COMPANIES AND SECURITIES LAW REVIEW COMMITTEE

REPORT TO THE MINISTERIAL COUNCIL
ON THE
CIVIL LIABILITY OF COMPANY AUDITORS

SEPTEMBER. 1986

CONTENTS

Part I

The Principle of Limited Liability

Part II

Review of Issues Arising from Limited Liability

Part III

Summary of Recommendations

REPORT OF THE COMPANIES AND SECURITIES
LAW REVIEW COMMITTEE ON THE
CIVIL LIABILITY OF COMPANY AUDITORS

To:

The Ministerial Council for Companies and Securities

[1] The Committee received a general reference from the Ministerial Council to enquire into and review the question of the optional incorporation of accountants in the context of the law relating to companies and the securities industry.

[2] The reference originated in a submission received by the Ministerial Council from representatives of the accounting profession. The Committee noted that the submission raised the question of some limitation on the civil liability of registered company auditors when carrying out their duties under the companies and securities legislation. The submission sought to resolve this issue by suggesting legislative changes to allow for the incorporation of auditors.

[3] The Committee believed that it was beneficial to treat separately the issues of limitation of civil liability and incorporation, and to focus in the first instance on the civil liability of company auditors. In November 1985 the Committee published Discussion Paper No. 3: "Civil Liability of Company Auditors"; a copy of which is reproduced in Appendix B of this Report. Submissions were called for by February 1986, and a list of respondents is found in Appendix A.

Structure of the Report

[4] Part I of this Report examines the various philosophical and pragmatic issues relevant to whether auditors should enjoy some relief from unlimited personal liability in contract and tort. The

Committee concludes, on the balance of competing interests, that auditors be granted limited liability in respect of their statutory functions under the companies and securities legislation, subject to the introduction of compulsory indemnity insurance.

[5] Part II of the Report reviews a range of issues arising from the introduction of limited liability and mandatory insurance, as identified by the Committee in its Discussion Paper. The Report outlines various matters that require further consideration, and in this regard favours the establishment of a Working Party comprising the NCSC and representatives of the professional bodies, in consultation with the insurance industry.

[6] Part III of the Report is a summary of the Committee's recommendations concerning the civil liability of company auditors.

Part I
The Principle of Limited Liability

[101] The foremost matter to be addressed in this Report is whether, in principle, the rule that auditors carry unlimited civil liability in tort and contract for breach of their audit duties under the companies and securities legislation, should be replaced by a provision granting auditors some limitation of these liabilities. The Committee takes the view that there is no obvious preferred answer; in the end it comes to a choice between various competing factors and the relative weight given to each.

Arguments for Retention of Unlimited Liability

[102] There are both philosophical and pragmatic arguments for maintenance of unlimited liability:

* The traditional rationale for unlimited liability is that auditors, like other professionals, must accept full responsibility for their work and be required to compensate those who, in reliance thereon, suffer loss. It is difficult to reconcile this concept of professionalism with limited liability.

* Following from this, granting limited liability to auditors may act as a precedent for other professions to seek similar protection.

* Unlimited liability may act as an incentive for auditors to perform competently their duties of monitoring managerial behaviour. This incentive may be undermined or compromised if limited liability is introduced.

* The auditing requirement is a State imposed mechanism to protect creditors and investors. The courts have emphasized the rigour of this duty and have resisted attempts at its dilution by shifting some loss back to the company.

* Limited liability may in certain instances deny plaintiffs full or greater monetary recovery than if no limitation existed.

* A limitation of liability would involve companies and the investing public bearing part of the losses they have incurred through the negligence of the auditor.

<u>Arguments for Introduction of Limited Liability</u>

[103] Support for this policy is based on considerations of the nature of auditing, and the shortcomings of unlimited liability in practice:

* Auditors perform a quasi public service role as part of the regulatory machinery provided by Government for the protection of investors, eg, Companies Code

s285(10)[1]. Auditors may, in this respect, be equated with Commission officers who are protected from civil liability provided they act in good faith: eg, NCSC Act s41(4). This parallel in functions justifies the granting to auditors of some relief from liability concerning those auditing activities which form part of the regulatory system.

* Auditors, unlike other professionals, occupy a position of status rather than contract regarding the performance of their duties. By virtue of s237 and s285 of the Companies Code, auditors are under an obligation to express a professional opinion in circumstances which provide them with no real opportunity to restrict the scope of, or modify by contract, their potential liability to clients or outside parties. An auditor's position of status rather than contract is reinforced by s282 (6), (11) which restrict the circumstances in which an auditor may resign.

* Auditors are required to undertake an independent assessment and evaluation of the relevant facts and cannot, except in limited circumstances, rely upon the representations of management[2]. By contrast, other professionals, such as lawyers, may base their advice upon facts obtained from the client, for whose accuracy or completeness they need take no responsibility.

* Society tolerates limited liability for many forms of service provision and auditing may be equated with these activities, rather than being confined by the traditional constraints of professional practices and standards.

