COMPANY LAW ADVISORY COMMITTEE

Memorandum to the Standing Committee of Attorneys-General on certain matters arising in connexion with this Committee's First Interim Report on Accounts and Audit

Introduction:

Several matters have been drawn to our attention arising from this Committee's recommendations regarding the accounts and audit provisions of the Uniform Companies Acts contained in the first interim report of the Committee on this subject.

2. Our attention has also been drawn to certain observations made by His Honour Mr. Justice Moffitt in his judgment in the Flack and Flack case (Pacific Acceptance Corporation Ltd. v. Forsyth) regarding the position of auditors with respect to group accounts. His Honour made a number of recommendations for amendment of the Uniform Companies Acts as they at present stand (i.e., before any amendments arising out of our first interim report).

3. An outline of these matters and observations and our comments on them appear in the following paragraphs.

Matters arising from the first interim report:

4. The Chairman of the Companies Auditors Board of New South Wales has drawn attention to the proposed provisions contained in section 166B of the draft Bill (prepared to give effect to the recommendations made in our first interim report) that requires an auditor to obtain the consent of the Board before resigning his position as auditor of a particular company (section 166B(5)). The Board has stated that it considers that the power to approve the resignation of an auditor should be given to the Registrar of Companies who, unlike the Board, has facilities for investigation which may be needed to perform the function adequately. The Board has also mentioned that section 166B(6) gives a "person aggrieved" by the grant or refusal of the Board's consent to the resignation of an auditor of a company a right of appeal to the Court within three months from the date of the grant or refusal. The Board suggests that a "person aggrieved" could include a shareholder and asks would it not be sufficient to limit the right of appeal to the auditor or to a director of the company. The Board also asks what the position is regarding the office of auditor during the three-months period allowed for appeal and

pending the decision of the Court on an appeal (e.g., if the Board has approved an auditor's resignation does the lodgment of an appeal suspend the approved resignation pending the outcome of the appeal?).

5. Our attention has also been drawn to the provision of proposed section 166B(2) which requires a company to give notice to the Board of a proposed resolution to remove the company's auditor but which does not give the Board a power to intervene nor does it require the Board to take any action upon being so notified.

6. Our attention has further been drawn to the provisions of proposed section 161B which re-enacts section 161A of the present Uniform Companies Act. This section requires that the financial year of a subsidiary is to co-incide with that of its holding company but that the Registrar may authorize a subsidiary to have or adopt a financial year that does not co-incide with that of its holding company. The Companies Auditors Board is given jurisdiction to hear appeals from a decision of the Registrar. It is contended that the appropriate authority to hear these appeals is the Court, having regard to the increased status and powers of the Registrar (especially in New South Wales where it is proposed that he will become the Commissioner of Corporate Affairs) and to the fact that section 12(6) confers upon the Court (in the absence of any other provision) jurisdiction to hear appeals from a decision of a Registrar.

Section 166B:

7. Ministers will recall that, in section D of our first interim report we recommended the establishment of a Companies Commission - a recommendation that is still under consideration - and that in paragraphs 50 and 52(d) of that report we recommended that the authority at present vested in and duties at present carried out by Companies Auditors Boards should be exercised by the Companies Commission.

8. The task which the Companies Auditors Board is asked by the proposed section 166B to perform does not, in our view, require any organisation or machinery which it does not at present possess. The decision whether or not to refuse consent to a resignation must depend on whether the auditor satisfies the Board that it is an appropriate case for resignation, and no particular powers are required for this purpose. We

