principles have not been endorsed as an accounting standard but are widely understood and accepted. Therefore, to the extent that F.C.A.'s pre-collapse accounts overstated debtors, they contravened generally accepted accounting principles and the individuals involved in the preparation and audit of these accounts can be criticized. However, the evidence about the appropriate writedown of debtors was not clear cut. The book value of debtors in the pre-collapse accounts may have been reasonable given the information available at that time. It is possible that a need for greater writedowns only became apparent subsequently and, in any case, it seems that the subsequent writedowns were overstated.

The only aspect in which F.C.A.'s pre-collapse accounting for debtors clearly contravened generally accepted accounting principles, was in the

[52] F.C.A.'s debenture rates from 1978 were well above 9.5 per cent per annum. For example, the 53rd Prospectus, current from March 1978, offered interest rates of between 10 per cent and 12 per cent per annum. However, these were flat rates paid quarterly and, from Bishop's evidence, it is unclear whether the 9.5 per cent per annum was a flat rate or a compounding rate.

treatment of doubtful debts. The accounting profession recommends adequate provision for doubtful debts. According to the notes on F.C.A.'s accounting policies, a provision was made, but the amount was not disclosed in the accounts or in the notes to the accounts.[53] The only mention of doubtful debts was a statement in the notes to the accounts, that principal outstandings omitted interest on loans where collection of the interest appeared doubtful. In evidence to the Supreme Court, Bishop explained that F.C.A. wrote off doubtful, as well as bad debts. Whilst the disclosure of doubtful debts may have provided useful information for financial statement users, it cannot be argued that F.C.A.'s method of accounting for debtors was potentially misleading, as the net amount of ordinary receivables was not affected.

To summarize, F.C.A.'s pre-collapse accounts probably overstated the value of the group's development ventures. There is no concrete evidence to suggest that accountants can be held responsible for this misinformation. Even so, there is no doubt that accounting for development properties is a troublesome area. Clearly defined standards which dealt specifically with the accounting for development real estate may have assisted F.C.A.'s accountants in calculating property costs and realizable values, or possibly in evaluating market values. The profession can be criticized for not producing a standard in this area. And finally, there is no conclusive evidence to suggest that accountants or the accounting profession caused, or contributed to, any overstatement of ordinary receivables in the pre-collapse accounts.

[53] See, for example, Finance Corporation of Australia Ltd, Notes to Audited Financial Statements, 1977 and 1978, Note le.

10.4 Conclusions

F.C.A.'s collapse resulted in losses for Bank of Adelaide shareholders of approximately $39m. The financial statement data issued prior to failure in 1979 did not depict F.C.A. shares as a particularly attractive investment, from the point of view of Bank of Adelaide shareholders. From the early 1970s, F.C.A.'s profitability, measured in terms of the rate of return on shareholders' funds, was low. From the mid-1970s, consolidated net profit declined. Asset backing was also low and, from at least 1976, F.C.A.'s debt ratio was relatively high. However, there was little indication that by 1979, F.C.A. would be unable to continue and that its failure would force its parent into a merger.

By 1979, it had become apparent that F.C.A.'s development ventures required a major writedown. F.C.A. ultimately reduced the book value of its development ventures by approximately $38m, although there is some evidence to suggest that this writedown was excessive. F.C.A.'s pre-collapse management attributed the writedown to adverse circumstances which arose in early 1979 and caused severe liquidity problems. It is true that these liquidity problems prevented further development and forced the premature sale of development properties. They made it necessary to change from a going concern to a liquidation basis of valuation and this contributed to the size of the writedown. Moreover, there is no evidence to suggest that this change should have been made prior to 1979. Nevertheless, there is evidence to suggest that the book value of F.C.A.'s development ventures was probably overstated prior to 1979. This conclusion is consistent with the misinformation hypothesis. F.C.A.'s financial statement data probably overstated the value of one of the company's major current assets and, in doing so, failed to provide investors with a clear warning of the extent of the company's demise. There is no conclusive evidence, however, to suggest that any individual accountant or the accounting profession was responsible for any overstatement of development venture values. With regard to the value of development ventures, the evidence does not support the responsibility hypothesis, although the accounting profession can be criticized for failing to define the accepted principles in this area.

It is also possible that F.C.A.'s pre-collapse accounts overstated the value of the group's ordinary receivables. Any such overstatement would have contravened accepted accounting principles. However, it is difficult to criticize the individual accountants in this area because it is not clear that there was any evidence of overstatement at the time the accounts were prepared.

Finally, whilst there is some evidence that F.C.A.'s pre-collapse accounts overstated the value of the group's current assets, it should be noted that the extent of this overstatement was exaggerated considerably in the post-collapse accounts. F.C.A.'s failure was much less significant than indicated by the book value of its assets. The accounting profession's responsibility for this misinformation is a separate issue.

CHAPTER 11

CONCLUSIONS AND THEIR IMPLICATIONS FOR THE AUSTRALIAN ACCOUNTING PROFESSION

This thesis has tested two related hypotheses referred to as the "misinformation hypothesis" and the "responsibility hypothesis". The misinformation hypothesis postulated that

> *certain failed or failing companies produced financial statement data which misrepresented their results and financial position and, therefore, did not provide investors with a clear warning of their demise.*

The hypothesis assumes that investment decisions are influenced by financial statement data. Whilst this assumption was not tested it was supported by a review of the literature in this area. The responsibility hypothesis postulated that

> *the accounting profession can be held responsible, at least in part, for any misrepresentations in these data.*

The hypotheses were tested using six major finance company failures which occurred in Australia between the early 1960s and the late 1970s. The case study companies were Reid Murray Acceptance Ltd., Latec Investments Ltd. and Stanhill Development Finance Ltd., each of which failed during the 1960s, and Cambridge Credit Corporation Ltd., Associated Securities Ltd. and Finance Corporation of Australia Ltd., each of which failed during the 1970s. The case studies were selected from two decades in an attempt to isolate any effects of improvements in the specification and enforcement of accounting principles since the early 1960s. The hypotheses were specific in that they were confined to the financial statement data of *certain* failed or failing companies. However, the evidence from the six cases contains some implications for the Australian accounting profession as a whole, which are considered in this chapter.

The evidence from the case studies was consistent with the misinformation hypothesis. Each of the case study companies, or companies closely associated with them, had produced some financial statement misinformation. However, evidence was not consistent with the responsibility hypothesis. In four cases, the misinformation resulted largely from non-compliance with generally accepted accounting principles. This misinformation was primarily the responsibility of the management and the individuals involved in the preparation and audit of the case study financial statement data. The accounting profession cannot be held responsible for the actions of individuals. In the remaining two cases, accountants were probably not responsible for the misinformation. Nevertheless, there is evidence from some of the cases to suggest that the profession's performance has been unsatisfactory in delineating principles in some areas, and possibly in disciplining members.

11.1 Conclusions from the 1960s Case Studies

Reid Murray Acceptance Ltd. was placed into receivership in January 1963 and its eventual failure resulted in substantial losses for shareholders and debenture holders. Despite providing some indications of failure, R.M.A.'s financial statement data were potentially misleading primarily because they overstated the value of debtors and profits. The auditors' reports attached to R.M.A.'s accounts were not qualified. The misinformation occurred mainly because of non-compliance with generally accepted accounting principles and, therefore, can be considered largely the responsibility of R.M.A.'s management and the individuals involved in the preparation and audit of R.M.A.'s financial statement data. The accounting principles violated by R.M.A. had not been specifically endorsed by the accounting profession. However, this omission was not particularly significant because the relevant principles were widely understood and accepted.

The financial statement data of the Reid Murray group are also relevant to the hypotheses because R.M.A.'s parent company, Reid Murray Holdings Ltd. (R.M.H.), guaranteed eight of the nine R.M.A. debenture issues and because R.M.A. lent a large part of its funds to the R.M. group at nominal interest rates. The Reid Murray group financial statement data did not indicate that failure was imminent. These data were potentially misleading in numerous areas. In most of the areas, the misinformation resulted from non-compliance with accepted accounting principles. The profession had not formally endorsed the principles in most of these areas but they were generally well understood and accepted. The non-compliance was not disclosed and the auditors' reports on these accounts were not qualified. Also, in one area the misinformation resulted from the application of a generally accepted accounting principle which was rendered inappropriate by unusual circumstances. The individuals involved should have been aware of these circumstances. The misinformation produced by the Reid Murray group was, therefore, largely the responsibility of the group's management and its individual accountants and auditors. Potentially misleading information was also produced in three areas where the appropriate accounting principles may not have been apparent. The accounting profession should not be held responsible for this misinformation. Given the procedures for developing and defining accounting principles, it is unreasonable to expect the profession to have defined principles in all areas. The profession issued standards in two of these areas within the next decade. However, it can be criticized for failing to follow up with a standard in the third area which was accounting for real estate development.

Thus, the individuals involved in the preparation and audit of the financial statement data of R.M.A. and the other companies within the R.M. group were primarily responsible for the misinformation. A number of these individuals were members of the accounting profession. However, there is insufficient evidence to determine the extent of disciplinary proceedings instigated by the accounting profession against these members. In this era, the I.C.A.A. did not publish the names of members disciplined and the A.S.A. reported names in some disciplinary cases but not others. There was only one report of a member expelled from the A.S.A. because of his involvement with the R.M.A. and/or R.M.H. accounts.

Claims of misleading accounts are often prompted by differences between the asset values recorded in financial statements and those in the receiver's statement of affairs. In the statement of affairs, all assets are recorded at their estimated realizable values. In the balance sheet, non-current assets are recorded at their acquisition cost, or at some revaluation of it which need not bear any relationship to realizable value. Current assets, on the other hand, are generally recorded at the lower of cost or realizable value. However, balance sheet estimates of the realizable value of current assets are not necessarily the same as estimates in the statement of affairs. Differences may simply reflect the switch from going concern to liquidation based accounting. Therefore, these differences may only be construed as misinformation where it can be shown that the going concern assumption was no longer reasonable. The going concern decision rests with management, although in attesting to the truth and fairness of the accounts the auditor must assess its appropriateness. The asset values in R.M.A.'s statement of affairs were approximately half those in the financial statements and most of the difference arose from current assets, and in particular, debtors. Part of the difference between the recorded values of R.M.A.'s debtors before and after failure was probably due to the switch from going concern to liquidation based values. There was insufficient evidence to conclude that the going concern assumption should have been dropped earlier. Much of the difference, however, occurred because R.M.A. made no provision for doubtful debts in its financial statements.

Latec Investments Ltd. was placed into receivership in September 1962 and, although it eventually recovered, its failure resulted in considerable losses for shareholders and depositors. Latec's financial statement data indicated that, in general, the company was reasonably sound. By the late 1950s, however, there was some evidence of potential problems in the long run but it was not apparent that failure was imminent. In the years leading up to receivership, Latec's accounts significantly overstated profits and net assets. The evidence suggests that financial statement misinformation occurred in at least 13 different areas. In 11 of the areas, the misinformation resulted from non-compliance with generally accepted accounting principles. Although the principles had been formally endorsed by the profession in only one of these areas, the principles in the remaining nine areas were well understood and accepted. The non-compliance was not disclosed and the auditors' reports on these accounts were not qualified. This misinformation was, therefore, primarily the responsibility of Latec's management and the individuals involved in the preparation and audit of Latec's financial statement data.

A number of the individuals involved with Latec's financial statement data were members of the accounting profession. One member was reported in the journals as being expelled from the A.S.A. because of his involvement with Latec's financial statement data. However, as in the Reid Murray case, the evidence of disciplinary action by the profession is incomplete.

Misinformation was also produced in two areas where there were no clearly defined accounting principles. The accounting profession should not be held responsible for this misinformation. The profession subsequently defined the appropriate principles in both of these areas within a short period of time.

There were some differences between the asset values recorded in the statement of affairs and those recorded in the financial statements. However, these differences were relatively small and related primarily to the value of Latec's subsidiaries. The differences were caused by the recognition by the receiver of the subsidiaries' liability to debenture holders. Prior to failure, this liability was contingent. Despite Latec's problems, there was no evidence to suggest that the liability should have been recognized earlier or that the going concern assumption should have been dropped. Indeed, by the time the receiver was appointed, Latec's management had changed hands and the new management had made a number of write-offs to correct the effects of the inappropriate accounting procedures followed previously. The receiver allowed Latec to continue trading and the current asset values in the statement of affairs coincided closely with these revised book values.

Stanhill Development Finance Ltd. was placed into receivership in August 1963 and its failure also resulted in considerable losses for shareholders and note holders. The only issues of S.D.F. notes and shares were made before the company commenced operations. It cannot be argued, therefore, that financial statement data about S.D.F. misinformed these initial subscribers. Moreover, from its first annual report, S.D.F.'s financial statement data showed that the company was in difficulty and that its fate was largely dependent on the fate of the public company, Stanhill Consolidated Ltd. (S.C.L.). S.D.F.'s accounts warned that the value of advances to S.C.L., which accounted for the major part of S.D.F.'s assets, was indeterminate. It is difficult to see how these accounts could be considered misleading from the point of view of any subsequent decisions made by S.D.F. investors.

However, the financial statement data of other companies within the Stanhill group were potentially misleading. These data were relevant to S.D.F. investors for two reasons. First, S.D.F. was floated partially on the basis of the favourable reputation of the Stanhill group. This reputation was based on the financial statement data of the Stanhill companies. Second, S.D.F.'s major asset consisted of advances to S.C.L. If S.C.L.'s financial statements had not been distorted, it is doubtful whether S.D.F. could have justified these advances or, at least, S.D.F. investors would have obtained an earlier and more accurate warning of the decline in the value of S.C.L.'s assets. The various companies in the Stanhill group produced financial statement misinformation in at least 10 different areas. In 8 areas the misinformation resulted from non-compliance with accepted accounting principles. Although the principles had been endorsed by the profession in only one of these areas, the principles in the remaining seven areas were well understood and accepted. The non-compliance was not disclosed and the auditors' reports on these accounts were not qualified. The misinformation produced by the various companies in the Stanhill group was, therefore, primarily the responsibility of management and the individuals involved in the preparation and audit of the accounts of these companies.

In contrast to the previous two 1960s cases, members of the accounting profession were not heavily involved with the management of the various Stanhill companies. The auditors of each of the major companies within the Stanhill group were members of the I.C.A.A. but there is insufficient evidence to determine whether the I.C.A.A. disciplined any of these members.

Misinformation was produced in two areas where there were no clearly defined accounting principles. These dealt with asset revaluations and development real estate. The accounting profession should not be held responsible for this misinformation but it can be criticized over its responsiveness to the lack of principles in these two areas. A standard on asset revaluations was not issued until 19 years after Latec's failure and, as discussed above, there is still no standard on accounting for real estate developments.

The appropriateness of the going concern assumption was not an issue in the S.D.F. case. The note to the accounts which stated that the value of the company's major asset was indeterminate clearly suggested that the recorded going concern value was inappropriate. A liquidation value may have been more useful but it is probable that it could not have been determined at the time the accounts were prepared. Indeed, it took the receiver several years to determine this value.

To summarize, the investors in Reid Murray Acceptance Ltd., Latec Investments Ltd. and Stanhill Development Finance Ltd. suffered considerable losses because of the failure of these companies in the early 1960s. An examination of the financial statement data of these companies and of companies closely associated with them has indicated that, in each case, there were a number of aspects which were potentially misleading for investors. The evidence from the 1960s case studies, therefore, is consistent with the misinformation hypothesis.

