



**HA3032 AUDITING AND ASSURANCE
SERVICES**

TRIMESTER 1, 2017

INDIVIDUAL ASSIGNMENT

Assessment Value: 20%

Instructions:

1. This assignment is to be submitted in accordance with assessment policy stated in the Subject Outline and Student Handbook.
2. It is the responsibility of the student who is submitting the work, to ensure that the work is in fact her/his own work. Incorporating another's work or ideas into one's own work without appropriate acknowledgement is an academic offence. Students can submit all assignments for plagiarism checking (self-check) on Blackboard before final submission in the subject. For further details, please refer to the Subject Outline and Student Handbook
3. Maximum marks available: 20 marks.
4. Due date of submission: Week 7 Friday.

**HIH Insurance Limited:
Business risk and Inherent Risk Assessment, Legal Liability, Ethics
This Case is based on Week 1 to 4**

Company History

In 1968, Ray Williams and Michael Payne formed CE Health International. As a result of a merger in 1995 between CE Heath and the Swiss based insurer Winterthur Insurance Company, the company HIH Winterthur was established. In 1998 the name of the company was changed again, this time to HIH Insurance Limited. This last name change had been brought about by the withdrawal of Winterthur from the operations. Winterthur had become increasingly nervous about the operations of the company and consequently had sold its shares. HIH continued to expand its insurance ventures with the purchase of FAI Insurance, World Marine and General Insurance and Cotesworth, which had direct links with Lloyd's Insurance. However, FAI had been purchased in 1998 at a premium from Rodney Adler (Non-Executive Director of HIH) and without either board consultation or the completion of a due diligence report. Accordingly, in September 2000, HIH was forced to write off its investment in FAI for \$400 million.

The insurance arenas entered into by HIH included the high-risk areas of marine, aviation, natural disasters and film financing insurance, in addition to the highly competitive workers' compensation insurance market in California. HIH experienced considerable losses due to its exposure to these high-risk areas. Such losses included:

- \$100 million from film losses
- Considerable damages claims from the major hailstorm in Sydney (from the takeover of FAI)
- Large losses from the 1999 Florida typhoon
- Extensive workers' compensation claims as a result of the industry deregulation in California. The Californian courts had altered the award scale for benefits, which resulted in a dramatic increase in the cost of claims to insurance companies such as HIH.

Board of Directors

Details regarding notable members of the Board of Directors of HIH and changes to the Board are outlined in the table below.

Name	Position	Resigned	Comments
Ray Williams (Founder CE Health in 1968)	Deputy Chairman and Chief Executive Officer	Dec, 2000	
Randolf Wein (replaced Ray Williams)	Deputy Chairman and Chief Executive Officer		
Geoffrey Cohen	Chairman		Former partner Arthur Andersen
Rodney Adler	Director	Feb 26, 2001	Sold FAI to HIH in 1998
Justin Gardener	Director	12 Oct, 2000	Former partner Arthur Andersen, and auditor of FAI in 1980s
Dominic Fedora	Finance Director	12 Oct, 2000	Former partner Arthur Andersen

Background to the Company Failure

In September 1999, Rodney Adler wrote to the Chief Executive Officer, Ray Williams, criticising the direction of the company and raising concerns about the company's financial position. More than a year later, on Tuesday, 27 February 2001, trading in HIH Insurance Limited shares was halted and ASIC commenced a formal investigation into market disclosure by HIH. Provisional liquidators were appointed to the company on March 15, after the company had flagged a provisional loss of \$800 million. In May the assets of the company directors, Adler, Fedora and Williams were frozen, pending further investigation. On 21 May, the Prime Minister, Mr John Howard, announced a Royal Commission into the collapse. ASIC began its investigation into the accounting for reinsurance agreements between HIH and Hannover Re and Swiss Re, and between FAI and National Indemnity and General and Cologne Reinsurance Australasia. The investigation by ASIC has raised many questions as to the role of directors, senior management and auditors.

In the two years preceding the cessation of trading, HIH's share price had fallen sharply. This was due to a combination of poor financial results and significant asset sales, which were intended to improve the balance sheet position, as well as fund insurance claims. It is interesting to note that during 2000 HIH had paid an amount of \$1.7 million to the auditors for auditing services, together with \$1.631 million for the provision of consulting and other services.