suggested in our first report that the functions of the Boards should be exercised by the Companies Commission in order to secure uniformity in the decisions which fall to be given by such bodies. For example, in the case of an auditor who is auditing the accounts of a company which is in financial difficulties, how long should the auditor be required to continue in office before he can be relieved of the task? Even more important is the case in which the auditor is auditing the accounts of a holding company and its subsidiaries. Without a central authority such as the Companies Commission, he will have to get a decision from each State or Territory in which any company in the group is incorporated, and if these decisions are not uniform he may find he has leave to resign from some but not others. At the risk of being tiresome, we reiterate our view that there should be a single authority to decide these matters. We recognise, of course, that the machinery of consultation among the Registrars is designed to promote uniformity of principle in administration with respect to matters of this kind. This is not the same thing as a single decision in cases in which it is important for those concerned that the decision should be the same for all the jurisdictions involved. However, if we are not to have a Companies Commission yet, the Ministers may wish to consider whether the appropriate course is to transfer the power to the Registrars, with their existing or proposed machinery for consultation, or to leave the power with the Companies Auditors Boards and to provide for similar consultation to ensure uniformity. The questions involved will often require a decision on ethical matters in relation to the profession of auditor, and if no other considerations had to be taken into account we would favour the view that the Companies Auditors Boards would be better equipped to judge matters of this kind than the Registrars.

Appeals from Companies Auditors Boards to the Court: Section 166B(6):

9. There appears to be merit in the criticism that the Board has made regarding the right given to a "person aggrieved" to appeal to the Court from a grant or refusal of consent by the Board to the resignation of an auditor. It appears that there is a possibility of an interregnum arising that could create difficulty. We think that there are two possible ways of dealing with the problem.

(1) The time allowed for appeal could be reduced from three months to one month (we would favour this alteration to the draft Bill in any event) and the Court could be given power to make such interim orders as it thinks necessary pending the hearing of the appeal; or

(2) the right of appeal could be limited to the case where the [Board] has refused to consent to an auditor's resignation, in which case the auditor would be liable to continue in office until the appeal was determined. An express provision would be needed making a decision consenting to resignation final (see paragraph (b) of section 12(6)).

We favour the second course combined, as indicated above, with the reduction of time allowed for appeal to one month. The Board suggests an alteration in the form of sub-section (5) with which we agree. Provision should also be made requiring the [Board] to notify the auditor and the company of its decision within a limited time (say seven days).

Duties of the Companies Auditors Board upon receiving notice of intention to remove an auditor: Section 166B(2).

10. The provision that a company is to notify the Board upon receipt of special notice of a resolution to remove an auditor is in the present Act - section 165(5)(a). We think the requirement exists so as to give notice to the Board that it may have to appoint a new auditor if the company fails to do so (present section 165 (11), new section 166(12)). There is a question whether an auditor who is removed by resolution of a company should have a right of appeal to the Board or, alternatively, whether his removal should, as in the case of resignation, be subject to the Board's consent. We deal with this question below.

Section 161B:

11. In Appendix "A" of our report we approved the proposal that the Companies Auditors Boards should exercise appellate jurisdiction from the decisions of the Registrars with respect to the financial years of subsidiary companies. In the light of the increase in power and status that is to be conferred upon the Registrar both in New South Wales by his translation into a Commissioner for Corporate Affairs and generally by reason of the insertion of section 162C giving to the

Registrars some of the more important dispensing powers that would under our recommendations have been exercised by the Companies Commission, it may be thought that the appropriate body to exercise the appellate jurisdiction under section 161B, as under 162C, is the Court. We have, however, no strong views on this matter.

Observations of Moffitt J. in Pacific Acceptance Corporation Ltd v Forsyth:

12. In his judgment in Pacific Acceptance Corporation Ltd v Forsyth, His Honour Mr Justice Moffitt made a number of recommendations for amendment of the law regarding audit of group accounts. His Honour was considering a case that arose under the Companies Act 1936 of New South Wales but he stated that his comments were also applicable to the law as it at present stands under the uniform Companies Acts. The major recommendations made by His Honour were as follows:-

(1) In the case of companies in which the public are shareholders, where practicable and subject to proper exceptions -

(a) the auditor of the consolidated accounts of a group should also audit the accounts of subsidiary companies of the group;

(b) if for some good reason this is impossible the Acts should prescribe and define the duties of the "parent" auditor and the "subsidiary" auditor;

(c) where the accounts of a subsidiary are not audited by the "parent" auditor and it is proposed to rely on the "subsidiary" auditor's opinion his appointment and identity should be disclosed and his appointment should be subject to confirmation by the shareholders of the parent company;

(d) where the accounts of a subsidiary are not audited by the "parent" auditor the law should require the presentation to the shareholders of the holding company of a consolidated account and balance sheet and the auditor's report thereon and should clearly impose duties and rights on the auditor equivalent to those provided in section 167 of the Act; and

(e) it is questionable whether the provision in clause 4(1)(a) of the Ninth Schedule permitting the presentation of a separate profit and loss account for each subsidiary rather than consolidated accounts should remain in the Act.