1: The nature and extent of the statutory obligations are outlined in the Discussion Paper: [27]-[47]; see also Baxt R: The Naked Auditor: Australian Business Law Review Vol 13 No 3 (1985) p154-160.

2: see generally Stokes D; Sullivan G: Auditor Reliance upon Management - a Legal Perspective: Company and Securities Journal Vol.3 (1985) p246 - 254.

* The policy of unlimited liability does not necessarily provide adequate or better protection to investors and creditors. There may be a significant imbalance between the extent of auditors' liability, as determined by the courts, and auditors' actual capacity to compensate aggrieved parties. The damages awarded may well exceed any professional indemnity insurance, either held or capable of being carried by auditors. This trend may be exacerbated by the apparent shrinking capacity of the professional indemnity insurance market.

* Unlimited liability may not be the best or only spur to the maintenance of good accounting standards. The possibility of diminution of reputation consequent upon any adverse Judicial finding, as well as disciplinary action by the NCSC and the professional bodies may constitute strong incentives for optimal work performance.

* Given the nature of the auditing task, the amount of money, considered as a multiple of the fees received, for which auditors may be held liable greatly exceeds that of other professions. Auditors appear to carry an excessively high monetary risk.

<u>Adverse Consequences of Retaining Unlimited Liability</u>

[104] As well as reviewing arguments in favour of limited liability, it is also necessary to consider the likely long term consequences if limited liability is withheld. Given the possibility that auditors will face further civil claims for substantial amounts, they may:

* resort to defensive auditing, in particular through increased use of protracted or qualified audits. This may have extremely serious consequences for client companies;

* favour pre-trial settlement of claims regardless of

the merits of the causes of action in question. This may both encourage unmeritorious litigation and militate against the establishment of a stable professional environment;

* make themselves Judgement-proof through divestiture of their assets and/or forgoing professional indemnity insurance;

* transfer part of the financial risk of unlimited liability through greatly increased audit fees.

[105] Unlimited liability may also:

* result in loss of confidence both within the commercial community and the auditing profession if a large or major auditing firm is rendered insolvent as a consequence of a damages claim;

* create or exacerbate disincentives for accountants to undertake auditing work, in consequence of the high personal risks involved;

* reduce competition and discourage new entrants to the auditing profession as, given the inadequacy of existing insurance cover, prudent users may prefer to engage larger and well established auditing practices with greater resources to meet any claims that may arise, at the expense of smaller, though no less capable, auditing firms.

Possible Alternatives to Limited Liability

[106] It is also necessary to consider whether adoption of policies other than limited liability may be a preferred response to the perceived problem of excessive damages claims. Other options include:

* higher levels of indemnity insurance

* review of the common law rules governing liability and damages

* provision for greater independence of auditors, or

* further improvement of auditing standards

Higher Indemnity Insurance

[107] Increasing the levels of indemnity insurance would be a suitable policy response only if it were made mandatory for all auditors and the prescribed insurance were at a sufficiently high level, for a reasonable premium. The Committee believes that unless Government is prepared to itself underwrite the risks through its own insurance offices, any such solution would be unworkable as the premiums would be too onerous for many auditors.

Changes to the Common Law

[108] A further option would be to redefine the duty and standard of care to which auditors are subject, and/or reform the rules on causation and remoteness of damage as they apply to auditors. The problem with this approach is that piecemeal ameliorative intervention may create unjustifiable anomalies and be too drastic and difficult a solution to the perceived problems arising from the operation of the common law in this particular and narrow context.

Greater Independence for Auditors

[109] It was submitted to the Committee that actions against auditors may have their origins not in any technical incompetence on their part, but in the tendency for auditors to become compromised by the directors of client companies. On this view, large claims against auditors would be much less likely to occur under a system where auditors were freed from the pressures to co-operate with directors. Independence from management would be enhanced

by strengthening the relationship between auditors and shareholders.

[110] The Committee believes that while the independence of auditors is important, there is no strong evidence available to support changes in the law governing the appointment and retirement of auditors, nor would any such changes be more than a partial solution to the question of auditors' liability.

Further Improvement of Auditing Standards

[111] A fourth option would be to promote improvements of technical and ethical auditing standards so as to more precisely define the obligations of an auditor to consider and comment on the transactions reviewed in the performance of an audit. One aspect of this might be the introduction of "peer review" which, as practised in the USA, constitutes an examination of audit procedures, rather than the detailed supervision of any particular audit. Another possibility might be a requirement that the holding of · qualification to act as an auditor be conditional on satisfactory participation to a prescribed level in continuing audit education sponsored by the professional bodies.

