

Current affairs in audit

Issues relevant to corporate collapse and accounting scandals

In the aftermath of an auditing and accounting crisis two issues are of importance. They are the impact and effectiveness of regulation introduced and does the business practices or pressures that caused the auditing and accounting crisis still exist? This month's edition of *Current Affairs in Auditing* will examine media articles relevant to these issues. Corporate collapse does not occur overnight and is the result of bad business practices that occurred many years before the company formally collapsed. It is possible that companies presently may be making bad decisions like undertaking a disastrous takeover that can sow the seeds for failure. Also companies may be earning inadequate profits and may mask these deficiencies by adopting earnings management. Pressures such as the possible sacking of the CEO who is "responsible" for the inadequate profits may lead to the company adopting earnings management to mask these problems. The continued use of earnings management cannot be sustained and eventually lead to failure.

Recently there have been some media articles discussing regulation. In particular articles have appeared in the media about Australian companies being listed on United States stock exchanges and the need for these companies to comply with US regulations. The contents of these articles provide an interesting contrast between US and Australian regulation of auditors.

CEO Turnover

In August's edition of *Current Affairs in Auditing* we commented upon a worldwide survey in 2003 on Chief Executive Officer (CEO) succession rates conducted by Booz Allen Hamilton and the Business Council of Australia. The point was made in this commentary that a major factor in CEO being replaced was poor performance and this factor could lead to poor performing CEOs adopting earnings management in order to prevent their sacking. In this month a survey on 2003 CEO succession rates relating to Australia was published. Significant results of this survey are as follows.

- 14.2% (2002, 16.8%) of Australian ASX 200 companies changed CEOs compared to the global average of 9.5% (2002, 10.7%).

- Poor performance resulted in 4.1% (2002, 4.9%) of Australian ASX 200 companies changing CEOs compared to the global average of 3.0% (2002, 4.2%). Merger driven replacements of CEOs resulted in 8.1% (2002, 8.4%) of Australian ASX 200 companies changing CEOs compared to the global average of 5.2% (2002, 5.1%). The remaining CEO changes resulted from regular transitions (BAH et al., 2004, pp. 1-2)
- The average tenure of departed CEOs in Australia was 5.6 years compared to the global average of 7.6 years (p.2).
- Contrary to the practice that can occur in United States and some European markets, the roles of Chairman and CEO are separated in Australia (p.4).

The report noted that the shorter tenure of CEOs in Australia means the CEO has “less time to execute the change agenda” (p.4). In relation to Australia’s business environment, the report notes

Australia’s smaller domestic economy means that acquisitions and mergers are disproportionately important in delivering growth. At the same time, M&A as a growth avenue inherently carries greater execution risk and stronger likelihood that one of the CEOs will depart (p.3).

The necessary growth for Australian companies to satisfy their shareholders can occur by greater involvement in Asian markets. However the report notes that “(e)xpansion in these markets exposes companies to considerable commercial risks associated with cultural differences, not to mention the complexities of managing multiple time zones and long distances” (p.3).

In last month’s edition of *Current Affairs in Auditing* we commented upon the increased responsibilities assumed by auditors for detecting fraud, particularly earnings management fraud. Whether CEO succession rates in Australia results in auditors confronting the problem of earnings management only will time will tell.

Merger mania

The need for companies in Australia to satisfy shareholders expectations for growth through acquisitions is consistent with a recent article published in *The Age* about mergers and acquisitions by Australian companies (Hughes, 2004, p.1). This article noted there have been more than 800 mergers and takeovers involving corporate Australia in the calendar year to date. This is nearly double previous highs of the past decade. The article also notes these takeovers and mergers occurred despite these acquisitions possibly having disastrous consequences for the acquiring company. The article notes that

Corporate titans love to play the takeover game even if history shows that moulding companies and cultures can be a torturous exercise, costing shareholders and consumers dearly (p.1).

Two recent examples of companies suffering disastrous consequences for ill advised takeovers are HIH Insurance and National Australia Bank. HIH Insurance Limited made three acquisitions, that included acquisitions in United Kingdom, United States and the FAI acquisition. There was a lack of due diligence in investigating the wisdom of these acquisitions and the acquisitions were poorly managed (Johnson et al., 2004, pp. 76-77). These acquisitions were a significant factor in HIH's collapse. The National Australia Bank acquired in 1998 HomeSide mortgage business in United States and in 2001 lost \$4 billion "because of inadequate hedging and incorrect interest rate assumptions used in the mortgage book" of HomeSide (Oldfield, 2003).

Factors that are leading to an increase in takeover and merger activity are

- Cash rich property trusts undertaking mergers or takeovers.
- Hedge funds who anticipate a takeover, buy shares and sell to the company undertaking the takeover. This increases the probability of a successful takeover.

Less intrusive takeover panel in Australia making it easier to make takeovers (Hughes, 2004, p.1)

References

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