The difficulties experienced by HIH were due in part to its policy in regard to prudential margins. The premiums received by insurance companies are invested for long periods of time in anticipation of future claims, and companies (including HIH until 1997) traditionally maintain a prudential margin out of these funds. A prudential margin means that a proportion of funds received by the company is maintained as a buffer in the event of unpredictable claims, such as those arising out of natural disasters such as earthquakes or floods. Some companies have margins such that there is an 80–90 per cent chance of covering claims. HIH discontinued this practice in 1997, choosing instead to adopt a reinsurance process.

The Aftermath of the Collapse

In September 2001 the independent Royal Commission commenced investigations into the collapse of HIH. The results were published in April 2003. The Commissioner concluded that “the primary reason for the collapse of HIH was the failure to provide properly for future claims. This failure was essentially due to mismanagement and an inadequate response to pressures emerging in insurance markets internationally.”

The Commissioner also concluded that “the Australian Prudential Regulation Authority (APRA) did not cause the collapse of HIH.” However, new legislation for general insurers was enacted in September 2001 and new prudential standards were issued in February 2002 (applicable from 1 July 2002).

In addition to the Royal Commission, was the preparation of the Ramsay Report whose purpose was to review existing requirements for the independence of auditors and to make appropriate recommendations for changes to those requirements. The

Ramsay Report was released in September 2002, prior to the findings of the Royal Commission.

The Corporate Law and Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 (CLERP 9 ACT) was passed in June 2004. The recommendations of the Ramsay Report and the Royal Commission are generally consistent with the CLERP 9 proposals with respect to audit reform. (*See Text Pages 105-109*)

For Arthur Andersen the situation deteriorated with the subsequent collapse of Enron in January 2002. In June the firm was found guilty of obstructing justice for the destruction of work papers. In May 2003 Andersen Australia was integrated into the partners and staff of Ernst and Young.

The result has been a major review of the auditing profession.

Appendix:

Australian Securities and Investments Commission (ASIC)

Media and information releases

05-94 Ray Williams sentenced to four-and-a-half years' jail

Friday 15 April 2005

Mr Jeffrey Lucy, Chairman of the Australian Securities and Investments Commission (ASIC), today announced that Mr Ray Williams, the former Chief Executive Officer of HIH Insurance Limited (HIH), has been sentenced to four-and-a-half years' jail with a non-parole period of two years and nine months.

Mr Williams was today convicted and sentenced on three criminal charges arising from his management of the HIH group of companies in the three-year period 1998 to 2000.

'ASIC welcomes the strong message that today's sentencing sends to corporate Australia', Mr Lucy said.

'ASIC, the courts and the community will not tolerate company directors who do not act honestly and in the best interests of shareholders', he said.

Mr Williams was sentenced in relation to offences concerning three substantial transactions, which significantly distorted the true financial position of HIH. These matters involved hundreds of millions of dollars and Mr Williams' criminal conduct occurred over an extensive period.

Mr William's sentencing today on the three criminal charges follows ASIC's successful civil penalty proceedings (commenced in 2001) that resulted in him being:

- banned from acting as a director of any company for 10 years
- ordered to pay compensation jointly with Mr Rodney Adler and Adler Corporation Pty Limited of approximately \$7 million, and
- ordered to pay a pecuniary penalty of \$250,000.

'Today's sentencing brings to a close ASIC's proceedings against Mr Williams concerning the collapse of HIH', Mr Lucy said.

ASIC's investigation into the matters surrounding the collapse of the HIH Insurance group of companies is continuing.

Background

Mr Williams was sentenced after pleading guilty on 15 December 2004 to three criminal charges:

- that he was reckless and failed to properly exercise his powers and discharge his duties for a proper purpose as a director of HIH Insurance Limited when, on 19 October 2000, he signed a letter that was misleading
- that he authorised the issue of a prospectus by HIH on 26 October 1998 that contained a material omission
- that he made or authorised a statement in the 1998-99 Annual Report, which he knew to be misleading, that overstated the operating profit before abnormal items and income tax by \$92.4 million.