The appropriateness of the going concern assumption was not a major issue in the S.D.F. and Latec case studies. In the R.M.A. case study, the difference between the statement of affairs and financial statement asset values would have been much less significant if the financial statements had included an adequate provision for doubtful debts. In any case, there was insufficient evidence to conclude that R.M.A. should have dropped the going concern assumption.

The misinformation resulted largely from the violation of generally accepted accounting principles and, therefore, can be considered primarily the responsibility of management and the individuals involved in the preparation and audit of the financial statement data. The evidence from the 1960s cases, therefore, is not consistent with the responsibility hypotheses.

It was argued that the profession could be criticized if it could be shown that it had not disciplined members involved with the presentation of financial statement misinformation. Members of the accounting profession were involved with the misinformation evident from the 1960s case studies. However, there is insufficient evidence to determine whether the profession took disciplinary action against most of these members. There were only two cases reported of members from the case study companies being expelled from the Australian Society of Accountants.

Some of the misinformation occurred in areas where there were no generally accepted accounting principles. The profession should not be criticized for the lack of principles but it can be criticized for not subsequently defining principles in some of these areas. In particular, the profession can be criticized for not defining the appropriate principles in the complex area of accounting for real estate developments.

For the 1960s case studies, however, the major lesson for the accounting profession was the need to enforce compliance with accepted accounting principles and to require disclosure and justification of any non-compliance.

11.2 Conclusions from the 1970s Case Studies

Cambridge Credit Corporation Ltd. was placed into receivership in September 1974. Although its affairs have not yet been finalized, it appears that its failure will cause considerable losses to the company's shareholders, debenture holders and noteholders. Despite impressive profit reports in the two years prior to receivership, Cambridge's financial statement data generally indicated that the group's shares, debentures and notes were not particularly attractive investments. However, the data gave no indication that failure was imminent. The evidence suggests that Cambridge significantly overstated its profits, assets and shareholders' funds from at least 1966. Yet its auditors' reports were never qualified. These overstatements enabled the company to continue to borrow when, under the terms of the debenture trust deed, it was without borrowing capacity. Cambridge produced financial statement misinformation in at least 20 different areas. In 16 of these areas, the misinformation resulted from non-compliance with generally accepted accounting principles. In 5 areas, the accounting principles had been specifically endorsed by the profession. In the other 11 areas, the principles had not been endorsed but were widely understood and accepted. In each case, the non-compliance was not disclosed and the auditors' reports were not qualified. The misinformation was, therefore, primarily the responsibility of Cambridge's management and the individuals involved in the preparation and audit of Cambridge's financial statement data.

A number of the individuals involved with Cambridge's management, accounting and auditing functions were members of the A.S.A. or the I.C.A.A. By the time the deficiencies in the Cambridge accounts became apparent, the A.S.A. and the I.C.A.A. published the names of members who were disciplined. There is no published record of disciplinary proceedings against any member involved with Cambridge's financial statement data, although given the length of legal proceedings involving Cambridge it is possible that the case may still be before the investigation committees of the I.C.A.A. and the A.S.A.

Misinformation occurred in four areas where there were no clearly defined accounting principles. The accounting profession cannot be held responsible for this misinformation. Standards have been issued in three of these areas, but once again the profession can be criticized for failing to follow up with a standard on accounting for real estate developments.

The overstatement of Cambridge's assets and shareholders' funds which was alleged by a Corporate Affairs investigation, was significantly less than the write-downs eventually recognized by the receivers. Probably, a substantial part of these writedowns resulted from the change from going concern to liquidation based values. Any misinformation which resulted from Cambridge's failure to drop the going concern assumption can be considered the responsibility of Cambridge's management and auditors. There was probably sufficient evidence to indicate that the going concern assumption was inappropriate well before the receivers were appointed.

Associated Securities Ltd. was placed into receivership in February 1979. Although its affairs have not yet been finalized, it appears that the failure will also cause considerable losses to the company's shareholders, term depositors and probably to second charge debenture holders. A.S.L.'s financial statement data generally showed that the group's investment opportunities were not particularly attractive, especially from the mid-1970s, but they gave no indication that failure was imminent.

A.S.L.'s financial statement data were potentially misleading primarily because of the overstatement of the value of some current assets. The overstatement of current asset values contravenes accepted accounting principles and, therefore, normally would be considered the responsibility of the individuals involved with the preparation and audit of the accounts. However, in A.S.L.'s case, the overstatement related to the value of development projects and property debtors. Detailed evidence of A.S.L.'s accounting is not available and this may be the reason for not identifying further sources of misinformation. However, assuming that A.S.L. adhered to the principles described in the notes to its accounts, the overstated values were presumably the responsibility of qualified valuers rather than accountants.

Thus, neither the individual accountants involved with A.S.L.'s financial statement data nor the accounting profession can be held responsible for A.S.L.'s financial statement misinformation. It should be noted, though, that the misinformation occurred in the area of accounting for real estate developments and the profession can be criticized, once again, for not delineating the appropriate principles in this area.

Whilst the evidence suggests that A.S.L.'s accounts overstated the value of its current assets, these overstatements were probably much lower than the writedowns estimated by the receiver. Part of these writedowns can be attributed to the change from going concern to liquidation based accounting. A.S.L. cannot be criticized for maintaining the going concern assumption. Despite its poor performance, the group's continued existence was virtually certain as long as it was supported by its "parent", Ansett Transport Industries. A.T.I. only decided to withdraw its support immediately prior to receivership.

Finance Corporation of Australia Ltd. collapsed in early 1979. Its failure was evidenced by substantial asset writedowns, which absorbed most of its shareholders' funds and which required an injection of additional capital of between $40m and $60m. Although F.C.A. was not placed into receivership, its parent, the Bank of Adelaide, was unable to provide this capital and was forced to merge with the Australia and New Zealand Banking Group. The failure caused considerable losses to Bank of Adelaide shareholders. The financial statement data issued by F.C.A. prior to failure did not depict the company's securities as particularly attractive investments. Nevertheless, there was little indication that F.C.A. would be unable to continue in its own right. By mid-1979, it was clear that the book value of F.C.A.'s development ventures was overstated and the evidence suggests that some overstatement had occurred in previous years' accounts. There is no conclusive evidence, however, to suggest that individual accountants or the accounting profession can be held responsible for any overstatement of the value of F.C.A.'s development ventures, although the accounting profession can be criticized for the lack of an accounting standard in this area.

It is possible that F.C.A.'s pre-collapse financial statements also overstated the value of the group's debtors. However, it is difficult to criticize either the individual accountants involved with F.C.A. or the accounting profession in this area. The evidence is inconclusive. The overstatement may not have occurred prior to the collapse or may have only become apparent subsequently.

Also, it should be noted that the apparent overstatement of the value of F.C.A.'s current assets was due, in part, to a change in the basis of valuation. The pre-collapse values were arrived at under the normal going concern assumption of realization in the ordinary course of business. Events in early 1979 made it necessary to hasten the realization of some of F.C.A.'s assets, particularly its development ventures. There is no evidence to suggest that the events of early 1979 should have been apparent to F.C.A.'s management, or its accountants and auditors, at the time that earlier accounts were prepared. The reliance on the going concern assumption in preparing these accounts, therefore, cannot be considered a cause of misinformation.

To summarize, the investors in Cambridge Credit Corporation Ltd., Associated Securities Ltd. and Finance Corporation of Australia Ltd., or more specifically its parent, the Bank of Adelaide, suffered considerable losses because of the failure of these companies during the 1970s. An examination of Cambridge's financial statement data indicated many sources of misinformation. There was also at least one source of misinformation in A.S.L.'s financial statements and at least one source of misinformation in F.C.A.'s financial statements. The evidence from the 1970s case studies, therefore, is consistent with the misinformation hypothesis.

In each of the 1970s case studies, there were significant differences between the asset values recorded in the financial statements and those identified after failure. These differences occurred partially because the going concern assumption was not maintained in estimating post-failure asset values. There was probably sufficient evidence to indicate that the assumption was inappropriate for Cambridge's later pre-collapse accounts. Cambridge's failure to drop the going concern assumption, therefore, provides further evidence to support the misinformation hypothesis. This source of misinformation was largely the responsibility of Cambridge's management and auditors. However, there was no evidence to suggest that the going concern assumption should have been dropped any earlier by A.S.L. or F.C.A.

The evidence from the 1970s case studies is not consistent with the responsibility hypotheses. Most of the misinformation in the Cambridge financial statement data occurred in areas where generally accepted accounting principles were not complied with, and the non-compliance was not disclosed. Therefore, the misinformation can be considered primarily the responsibility of management and the individuals involved in the preparation and audit of these data. From the early 1970s, there was a substantial increase in the number of principles endorsed by the profession. Some of the misinformation produced by Cambridge resulted from a violation of some of these endorsed principles. However, most of the misinformation resulted from the violation of unendorsed principles. A.S.L.'s and F.C.A.'s financial statement misinformation occurred primarily because of the overstatement of the value of the groups' development ventures, which were classified as current assets. The overstatement of current asset values contravenes generally accepted accounting principles. However, the valuation of development ventures depends not only on accountants' calculations but also on estimates of market values. These estimates require a number of assumptions and predictions such as the period of realization and the condition of the market, and are generally the responsibility of valuers rather than accountants. The evidence suggests that in the A.S.L. and F.C.A. cases, the overstated development venture values were probably the responsibility of valuers rather than accountants.

There are, however, two grounds for criticizing the role of the accounting profession in the 1970s case studies. First, accountants were extensively involved in the preparation and presentation of the Cambridge financial statement misinformation. This misinformation resulted largely from non-compliance with accepted accounting principles, a number of which had been specifically endorsed by the accounting profession. Yet, so far there is no evidence of disciplinary measures being taken by the profession against any of the members involved with Cambridge's financial statement data. Second, significant misinformation in each of the cases occurred in accounting for real estate developments, yet the profession has not followed up with an accounting standard in this area. The failure of the profession in this respect is particularly significant since accounting for real estate developments was also a major source of misinformation in two of the 1960s cases.

Overall, the evidence from the 1960s case studies suggested that the profession needed to improve compliance with accepted accounting principles. The evidence from the individual cases drawn from the 1970s differed over the primary causes of financial statement misinformation. The Cambridge case indicated that the enforcement of accounting principles was still a major problem in the 1970s. The steps taken by the profession to enforce its principles had apparently not been effective. The other two case studies from the 1970s did not provide evidence of non-compliance with accepted accounting principles but they did indicate the need to define the principles of accounting for real estate developments.

11.3 Implications for the Australian Accounting Profession

The case studies showed that each of the failures resulted in considerable losses for investors. In each case, there were aspects of the financial statement data published prior to failure which were potentially misleading. The misinformation in four of the six cases resulted largely from the violation of generally accepted accounting principles, although some of it also occurred in areas where the appropriate principles were unclear. Whilst much of the responsibility for the financial statement misinformation rested with individual accountants and auditors, the results of the case studies have a number of implications for the Australian accounting profession.

11.3(i) The Adequacy of Accepted Accounting Principles

Generally, it is assumed that compliance with accepted accounting principles ensures a "true and fair" view. Overall, the case studies found very few instances of accepted accounting principles causing misinformation. The inadequacies of information about asset values produced under historic cost principles have been acknowledged by the profession itself.[1] In the case studies, however, the recording of non-current assets at their historic cost was not considered potentially misleading. Only the most naive financial statement users could have misinterpreted this information. Moreover, it was not a major issue in the case studies, since most of the questionable valuations involved current assets which, under generally accepted accounting principles, should have been recorded at the lower of cost or realizable value.

The going concern assumption is another accepted accounting principle which has been questioned. For example, Chambers [1978, p. 101] argued that asset values based on the going concern assumption are misleading. He recommended that all assets should be recorded at their net selling price, in combinations or quantities in which they might ordinarily be sold or put out of use. Chambers view, however, has not gained widespread support. Net selling prices are of little relevance when assets are highly unlikely to be liquidated. In the case studies, going concern values were considered to be potentially misleading only when it could be shown that the going concern assumption should have been dropped. Significant differences between going concern and liquidation values existed for most of the case study companies, but it was only in Cambridge's case that there was substantial evidence that the going concern assumption was probably inappropriate. Generally, therefore, the going concern assumption was not a major cause of misinformation and only the most naive investors would have expected assets to

[1] For example, the profession has recommended that financial statements include supplementary current cost information. See Institute of Chartered Accountants in Australia/Australian Society of Accountants [1983a], *Statement of Accounting Practice, SAP1: Current Cost Accounting*. This statement was first published as a provisional accounting standard in 1976. It was reclassified as a statement of accounting practice in November 1983.

realize their book values.

It should be noted that in assessing the adequacy of the accepted accounting principles a reasonable understanding of financial statement information has been assumed. The data has been interpreted from the point of view of an investor who is neither totally naive nor extremely sophisticated. As discussed in Chapter 3, both in the U.S. and Australia financial statements have been prepared for users of this quality. It could be argued that the financial statement data in most of the case studies provided some indications of failure. These may have been sufficient to drive away the sophisticated investors. Further research into the financial literacy of investors who lose in company failures may be worthwhile. If it can be shown that these investors are financially illiterate, this may have implications for the accounting profession's development of accounting standards.

Whilst the case studies generally indicated that the *existing* accepted accounting principles were generally adequate, they did indicate that there were certain problem areas where there were no accepted accounting principles. The accounting for real estate developments was one of the most consistent causes of misinformation in the various case studies. Despite its existence as a troublesome area from at least the early 1960s, the accounting profession has not yet defined a set of accepted principles in this area. The profession can be criticized in this respect. A discussion paper of the accounting for real estate developments was published by the A.A.R.F. in 1982 but no standard has followed.

11.3(ii) The Enforcement of Accepted Accounting Principles

11.3(ii)(a) The evidence of non-compliance

The evidence from four of the case studies indicates that a major cause of misinformation was non-compliance with generally accepted accounting principles. This conclusion substantiates the conclusions of the A.S.A. [1966] report on the accounting principles and practices followed by various companies which failed in the early 1960s. Birkett and Walker [1971] also found that non-compliance was a cause of misinformation in the financial statements of a number of companies which failed during the 1960s. They concluded, however, that the misinformation was not merely the result of non-compliance with accepted principles. In their opinion, the profession needed to examine its principles as well. During the 1970s, the profession began to formulate its accepted principles as accounting standards and to require compliance with these standards. Yet, the evidence from the Cambridge case in the 1970s suggests that these moves did not ensure that financial statement data complied with generally accepted accounting principles. From the profession's point of view, therefore, it is necessary to consider the extent of the non-compliance problem and solutions to it.