[112] The Committee sees some force in the argument that the granting of limited liability be conditional upon the profession taking effective steps to minimise the possibility of audit failure. However the Committee recognises that the Institute of Chartered Accountants and the Australian society of Accountants have already demonstrated a real concern for the maintenance of professional standards and have been active in promoting professional development courses in various aspects of accounting practice, including auditing. Furthermore the Committee feels unable, at this stage, to confidently state whether the professional bodies could, through greater surveillance and quality control of statutory audits, further raise standards such as to overcome or

significantly lessen the incidence of civil liability of auditors. In any event, it is doubtful whether placing the focus on improvement of standards through professional self-regulation is a complete or substantial response to the issue of unlimited liability, nor does it address the various defensive measures (eg, divestiture of assets) which auditors may employ to protect themselves from the consequences of such liability.

A Pragmatic Approach to the Issue of Liability

[113] Having reviewed the various arguments outlined above on this question, the Committee finds that no obvious "right" solution is apparent. The Committee believes that despite what might be said about the role and function of auditors at a conceptual level, any real Justification for a limitation of auditors' liability lies in pragmatic considerations. In modern times, the damages that may be awarded when an auditor's breach of duty is proved, may be so high as to financially destroy the auditor and the firm, without there being any realistically available insurance cover. This trend, if not addressed, may make insurance practically unobtainable, engender unwillingness by some professional people to serve as auditors, encourage divestment of assets by auditors fearful of crushing personal liability and, ultimately, undermine significantly the integrity of the audit system envisaged by the legislation. There needs to be a redressing of the seeming imbalance between the extraordinary extent of liability and the auditor's ability to pay.

[114] These policy issues raise questions of competing economic interests: those of investors who rely on audits and on adherence to professional standards by auditors; the interests of the accounting profession in reducing the audit risk to a level comparable to audit returns; the interests of insurers offering professional indemnity cover; as well as the public interest in the maintenance of a system of diligent and independent audit. Submissions received by the Committee make it clear that some of these competing interests are irreconcilable and so require a

pragmatic decision unrelated, for the most part, to any abstract notion of what is, in a theoretical sense, desirable law reform.

[115] The Committee notes a recent instance in the USA where essentially pragmatic considerations appear to have been paramount in initiating a limitation of liability provision. As from July 1986, corporations in the State of Delaware may limit the liability of their directors in certain instances. As explained in the legislative synopsis:

"the new [provisions] represent a legislative response to recent changes in the market for directors' liability insurance. Traditional policies have been unavailable in many cases, and changes in the insurance market have threatened the quality and stability of the governance of Delaware corporations because directors have been unwilling, in many instances, to serve without the protection which such insurance provides, and in other instances, may be deterred by the unavailability of insurance from making entrepreneurial decisions"[3].

[116] The Committee concludes, after taking all the policy issues land options into account, and on the balance of interests, that limited liability for company auditors be introduced. The nature and form of possible liability limitations are further discussed in Part II, Issues 1-6 at [202] [256].

Limited Liability and Compulsory Indemnity Insurance

[117] The Committee believes that any move to confine to a more reasonable level the potential liability of auditors must be balanced by the introduction of compulsory indemnity insurance, in order to increase the financial capacity of auditors to meet damages awards. Compulsory insurance will provide some guaranteed return to all plaintiffs in the

3: Securities Regulation and Law Report Vol. 18 (1986) p943; generally Block D; Barton N; Garfield A: Advising Directors on the D & O Insurance Crisis: Securities Regulation Law Journal Vol. 14 No 2 (1986) p 130-149.

event of liability being proven, in contrast to the present system of unlimited liability and voluntary indemnity insurance, where the capacity of auditors to meet a valid compensation claim varies depending on the level of any indemnity insurance held and the auditors' personal assets. This is further discussed in Part II Issues 7-9 at [257]-[267].

Incorporation of Auditors

[118] From the outset of its review the Committee sought to treat separately the issues of limitation of civil liability and incorporation of auditors. In this Report the Committee confirms the necessity of maintaining this division and reiterates that incorporation alone may not necessarily constitute an effective response to the liability issue as:

* directors of auditing companies who participate in its auditing activities may be personally liable in tort, concurrently with the corporation, in the event of a breach of duty by the corporation[4];

* individuals associated with an auditing company may be subject to court orders pursuant to s542 or s574(8) of the Companies Code; and

* the effect of the Trade Practices Act s4B and s74 may be to deny to incorporated auditors any limitation of civil liability where the audit fee does not exceed $40,000.

[119] The Committee has noted comments in various submissions favouring incorporation of auditors, for reasons other than any limitation of liability. The Committee is also aware of recent moves by the professional bodies to allow for the incorporation of accountants, other than auditors. The Committee indicates its willingness to separately consider whether the Companies Code be amended to allow for the incorporation of auditors, should an expression of interest from Ministers or the profession be forthcoming.

4: cf: C Evans & Sons Ltd v Spritebrand Ltd [1985] 1 WLR 317

Part II
Review of Issues Arising from Limited Liability

[201] The Discussion Paper identified eleven issues following from the possible introduction of limited liability. In this Report each will be reviewed in turn.