ASIC's HIH investigation has already led to criminal prosecutions of 9 former senior executives, including directors, of FAI, HIH and associated entities on 31 Corporations and Crimes Act charges. These criminal prosecutions include:

- On 23 December 2003, Mr William Howard, a former General Manager of HIH Insurance Limited, was sentenced to three years imprisonment, fully suspended on the basis of on-going assistance to the HIH investigation. Mr Howard had pleaded guilty to two counts of criminal misconduct, namely that he dishonestly received from Mr Brad Cooper approximately \$124,000 in return for facilitating payments by HIH directly or indirectly in favour of Mr Cooper. Mr Howard also admitted facilitating a payment of \$737,000 to a company associated with Mr Cooper knowing that the payment obligation had already been discharged.
- On 22 October 2004, Mr Bradley Cooper was committed for trial on six charges of corruptly giving a cash benefit to influence an agent of HIH Insurance Limited, namely Mr Howard, and seven charges of publishing a false or misleading statement with intent to obtain financial advantage. The trial is set down to commence on 1 August 2005.
- On 20 April 2004, Mr Charles Abbott, the former Deputy Chairman of HIH Insurance Limited, was charged with dishonestly using his position as a company director. The committal hearing is set down to commence on 30 May 2005.
- On 19 July 2004, Mr Timothy Maxwell Mainprize was committed for trial on charges of failing to act honestly in the exercise of his powers and discharge of

his duties as an officer of FAI General Insurance Company Limited. He was also committed on one count of providing false and misleading information. His trial is set down to commence on 5 September 2005.

- On 19 July 2004, Mr Daniel Wilkie was committed for trial on charges of failing to act honestly in the exercise of his powers and discharge of his duties as an officer of FAI General Insurance Company Limited. He was also committed on one count of providing false and misleading information. His trial is set down to commence on 5 September 2005.
- On 19 July 2004, Mr Stephen Burroughs was committed for trial on charges of failing to act honestly in the exercise of his powers and discharge of his duties as an officer of FAI General Insurance Company Limited.
- On 16 February 2005, Mr Rodney Adler pleaded guilty to four charges, two of disseminating false information that was likely to induce people to buy HIH shares, one of making and publishing false statements and one of being intentionally dishonest and failing to discharge his duties in good faith. Mr Adler was sentenced on 14 April 2005 to four-and-half years' jail with a non-parole period of two-and-a-half years.
- On 24 March 2005 Mr Terry Cassidy pleaded guilty to two charges of recklessly making false statements and one charge of recklessly failing to discharge his duties as a director for a proper purpose. There will be a sentencing hearing commencing on 19 April 2005.

Question 1 — Business Risk and Inherent Risk Assessments

"It is difficult for an insurance company to go broke in the space of a year, let alone a few months" *Sydney Morning Herald*, May 19–20, 2001.

Required:

- a) *How would you assess the business risk of HIH Insurance Limited?*
- b) *List several inherent risk factors effecting HIH at the financial report level and whether they would have contributed to an **increase or decrease** in the inherent risk assessment.*

Question 2— Legal Liability

Sydney solicitor Bruce Dennis will be coordinating a class action for some 600 HIH shareholders against the auditors — Andersens (as the firm is now known). In addition, HIH's liquidator, Tony McGrath of KPMG Peat Marwick is also likely to seek to recover funds for HIH creditors.

Required:

- a) *Discuss the facts and findings of relevant court cases that Andersens should refer to in determining the likelihood of the partnership being held liable to:*
 - 1) *clients*
 - 2) *creditors.*
- b) *What conditions need to exist for a negligence action to be upheld?*

Question 3 — Ethics

The HIH board of directors includes three former partners of the audit firm Arthur Andersen. In the past decade, Andersens has earned more than \$8 million from auditing HIH books and \$7 million for other services.

Required:

- a) *Why would HIH have wanted to hire prior members of its external audit team?*
- b) *What are the advantages of having the same firm provide both the auditing and consulting services?*
- c) *Indicate whether these circumstances represent a violation of ethical standards and give reasons for your answer.*
- d) *Outline the primary recommendations for audit reform proposed by the Ramsay Report and CLERP 9. What impacts do you feel these changes will have on the practice of auditing?*