The case studies do *not* prove that non-compliance with accepted accounting principles is a major problem facing the accounting profession. Finance companies are highly dependent on investor confidence for their continued existence. It is possible, therefore, that in difficult times they are more prone to non-compliance than firms in other industries. There have been a number of other studies, however, which indicate that non-compliance with accepted accounting principles is quite extensive. For example, Christofi [1977] surveyed the 1976 financial statements of 100 listed companies of varying size and industry. Focussing on the accounting standards covering the profit and loss statement, inventories, tax effect accounting, depreciation and accounting policies, he found an average non-compliance rate of 21.8 per cent. Ryan, Heazlewood and Andrew [1980] surveyed the 1976, 1977, 1978 and 1979 accounts of 250 major Australian companies for compliance with various aspects of the accounting standards, recommendations and companies legislation. Although they found that generally the rate of compliance had improved substantially since their earlier study,[2] significant non-compliance still existed in some areas.[3]

A survey conducted by the N.S.W. Corporate Affairs Commission in 1978 found that the financial statements of 1272 (ie. 41 per cent) of 3214 companies examined did not comply with one or more of the accounting standards.[4] In 794 cases, the non-compliance was considered so significant that further information was sought. For the remaining 478 companies, the non-compliance was considered immaterial and/or the disclosure of the departure, reasons and effects was considered adequate. The survey covered all classes of companies and found that non-compliance was particularly prevalent in the accounts of listed companies. For example, 59 per cent of the listed companies' financial statements did not comply with one or more of the accounting standards. Similar surveys conducted by the Commission in 1975, 1976 and 1977 found non-compliance rates for listed companies of 24 per cent, 37 per cent and 50 per cent, respectively.[5]

[2] Ryan *et. al.* [1977].

[3] For example, in 1978-79, 65 per cent of the companies which had changed accounting policy violated AAS6 by not disclosing the reason for change and 18 per cent of all companies violated AAS3 by not applying tax effect accounting.

[4] Morley [1979].

[5] *Ibid.*

In addition, there have been a number of surveys of compliance with particular standards. For example, Trotman [1977] surveyed the financial statements of 150 listed companies for compliance with the standard on accounting for inventories. He found widespread non-compliance in the disclosure of the method of treating overhead (51 per cent) and in the disclosure of the method of assigning costs (80 per cent). He also found that 17 per cent of the companies had not complied with the bases of valuation recommended by the standard. Davison and Lourens [1978] examined the 1977 financial statements of 61 mining companies and concluded that the introduction of the standard on the extractive industries in October 1976, had made little impact. Heazlewood [1982] also examined the impact of the extractive industries standard, using a sample of 77 mining companies. He found that only 16 per cent of the companies specifically mentioned adopting the standard over the three years since its introduction and that a wide range of methods were still being used. Leppinus [1977] surveyed the financial statements of 37 listed companies for compliance with the standard on tax effect accounting and found that 27 per cent of these companies did not use tax effect accounting. In another survey, in 1981, he found that approximately 20 per cent of a sample of 76 companies did not use tax effect accounting.[6]

Harris [1981] examined the 1978 and 1979 annual reports of 125 listed companies to determine whether they depreciated their buildings in compliance with the depreciation standard. He found a non-compliance rate of 21 per cent in 1978 and a similar rate in 1979. Ramsay [1981] examined the 1975 and 1978 annual reports of 393 public companies to determine whether they depreciated their buildings. He found non-compliance rates of 25 per cent in 1975 and 22

[6] Leppinus [1981].

per cent in 1978. Kerin [1981] examined the annual reports of 250 listed companies for 1975 and 1980 to determine whether they used tax effect accounting and whether they depreciated their buildings. He found non-compliance rates of 22 per cent in 1975 and 18 per cent in 1980 for the depreciation of buildings, and 18 per cent in 1975 and 13 per cent in 1980 for tax effect accounting.

Although each of these surveys indicate widespread non-compliance, they suffer from a number of weaknesses. Several of them were based on small samples. For example, the studies by Davison and Lourens [1978], Heazlewood [1982] and Lepinnus [1977 and 1981] were based samples of less than eighty companies. Some of the larger samples were not randomly selected and, therefore, may not have been representative. For example, the largest survey, by the N.S.W. Corporate Affairs Commission, concentrated on companies with a history of non-compliance. Christofi [1977] stated that his sample was not random, whilst Harris [1981] did not explain his basis of sample selection. In addition, most of the studies dealing with a specific standard may have been biased against compliance because they focussed on controversial areas such as the depreciation of buildings and tax effect accounting. Despite these weaknesses, the evidence suggests that the accounting profession has not achieved a high level of compliance with its accounting standards.

Moreover, in one respect, these surveys understate the extent of the non-compliance problem. They focussed on non-compliance with accounting standards.[7] In the case studies, non-compliance with unendorsed principles was more widespread than non-compliance with accounting standards. It is

[7] Ryan *et al.* [1980] did consider compliance with the statement *D1.1 Presentation of Balance Sheet*, which had not been endorsed as an accounting standard, but generally the surveys were limited to accounting standards.

probable, therefore, that non-compliance with accepted accounting principles has been even more widespread than indicated by these other surveys. It is necessary to consider the significance of this non-compliance problem.

11.3(ii)(b) The relevance of non-compliance

The case studies indicated that non-compliance with accepted accounting principles caused financial statement misinformation. It has been argued, however, that non-compliance is not significant, provided that it is properly disclosed. This argument hinges on the semi-strong form of the efficient markets hypothesis, which postulates that all publicly available information is reflected fully in security prices. According to this hypothesis, provided that non-compliance is disclosed, the market will not be misled. Naive investors may be misled but the market will be kept efficient through the arbitrage actions of sophisticated investors. However, this argument ignores the equity effects of non-compliance on *individual* investors. While the market may be unaffected, the sophisticated investors, who are able to correctly interpret the implications of the non-compliance, will gain at the expense of other investors.

The efficient markets argument only holds where non-compliance is disclosed. However, there are indications that non-compliance is often undisclosed. For example, in the case studies, the non-compliance was largely undisclosed. Most of the surveys cited above did not distinguish whether the non-compliance was disclosed, although the survey by the N.S.W. Corporate Affairs Commission for 1978 indicated that non-compliance was not disclosed in approximately 62 per cent of the non-complying accounts.[8] In these cases, the non-compliance may have resulted in financial statement data which misled financial statement users.

It has also been argued that non-compliance is not significant provided that it is appropriate to the circumstances. This argument hinges on the concept of diversity. Generally accepted accounting procedures may not be appropriate to all circumstances, and in some cases, a true and fair view may only be achieved by choosing another method. Indeed, the profession's pronouncement on conformity with accounting standards allows departures from the standards

> "...in rare circumstances in which adherence to an accounting standard would not, in the opinion of the directors, produce a true and fair view"

provided that

> "...the reasons for such departures and its financial effects are properly disclosed."[9]

While the profession has recognized that non-compliance may be appropriate "in rare circumstances", the non-compliance found in the surveys was widespread. Moreover, some writers have questioned the validity of the diversity concept, in which case *any* non-compliance cannot be justified.[10]

[8] On the other hand, Harris [1981], Ramsay [1981] and Kerin [1981] found much higher levels of disclosure. One possible explanation for this difference is that their studies focussed on controversial standards and companies may have felt less reluctant to disclose non-compliance with them. Also, there would have been little point in not disclosing these types of non-compliance as the fact that buildings had not been depreciated or that tax effect accounting had not been adopted would have been apparent from a cursory examination of the accounts. It is likely that the Corporate Affairs examination picked up, in addition, the more obscure forms of non-compliance which would not have been apparent unless disclosed separately.

[9] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1979].

[10] See, for example, Henderson and Peirson [1980, pp. 99-102].

11.3(ii)(c) The reasons for non-compliance

The widespread non-compliance with accepted accounting principles seems to have had significant implications for investor information. It is necessary to consider, therefore, why the profession has not achieved compliance with its accepted principles. The profession made no attempt to enforce compliance with its accepted accounting principles until 1971, when the I.C.A.A. issued the pronouncement *K1, Conformity with Institute Technical Statements*.[11] *K1* recommended compliance with the Institute's statements and recommendations. In 1973, *K1* was adopted by the A.S.A. as *Statement 300, Conformity with Statements of Accounting Standards*. By this time, it applied to the accounting standards promulgated by the A.S.A. in association with the I.C.A.A. Initially, the I.C.A.A. had reassured members that the intentions of *K1* were educational rather than disciplinary. However, by 1973, members of the A.S.A. and the I.C.A.A. were warned that the relevant Council would enquire into failures to comply with accounting standards or to disclose any non-compliance. In 1976, the wording of *K1/300* was strengthened to include a veiled threat of disciplinary action. Members were warned that the relevant Council *may* take such action as it considered appropriate. This wording was retained in a revised version of *K1/300*, issued in 1978. A further revision of the statement, issued in 1979, was even more forceful. It warned members that failure to observe its provisions would constitute conduct detrimental to the profession, under the terms of the I.C.A.A.'s Charter or the A.S.A.'s Articles of Association, and would expose members to the possibility of investigation and disciplinary action.[12]

[11] Chapter 4 traces the history of *K1/300* prior to 1979.

[12] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1979].

These attempts to ensure compliance with accounting standards, or the disclosure of non-compliance in the rare circumstances in which it was appropriate, were unsuccessful for three main reasons. First, financial statements may have been influenced by non-members, over whom the profession has had little direct influence. For example, the legal responsibility for financial statements rested with directors. The profession has had no direct control over directors who were not members. In addition, in some States there has been no registration requirement for accountants.[13] This has meant that it has been possible for persons other than members of the I.C.A.A. and the A.S.A. to practise as accountants.

Second, the profession's attempts to influence non-members indirectly, through the auditors' report, seem to have been ineffective. Generally, legislation has required registered auditors to be members of the I.C.A.A. or the A.S.A. and, therefore, subject to the provisions of *K1/300*. The specific requirements for auditors to report non-compliance have varied with the different versions of *K1/300*. However, its basic objective was to ensure that the auditors disclosed any non-compliance, particularly if it was not disclosed elsewhere. Although not stated explicitly until the 1978 version of *K1/300*, auditors were required to qualify their reports where they considered that the non-compliance was unjustified. Assuming that directors would prefer not to have their accounts qualified, the auditor should have been able to discourage non-compliance. However, Henderson and Peirson [1980, pp. 101-102] concluded that while Australian managers may fear an audit qualification which reflected on their competence and integrity, there was little evidence to suggest that they feared audit qualifications on technical grounds. Also,

[13] The issue of the registration of accountants was raised in South Australia in the late 1970s and eventually was referred to the State and Federal Attorney Generals and to the National Companies and Securities Commission for consideration. No action had been taken by 1986.

Chambers [1978, p. 61] concluded that qualified audit reports were so prevalent that there was little "cost" associated with them. Certainly, audit reports qualified because of non-compliance with accounting standards are not unusual. For example, 337 of the 759 qualified audit reports received by the N.S.W. Corporate Affairs Commission during 1977 were qualified because of departures from accounting standards.[14] It seems, therefore, that the power of the auditor to encourage compliance with accounting standards has been limited.

The third reason that the accounting profession has not achieved compliance with accounting standards is that its sanctions against its own members have been ineffective. From 1976, the I.C.A.A. and the A.S.A. have threatened their members with disciplinary action if they failed to observe the provisions of *K1/300*. This action could have included fines, suspensions or expulsions. However, fines are likely to have been ineffective because they could have been avoided by members simply resigning from their professional body. Resignation from the I.C.A.A. or the A.S.A. may have meant some loss of status, but it would not necessarily have meant a loss of income as an offender could continue to practise as an accountant. For the same reason, suspensions and expulsions are also likely to have been ineffective sanctions. Moreover, the professional bodies have been most reluctant to apply these sanctions. Since 1972, the I.C.A.A. has monitored compliance through an annual survey of selected published company accounts. It has sent letters to members who held appointments with the companies which did not comply with accounting standards. Some cases of non-compliance have been referred to the various State Investigation Committees but the Institute appears to have been most reluctant to instigate any further action.

[14] Ryan [1977, p. 560].

Furthermore, the A.S.A. has had no mechanism for monitoring compliance with accounting standards. The studies discussed above indicate widespread non-compliance with accounting standards. Yet, reports of either the I.C.A.A. or the A.S.A. instigating disciplinary actions on the grounds of non-compliance with accounting standards have been rare.[15]

In addition, the compliance requirements of *K1/300* have applied only to accounting standards. The profession has made little attempt to enforce accepted accounting principles which have not been endorsed as standards. The journals of the I.C.A.A. and the A.S.A. contain very few reports of members disciplined for non-compliance with accepted accounting principles. Indeed the members from the 1960s case studies who were expelled from the A.S.A. were two of the handful of members who have been disciplined by the professional bodies on these grounds. The range of endorsed principles has increased. For example, Chapter 4 showed that prior to 1979 the profession had issued nine accounting standards. By 1985, a further eleven standards have been issued. It could be argued that as the range of accounting standards is increased, the scope for non-compliance with accepted accounting principles should decrease. However, this will not necessarily follow because of the ineffectiveness of the profession's compliance requirements. The increase in the range of standards may assist those who are uncertain about the appropriate principle to use, but it will do little to discourage deliberate non-compliance. Moreover, with only twenty accounting standards, there are still many areas where there are no endorsed principles. The accounting standard *AAS6: Accounting Policies: Determination, Application and Disclosure* sets out guidelines for choosing an accounting method where there

[15] In 1978 a member of the I.C.A.A. was expelled for a number of offences including the violation of *K1/300*. However, his other offences, on their own, probably provided sufficient grounds for expulsion. See *The Chartered Accountant in Australia*, September 1978, p. 70.

are no standards.[16] Once again, although this may assist those who are uncertain about the appropriate principles, it will not discourage deliberate violations of accepted principles because the ineffectiveness of the compliance requirements means that *AAS6* may be ignored.

The problems which the Australian accounting profession has faced in achieving compliance with its accepted principles become apparent when the disciplinary mechanisms in other professions are considered. In the accounting profession, disciplinary action may be invoked only against members of the two professional bodies. Moreover, because there are no statutory registration requirements members can avoid the consequences of disciplinary action by resigning from the professional bodies and still continue to practise as accountants. In contrast, in the legal and medical professions practitioners are registered with statutory registration boards which issue practising licences annually. Lawyers and doctors are disciplined through statutory bodies which have authority over all registered practitioners. In the legal profession, most disciplinary matters are handled by the Law Societies in each State but these professional associations are given the statutory power to discipline non-members. In the medical profession, the disciplinary tribunal in each State is external to the various professional associations, although in practice, the control of these tribunals has remained within the hands of the medical profession. In both professions, the disciplinary bodies have the power to deregister.

11.3(ii)(d) The implications of non-compliance

Has the profession's inability to achieve compliance with its accepted

[16] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1977].

accounting principles had implications for its status as a profession? According to Benson, the community accords professional status to occupational groups which have certain characteristics. For example, a profession must give advice and service to the community, in a specialized field of learning. It must restrict entry to those with some minimum standard of education. It must impose on members high standards of conduct and performance, above those required by law. Its rules of conduct must protect the interests of, or improve the level of service to, the community. And it must have a governing body which has the power to control and discipline its members. The governing body must apply disciplinary sanctions where the standards of conduct are not observed.[17] Where a profession fails to protect community interests within its area of expertise, society may withdraw its support for the profession, for example, by substituting legal or other modes of regulation.