Issue 1: Indemnification of the Auditor; Discussion Paper [51]-[53]

[202] The Committee invited comments on the desirability of maintaining s237 of the Companies Code, which prevents an auditor from obtaining, by contractual arrangements with the client company, a limitation of civil liability in relation to the company. The argument in favour of freeing auditors from this provision was that it would allow auditors and client companies greater flexibility in determining the terms upon which auditing activities were undertaken.

[203] The submissions received gave no support to any general exemption of auditors from s237. The view generally taken was that it would be inconsistent with the audit function if auditors and the management of client companies were empowered to negotiate a liability limit as:

* it might lead to a decrease in the accuracy and reliability of audits and encourage resort to low cost/limited scope audits;

* it would be commercially unsatisfactory to have audit contracts differing between client companies;

* it may compromise or threaten the independence of auditors if directors were permitted to negotiate the extent of the potential liability of the auditor to the company.

[204] The safeguard mooted in the Discussion Paper - a requirement of shareholder approval of any contractual variation of liablity, with appeal rights by aggrieved shareholders and creditors - was rejected as not providing any real protection for investors or creditors. The Committee therefore concludes that s237 of the Companies Code, as it applies to auditors, be retained in its current form.

[205] There were suggestions that an exempt proprietary company should be able to reach a special arrangement with an auditor, outside the operation of s237. The argument advanced was that as an exempt proprietary company is free to provide un-audited key financial data in its annual return, it may be at odds with this that the alternative is a requirement of a full statutory audit subject to s237, rather than something less; such as an independent check that the company is keeping accounting records from which a balance sheet and profit and loss account could conveniently be prepared and that records are in a form which would enable them to be conveniently audited.

[206] The Committee is opposed to the introduction of "limited audits" for exempt proprietary companies free of the constraints of s237. Members of such companies, if they do not wish to have an audit (as that concept is presently understood by the legislation and professional standards) are free to engage a person to perform such other checks as they wish, but are not free to refer to it as an audit. Such "limited audit" proposals:

* would enable the majority of members of an exempt proprietary company to exert pressure on a minority desiring an audit to agree to corner cutting methods (see Companies Code s279); this could be a matter of particular concern in the case of family companies; and

* would allow representations to be made to creditors that the accounts were "audited" without creditors being aware (by inspection) of the audit limitations.

[207] In summary the Committee believes that the proposal for "limited audits" for exempt proprietary companies outside s237 would entail a complex statutory provision for what can already be conveniently achieved by other means; would complicate and confuse professional audit standards; would facilitate misleading representations to third parties; and would influence the truncation of minority rights within a proprietary company.

Issue 2: Liability of Auditors - Primary or Secondary: Discussion Paper [53]-[60]

[208] As pointed out in the Discussion Paper, the original cause of loss to investors through inadequate or misleading financial statements will, in many instances, be some act or omission on the part of the directors or other persons in the company. However, claims have been pursued against auditors in preference to directors, principally because auditors may have greater assets, including indemnity insurance, from which to meet claims and these are available to plaintiffs by operation of the common law principles of causation and remoteness of damage and Joint and several liability. For commercial reasons there is no compelling reason why a plaintiff should pursue any other party if the auditor is perceived to have sufficient or the only substantial resources to meet all or part of the Judgement. Likewise a defendant auditor will have little incentive to seek a cross-claim against defaulting directors or other parties if the expectation is that the cost of pursuing the apportionment claim will exceed any reasonably anticipated recovery. For these reasons, auditors may shoulder all or a disproportionate share of the blame and cost of corporate failure, and there is a need for a more equitable sharing of the burden amongst those

responsible for causing the loss. A number of options addressing this issue were referred to in the Discussion Paper, and are reviewed in turn.

<u>Option 1:</u> Require that a plaintiff exhaust all remedies available against the defaulting director or other parties before having recourse to the auditor.

[209] This option would, in effect, reverse the current practice whereby plaintiffs proceed first, and often only, against the auditor. However the Committee believes that this option suffers a number of disadvantages:

* it may serve to increase the time involved in the litigation process, particularly where defendant directors are the subject of actual or pending criminal prosecution;

* it will deny plaintiffs the right to make an economic decision whether it is worthwhile to sue the directors, thereby subjecting plaintiffs to unnecessary delay and expense in circumstances where directors are difficult to locate or have few assets;

* it may involve different courts hearing the claims, first against the directors and subsequently against the auditor. This may result in duplication of evidence and the need for the court hearing the claim against the auditor to take cognizance of the awards made by the earlier court;

* it would, in most instances, merely delay the litigation process against the auditor, but would not overcome the problem of the level of damages awarded against auditors, given the likelihood of minimal contribution from directors and other defendants.

For these reasons the Committee does not favour this option.

Option 2: Enable the amount of loss /or which an auditor is liable to be ascertained in a manner different from that by which any loss attributable to directors or other relevant persons is determined.

[210] This option was intended to give force to the observation that an auditor should not be seen as the guarantor of the general conduct of the business enterprise[5].