(2) The Act should be amended to provide some aids to the independence of auditors by minimising the conflict of interest and duty of auditors; in particular by providing some protection in appropriate cases for continuance in office subject to Court supervision of an auditor who qualifies a report in defined material aspects.

His Honour's recommendations appear to have been prompted by the view that where the "subsidiary" and "parent" auditors are not the same person the "subsidiary" auditor is in a weak position because he is, in effect, appointed by the management of the holding company (which normally controls the voting power in a meeting of the members of the subsidiary) and that the existence of different auditors leads to different accounting methods being adopted within the group and the likelihood that frauds committed by a person having access to various companies within the group will remain undetected. His Honour also considered that some auditors of consolidated accounts avoid taking responsibility for the field covered by another auditor or minimise their responsibility in this regard.

13. His Honour's observations were, we think, largely justified in relation to the Act of 1936, with which he was dealing. They may have been loss so in relation to the Act of 1961, although there appears to have been some uncertainty as to the requirements for the audit of group accounts. As indicated below, we think that the dangers to which His Honour adverted have been sufficiently provided for by the amendments proposed in the Draft Bill.

14. With regard to recommendation 1(a), we do not think it practicable to insist that a holding company and all its subsidiaries should have the same auditor. The proposal would, for example, be impracticable where the holding company or any of its subsidiaries were incorporated overseas. It is also possible that a holding company might have such a large number of subsidiaries, or that they might be located in such areas, that it would be highly inconvenient to have them audited by the same auditor.

15. There are also cases in which a company may be a subsidiary of more than one holding company. Although such cases are rare, the possibility would have to be provided for if the recommendation were adopted. It should also be pointed out that His Honour's recommendations are not in terms confined to wholly-owned subsidiaries, although this appears to be the kind of case he had in mind. Where subsidiaries are not wholly-owned, the interests of the minority must be taken into account, as pointed out in paragraph 19 below.

16. Recommendation 1(b) is to the effect that the Acts should prescribe the duties of the auditors of the parent and of the subsidiaries, respectively. Section 167 of the Draft Bill prescribes the duties of auditors generally, and also makes specific provision in relation to group accounts. These provisions were designed to overcome the uncertainty in relation to group accounts to which His Honour refers.

17. His Honour also states that - "It is well recognised that fraud and error can occur within a consolidation by adopting different accounting methods with different companies within the group." We are not familiar with the facts of the case with which he was dealing, but we find it difficult to envisage a case in which correct accounting methods have been adopted in the case of each company, and in which differences in the accounting methods used give rise to the possibility of fraud and error. Perhaps such a situation could arise if the auditor of the parent company accepted no responsibility for the consolidation. We do not think he would have been entitled so to act under the 1961 Act, but in any event, under the Draft Bill, he must not only report on the consolidated accounts, but must state whether he is satisfied that the accounts to be consolidated are in form and content appropriate for that purpose (see s.167(2)(c)(iii)).

18. Recommendation 1(c) is that the appointment and identity of the auditor of a subsidiary should be disclosed to and be subject to confirmation by the shareholders of the parent. We doubt whether the proposal would achieve any significant result. The proposal assumes that the directors or the management of the holding company would choose an auditor of the subsidiary who is likely to be accommodating in his attitude (which is possible) and that, if his appointment were voted on by the shareholders of the holding company, they would be able to discern the risk involved in appointing that

person. In our view the circumstances in which shareholders would be possessed of sufficient information to prompt them to reject a registered auditor recommended by the directors would be extremely rare.