Members of the Australian accounting profession have been involved in the production of financial statements which have not complied with accepted accounting principles and, therefore, have not served the interests of the community. According to the Benson criteria, to maintain its professional status the accounting profession should have disciplined these members. The evidence from the 1960s case studies is incomplete. The A.S.A. expelled two of its members although more members than these two were involved in the production of financial statement data which did not comply with accepted accounting principles. It is impossible to tell whether the I.C.A.A. disciplined any of its members. As far as the 1970s case studies are concerned, the Cambridge financial statements were the only ones which clearly

[17] These characteristics were outlined by Sir Henry Benson, G.B.E., F.C.A., in a lecture, given in London in October 1980, on "The Professions and the Community", see Benson [1981].

violated accepted accounting principles. So far, neither the I.C.A.A. nor the A.S.A. has disciplined any members involved with Cambridge. Moreover, there is ample evidence of non-compliance with accounting standards by companies other than the case study companies. Yet, according to the profession's journals, there are very few instances of disciplinary action on these grounds. It appears, therefore, that in this respect the Australian accounting profession has not satisfied the criteria for professional status. The evidence presented in Appendix C suggests that the legal and medical professions in Australia may have been equally ineffective in the discipline of their members. However, the Benson criteria are not relative. The inadequacies of the legal and medical professions in disciplining members do not excuse the accounting profession's failure to apply disciplinary sanctions where standards of conduct have not been observed.

There is some evidence that by the late 1970s the accounting profession was concerned about its discipline problem particularly in the context of the quality of the financial statements produced by failing companies. For example, in November 1977, the I.C.A.A. appointed a Professional Standards Review Committee, chaired by J.M. Hilliard, to examine and report on public criticism of the profession, particularly with reference to the Institute's investigations and disciplinary procedures. The public criticism analysed by the Hilliard Committee specifically included claims of misleading accounting information which had followed several recent company failures. The Hilliard Report was submitted in November 1978.[18] The Committee concluded that

> "...from the viewpoint of the investor there is understandable puzzlement and annoyance at the seeming inability of accountants to prepare and present accounts which are comprehensible, useful for

[18] Institute of Chartered Accountants in Australia [1978].

> comparison purposes, and reliable as an indicator of the present and likely continued profitability of each business entity."[19]

According to the Hilliard Committee, the present disciplinary provisions were inadequate largely because of the I.C.A.A.'s inability to compel members or non-members to appear before its investigation committees, or to produce the relevant books and documents. Whilst the National Council of the I.C.A.A. approved some of the Committee's recommendations, others, particularly those with more far reaching implications, were deferred for further consideration.[20]

In February 1980, the I.C.A.A. and the A.S.A. appointed The Joint Committee of Inquiry into Disciplinary Procedures Relevant to Public Interest Cases, chaired by Sir Ernest Savage. The "Savage Report" was submitted in October 1980.[21] It concluded that the basic cause of public criticism was company failures where investors and creditors had suffered and where members of the profession as directors, officers or auditors were seen to be accountable. In the opinion of the Savage Committee, much of the criticism could be traced to accounting standards, and in particular, to deficiencies in existing standards; to the lack of appropriate standards or to the failure to comply with standards. The Committee's terms of reference did not include the consideration of accounting or auditing standards, *per se*. However, with regard to the failure to comply with standards, the Committee concluded that the investigation and disciplinary procedures of the Australian accounting bodies were not adequate for the prompt and effective consideration of public

[19] "Criticism, Independence and Discipline, The Report of the Professional Standards Review Committee", *The Chartered Accountant in Australia*, April 1979, pp. 65-73.

[20] Institute of Chartered Accountants in Australia [1979].

[21] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1980].

interest cases. It recommended the introduction of a joint discipline scheme made up of four committees, which included a committee of inquiry, an investigation committee, a discipline committee and an appeals committee.[22] After a lengthy period of consideration by both professional bodies, this scheme was not adopted.

It must be understood, however, that the failure to achieve compliance with accepted accounting principles is not simply the result of inadequate discipline within the accounting profession. Two factors outside of the control of the profession have limited its ability to enforce accepted accounting principles.

First, legal responsibility for financial statements has rested with directors. The profession has been unable to influence directors who were not members of the I.C.A.A. or the A.S.A. Indeed, the Hilliard Committee considered the profession's lack of power over non-members one of the major weaknesses of its disciplinary procedures. Second, the effectiveness of the disciplinary measures available to the profession has been limited by the fact that membership of the I.C.A.A. or the A.S.A. has not been a necessary condition for pratising as an accountant. Both of these problems could only be remedied by government action.

Since the time of the case studies, the government has acted to overcome these deficiencies. In 1984, the federal government introduced the Accounting Standards Review Board (A.S.R.B.). The A.S.R.B. is an independent body which

[22] The Savage discipline scheme was based on the scheme proposed by the Grenside Committee in the United Kingdom. Discipline within the accounting profession has been an international issue. In the U.K., the Cross Committee was appointed to consider the investigatory and disciplinary powers of the British accountancy bodies. The report of the Cross Committee was submitted in November 1977. The Grenside Committee was appointed to consider the Cross Report. The report of the Grenside Committee was submitted in May 1978.

reviews accounting standards for acceptability to the community and refers them to the National Companies and Securities Commission (N.C.S.C.) for endorsement. The *Companies Act, 1981* has been amended to provide legislative backing for approved standards.[23] The members of the A.S.R.B. are drawn from the accounting profession and included representatives from industry, academia and public practice. The introduction of the A.S.R.B. and the accompanying legislation require compliance with endorsed standards. Thus members and non-members alike face powerful compliance requirements.

Government action was necessary to overcome the accounting profession's lack of authority over non-members and its lack of effective authority over members. It is necessary to consider whether this action reflects a "withdrawal of community support" as described by Benson, and therefore a decline in the status of the Australian accounting profession. The A.S.R.B. was first proposed in federal parliament in 1979. Initially, the concept was not well received by the accounting profession. It was viewed as increased government regulation of the profession. The issues of self-regulation as opposed to government regulation received considerable attention in the journals of the I.C.A.A. and the A.S.A. By mid-1982, the profession had accepted the need for co-regulation because of its inability to enforce accounting standards against non-members, although it did not acknowledge that co-regulation was also warranted because of its inability to enforce accounting standards against its own members.[24] Although the control of the A.S.R.B. has remained largely in the hands of accountants, by late 1984 it had become apparent that the A.S.R.B. could significantly influence the role of the accounting profession in defining its accounting principles. For example,

[23] *Companies Act, 1981*, s266B-F.

[24] "Submission to the NCSC on the Proposed Accounting Standards Review Board", *The Chartered Accountant in Australia*, June 1982, pp. 11-13.

in January 1985, the chairman of the joint I.C.A.A./A.S.A. Accounting Standards Board wrote to members expressing reservations about the format of the first three standards it had submitted for A.S.R.B. approval. According to this letter, these standards had been formulated after lengthy discussions with the A.S.R.B.[25] Clearly the introduction of the A.S.R.B. has resulted in some loss of independence for the accounting profession.

Moreover, this is not the only area where government regulation has been imposed. In June 1979, the Interstate Corporate Affairs Commission, representing the various State Corporate Affairs Commissions, announced that, in a prospectus report, auditors may be required to state specifically the basis of asset valuation in the accounts, whether these valuations were based on any assumed support from other entities and whether, in the absence of this support, the asset valuations were currently realizable. These requirements enabled Corporate Affairs Commissions to make their own evaluation of the appropriateness of asset valuations and the going concern assumption, at least for financial statements included in prospectuses. The evidence suggests that, in terms of the Benson criteria, that the accounting profession has not sufficiently protected the interests of the community in the provision of financial statement information, and therefore, that government regulation has been substituted for self-regulation.

It is not clear, however, that this intervention, in particular, the introduction of the A.S.R.B. and associated legislation, will provide the optimal solution. It will involve considerable costs in reviewing the accounting standards, monitoring compliance and taking action against non-compliance. Provided that these tasks are performed properly and adequate

[25] Australian Accounting Research Foundation, Advice to Members, A.A.R.F. Submission of Accounting Standards to the Accounting Standards Review Board, January 1985.

penalties are imposed for non-compliance, there should be a significant improvement in the level of compliance with accounting standards, although the evidence from the legal and medical professions suggests that statutory involvement in the disciplinary process will not necessarily result in effective discipline.

Only time will tell whether the benefits of the A.S.R.B. will outweigh its costs. Certainly, the costs to the community could have been reduced by achieving effective self-regulation. For example, if the government had introduced registration requirements which restricted the term "accountant" to members of the professional bodies and had required financial statements to be prepared by registered accountants, then the profession's disciplinary procedures may have been more effective. With access to effective sanctions, the profession may have been motivated to discipline its members for non-compliance, although once again the evidence from the other professions does not support this view. Also, the government may have been able to enhance compliance by non-member directors by increasing the costs associated with qualified auditors' reports. Even if compliance could only be achieved through legislative backing, the costs of government intervention could have been reduced by the N.C.S.C. automatically endorsing all standards set by the profession. However, there may have been risks associated with the government endorsing standards over which it had no control. The benefits to the community may have been increased further, if the government had endorsed all generally accepted accounting principles, although in practice this may have caused problems. Apart from the government's lack of control over the principles endorsed, there may have been disagreement within the profession over principles which had not been specifically formulated as standards. Whether or not the system of government regulation is ideal, it has the potential to improve compliance with accounting standards and, therefore, to decrease financial statement misinformation.

11.3(iii) The Role of the Auditor

The financial statements of four of the case study companies had the potential to mislead investors largely because of non-compliance with generally accepted accounting principles. Auditors are required by law to attest to the truth and fairness of the view provided by financial statements. The accounting profession interprets a true and fair view as that produced under generally accepted accounting principles. The auditors of these case study companies, therefore, should have qualified their reports where misinformation resulted from non-compliance with accepted accounting principles. However, the auditors' reports in the case studies were not qualified and the role of the profession in this area can be questioned.

In some of these cases, the evidence indicated that the auditors were concerned about the quality of the financial statements and, because of this concern, they had negotiated "improvements" to the statements. For example, it was only at the auditor's insistence that the Reid Murray accounts included some provision for doubtful debts, that the S.D.F. accounts included a warning that the value of its major asset was indeterminate and that the Cambridge accounts included any warning of the group's continuing interest in properties which had been sold. However, some of these improvements were such a compromise that they should have left the auditors with doubts about the truth and fairness of the view provided by the financial statements. An appropriately qualified audit report may have been much more informative than the compromised financial statements which were issued.

The conformity pronouncement effectively required auditors to ensure that non-compliance was disclosed and to qualify their reports where the non-compliance was unjustified. Apart from this pronouncement, the profession paid limited attention to the responsibilities of auditors until 1974, when the joint I.C.A.A./A.S.A. *Statement of Auditing Standards* was issued.[26] This standard was revised in 1977.[27] The I.C.A.A. and the A.S.A. considered that this statement set out the basic responsibilities of auditors but, unlike the accounting standards, it was not the subject of any specific compliance requirement. Indeed, the wording of the standards was so general that they would have been difficult to enforce.

The profession's concern over the role of the auditor has not been limited to simply issuing auditing standards. The I.C.A.A.'s Hilliard Committee was appointed partially because of the prevalence of public criticism of auditors. These criticisms included complaints about the auditor's failure to discover fraud by company officials and the alleged imprecision, inadequacy and subjectivity of the "true and fair" type of audit report.[28] The Committee attributed many of the criticisms to a lack of understanding of the role of the auditor on the part of the public, the government and the press. It concluded that there was a need to differentiate clearly between the responsibilities of directors and of auditors. In particular, the public should be made aware that directors and not auditors are responsible for a company's accounts and for the installation and proper operation of an accounting system with adequate internal controls. The Committee also argued that auditors should not be responsible for the

[26] The I.C.A.A. had issued recommmendations on auditing from as early as 1951. However, the first joint I.C.A.A./A.S.A. auditing standard was not issued until 1974. Statements on Auditing Practice were issued from the early 1970s, but these statements were confined to practical issues.

[27] See Institute of Chartered Accountants in Australia/Australian Society of Accountants [1977].

[28] Institute of Chartered Accountants in Australia [1978].

detection of all fraud but that they should satisfy themselves that the accounting and internal control systems are adequate and properly applied. The Committee also considered that the public needed to be better informed about the estimation and approximation which was involved in accrual based accounting and about the differences between going concern and liquidation based values and the implications of a premature decision to drop the going concern assumption. In their opinion, many of the criticisms of the failure to switch from going concern to liquidation values were based on hindsight.

However, the Hilliard Committee did not attribute the criticisms entirely to the public's lack of understanding of the role and responsibilities of auditors. It also saw a need to improve the audit function and made a number of recommendations including the use of audit committees as a voluntary aid to assist communication with directors, the conduct of quality control, audit reviews by other offices (or partners) within the same firm, the periodic rotation of partners on particular audits, and the review of financial statements by a second partner, prior to their issue. The Committee also concluded that the I.C.A.A.'s ethical ruling on independence urgently required revision. In addition, it proposed that a statement should be issued to members explaining auditors' responsibilities in the event of apparent illegal or questionable acts of management. The I.C.A.A. referred the review of its ethical ruling on independence to its Professional Standards Committee and, thereafter, to the A.S.A. A joint ethical pronouncement on professional independence was issued in 1982.[29] It defined specific situations where members were not to act for clients because of the apparent risk to their independence and warned that failure to follow the pronouncement "may" lead to disciplinary action. The proposal for a statement on questionable acts of

[29] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1982].

management was referred to the I.C.A.A.'s Technical Reference Panel but was not pursued. Most of the other recommendations on the role of the auditor, made by the Hilliard Committee, received no immediate follow-up. They were, however, published in the I.C.A.A. journal as suggestions to improve the audit function.[30]

During the early 1980s, the profession worked towards defining the responsibilities of auditors in specific situations, by issuing a number of *Statements of Auditing Practice*.[31] These statements were not issued in response to the recommendations of the Hilliard Committee. Most of them were Australian versions of the *International Auditing Guidelines*, but some did deal with issues which had been raised by the Hilliard Committeee. These included evaluating accounting systems and internal control, the going concern decision, quality control in audit work and the detection of fraud and error. Between 1981 and 1985, the profession revised three, and issued a further eighteen *Statements of Auditing Practice*. These statements may overcome some of the criticisms of the role of auditors, although their content has tended to be general. Moreover, they are not intended to be binding on members. They are to provide "authoritative guidance" which may be departed from, provided that details of the departure and the reason for it are included in working papers.[32] With their general content and lack of force, they may not be sufficient to ensure that auditors adequately fulfil their responsibilities. This may be another area which attracts government

[30] "National Council Report", Chartered Accountant in Australia, July 1979, pp. 4-5.

[31] *Statements of Auditing Practice* had been issued since the early 1970s. However, prior to 1981, only six statements had been issued and these dealt largely with non-controversial matters such as bank confirmation requests and solicitors' representation letters.

[32] Institute of Chartered Accountants in Australia/Australian Society of Accountants [1977a].

intervention, although the provisions already exist to take legal action against auditors who fail to do their job properly.

11.3(iv) The Need for Additional Information in Financial Statements

Generally, the case studies indicate that published accounting information provides an inadequate warning of failure. Even if the financial statements contained no misinformation, their ability to indicate failure could be improved by including some additional information. For example, insufficient cash flows are the ultimate cause of business failure. Cash flow statements would provide investors with an additional, and probably more sensitive, indicator of failure. Some of the case studies indicated that companies which trade heavily in real estate are particularly vulnerable. Investors in this type of company may benefit from an independent valuation, at each balance date, of real estate held for trading. This could be included in the financial statements as suplementary information. The costs of obtaining annual valuations would fall on existing shareholders but the valuations could provide them, as well as other investors, with an early warning of business difficulties. Furthermore, financial statements are concerned with past performance, which will not necessarily provide a good indicator of future performance. The inclusion of forecast data, as a supplement to the financial statements, may be useful, although there may be problems with subjectivity. Finally, value added statements may be useful. Value added is a lower dollar value measure of output than sales revenue. As such, it is more sensitive to change and, therefore, it should provide an earlier warning of a downturn in activity.