[211] In the context of this option, the Discussion Paper posed the question whether the law should be changed to give the court, when assessing claims against an auditor, a discretion to fix damages at a point between:

* the amount of loss caused at the date of the breach; and

* the amount of the loss apparent at the date that the breach is discernible, where the latter exceeds the former.

[212] This option received support in a suggestion that an auditor should be liable only to the "actual error amount" (eg, if the provision for doubtful debts should have been $X more than the actual provision, then the auditor should be liable only for that amount and not be liable for any consequential loss).

[213] However strong objections were taken in submissions to this second option:

* it would constitute a substantial departure from

5: This observation finds support in Lloyd Cheyham Ltd v Littlejohn & Co (1955) UK High Court (unreported) where Woolf J, in rejecting negligence claim against a firm of auditors noted that the plaintiff "had placed a wholly unjustified responsibility on the auditors", and had "sought to blame his loss on the failure of the auditors to provide him with the protection which he did not provide for himself. While it is right that auditors should exercise a duty of care to those who they appreciate will rely on their audited accounts this duty does not mean that a [plaintiff] need not exercise any care to protect ": Accountancy June 1986 p86-89.

the common law principles of causation and remoteness of damages, as currently adopted in the courts in awarding damages in contract and tort;

* it may involve a court in making an arbitrary apportionment of damages in accordance with the extent of the loss which it thinks should be borne by the defaulting auditor;

* it may be very difficult to implement this option, as the initial loss may be compounded by later, often independent, acts of negligence by the auditor, thereby causing insoluble difficulties in establishing causation;

* it may lead to considerable uncertainty; affecting the courts in administering the law; affecting auditors, directors and other defendants in understanding the extent of their liability, and affecting claimants in determining their entitlement to recover their loss.

The Committee sees force in these objections and concludes that this option should be abandoned.

Option 3: Courts be given a discretion to apportion liability between directors, other relevant parties and the auditor, having regard to their differing degrees of culpability.

[214] This would ensure that auditors who could discharge their assessed liability would not be rendered insolvent by the impecunious state of the company directors or other defendants.

[215] The argument against this option is that it would be of benefit to the public only if directors, at least, could meet their share of liability. Several submissions argued for indemnity insurance for directors of all public companies in order to make this

option workable. However such insurance would probably be highly selective at even minimal levels of directors' coverage and the Committee therefore doubts whether insurers would voluntarily offer indemnity insurance to all directors of public companies at affordable premiums. Short of this, many directors would lack the incentive or be unable to obtain cover. Therefore, without compulsory Government underwritten insurance, this option has limited attraction and is not recommended.

Option 4: Legislate to limit the effective life of an audit so that losses arising subsequently could not be attributed to it.

[216] This approach was seen by respondents as arbitrary and being too harsh in its effect on plaintiffs. It is not supported by the Committee.

[217] An alternative put forward in submissions was for the introduction of a shortened limitation period. It was suggested that the limitation period for civil actions against auditors be reduced from six years to, say, three years. It was argued that this reduction may lessen costs, help overcome the evidential problems associated with the recall and review of long past events, and otherwise respond to the delays and difficulties encountered in litigation against auditors[6].

[218] The Committee is opposed to any proposal to reduce the limitation period. It would discriminate heavily against would be plaintiffs in those instances where the existence or effects of a faulty audit took some years to appear and it would introduce an inexplicable exception to the statutory limitation period that prevails in all other civil litigation. On these grounds the Committee rejects the submission.

6: See comments by Rogers J in Cambridge Credit Corp Ltd v Hutcheson & Ors (1983) 8 ACLR 123 a 162.

Option 5: Legislate to limit the maximum potential amount of an auditor's liability.

[219] The Committee considers this to be the most direct and suitable means of translating into practice the principle of limited liability for company auditors. This policy will offset any injustice in the present position in consequence of claimants seeking full recovery from negligent auditors without looking to directors, while it avoids any rule that claims against auditors be conditional on concurrent or preceding action against defaulting directors or other relevant persons.

[220] The Committee sees no objection in principle to a voluntary lifting or variation of the legislative liability limitation. Thus if any person, whether or not connected with the company, wishes to have a separate and additional right of action against an auditor, or a claim unencumbered by any liability limitation, it Should be open to that person and the auditor to make a voluntary arrangement under which the auditor enters into a special contractual undertaking in respect of the audit.

Issue 3: Statutory Limited Liability: Discussion Paper [61]-[63]

[221] The Committee perceives that auditors, in performing their statutory duties, fulfil an important regulatory function, and should be entitled to some protection on these grounds. Accordingly the Committee believes that the principle of limited liability should apply in respect of the various audits required to be provided by or under the provisions of the Companies and Securities legislation, or by or under a court order made in the exercise of a power conferred by that legislation. This would cover audits conducted pursuant to Part IV Division 6 (prescribed interests) and Part VI Division 3 of the Companies Code, and under

Part VI of the Securities Industry Code and Part VI of the Futures Industry Code.