19. As indicated above, His Honour did not limit his remarks to the case of a wholly-owned subsidiary. In the case of wholly-owned subsidiaries, they may have been brought into existence by the parent, or they may have become so by acquisition of the shares. In the latter case they will already have an auditor and it would have to be decided whether the suggested requirement of approval would apply to him. But in the case of a subsidiary not wholly-owned, there are substantial reasons for having an auditor for the subsidiary, who does not owe any allegiance to the holding company, and who will see that the interests of minorities are protected. In such a case, therefore, there is no good ground for requiring that the auditors of parent and subsidiary should be the same, or for requiring confirmation of appointment to the subsidiary by the shareholders of the majority shareholder. As we have said, however, we do not think the recommendation provides a real safeguard and we do not recommend its adoption.

20. Recommendations 1(d) and (e) can be dealt with together. 1(d) is to the effect that where the accounts of a subsidiary are not audited by the parent auditor, the law should require the presentation to the shareholders of the parent company of a consolidated account and balance sheet and the auditor's report thereon, and should clearly impose duties and rights equivalent to those provided for in section 167 of the Act. 1(e) is a suggestion, rather than a firm recommendation, that the liberty given to present separate accounts of a subsidiary should be taken away. Section 167 of the Draft Bill now requires the audit of group accounts, which will normally be consolidated accounts, and section 164(1) requires that they be sent to the shareholders of the parent company. The duties and rights of the auditor with respect to the audit of group accounts are defined in section 167. While the option of presenting separate accounts rather than a consolidation is retained, it is subject to safeguards, viz., that the directors must give reasons for so doing, that significant inter-company transactions must be disclosed in notes to the accounts (Ninth Schedule, clause 9(5)(a) and (b)), and that the auditor must state whether he agrees with the reasons

given by the directors (section 167(3)(g)). These safeguards are in our opinion adequate to prevent the privilege of presenting separate accounts from being used to mislead. We would add that there are some cases in which it is more informative to present separate accounts than to consolidate.

21. Recommendation 2 proposes the provision of some aids to the independence of the audit profession by minimising the conflict of interest and duty of auditors, in particular by providing some protection in appropriate cases for continuance in office subject to Court supervision of an auditor who qualifies a report in defined material respects. We have already recommended provisions giving an auditor life tenure unless removed in accordance with the Act (section 166(4)). We have also placed the auditor under a duty to report certain breaches of the Act to the Registrar (sections 167(8) and (9)). As explained in our first report, these sub-sections were designed to strengthen the hand of the auditor by putting him under a duty to report which could be used as a lever against the directors or management. We have also provided for an express declaration that the auditor has qualified privilege (section 167B) , and we have replaced the provision which made the auditor's remuneration dependent on a resolution of the company by a provision that the auditor is entitled to his reasonable fees and expenses (section 166C). We considered a suggestion that the consent of the Board should be required before an auditor could be removed by a resolution of the company, but concluded that such a provision might make it more difficult for directors to get rid of an auditor whom they regarded as incompetent, but against whom they had no specific complaint, and that on balance it was desirable that the shareholders should have the final say in such cases.

It is true, as His Honour says, that in substance it is the directors or management of a holding company who can decide on removal of the auditor of a subsidiary, and that the right given to the auditor to make representations would in such a case be of little advantage to him. Under the Draft Bill, however, if the auditor of a subsidiary has qualified the report or has commented on any of the matters referred to in section 167(3), the auditor of the parent will become aware of the qualification, and will have to refer to it in his report on the group accounts. The auditor of the parent is also, under section 167(5), entitled to access to the records of the

subsidiary, and to information from any officer or auditor of the subsidiary. In the circumstances, an attempt to silence the auditor of a subsidiary by removing him or threatening to do so is in our view highly unlikely.

22. For these reasons, we do not recommend that any action should be taken to give effect to His Honour's recommendations, beyond what is already proposed in the Draft Bill.

23. The conclusions expressed in this memorandum represent the views of all three members of the Company Law Advisory Committee. The text was for the most part approved by all members but in its final form has not been seen by Mr. Cox owing to his absence overseas. It has been seen and approved by Mr. Rodd.

R. M. EGGLESTON.

29th June 1970.