11.4 The Lessons for the Profession

In conclusion, the case studies indicate that over the past two decades investors have lost substantial sums in companies which have produced potentially misleading financial statements. Much of the misinformation occurred because of the failure of management and the individuals involved in the preparation and audit of the statements to comply with accepted accounting principles. Other evidence suggests that the problem of non-compliance with accepted accounting principles has not been confined to the case study financial statements. It has been widespread, and the profession can be criticized for not disciplining its members effectively for their non-compliance.

Recently, the federal government has established an Accounting Standards Review Board to review and to endorse standards developed by the profession. It is now an offence under the *Companies Act, 1981* not to comply with, or not to disclose non-compliance with, endorsed standards. This will overcome the problems associated with the profession's lack of influence over non-members and its inability to control its own members. However, the introduction of the A.S.R.B. has resulted in some loss of independence for the profession. Further losses may occur if the profession fails to serve the interests of society. It must ensure that existing generally accepted principles are endorsed as standards as quickly as possible, to make government regulation most effective. It must develop standards in areas where there are no generally accepted principles, to avoid confusion and to limit the opportunity for creative accounting. It should provide additional information, if it can be shown that such information would significantly benefit financial statement users and could be provided at a reasonable cost. Most importantly, the profession must be willing to discipline members who do not comply with its accepted principles and ethical rulings. The law should ensure compliance with endorsed accounting standards. However, to maintain its status as a profession, the I.C.A.A. and the A.S.A. must show that they are serving the interests of the community. They must give more than the bare minimum required by law.

APPENDIX A

CALCULATION OF FINANCIAL RATIOS

1. Return on shareholders' funds =

$$\frac{\text{net income after tax and preference dividends}}{\text{average ordinary shareholders' equity}}$$

where average ordinary shareholders' equity

= (opening ordinary share capital + opening unappropriated profits + closing ordinary share capital + closing unappropriated profits) ÷ 2

2. Dividend rate = dividends declared as a percentage of issued share capital.

3. Asset backing per share = $\frac{\text{total tangible assets - total liabilities}}{\text{no. of issued shares}}$

4. Debt ratio = $\frac{\text{total liabilities}}{\text{total assets}}$

5. Return on total assets = $\frac{\text{earnings before interest and taxes}}{\text{average total assets}}$

Note: Where the rate of return on total assets has been calculated from interim financial statements, it has been doubled to enable comparison with annual rates of return.

6. Asset cover for debentures =

$$\frac{\text{total tangible assets - any prior ranking charges}}{\text{total debentures outstanding}}$$

7. Interest cover = $\frac{\text{earnings before interest and tax}}{\text{interest expense}}$

8. Current ratio = $\frac{\text{current assets}}{\text{current liabilities}}$

APPENDIX B

THE DEVELOPMENT OF ACCOUNTING STANDARDS IN THE U.K. AND U.S.A.

This Appendix traces the development of accounting standards in the U.K. and U.S.A. The term "accounting standards" is used in the same context as it is used in Chapter 4. It refers to all authoritative pronouncements on preferred accounting practice which should be followed in preparing financial statements. The period of analysis is not extended beyond the period of the case studies, that is late 1979.

B1 Accounting Standards in the U.K.

B1(i) The Professional Associations in the U.K.

To trace the development of accounting standards in the U.K., it is necessary first, to identify the major professional associations which have represented the accounting profession in the U.K. Then, the contributions which these associations have made to the development of accounting standards can be assessed.

Prior to 1942, the accounting profession in the U.K. was represented by several major professional associations. These included The Institute of Chartered Accountants in England and Wales, The Institute of Chartered Accountants in Ireland, The Society of Incorporated Accountants and Auditors and The Association of Certified and Corporate Accountants (which was renamed The Association of Certified Accountants in 1971). They also included The Society of Accountants in Edinburgh and similar societies in Glasgow and Aberdeen. In 1951, the various Scottish societies amalgamated to form The Institute of Chartered Accountants of Scotland. In 1957, the Society of Incorporated Accountants and Auditors merged with the Institutes in England, Ireland and Scotland. In addition, professional associations developed in the areas of cost and management accounting and public finance.

B1(ii) U.K. Accounting Standards before 1970[1]

Prior to 1942, the accounting profession expected compliance with generally accepted accounting principles but none of the professional associations provided their members with any official guidance on accounting principles. However, in 1942, the Institute of Chartered Accountants in England and Wales (the English Institute) established a Taxation and Financial Relations Committee to consider matters affecting taxation and the financial relationship between the business community and government departments, in particular the Department of Inland Revenue. The preparation of pronouncements on accounting principles became one of the major tasks of this committee. Indeed, between 1942 and 1969, the Council of the English Institute approved and issued twenty-nine "Recommendations on Accounting Principles", which had been drafted by the Taxation and Financial Relations Committee, or the Taxation and Research Committee as it was renamed in 1949.

Table B1 shows the diversity of subjects covered by the English Institute's recommendations. Although some of them dealt with specific issues, such as accounting for tax reserve certificates, war damage claims and investment grants, many of them covered broad areas such as accounting for taxation, reserves and provisions, consolidations, and the effects of inflation. The object of these recommendations was to offer guidance to members on best practice. They were not binding on members but, according to Zeff [1972, p.22],

> "while hard evidence is not available, informed observers attest to the effectiveness of the Recommendations in upgrading practice."

[1] Much of the information in this section and the preceding section is drawn from Zeff [1972, pp.1-70].

Table B1: Recommendations on Accounting Principles Published by the Institute of Chartered Accountants in England and Wales

No.	Year of Issue	Subject Matter
1	1942	Accounting treatment of tax reserve certificates.
2	1942	Accounting treatment of war damage contributions, premiums and claims.
3	1943	Accounting treatment of taxation in the accounts.
4	1943	Accounting treatment of income tax deductible from dividends payable and annual charges.
5	1943	The inclusion of proposed profit appropriations.
6	1943	Disclosure of reserves and provisions.
7	1944	Consolidated accounts for holding companies and subsidiaries.
8	1944	Form and content of balance sheet and profit and loss accounts.
9	1945	Depreciation of fixed assets.
10	1945	Valuation of stock-in-trade.
11	1946	Accounting treatment of post-war refunds from excess profits taxes.
12	1949	Rising price levels in relation to accounts.
13	1949	Accounting reports for prospectuses.
14	1949	Accounting for the estates of deceased persons and similar trusts.
15	1952	Accounting in relation to changes in the purchasing power of money.
16	1953	Accountants' reports for prospectuses.
17	1957	Events occurring after the balance sheet date.
18	1958	Presentation of balance sheet and profit and loss account.
19	1958	Taxation in the accounts of companies.
20	1958	Accounting treatment of investments in the balance sheets of trading companies.
21	1960	Retirement benefits.
22	1960	Accounting treatment of stock-in-trade and work in progress in financial accounts.
23	1964	Hire purchase, credit sale and rental transactions.
24	1967	Accounting treatment of investment grants.
25	1968	Accounting treatment of changes in foreign exchange rates.
26	1968	Accounting implications of Land Commission Act 1967.
27	1968	Taxation in the accounts of companies.
28	1968	Accounts of investment trust companies.
29	1969	Trust accounts

Source: Zeff [1972, passim] and data provided by the Librarian of the Australian Society of Accountants (Adelaide Office).

Whilst this is probably true, the effectiveness of the recommendations was limited by a number of factors. Their approach was generally broad and usually allowed a number of alternative practices. They were directed only at members of the English Institute and they were not binding on those members. Indeed, surveys of published accounts conducted by the English Institute in the late 1960s indicated that some of the recommendations were not widely followed. By the late 1960s, the other professional associations had not provided their members with any official pronouncements on accepted accounting principles.[2]

Bl(iii) U.K. Accounting Standards from 1970

By the late 1960s, the accounting profession in the U.K. had become the subject of considerable public criticism. For example, in October 1967, ten weeks prior to balance date, Associated Electrical Industries Ltd., which was the subject of a takeover bid by General Electric Company Ltd, forecast a profit of 10m for the year. The actual result for the period, reported in the following year, was a loss of 415m. According to Zeff [1972, p.34]

> "the financial press was left incredulous and not a little bit inquisitive about the alleged plasticity of accounting practices and the consequent validity of forecasts and published accounts prepared on the basis of these practices."

Further criticisms resulted from a takeover bid made by Leasco Data Processing Equipment Corporation for Pergamon Press Ltd in 1969. Leasco's bid was based on Pergamon's reported profits for 1968 and profit forecast for 1969. Subsequently these figures were found to be significantly overstated

[2] In fact, the Institute of Chartered Accountants of Scotland had issued one pronouncement on inflation accounting. However, this was the only pronouncement published by the Scottish Institute and was prompted by its disagreement with the English Institute's Recommendation No. 15.

because of questionable accounting practices which were accepted without qualification by Pergamon's auditors.

In the meantime, Professor Edward Stamp had published a number of articles which questioned the profession's accounting principles. Following the Leasco-Pergamon affair, Stamp published an article entitled "Auditing the Auditors" in *The Times*.[3] In this article, he identified two main weaknesses in the area of financial reporting. These were the multiplicity of accepted accounting principles, which he attributed to the lack of a conceptual framework, and the auditor's lack of independence.

In response to the mounting public criticism, in December 1969 the Council of the English Institute published a "Statement of Intent on Accounting Standards in the 1970s". This statement informed the public of the Council's commitment to improve financial reporting by decreasing diversity, by requiring disclosure of accounting bases and disclosure of departures from definitive accounting standards and by ensuring wider exposure for major proposals on accounting standards. To this end, in early 1970 the English Institute established an Accounting Standards Steering Committee (ASSC), charged with developing definitive standards of financial reporting. The Irish Institute joined the Accounting Standards Steering Committee later in 1970, followed by the Scottish Institute in 1971. The Councils of the three Institutes decided to issue standards prepared by the ASSC in their own name, rather than jointly.

As a starting point, in 1970 the ASSC published a five year programme which identified twenty areas for the development of accounting standards. Although the programme appeared ambitious, Table B2 shows that work was in progress in twelve of these areas prior to the establishment of the ASSC.

[3] This article is discussesd in detail in Ashton [1983, Chapter 1].

Table B2: A.S.S.C. Five Year Programme, Published 1970

Ref. No.		Planned Release Date	Whether work in progress at time programme was agreed	Position at June 1975
1	Disclosure of accounting bases	1970	Yes	SSAP2
2	Form and content of profit and loss account	1970	Yes	Deleted from programme
3	Form and content of balance sheet	1970	Yes	Deleted from programme
4	Treatment of extraordinary and prior year items	1970	Yes	SSAP6
5	Changes in accounting bases	1970	No	Dealt with in SSAP6
6	Treatment of investments in the accounts of trading companies and industrial holding companies	1970	Yes	Deleted from programme
7	Treatment of income of associated companies	1970	Yes	SSAP1
8	Fundamental principles of inventory valuation	1970	No	SSAP9
9	Fundamental principles, form and content of group accounts	1971/2	Yes	Research Study completed
10	Accounting for mergers and acquisitions	1971/2	Yes	ED3
11	Accounting for contract work in progress	1971/2	Yes	Dealt with in SSAP9
12	Fundamental principles of depreciation	1971/2	Yes	ED15
13	Earnings per share	1971/2	Yes	SSAP3
14	Accounting for research and development	1971/2	No	ED14
15	Accounting treatment of pension funds in company accounts	1971/2	No	Research Study completed

16	Form and content of pension fund accounts	1971/2	Yes	Deleted from programme
17	Accounting for changes in the purchasing power of money	1973/4	No	PSSAP7
18	Fundamental objects and principles of periodic financial statements	1973/4	No	Research Study in progress (later published as The Corporate Report)
19	Accounting for Goodwill	1973/4	No	Under study by ASSC
20	Insurance Company Accounts	-	No	Deleted from programme

Source: Leach and Stamp eds. [1981, pp.186-187]

Table B2 also shows that by June 1975, that is at the end of five years, only seven of these areas had been covered by statements of Standard Accounting Practice. Of the remaining thirteen areas, one was covered by a provisional statement, three were covered by exposure drafts, two were covered by completed research studies, two were under study by the ASSC, and five had been deleted from the programme. By 1979, ten of the initial twenty areas had been covered by Statements of Standard Accounting Practice.

In its first five years, however, the ASSC did not confine itself to these twenty areas. Indeed, by June 1975 a total of nine Statements of Standard Accounting Practice had been issued, three of which covered areas not included in the initial programme. Moreover, in the next four and a half years a further six Statements were issued, three of which covered areas additional to the initial programme. Table B3 lists the Statements of Standard Accounting Practice produced by the A.S.S.C. (or the Accounting Standards Committee as it was renamed in 1976) by the end of 1979.

Table B3: Statements of Standard Accounting Practice, 1970-1979

SSAP No	Title	On general release
1	Accounting for the Results of Associated Companies	January 1971
2	Disclosure of Accounting Policies	November 1971
3	Earnings Per Share	March 1972
4	The Accounting Treatment of Government Grants	April 1974
5	Accounting for Value Added Tax	April 1974
6	Extraordinary Items and Prior Year Adjustments	April 1974
7	Accounting for Changes in the Purchasing Power of Money	June 1974
8	The Treatment of Taxation under the Imputation System in the Accounts of Companies	September 1974
9	Stocks and Work in Progress	June 1975
10	Statements of Source and Application of Funds	August 1975
11	Accounting for Deferred Taxation	September 1975
12	Accounting for Depreciation	January 1978
13	Accounting for Research and Development	January 1978
14	Group Accounts	September 1978
15	Accounting for Deferred Taxation	November 1978

Source: Leach and Stamp eds. [1981, p.188]

The Statements of Standard Accounting Practice carried considerably more weight than the earlier "Recommendations" of the English Institute. Being published by the Councils of the English, Scottish and Irish Institutes they covered a much wider body of members. More importantly, from January 1971, the explanatory foreword issued with the Statements explicitly stated that

> "The Council expects members of the Institute who assume responsibilities in respect of financial accounts (signified by the association of their names with such accounts in the capacity of directors or other officers, auditors or reporting accountants) to observe accounting standards. The onus will be on them not only to ensure disclosure of significant departures but also, to the extent that their concurrence is stated or implied, to justify them. The Council, through its Professional Standards Committee may inquire into failures by members of the Institute to observe accounting standards or to disclose departures therefrom."[4]

The authority of the Statements of Standard Accounting Practice was further enhanced in March 1971 when the Councils of the three Institutes issued "Statement on Auditing 17", which required auditor's reports to refer to all departures from accounting standards, whether or not they were disclosed in the accounts. Moreover, the statement required auditors to qualify their reports where a departure was considered unjustified or to state their concurrence in the rare circumstances where a departure was justifiable.