Issue 4: Method of Fixing Liability Limitation (Statutory cap): Discussion Paper [64]-[72]

[222] In the Discussion Paper, the Committee canvassed four ways in which the civil liability of auditors arising from a statutory audit could be limited:

(i) prescribe a maximum level of monetary compensation per audit, as is done in West Germany;

(ii) define maximum liability as a percentage of the assessed financial loss resulting from a faulty audit;

(iii) determine maximum liability as some multiple of the fee charged for the audit; or

(iv) assess maximum liability as a percentage of gross professional auditing fees of an individual or firm over a set period.

To this, a fifth option was suggested by some respondents and may be added:

(v) stipulate maximum liability by reference to the size of the client company.

[223] The Committee reviewed the merits of each of these statutory cap formulae, and for the reasons set out below, favours the third option.

Option 1: A Prescribed Maximum

[224] This statutory cap option received little support in the submissions. The main arguments against it were that:

* there would be no rational connection between the extent of liability and the nature and size of the audit performed;

* it would make no allowance for the wide range of potential liability from the smallest to the largest company audit. A low limit may afford inadequate protection to investors whilst a high limit would require smaller audit firms to carry excessive levels of insurance cover to avoid exposure to burdensome liability.

[225] The Committee believes that a prescribed maximum, while having the benefit of simplicity, would be unsuitable. It would bear no necessary relationship to the size or complexity of an audit or the fee charged. Given these arbitrary factors, the option is not supported.

<u>Option 2:</u> Maximum liability as a percentage of the assessed financial loss arising from a faulty audit.

[226] This statutory cap formula has the advantage over the first option of avoiding an arbitrary and fixed maximum liability amount, and it could be further refined by means of a stated minimum potential liability with a fixed percentage, or decreasing percentage, for losses in excess of that minimum.

[227] This option received little support in the submissions. It was pointed out that the assessed liability may itself be substantially more than should be borne by auditors having regard to the extent of their responsibility. Depending upon the percentage chosen, it may result in either a too low damages return, or a liability so great as to cause over-bearing financial hardship to auditors. Because of these possibly adverse consequences, the Committee does not support this option.

Option 3: Maximum liability as some multiple of the fee charged for the audit.

[228] This statutory cap option received strong support in the submissions. Its purpose is to introduce a direct correlation between the nature and size of the audit engagement, as reflected in the audit fee, and the auditor's potential liability. A liability limitation based on this risk - fee nexus would have other advantages:

* it would avoid any in-built discrimination between larger and smaller firms in competition for audit work (in contrast to Option 4: see [237]);

* it would overcome the perception that auditing risks are increasing disproportionately to any upward movement in audit fees.

[229] The Committee posed the question in the Discussion Paper whether adoption of this option might encourage some firms to lover their fees in order to reduce their maximum potential liability, thereby leading to "corner cutting" in the performance of audits. It was strongly asserted in the submissions that recourse to such measures would be unlikely, as auditors who chose to perform less work for a lower audit fee would still be open to substantial damages, while putting at risk their professional reputation by a finding of liability.

[230] Adoption of this option would also overcome the disclosure problem referred to in the Discussion Paper at [71]. By relating the maximum liability to the fee charged for the audit, publication of the audit fee in the accounts of the client company would enable interested parties to easily determine the maximum potential liability in each case.

[231] One problem with linking maximum liability to fee charged for an audit is the possibility of individuals hiding the fees received under the disguise of "remuneration for other services". The Committee recognises that where an auditor performs other work for the company, there is a need to ensure that the fee for the statutory audit is not artificially reduced while the fees for other work are loaded in compensation. However this difficulty could be overcome in various ways:

* tighten the existing disclosure requirements in relation to auditors' remuneration, as found in Schedule 7 of the Companies Regulations;

* provide courts with a discretion to review the fee structure where it appears the stated figure has been artificially deflated.

[232] Given the Committee's support for determining the maximum liability as some multiple of the fee charged for the audit, further matters require consideration:

(a) what multiple should apply; and

(b) should the maximum liability formula apply to each litigant, each separate civil action, or each event the subject of possible litigation.

[233] As regards the multiple, various formulae were suggested, eg, multiples of ten or twenty times the audit fee. It was also suggested that there should be a fixed minimum figure of potential liability, with the multiplication formula to apply to excess amounts. The Committee believes that the multiple should be fixed sufficiently high to make any damages award substantial enough to provide, what in the generality of cases, would be a significant contribution towards meeting the losses attributable to the auditor's fault. However

this figure should not be significantly beyond the reach of available indemnity insurance, nor require a premium level that forces many smaller firms to consider abandoning the provision of auditing services.

[234] The Committee does not feel that it is sufficiently informed to make a specific recommendation concerning a suitable multiple, or whether this should be supported by a minimum floor figure. Instead the Committee recommends that this consideration be left to a Working Party comprising the NCSC and its delegates together with members of the Institute of Chartered Accountants and the Australian Society of Accountants, in consultation with the insurance industry.

