

A Brief Account of the Adsteam Saga

The Adelaide Steamship Company Limited began operating passenger and cargo ships since 1875. A downturn in its core activities during the 1960's and 1970's led the company to diversify into other activities. Under the leadership of John Spalvins it went to acquire enough interests to effectively control some of the leading companies in the food, ship towage, building, retailing and financial industry throughout the 1980's, without having majority ownership or more than 50% interest. Clarke et al described how this acquisition strategy resulted in an extremely complicated cross-shareholder-based structure for Adsteam (2003, p. 158).

Things took a different turn in 1989. Adsteam went for two ambitious investment schemes that went bad, one of which involved the 100% debt-financed acquisition of IEL for \$900 million. Analysts took notice of this and gave unfavourable assessments of Adsteam's liquidity and ability to pay its debts. With the growing perception from its financiers that it lacked assets to guarantee its loans, the money stopped flowing to prop the conglomerate's operations, leading to John Spalvins' departure and the eventual breaking up of Adsteam under a new administration.

Building The Adsteam Pyramid

Debt and gearing

The Adsteam acquisition binge was fuelled by massive borrowings. In order to elicit the trust of investors Adsteam had to show its performance in the best possible light (Gay and Simnett, 2003). Clarke et al (2003, p. 261) refers to the 'judicious use of controlling shareholdings' by Adsteam management to hide debt off the company's balance sheet. The prevailing accounting standards of that time, as Deegan explains, did not require companies to consolidate a subsidiary company's activities if no effective ownership or more than 50% ownership prevailed (2003, p.760). Adsteam knew well what the accounting standards allowed them to do in order to keep the high gearing on its subsidiaries off its balance sheet. Clearly misleading, these assertions were given further credibility with the mark of approval from Deloitte, the company's auditors of the time.

Profit

Adsteam's financial statements did not really reflect the true and fair view, because they were based on the intra-group transactions. Dividend from the other members of the group contributed to a large part of each company's income. The non-consolidation and consolidation reports also give quite different pictures of the company's performance. In 1991, for example, the non-consolidation profit was \$980 million, compared with the consolidation profit of \$250 million (Sykes, 1993).

Asset

Adsteam deliberately increased the value of its asset in several ways (Sykes, 1993):

- 1) It carried forward FITB as an asset when its realization was uncertain. The accounting standards allowed the realization of a tax benefit arises only if the company will earn sufficient revenue in the future and the relevant taxation legislation will not change.
- 2) The companies in the group invested and loaned to each other and accounted for "interest receivable" to increase revenue, operationally did not actually have any effect on the performance of the companies.

Auditing Issues

Several reasons can be identified as to the failure of the auditor to detect the lack in truth and fairness as portrayed in the Adsteam financials:

Inadequate Planning of the Audit

The auditing approach taken by Deloitte's in going through Adsteam's financial reports could be characterised as one of the transactions-cycle approach. This approach relied purely on verifying whether the prevailing accounting standards and statutory guidelines of that time were complied with. The problem with this was that these standards were deficient to shed light on the true and fair position of Adsteam as described by some (Kohler, 1991). Deloitte 's exercised little of its professional judgement or original thought when attesting to Adsteam's assertions.

It would have been more appropriate for the auditors to pay more attention to the client's systems dynamics, not only the company's transactions, but also the its environment, its emergent behaviours that have great impact on the company's business. KPMG calls this the Strategic-Systems Lens approach (Bell et al, 1997). The complexity involved in Adsteam's business strategy of cross-shareholdings within diverse industries implies complex transactions that inherently pose the occurrence of more misstatements. Attesting to the truth and fairness of financial assertions simply because they adhered to accounting standards was simply not enough to unravel Adsteam. This is view is supported by Deane 'that a company's compliance with the standards virtually ensures that the income statement will not show its actual financial performance or the balance sheets its actual financial position in any meaningful, serviceable, way' (2002, p. 9).

Gay and Simnett puts emphasis on this point that complying with accounting standards would not ensure financial reports will be true and fair. Citing the Corporations Act of 2001 *auditors are obligated to report an opinion as to whether the financial report is in accordance with the law, including compliance with accounting standards (s. 296) AND provides a true and fair view (s. 297)*. The inadequacy of accounting standards alone is further evidenced by constant amendments to the standards, as they deem necessary. In order to 'catch' the schemes employed by the likes of Adsteam, the Australian Accounting Research Foundation pushed for the introduction of the 'control' over the 'ownership' criterion as the trigger for need to consolidate. This led to the amendments to AASB 1024 to require consolidation by virtue of control.

Lack of Independence

What may have caused Deloitte's to show a lack of judgment or original thought can be traced on its lack of independence. The lack of auditor independence in the Adsteam case can be construed from the terms of settlement between the ASIC, former directors of Adsteam and auditing firm Deloitte. One of which was to adopt a policy not to accept an audit engagement where other services have been performed which substantially affect information subject to the current year audit engagement (ASIC Media Release 00/452, p.

3). Perhaps Deloitte's did not want to 'compromise' its other engagements with Adsteam by giving a qualified opinion.

Lessons from Adsteam

In light of the Adsteam experience auditors need to be reminded of exercising duty of care and utmost professionalism when engaging clients. The adverse effects of giving an inappropriate audit on financial reports that is misstated extends beyond the end users of such reports, the likes of which include shareholders who rely on false financial information. In every engagement auditors face engagement risk, or exposure to loss or injury to the professional practice from litigation, adverse publicity or other events arising in connection with a financial report audit. Deloitte's were sued for damages for giving inappropriate audit opinion on the misstated financial statements of Adsteam. It ended up agreeing on an out-of-court settlement and paying \$10 million in compensation (ASIC Media Release 00/452, p. 2).

Auditors can mitigate this engagement risk by careful assessment and acceptance of clients, and following an approach for instance resembling the Strategic-Lens Approach method when planning their audit and adhering to client independence. Signs that auditors endeavour to observe professionalism.

Clarke et al (2003, p. 291) remind us, that much of the publicly disclosed accounting by failed companies was in accord with the prevailing accounting standards. They were creative but certainly within the bounds of the regulations. The key role of auditors is to therefore use their independent, professional judgement in determining when attesting to financial reports and that these represent commercial realities. The accounting data must reflect the actual business activity of the entity being audited. Furthermore, auditors should understand the client's business operation and strategy to better plan auditor procedure to cover all materials for credibility and reliability of financial statements. As we know, the company had a weak internal control system due to its extremely complicated corporate structure, multiple intra-group deals, incompatibility of data systems, and lack of transparency in respect of disclosures. Therefore, the auditor should

also understand internal control structure to determine the nature, scope and time of audit procedure.

On the other hand, regulators such as CPA and ICAA should try to improve the accounting standard as a whole and to fill in the 'missing pieces'. This will help keep corporations from collapsing due to the playing with the standards.

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