Whilst these compliance requirements were directed at members of the three Institutes, they provided no direct mechanism to enforce compliance with accounting standards by non-members. The main sanction against non-members who breached accounting standards was the threat of a qualified audit report. The Institutes sought the assistance of the Stock Exchange in policing accounting standards as the Stock Exchange has the power to suspend

[4] Council of The Institute of Chartered Accountants in England and Wales, Council of The Institute of Chartered Accountants in Ireland, Council of the Institute of Chartered Accountants of Scotland, *Statements of Standard Accounting Practice, Explanatory Foreword*, issued January 1971, amended July 1971.

companies which do not comply with accounting standards, or disclose non-compliance, in the preparation of their annual reports. However, according to Stamp, the Stock Exchange was not willing to suspend companies for non-compliance with accounting standards as it considered that the penalty was too severe and that suspension on these grounds penalized rather than protected shareholders.[5]

By the late 1970s, there was some evidence that the compliance requirements developed by the accounting profession in the U.K. had not been completely successful. The literature largely attributes the enforcement problems to the auditor's lack of power over non-member managers, whose interests may conflict with shareholders.[6] The extent of the non-compliance problem is unclear. However, a committee set up by the Accounting Standards Committee to review the standard setting process in the U.K. recommended the appointment of a supervisory body "of undoubted standing in the community" to enquire into instances of non-compliance with accounting standards.[7] This approach was seen as preferable to government regulation.

B1(iv) Accounting Standards in the U.K., A Summary

In brief, prior to 1942, the accounting profession in the U.K. had made no attempt to codify its accounting principles. Between 1942 and 1969 the English Institute issued 29 Recommendations on Accounting Principles. Some of these were confined to specific areas such as war claims but many of them dealt with broad areas of princple. However, the impact of these

[5] Leach and Stamp eds. [1981, p.244].

[6] See, for example, Accounting Standards Committee [1981], Watts in Leach and Stamp [1981, pp.27-40], and Stamp, E. in Leach and Stamp [1981, pp.231-247].

[7] Accounting Standards Committee [1981].

Recommendations was limited because they were not mandatory and they applied only to members of the English Institute. Moreover, their content tended to be more general than specific. In 1970, the English and Irish Institutes and, in 1971, the Scottish Institute began to issue Statements of Standard Accounting Practice. By the end of 1979, fifteen such statements had been issued. Members of the three Institutes were required to observe these standards or to disclose non-compliance and there is no doubt that they have been more effective than the earlier "Recommendations". However, by the late 1970s, it was apparent that the accounting profession still faced problems over compliance with its accounting standards.

B2 Accounting Standards in the U.S.A.[8]

B2(i) The Professional Associations in the U.S.A.

The accounting profession in the U.S.A. has been represented by a number of professional associations. These include

(i) The American Institute of Certified Public Accountants (AICPA) which evolved from the American Association of Public Accountants, founded in 1887. Between 1916 and 1957, the AICPA was known as the American Institute of Accountants.

(ii) Various state societies of certified public accountants

(iii) The American Association of Accountants (AAA) which was founded as the American Association of University Instructors in Accounting in 1916 and renamed in 1935-36.

(iv) National Association of Accountants (NAA) which was founded as the National Association of Cost Accountants in 1919 and renamed in 1957. The NAA is primarily concerned with cost and management accounting issues.

[8] The information relating to the development of U.S. accounting standards prior to the FASB has been drawn from Zeff [1972, pp.110-268], Zeff [1984], Carey [1970] and Most [1982, pp.83-118].

(v) The Financial Executives Institute (FEI) which was founded as the Controllers Institute of America in 1931 and renamed in 1962.

Accountants in public practice may be members of any or all of these associations. However, according to Zeff [1972, p.112]

> "... the American Institute (ie, the AICPA) is generally regarded as spokesman for U.S. certified public accountants."

Certainly, the AICPA has been the most important source of statements on accounting principles. It is convenient, therefore, to split the development of accounting standards into four periods, coinciding with major initiatives introduced by the AICPA. These initiatives include the establishment of the Committee on Accounting Procedure (CAP) in 1936, the replacement of the CAP with the Accounting Principles Board (APB) in 1959, and the replacement of the APB with the Financial Accounting Standards Board in 1973. Thus, the four periods cover the years prior to 1936, 1936 to 1959, 1959 to 1973 and the years from 1973.

B2(ii) U.S. Accounting Standards Prior to 1936

The first pronouncement on accounting principles made by a professional body in the U.S. was issued by the AICPA (or more correctly its predecessor, the American Institute of Accountants) in 1917. There had been some debate within the profession over the charge of imputed interest on capital investments as part of the cost of production. The AICPA recommended that such interest should not be included as a product cost. The recommendation was accepted by the membership and, according to Zeff [1972, p.116], this implied

> "... that all Institute members were expected to conform to the recommendation."

Around the same time, two government agencies, the Federal Trade Commission and the Federal Reserve Board, expressed dissatisfaction over the quality of financial statements, in particular their lack of uniformity. The AICPA responded by drawing up a memorandum entitled "Approved Methods for the Preparation of Balance Sheets". This memorandum was first published by the Federal Reserve Board in 1917. However, it is doubtful whether this statement could be classified as an early accounting standard. It was published as a "tentative proposal" and, moreover, it dealt mainly with auditing rather than accounting matters. In 1929 a revised version entitled "Verification of Financial Statements", was prepared by the AICPA and issued by the Federal Reserve Board, this time without the "tentative" qualification. The emphasis, however, remained on auditing matters. Also in 1929, the AICPA adopted Rule No. 2 as part of the Rules of Professional Conduct. This rule provided for discipline of a member who certified financial statements which were misleading or omitted essential facts but, according to Carey [1970, p.450], no standards existed to determine what was misleading or essential fact.

In 1920, the librarian of the AICPA was authorized to issue bulletins on accounting principles, in response to selected inquiries from members. Between 1920 and 1929, thirty three special bulletins were published. However, they were issued

> "as opinions of accountants to whom the questions are referred"

and, as such, did not carry the authority of the AICPA. In addition, between 1922 and 1930, the AICPA's Special Committee on Terminology compiled and published a list of approximately 6000 terms and definitions. However, these were described as "advisory" and did not carry the authority of the AICPA.

In the late 1920s, the New York Stock Exchange (NYSE) expressed dissatisfaction with the quality of the financial statements of listed companies. In response, the AICPA established a Committee on Co-operation with Stock Exchanges. The NYSE was particularly concerned about the diversity of accounting methods used by listed companies. The Committee on Co-operation with Stock Exchanges did not share the NYSE's concern. It argued that uniformity was not important, provided that accounting methods were applied consistently and disclosed in detail. Consistent with this approach, in 1932 the Committee on Co-operation with Stock Exchanges submitted a list of five broad accounting principles to the NYSE. These principles, plus one other, were accepted by the membership of the AICPA in 1934. They dealt with accounting for unrealized income, additional paid up capital, pre-acquisition retained earnings of subsidiaries, dividends on treasury stock, receivables and treasury stock. These principles were not intended to produce uniformity in detailed accounting methods. Indeed, the AICPA maintained that uniformity was not desirable provided disclosure was adequate. However, the issue of disclosure was not followed up at this stage.

In 1934, the Securities and Exchange Commission (SEC), was created to administer the Securities Act (1933) and the Securities Exchange Act (1934). Under this legislation, the SEC effectively had the power to determine the accounting and auditing practices used by listed companies in the preparation of financial statements. It had no legal power but could refer cases of fraud and deception to the courts. In practice, however, the SEC has made only limited use of this power.

To summarize, prior to 1917, the accounting profession in the U.S. had not made any authoritative pronouncements on accounting principles. The first such pronouncement was issued by the AICPA in 1917 and dealt with the accounting for imputed interest in calculating production costs. Despite the attention paid to terminology and specific issues of principle, no further pronouncements were made until 1934 when the AICPA issued six broad accounting principles.

B2(iii) U.S. Accounting Standards, 1936-1959

In 1936, the AICPA appointed the Committee on Accounting Procedure (CAP) to express opinions on particular points of accounting procedure. Around the same time, the American Association of University Instructors in Accounting reformed as the American Accounting Association (AAA), with one of its aims being the development of accounting principles. Its first effort in this area consisted of a five page "Tentative Statement of Accounting Principles Affecting Corporate Reports" which was published in 1936. This statement summarized the body of accounting principles underlying the preparation of financial statements. However, it was very general and lacked authority and, as such, cannot be considered an early accounting standard.

Prompted by the AAA's activity, in 1938 the AICPA's Committee on Accounting Procedure produced a 138 page "Statement of Accounting Principles" based on a survey of existing practices. However, this statement also lacked authority as it was published in the name of the CAP, not the AICPA.

In the meantime, in 1937 the SEC began its issue of Accounting Series Releases (ASR) which it described as

> "a program for the publication, from time to time, of accounting principles for the purpose of contributing to the development of uniform standards and practice in major accounting questions."[9]

In the following year, in ASR No. 4, the SEC announced that financial statements, prepared using accounting principles for which there is no substantial authoritative support, would be presumed misleading, despite disclosure. Clearly, the SEC was calling on the profession to identify principles for which there was substantial authoritative support, that is to develop accounting standards.

[9] ASR No 1 quoted in Zeff [1972, p.132].

The AICPA responded by expanding the membership of the CAP to include interested parties such as the SEC and NYSE. In addition, it set up a research department to support the CAP. In 1939, the CAP began to issue Accounting Research Bulletins (ARB) which delineated accounting principles in specific areas. By the end of the first year, the CAP had issued four ARBs. The first ARB ratified the six broad principles approved in 1934. The second and third ARBs dealt with accounting for bonds and corporate quasi-reorganisations and the fourth dealt with foreign currency transactions. However, these bulletins were issued as conclusions and recommendations of the CAP and not the AICPA.

In 1940, the SEC brought together all of its rules on the form and content of the financial statements of listed companies under Regulation S-X. At this stage, the SEC had the opportunity to influence the accounting practices of all companies which reported to it. However, Regulation S-X was largely confined to the nature and extent of disclosure.

During the 1940's, there was considerable debate over whether the CAP should continue to deal with specific issues or attempt to develop a comprehensive framework for accounting principles. Despite this debate, the CAP pushed ahead with the issue of ARBs dealing with specific issues. Between 1940 and 1952 the CAP issued a further 38 ARBs.

In 1953, the CAP issued ARB No 43 which was a restatement of all ARBs issued to date. It superseded all prior ARBs and covered the form of financial statements, accounting for working capital, inventory, intangible assets, contingency reserves, earned surpluses, depreciation, taxes, government contracts, foreign operations and exchange, compensation and bonds.

However, by 1953, the notion of greater uniformity in accounting principles had gained acceptance within CAP and gradually its pronouncements had become more definitive. On occasions, the CAP found itself recommending one particular principle which differed from those used by some leading practising accountants and, sometimes, those recommended by outside bodies such as the SEC. Thus, during this period the authority of the CAP and its ARBs was questioned both within and outside the profession.

Members of the AICPA were not forced to comply with ARBs. Indeed, each ARB included a statement that

> "Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of opinions reached by the committee (ie the CAP) rests upon their general acceptability."[10]

The only accounting principles adopted by the membership were the imputed interest pronouncement of 1917 and the six broad princples identified in 1934 and restated in ARB No. 1. Nevertheless, ARBs also stated

> "It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departures must be assumed by those who adopt other treatment."[11]

The auditor was expected

> "to bring out the exceptional procedure and the circumstances which render it necessary"[12]

In 1940, Rule No 2 on auditing which provided for discipline of members who certified misleading financial statements, had been rewritten as Rule No 4. This required auditors to disclose any material departures from generally accepted accounting principles but the status of ARBs in the context of this rule was unclear. It seems that if the principles delineated in an ARB did not gain general acceptability, compliance with them and disclosure of

[10] *Ibid.*

[11] *Ibid.*

[12] ARB No. 1 quoted in Zeff [1972, 160-161].

departures from them was not expected. The text of ARBs issued from 1953 was amended so that departures were defined as

> "departures from accepted procedures, as evidenced in committee (ie CAP) opinions."[13]

However, according to Zeff [1972, p.182], even with this clarification such depatures were seldom disclosed or explained. The principles outlined in ARBs had to rely on endorsement by outside enforcement agencies such as the SEC and the NYSE to gain any authority.

The lack of authority was not the only problem facing the CAP. By the late 1950s, there was some dissatisfaction with the CAP's specific issues approach. Some members considered that the development of a comprehensive framework was a necessary prerequisite to specifying detailed principles. Other members accepted the specific issues approach but favoured flexibility rather than greater uniformity, while another group thought the CAP was too flexible. In addition, there was some feeling that the CAP had moved too slowly. Lacking in authority, the CAP was dependent on the support of the membership but, by the late 1950s, this support was faltering. Moreover, the CAP was also subjected to pressure from outside. The AAA had began to issue its own series of statements on accounting principles and there was a view that these statements reflected a more progressive approach. The Controllers Institute of America began to pressure the CAP for some influence over ARBs. In addition, from the mid-1950s, the financial press became increasingly critical of the diversity of accounting princples and the apparent lack of independence of the CAP. Not surprisingly, the CAP was disbanded in 1959. By this time it had issued 51 Accounting Research Bulletins, which are listed by date of issue in Table B4.

[13] Zeff [1972, p.182].

To summarize, the CAP was the first AICPA committee charged with the on-going task of delineating accounting principles and the Committee's ARBs were the first series of pronouncements on accounting principles to emanate from the AICPA. However, the ARBs were published as opinions of the CAP. They lacked authority. Members were supposed to justify departures from the ARB principles but they seldom did. The authority of ARBs was dependent on the support of the membership but, by the late 1950s, the CAP had fallen from favour, both within and beyond the profession.

B2(iv) U.S. Accounting Standards, 1959-1973

In September 1959, the AICPA replaced the CAP with the Accounting Principles Board (APB). The aim of the APB was to determine appropriate accounting practices and to narrow areas of difference and inconsistency. The AICPA did not tackle the authority problem at this stage, as it was intended that the APB, like the CAP, would rely on persuasion rather than compulsion. However, the issue of a comprehensive framework was addressed, as it was decided that the APB would begin with a study of postulates. Accounting principles were to be formulated on the basis of these postulates and then rules were to be developed for the application of the principles in specific situations.