[235] As regards application of the liability formula, the first and second alternatives - the maximum liability formula to apply to each litigant or each separate civil action - may have capricious results. The potential liability of auditors would be dependent on the number of plaintiffs or civil actions arising from a particular faulty audit, with the result that in many cases there may be no effective limitation of liability. The Committee is therefore drawn to the third alternative - the maximum liability formula to apply to each event the subject of litigation - as the most suitable means of providing a statutory cap protection for auditors. However there may be a real question as to the characterisation of an "event˜ for the purpose of determining liability. The Committee concludes that further clarification of this matter, in the sense of a possible definition in any legislation giving effect to the limitation of auditors' liability, should be one of the terms of reference of the proposed Working Party.

[236] The Working Party would also need to consider the application of the maximum liability formula to groups of companies where the audit report covers both the holding company's financial statements and the groups

consolidated statements. For instance, should the liability limit of the holding company auditor apply only in respect of the fees received by that auditor or the fees payable to all auditors of the group? On one view, the holding company auditor must take primary responsibility for the consolidated financial statements covered in the report, and therefore the liability limit of that auditor should be a multiple of the group audit fees.

<u>Option 4:</u> Maximum liability as a multiple of the total gross professional feet to the firm from auditing over a set period.

[237] This statutory cap formula differs from the prior option in that the multiple would relate to gross annual audit fees rather than the fees of the particular audit under review. This gross fee option was rejected by most respondents. Its drawbacks include:

(i) the lack of any rational relationship between the amount of liability and the nature and size of the relevant audit;

(ii) the liability limit would be unknown at the time of entry into the audit contract unless the multiple was related to gross fees over a prior period;

(iii) it would produce an identical liability limitation for firms with similar total audit fees but dissimilar individual audit fees. An example would be two firms with comparable gross audit fees, the first having two large audits contributing the whole of its audit fees and the second having a large number of small audit clients. The clients in the second firm would seem to be advantaged vis-a-vis the clients of the first firm;

(iv) larger auditing firms would be able to demonstrate a higher maximum liability limit and would have an unjustifiable competitive edge over smaller firms.

For these reasons the committee rejects this option.

Option 5: Maximum liability as a percentage of the size of the client company, measured by its total gross income and assets.

[238] An advantage claimed for this statutory cap formula was that it would enable auditors to decide whether they wished to limit their exposure to client companies of a certain size and to decide the level of professional indemnity insurance they required. It would also entitle a company to determine what size of audit firm it would prefer and to judge the ability of the firm to meet a claim.

[239] The Committee believes that while there is some merit in this fifth option, audit fees rather than size of the client company should be the preferred nexus with maximum potential liability. Liability based on audit fee is simpler to determine; is more closely related to the work involved in conducting the audit and avoids any discrimination in favour of larger client companies. Also it may be difficult to arrive at a satisfactory formula to determine the comparative size of client companies eg. trading companies with large turnover but few assets compared with companies that are rich in assets but have a minimal to nil turnover.

Issue 5: Ambit of the Limited Liability Protection: Discussion Paper [73]-[74]

[240] The Committee considers that the limitation of liability formula based on a multiple of the audit fee should apply to all civil actions against auditors arising from the performance of their statutory duties, whether the cause of action rests in contract, tort or otherwise. It is not intended that defendants other

than auditors eg. directors or other persons involved in the company's management, should benefit from the statutory liability cap. Accordingly any legislation should preserve the full common law rights of a claimant against those persons.

[241] An auditor will remain entitled to enforce rights of contribution from other parties. However the liability of an auditor to make contribution to any other defendants should be subject to the limitation of liability formula.

[242] Within the ambit of these guiding principles a number of specific matters need further consideration.

Defamation

[243] The Companies Code s30, the Securities Industry Code s81, and the Futures Industry Code s99 protect auditors from defamation proceedings arising from the exercise of their statutory duties, subject to proof of malice. The Committee believes that these provisions should be maintained such that upon proof of malice, the statutory liability cap should not apply to the defaulting auditor. However partners of the defaulting auditor should in some circumstances be given the benefit of the limited liability protection: see below [246]-[252]

Nature of the Auditor's Default

[244] The purpose of the statutory liability cap is to partially protect auditors from the common law consequences of their negligence; but not their intentional wrongdoing. It follows that any limitation of liability provision should have no application to an auditor who, in performing an audit, is either fraudulent or is aware of or is knowingly a party to a material mis-statement or other criminal fraud.

[245] A more difficult policy question arises where an auditor acts, not with knowledge or fraudulent intent, but with reckless indifference or disregard for the due performance of relevant statutory obligations. The Committee considers that short of actual knowledge of wrongdoing, the limitation of liability provision should still apply to the auditor. The Committee recognizes that this may have the undesirable effect of appearing to protect auditors from the full rigours of their gross negligence or recklessness. However auditors remain subject to possible disciplinary action by the NCSC and the professional bodies and this may offset the possible detriment in applying the statutory cap to instances of recklessness.