The APB commissioned research studies in the areas of postulates and principles but subsequently rejected their findings as too different from existing generally accepted accounting principles. It became apparent that a postulates-principles framework consistent with existing practice was not easily obtainable. In 1965, *Accounting Research Study No 7, Inventory of Generally Accepted Accounting Principles For Business Enterprises* by Paul

Table B4: Accounting Research Bulletins

Number	Topic	Date of Issue
1	General introduction & rules formerly adopted	Sept., 1939
2	Unamortized discount and redemption premiums on bonds refunded	Sept.,; 1939
3	Quasi-reorganization or corporate readjustment	Sept., 1939
4	Foreign operations and foreign exchange	Dec., 1939
5	Depreciation on appreciation	Apr., 1940
6	Comparative statements	Apr., 1940
7	Reports of Committee on Terminology	Nov., 1940
8	Combined statement of income and earned surplus	Feb., 1941
9	Report of Committee on Terminology	May, 1941
10	Real and personal property taxes	June, 1941
11	Corporate accounting for ordinary stock dividends	Sept., 1941
12	Report of the Committee on Terminology	Sept., 1941
13	Accounting for special reserves arising out of the war	Jan., 1942
14	Accounting for United States Treasury tax notes	Jan., 1942
15	The renegotiation of war contracts	Sept., 1942
16	Report of the Committee on Terminology	Oct., 1942
17	Post-war refund of excess-profits tax	Dec., 1942
18	Unamortized discount and redemption premium on bonds refunded (supplement)	Dec., 1942
19	Accounting under cost-plus-fixed-fee contracts	Dec., 1942
20	Report of the Committee on Terminology	Nov., 1943
21	Renegotiation of war contracts (supplement)	Dec., 1943
22	Report of Committee on Terminology	May, 1944
23	Accounting for income taxes	Dec., 1944
24	Accounting for intangible assets	Dec., 1944
25	Accounting for terminated war contracts	Apr., 1945
26	Accounting for the use of special war reserves	Oct., 1946
27	Emergency facilities	Nov., 1946
28	Accounting treatment of general purpose contingency reserves	Jul., 1947
29	Inventory pricing	Jul., 1947
30	Current assets and current liabilities - working capital	Aug., 1947
31	Inventory reserves	Oct., 1947
32	Income and earned surplus	Dec., 1947
33	Depreciation and high costs	Dec., 1947
34	Recommendation of Committee on Terminology. Use of the term "Reserve"	Oct., 1948
35	Presentation of income and earned surplus	Oct., 1948
36	Pension plans - accounting for annuity costs based on past services	Nov., 1948
37	Accounting for compensation in the form of stock options	Nov., 1948
38	Disclosure of long term leases in financial statement of lessees	Oct., 1949
39	Recommendatioin of the Subcommittee on Terminology - Discontinuance of use of the term "Surplus"	Oct., 1949
40	Business combinations	Sept., 1950

41	Presentation of income and earned surplus (supplement)	Jul., 1951
42	Emergency facilities - depreciation, amortization & income taxes	Nov., 1952
43	Restatement and revision of ARBs	June, 1953
44	Declining balance depreciation	Oct., 1954
45	Long term construction contracts	Oct., 1955
46	Discontinuance of dating earned surplus	Feb., 1956
47	Accounting for cost of pension plans	Sept., 1956
48	Business combinations	Jan., 1957
49	Earnings per share	Apr., 1958
50	Contingencies	Oct., 1958
51	Consolidated financial statements	Aug., 1959

Sources: Details of Bulletins 1 to 42 were provided by the Librarian of the Australian Society of Accountants (Adelaide office). Details of Bulletins 43-51 were drawn from F.A.S.B. [1983a].

Grady was published.[14] Although comprehensive, this was largely an exposition of accepted practice. It was, however, accepted by the APB and the search for a comprehensive framework subsided, at least for the time being.

In the interim, the APB began to issue "Opinions" on specific issues. For example, APB Opinion No 1, issued in November 1962, clarified the application of a previous ARB on income tax allocation. APB Opinion No 2, on investment credit, proved to be highly controversial. It recommended one method, yet the SEC allowed two. Once again the authority of the profession's instigator of accounting principles was questioned. To overcome this problem, in October 1964, the AICPA issued a special bulletin on "Disclosure of Departures from Opinions of the Accounting Principles Board" which required auditors to disclose material departures from principles accepted in APB Opinions.[15] Any violations were to be referred to the AICPA's Practice Review Committee. However, this pronouncement gave the auditor the option to give an unqualified opinion if the principle which departed from an APB Opinion had

[14] Grady [1965].

[15] APB [1964], *Opinion No 6, Status of Accounting Research Bulletins*, Appendix A.

substantial authoritative support. Although the authority of APB Opinions was enhanced by this pronouncement, the unqualified audit opinion option undermined this authority.

Moreover, the requirements outlined in the October 1964 bulletin were not incorporated into existing ethical rulings or auditing standards. In 1962, the Committee on Auditing Procedure had produced a Statement on Auditing Procedure which required auditors to report whether financial statements are presented in accordance with generally accepted accounting principles. And, by then, the AICPA's code of ethics defined an auditor's failure to disclose departures from generally accepted accounting principles and auditing procedures as discreditable conduct. However, the October 1964 bulletin did not specifically define APB Opinions as generally accepted accounting principles. In fact, it recognized the possible existence of generally accepted principles which differed from APB Opinions. Thus, APB Opinions were not enforceable under the AICPA's code of ethics. Compliance with APB pronouncements effectively remained voluntary. In 1969, members were asked to approve a new rule 202(e) which specifically required compliance with APB opinions as part of the AICPAs code of ethics. However, the membership failed by a very small margin to approve the rule and the provisions for disclosing departures from APB Opinions remained outside the code of ethics.

In addition to clarifying the status of APB opinions within the profession, the AICPA moved to improve their status outside the profession during the 1960s. This was achieved by expanding the APB's consultation with outside groups prior to issuing opinions.

However, in the late 1960s, the APB issued Opinion No 16 on business combinations and Opinion No 17 on goodwill, both of which proved to be highly controversial. Also during the late 1960s, U.S. stock markets experienced a speculative boom. In this climate, a number of promoters took advantage of inadequacies in accounting principles to inflate reported earnings. When the speculative bubble burst some investors took legal action against the auditors of these companies. This litigation attracted the attention of the financial press and the adequacy of existing accounting principles became a public issue.

Fuelled by these controversies, there was mounting criticism of the APB. Criticisms included its failure to establish a comprehensive framework, the rigid nature of its Opinions which were viewed by some as rules rather than principles, and the alleged lack of independence of its members. Indeed, despite more elaborate administrative procedures, the APB had operated in a similar manner to the CAP. By the end of the 1960s, there were calls from both within and beyond the profession for a full scale review of the procedure for establishing accounting principles. In January 1971, the president of the AICPA called a conference of 35 prominent certified practising accountants from 21 major accounting firms. The conference recommended the appointment of two study groups, one to consider the establishment of accounting princples and the other to consider the objectives of financial statements. Acting on this advice, in March 1971, the AICPA appointed an accounting principles group, chaired by F. M. Wheat, and a financial statements objective group, chaired by R. M. Trueblood.

In the meantime, in August 1970, the AAA had appointed a Committee on the Establishment of an Accounting Commission to consider the desirability of a commission to inquire into the formulation of accounting principles. In February 1971, the committee recommended the establishment of such a commission, citing seven areas of dissatisfaction with the APB. However, the AAA deferred action on this recommendation until after the report of the Wheat Committee. Indeed, the AAA was represented on the Wheat Committee and the

"Accounting Commission" idea was dropped.

In March 1972, the Wheat study group recommended the establishment of a Financial Accounting Standards Board (FASB) to take the responsibility for establishing accounting principles. It proposed that the FASB be largely independent of the AICPA, being sponsored by the various organizations whose members had a strong interest in financial accounting. Within two months, the membership of the AICPA had approved the introduction of the FASB to replace the APB. The APB was disbanded in June 1973. By this time it had issued 31 Opinions. Table B5 lists the APB Opinions, by date of issue.

To summarize, the CAP was replaced by the APB in 1959. The aim of the APB was to determine appropriate practice and to narrow areas of difference and inconsistency. The APB attempted to develop a comprehensive framework. Ultimately, it abandoned this approach and proceeded as the CAP had, by issuing pronouncements on specific issues. The AICPA attempted to grant some authority to APB opinions by issuing a separate bulletin which required disclosure of departures from Opinions. However, the effectiveness of this provision was limited because it was not incorporated into existing ethical rulings or auditing standards. By the late 1960s, the APB was subjected to considerable criticism both within and beyond the profession. In 1971, the AICPA appointed the Wheat Committee to consider the standard setting process. It recommended the replacement of the APB with the FASB.

B2(v) U.S. Accounting Standards from 1973[16]

The FASB commenced operations on 1 July 1973. The FASB has seven full-

[16] Most of the information contained in this section has been drawn from Loeb [1978, pp.96-134], Olson [1982], Most [1982, pp83-118], and Flegm [1984].

Table B5: APB Opinions

Opinion No.	Title	Date of issue
1	New Depreciation Guidelines and Rules	Nov 1962
2	Accounting for the "Investment Credit"	Dec 1962
3	The Statement of Source and Application of Funds	Oct 1963
4	Accounting for the "Investment Credit" (Amending No. 2)	Mar 1964
5	Reporting of Leases in Financial Statements of Lessee	Sept 1964
6	Status of Accounting Research Bulletins	Oct 1965
7	Accounting for Leases in Financial Statements of Lessors	May 1966
8	Accounting for the Cost of Pension Plans	Nov 1966
9	Reporting the Results of Operations	Dec 1966
10	Omnibus Opinion - 1966	Dec 1966
11	Accounting for Income Taxes	Dec 1967
12	Omnibus Opinion - 1967	Dec 1967
13	Amending Paragraph 6 of APB Opinion No 9, Application to Commercial Banks	Mar 1969
14	Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants	Mar 1969
15	Earnings per Share	May 1969
16	Business Combinations	Aug 1970
17	Intangible Assets	Aug 1970
18	The Equity Method of Accounting for Investments in Common Stock	Mar 1971
19	Reporting Changes in Financial Position	Mar 1971
20	Accounting Changes	Jul 1971
21	Interest on Receivables and Payables	Aug 1971
22	Disclosure of Accounting Policies	Apr 1972
23	Accounting for Income Taxes - Special Areas	Apr 1972
24	Accounting for Income Taxes - Investments in Common Stock Accounted for by the Equity Method (Other than Subsidiaries and Corporate Joint Ventures)	Apr 1972
25	Accounting for Stock Issued to Employees	Oct 1972
26	Early Extinguishment of Debt	Oct 1972
27	Accounting for Lease Transactions by Manufacturer or Dealer Lessors	Nov 1972
28	Interim Financial Reporting	May 1972
29	Accounting for Nonmonetary Transactions	May 1973
30	Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions	June 1973
31	Disclosure of Lease Commitments by Lessees	June 1973

Source: Financial Accounting Standards Board [1983a] time, salaried members, who are appointed by the Financial Accounting Foundation (FAF). The Wheat Committee recommended that the membership of the FASB comprise four certified practising accountants and three others with extensive experience in financial reporting, although the requirement for four certified practising accountants was dropped in 1977. The FAF has nine trustees. The Wheat Committee recommended that they be appointed by the AICPA Board of Directors but this requirement was also dropped in 1977. The trustees include four certified practising accountants, one of whom is the President of the AICPA, two financial executives, one financial analyst and one accounting educator. The FASB is generally answerable to the FAF, and relies on the FAF to raise funds for its operations. In addition, a larger body, known as the Financial Accounting Standards Advisory Council (FASAC) is appointed by the FAF. The FASAC exists to consult with the FASB over priorities, to help the FASB set up task forces and to review proposed standards. The membership of the FASAC is drawn from a wide range of interests, including government, law, accounting, education, large and small businesses, large and small accounting firms, investors, creditors and other financial statement users. Thus, the FASB is the operating arm of a tripartite organization charged with the development of accounting standards. The FASB is appointed, funded and overseen by the FAF and supported, in a technical sense, by the FASAC.

This organizational structure offers several major advantages over previous standard setting arrangements. First, it is independent, both because some of the FAF's trustees are drawn from outside the AICPA and because the full-time salaried members of the FASB sever ties with former employers. Second, the FASB is considerably smaller and therefore more manoeuvrable than either the APB or the CAP. Third, the FASB has a broader skill base available to it because its support group, the FASAC, is drawn from varying occupations. And finally, the FASB has a much broader financial base than the APB or the CAP which were financed solely by the AICPA. For example, according to Most [1982, p.106-108], the average budget of the FASB is approximately $5m (U.S.) per annum. This budget is financed by contributions and publication sales. Approximately one half of the contributions come from public accounting firms and half from other businesses. To maintain independence, no single contribution may exceed $50,000.

In addition to an improved standard setting mechanism, steps were taken to ensure the authority of FASB statements. In 1973, the AICPA membership approved a new code of ethics which effectively required members to comply with the accounting standards set by the FASB. According to Olson [1982, p.4], this was

> "... a significant step because it explicitly brought the standards directly under the profession's disciplinary machinery for the first time."

In addition, the SEC issued ASR No 150 which effectively required reporting companies to comply with FASB standards.

Between July 1973 and December 1979, the FASB issued thirty four standards (See Table B6). It was far more productive than its predecessor, the APB, which issued thirty one opinions between September 1959 and June 1973. However, the FASB like the APB has been subjected to considerable criticism. Part of this criticism has resulted from the controversial nature of some of the FASB standards. For example, Statement No 8 on foreign currency transactions was highly controversial.

Table B6: FASB Statements

Statement No	Title	Date of Issue
1	Disclosure of Foreign Currency Translation Information	Dec., 1973
2	Accounting for Research and Development Costs	Oct., 1974
3	Reporting Accounting Changes in Interim Financial Statements (an amendment of APB Opinion No 28)	Dec., 1974
4	Reporting Gains and Losses from Extinguishment of Debt (an amendment of APB Opinion No 30)	Mar., 1975
5	Accounting for Contingencies	Mar., 1975
6	Classification of Short-Term Obligations Expected to Be Refinanced (an amendment of ARB No. 43, Chapter 3A)	May 1975
7	Accounting and Reporting by Development Stage Enterprises.	June 1975
8	Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements	Oct., 1975
9	Accounting for Income Taxes - Oil and Gas Producing Companies (an amendment of APB Opinions No. 11 and 23)	Oct., 1975
10	Extension of "Grandfather" Provisions for Business Combinations (an amendment of APB Opinion No 16)	Oct., 1975
11	Accounting for Contingencies - Transition Method (an amendment of FASB Statement No 5)	Dec., 1975
12	Accounting for Certain Marketable Securities	Dec., 1975
13	Accounting for Leases	Nov., 1976
14	Financial Reporting for Segments of a Business Enterprise	Dec., 1976
15	Accounting by Debtors and Creditors for Troubled Debt Restructurings	June 1977
16	Prior Period Adjustments	June 1977
17	Accounting for Leases - Initial Direct Costs (an amendment of FASB Statement No 13)	Nov., 1977
18	Financial Reporting for Segments of a Business Enterprise - Interim Financial Statements (an amendment of FASB Statement No 14)	Nov., 1977
19	Financial Accounting and Reporting by Oil and Gas Producing Companies	Dec., 1977
20	Accounting for Forward Exchange Contracts (an amendment of FASB Statement No 8)	Dec., 1977
21	Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises (an amendment of APB Opinion No 15 and FASB Statement No 14)	Apr., 1978
22	Accounting for Leases - Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt (an amendment of FASB Statement No 13)	June 1978
23	Inception of the Lease (an amendment of FASB Statement No 13)	Aug., 1978

24	Reporting Segment Information in Financial Statements That Are Presented in Another Enterprise's Financial Report (an amendment of FASB Statement No 14)	Dec., 1978
25	Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies (an amendment of FASB Statement No 19)	Feb., 1979
26	Profit Recognition on Sales-Type Leases of Real Estate (an amendment of FASB Statement No 13)	Apr., 1979
27	Classification of Renewals or Extensions of Existing Sales-Type or Direct Financial Leases (an amendment of FASB Statement No 13)	May 1979
28	Accounting for Sales with Leasebacks (an amendment of FASB Statement No 13)	May 1979
29	Determining Contingent Rentals (an amendment of FASB Statement No 13)	June 1979
30	Disclosure of Information about Major Customers (an amendment of FASB Statement No 14)	Aug., 1979
31	Accounting for Tax Benefits Related to U.K. Tax Legislation concerning Stock Relief	Sept., 1979
32	Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters (an amendment of APB Opinion No 20)	Sept., 1979
33	Financial Reporting and Changing Prices	Sept., 1979
34	Capitalization of Interest Cost	Oct., 1979

Source: Financial Accounting Standards Board [1983b]

There were also a number of other developments during the 1970s which undermined the standard setting process. For example, the SEC had adopted a policy of reliance on the FASB for the development of accounting standards. Subsequently, it announced its intention to handle disclosure matters itself and rely on the FASB for guidance on measurement issues. Indeed, according to Olson [1982 p.70], in this period the SEC issued an unprecedented number of ASRs, many of which dealt with accounting disclosure matters. In this respect, the SEC preempted the role of the FASB. Moreover, in 1975, Arthur Anderson and Co sued the SEC over its reliance on the FASB for the development of accounting standards. They argued that this reliance amounted to an unlawful delegation of authority by a statutory body. Arthur Anderson and Co eventually withdrew their case but the fact that one of the major international accounting firms had taken this action did little to enhance the status of the FASB. In the meantime, The Energy Act (1975) included a directive that the SEC ensure that uniform accounting standards were developed for the petroleum industry. During the oil embargo in 1974 and the ensuing chaos, it had become apparent that the financial statements of companies in the petroleum industry were not comparable because of the application of alternative accounting methods.

The Accounting Standards Executive Committee (ASEC) which was set up by the AICPA in late 1972 also caused some problems for the FASB. The ASEC was intended to provide guidance to members on an interim basis until the FASB took action. However, the ASEC's Statements of Position were seen in some circles, particularly the Financial Executives Institute (FEI), as a separate set of accounting standards. This problem was eventually resolved when the FASB appointed a special screening committee to review emerging problems and to determine whether they should be dealt with by the FASB or the ASEC.

Moreover, according to Olson [1982, p.4], there were a number of developments outside the standard setting arena which eroded public confidence in the accounting profession and the standard setting process. These included the Equity Funding fraud, the Penn Central bankruptcy (and several other highly publicized bankruptcies), and the illegal political contributions and improper payments made by some companies which escaped the attention of their auditors.

By the mid-1970s, there was widespread dissatisfaction with the FASB. In 1976, a report which reviewed the operations of various federal regulatory agencies recommended that the SEC establish a basis for uniform accounting standards. In 1977, there was a congressional inquiry into the performance of the public accounting profession and the standard setting structure. In 1977, and again in 1978, congressional hearings inquired into the propriety of the SEC's reliance on the FASB for the development of accounting standards. In addition, a review of the performance of auditors led to a proposal to regulate accountants practising before the SEC.

By 1978, government regulation of both the standard setting process and certified practising accountants appeared imminent. However, the FAF had already acted. In 1976, the FAF trustees appointed a committee to review the structure and operations of the FAF, FASB and FASAC. It was on the recommendation of this committee that the requirements that FAF trustees were elected by the AICPA Board and that the FASB include four certified practising accountants were dropped. This committee also reduced the FASB vote necessary to approve standards from five to four. These changes were intended to reduce the AICPA's influence over the FASB and, therefore, to reduce criticisms of the accounting profession in this area. They were also intended to speed up the standard setting process. In this respect, at least, the changes seem to have been successful. Table B6 shows that in the four years to June 1977 the FASB had issued sixteen standards, whilst in the two and a half years from July 1977 to December 1979 a further eighteen standards were issued. Moreover, this improvement was maintained beyond the case study period. For example, by June 1983 the FASB had issued a total of 72 accounting standards.

The AICPA also took action to avoid government regulation. In mid-1978, it split its membership into two sections. One section included members who dealt with the accounts of companies reporting to the SEC and the other included members who dealt with private company accounts. The AICPA introduced three-yearly peer reviews for both sections and established a review board for the SEC section, to oversee and report on the activities of its members. Although these actions deterred government intervention, congress required the SEC to report to it annually on progress made in areas of standard setting, in particular, and public accounting, in general.

To summarize, the period from 1973 was characterized by rapid far reaching changes. The introduction of the FASB marked the establishment of a semi-autonomous standard setting organization. Also for the first time, the AICPA moved to enforce accounting standards by including within its code of ethics a requirement that members comply with accounting standards. The rate at which accounting standards were issued by the FASB far exceeded the output of its predecessors, the APB and the CAP. However, the FASB and the accounting profession in general incurred considerable criticism in the mid-1970s and by the late 1970s government regulation appeared imminent. Some of this criticism resulted from actions of the FASB and the AICPA in the standard setting arena and some of it resulted from outside developments. By the end of the 1970s, both the FASB and the AICPA had avoided immediate government intervention by restructuring their organizations. However, it was apparent that self-regulation would only be maintained if the FASB performed satisfactorily in setting standards and if the AICPA was effective in enforcing them.

APPENDIX C

THE CODIFICATION OF STANDARDS AND RULES OF CONDUCT IN THE MEDICAL AND LEGAL PROFESSIONS IN AUSTTRALIA

The development of criteria to assess the responsibility of the Australian accounting profession for financial statement misinformation requires some understanding of parallel developments in other professions in Australia. This part of the thesis, therefore, briefly outlines developments in the medical and legal professions in Australia in the areas of the codification and enforcement of standards and rules of conduct.

C1 The Medical Profession[1]

The Australian Medical Association (AMA) is the major professional body representing the medical profession in Australia. The AMA was formed in 1962 with the amalgamation of various state branches of the British Medical Association in Australia. The medical profession in Australia has not codified technical standards similar to accounting standards. This is hardly surprising as medicine is more of an exact science than accounting. Its technical procedures tend to be scientifically derived rather than simply being drawn from a diverse range of existing practices. Thus, the performances of the accounting and medical professions in this area are not comparable.

[1] There has not been a great deal written in this area. Indeed, according to Burton [1979], there was no text book on medical ethics in Australia prior to the first edition of his book published in 1970. Much of the information presented in this section is drawn from discussion with the Secretary of S.A. Branch of the Australia Medical Association, Mr. C. Dobby. Other useful references include Burton [1979], Sackville [1980] and Nieuwenhuysen and Williams-Wynn [1982].

Nevertheless, the technical standards of the accounting profession are, in a sense, a subset of its rules of conduct. It is appropriate, therefore, to consider the medical profession's codification of rules in this more general area. The AMA first codified its rules of conduct in 1966 with the issue of its Code of Ethics. Between the establishment of the AMA in 1962 and 1966, rules of conduct were spelled out in the ethical by-laws of the various state branches of the AMA which, in turn, had been drawn from the ethical by-laws of their predecessors, the state branches of the British Medical Association in Australia. The AMA's Code of Ethics provides for disciplinary action in the case of serious misconduct and the earlier by-laws included similar provisions. However, the AMA has been virtually inactive in disciplining its members, particularly for misconduct. Most of its effort in codifying and enforcing rules has been confined to matters of the etiquette of intraprofessional relations.

The discipline of members of the medical profession in more serious matters has been left to the Medical Board in each state. Each Medical Board is an independent regulatory body convened under state legislation which is usually referred to as the Medical Practitioners Act. Although the provisions of these Acts vary from state to state, each Act requires the Medical Board to maintain a register of all practitioners. Registration is renewable annually. In addition, the Medical Boards have the statutory power to discipline registered practitioners by reprimanding, suspending or deregistering them. Complaints about the conduct of medical practitioners are forwarded to the state Medical Board from patients, the state Minister of Health or the AMA itself.[2] An investigation committee of the Medical Board

[2] Although the medical profession is considering a peer review system, currently the medical profession has no mechanism for reviewing the competence of its members. Thus, complaints from the AMA are not common.

considers each case. Complaints which appear valid and involve serious misconduct are forwarded to a disciplinary tribunal which, in turn, makes a recommendation to the Medical Board. Thus, individual practitioners are disciplined by the Medical Board on the recommendationi of a disciplinary tribunal.

The extent of the penalties imposed by the Medical Boards depends on the extent of the misdemeanour. For example, according to Burton [1979, p.17], a practitioner is likely to be reprimanded for failing to carry out professional duties adequately. Deregistration is recommended only in the case of gross misconduct. For example, s17 of the Medical Practitioners Act 1970 (Victoria) requires deregistration where a practitioner is guilty of "infamous conduct in a professional respect".

Sackville [1980] asserts that, at least in New South Wales, the disciplinary provisions of the Medical Practitioners Act have been largely ineffective because the control of the Medical Board has rested in the hands of the medical profession. For example, under the Medical Practitioners Act 1938 (N.S.W.), which was current in N.S.W. in the late 1970s, the Medical Board of thirteen included eleven medical practitioners. According to Sackville [1980, p.26], between 1969 and 1977 the Investigation Committee of the N.S.W. Medical Board considered 141 complaints against medical practitioners. In 83 cases, the complaints were dismissed or the committee took no further action. In 21 cases, the committee administered cautions. Only 17 of the 141 cases were referred to a disciplinary tribunal.

To summarize, the medical profession in Australia, as represented by the AMA, has not codified its technical standards but it has had no real need to do so. The procedures in medicine tend to be derived from scientific principles and are largely clear cut. Rules of conduct in other areas have been defined by the AMA since 1966 and by various state professional societies before 1966. These rules have tended to focus on matters of etiquette although they have included a general provision for discipline in the case of misconduct. However, the AMA and its predecessors have played a limited role in the area of discipline. The major disciplinary force has been the Medical Boards set up under the various state Medical Practitioners Acts. The Medical Boards are independent of the AMA although they are controlled largely by medical practitioners. There is some evidence to suggest that, despite its apparent independence, this type of disciplinary mechanism has not been particularly effective.

C2 The Legal Profession

C2(i) The Structure of the Legal Profession[3]

The structure of the legal profession varies considerably from state to state. In the eastern states there is a distinction between barristers and solicitors which does not exist elsewhere. These differences are reflected in the structure of the professional associations. For example, the legal profession in each state has its own association which is generally called the Law Society. However, in New South Wales, Queensland and Victoria, barristers belong to a Bar Association. Barristers are fewer in number than solicitors and these Bar Associations are much smaller than the state Law Societies. In the other states, lawyers may practise as solicitors, barristers or both. Although there are separate Bar Associations for lawyers who practise solely as barristers, membership of the state Law Society is also required. At the federal level, the Law Council of Australia, which was founded in 1933,

[3] This section provides a very brief and simplified summary of the structure of the legal profession in Australia. Further details may be obtained from Disney *et al.* [1977] and New South Wales Law Reform Commission [1979c].

represents the various state Law Societies. The legal profession, however, is regulated by state legislation and therefore, the various state Law Societies tend to dominate the Law Council of Australia especially in the areas of professional conduct and discipline. The Australian Bar Association (ABA) was founded in 1962 to represent the various state Bar Associations at a federal level. However, the ABA has no formal powers of regulation and conduct.

A complete analysis of the Australian legal profession's codification and enforcement of standards would require a study of the developments within the Law Society and Bar Association in each of the eastern states and within the individual Law Societies in the remaining states and territories. Such a study is beyond the scope of this thesis. Instead, this thesis will concentrate upon the developments within the Law Societies. Certainly, the various Law Societies are the major professional associations representing the legal profession in Australia. The following discussion covers Law Societies in general, although the generalization may result in some minor inaccuracies as developments within the various societies and within the legislation in each state have not always coincided.

C2(ii) Written Codes in the Legal Profession

Generally, the Law Societies have not issued their members with any Ethical Codes or Rules of Conduct.[4] According to the Law Society of New South Wales,

[4] This is not strictly true since the Law Society of South Australia introduced a set of Rules of Professional Conduct in 1984.

> "... the standards of conduct expected of a solicitor are well known and understood by the members of the profession ..."[5]

This does not mean that members are given no guidance on professional conduct. According to Disney *et al* [1977, p208], each Law Society employs at least one salaried officer to provide guidance to members on matters of professional conduct. This guidance is based on previous rulings by the Council of the Law Society, judicial decisions and various textbooks on legal ethics and professional conduct.

C2(iii) Enforcement

In the legal profession, therefore, members are not provided with written standards or rules of conduct. Rules, however, do exist in a variety of places and members are said to be aware of them. The mechanisms through which these rules are enforced, or more accurately, the disciplinary measures which are applied to members who disregard such rules are largely the result of the Legal Practitioners Acts in various states.

The various Legal Practitioners Acts require lawyers to hold a current practising certificate, which is renewable annually. In most states, practising certificates are issued by the Law Societies. The Legal Practitioners Acts, therefore, grant the Law Societies the statutory power to register lawyers.

The Legal Practitioners Acts also confer disciplinary powers on the state Law Societies. These powers are not a recent development. For example, they were first conferred on the Law Society of New South Wales in 1935. They cover non-members as well as members. The discipline process for professional

[5] Background paper to New South Wales Law Reform Commission quoted in Sexton and Mahey [1982, p.169].

misconduct generally begins with a complaint from someone outside the Law Society, usually a client. It is most unusual for complaints to emanate from within the Society as there are no internal procedures for the regular review of the conduct of members. Complaints are then referred to the Society's legal department to be reviewed by a legal officer of the department. If, after investigation, the legal officer considers the complaint to be valid it is forwarded to the Society's Complaints Committee. Usually the Complaints Committee then makes a recommendation to the Council of the Law Society, although the Committee itself may decide that there is no case to answer. The Council, in turn, considers recommendations made to it and finds either that there is no case to answer or that some further action is necessary. This further action can include censure by the Society, the cancellation of the solicitor's practising certificate or referral to the statutory disciplinary tribunal. Disciplinary tribunals in some states may hand down penalties against solicitors found guilty of misconduct. In other states, they make recommendations to the Supreme Court. The composition, jurisdiction and powers of these disciplinary tribunals vary considerably from state to state. However, according to Disney *et al* [1977, p.210], although these tribunals are apparently independent of the Law Societies, they are strongly influenced by them because

> "in all jurisdictions appointments are invariably made from persons who have been nominated by the Council of the Law Society and have lengthy experience in Council affairs".[6]

The discipinary tribunal may order that a solicitor be struck off the roll of solicitors, be suspended from practice or be fined. Alternatively the disciplinary tribunal may dismiss the charge or decline to make a finding of

[6] New South Wales Law Reform Commission [1979b, p.39 & 84-85].

professional misconduct even though it may make an order reprimanding the solicitor.

The New South Wales Reform Commission was highly critical of the disciplinary process in the legal profession in New South Wales. It reviewed a sample of 50 per cent of the 2592 complaints made to the N.S.W. Law Society in 1974, 1975 and 1976. It found that approximately 95 per cent of those complaints did not go beyond the Legal Department of the Law Society. Of the remaining 5 per cent forwarded to the Complaints Committee, 3.5 per cent (of the total sample) went on to the Council and 1.2 per cent were then forwarded to the Solicitors' Statutory Committee (a disciplinary tribunal). This 1.2 per cent represented fifteen solicitors. Of those fifteen, the Statutory Committee recommended eight should be struck off the role, one should be suspended and three should be fined. The remaining three cases were still under consideration. The N.S.W. Law Reform Commission concluded that disciplinary system was unfair and ineffective in all areas except misconduct relating to solicitors trust funds. Similar investigations have not been made in other states. However, to the extent that the disciplinary systems in these states correspond to the system in New South Wales, one would expect similar findings.

To summarize, the legal profession in Australia has tended not to codify its standards and rules of conduct. The registration and discipline of lawyers is controlled by state legislation. This legislation has tended to give the various state Law Societies the statutory power to control the registration and discipline of lawyers. The legislation prohibits professional misconduct. The Law Societies are largely responsible for determining whether professional misconduct has occurred. There is some evidence to suggest that their discipline has been largely ineffective.

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