Partners of the Defaulting Auditor

[246] By virtue of the partnership legislation, partners can be jointly and severally liable for the default of a fellow partner acting in the ordinary course of the business of the firm. The Committee takes the view that within the statutory cap formula this principle should remain. However the limited liability policy may be significantly undermined if partners were automatically exposed to unlimited liability, not through their own actions, but in consequence of the defamation, fraud, or knowledge of wrongdoing of a fellow partner.

[247] Given this problem, the Committee considered three policy options, here set out in lessening degrees of severity for co-partners:

*· an obligation to act test;

*· a reasonable suspicion test;

*· an actual knowledge test.

[248] Under the first test, the limitation of liability cap would apply to co-partners only where they established that they took all reasonable steps to ensure that the

actions of their fellow partners would not expose them to liability.

[249] The Committee believes that this test may be too harsh and imprecise in its application and would do little to remove the perception of the unreasonably high financial risks associated with auditing. Employment of this test may result in co-partners having little real protection from unlimited liability.

[250] Under the reasonable suspicion test, the statutory cap would apply to co-partners except where they had or should have had a reasonable suspicion of improper behaviour by the defaulting partner. While this is less burdensome than the former test, the Committee is concerned that a reasonable suspicion test in effect imposes a negligence standard for determining the liability of co-partners; a standard more onerous than that pertaining to the defaulting auditor. On that basis the Committee rejects this test.

[251] This leaves the third option; that co-partners should enjoy the statutory cap protection except where they had actual knowledge of, or were knowingly a party to, the fraudulent or otherwise improper auditing conduct. The Committee prefers this option as it is consistent with the test of unlimited liability applicable to defaulting auditors. Also it avoids the need for auditing firms to establish costly and complex internal audit review mechanisms; a procedure probably necessary if either of the other two tests were adopted. The Committee notes the possible criticism that an actual knowledge test may discourage co-partners from making due enquiry into the internal affairs of their auditing firms. However the possibility of an adverse finding of liability, even within the statutory cap formula, and/or disciplinary action against the co-partners, should act as a sufficient disincentive to any such neglect.

[252] A problem common to these three policy options is whether the chosen test should be applied on a general basis (ie: if one co-partner of the defaulting auditor fails the test, then all partners lose the limited liability protection) or only on a partner by partner basis (ie: only those partners who fail the test are subject to unlimited liability). The Committee considers that given the size of some auditing firms, the variety of activities other than auditing in which co-partners are engaged, and the potentially crushing financial consequences of loss of the statutory cap protection, the latter option (partner by partner basis) is preferable.

<u>Issue 6: Liability of Employees:</u> Discussion Paper [75].

[253] Consideration of the liability of persons employed by the auditor to participate in the audit raises two issues requiring separate consideration:

* the liability of employees for their own default;

* the liability of principals for the default of their employees.

[254] As regards an employee's own liability, it is appropriate to apply the same principles as with a defaulting auditor ie, an employee shall enjoy the statutory cap protection unless he is either himself fraudulent or is aware of or is knowingly a party to a material mis-statement or other criminal fraud. It would be inequitable to limit the liability of auditors but not offer similar protection to employees. Specific provision to this effect may be necessary, given the difference in the law of the various States as to the circumstances in which an employee is liable in his own right or is open to an indemnity or contribution claim by an employer.

[255] As regards the liability of the principal for the default of the employee, a similar problem arises as with co-partners. By application of the common law principles of vicarious civil liability, a principal may, through the fraud or other improper behaviour of an employee, lose the statutory cap protection and be exposed to unlimited personal liability. Given this possibility, the same policy options could here be applied as with co-partners: see [247]. It is arguable that as principals may exercise greater control over their employees than their co-partners, the stricter "obligation to act" test should be adopted: ie, principals shall suffer the full consequences of vicarious liability except where they establish that all reasonable checks were undertaken to guard against the fraud of employees. Any lesser standard may encourage principals to avoid supervision of their employees. The Committee recognises the strength of this policy option but queries its effectiveness as a checking procedure, as fraud by an employee, as opposed to mere negligence, is the least likely to be easily detected by this means.

[256] The Committee concludes that for the purpose of any claim against a principal arising from the actions of an employee and in excess of the statutory cap provisions, the principle of vicarious liablity be suspended, except where the principal had actual knowledge of or was knowingly a party to the fraud or other improper behaviour of the employee. The same test therefore would apply to co-partners and principals. Without this uniformity of approach the anomaly may arise of partners being protected from the unlimited liability consequences of the fraud of a fellow partner, but not that of an employee.

Issue 7: Compulsory Indemnity Insurance: Discussion Paper [76]-[79].

[257] The Committee has already indicated: [117], that as a balance to the introduction of limited liability, auditors be required to hold professional indemnity insurance to a prescribed level. This end could be achieved by providing that an individual's right to audit be conditional upon holding an appropriate insurance cover.

[258] The primary purpose of mandatory insurance is to create a degree of protection for plaintiffs, by ensuring that some resources will be available to meet valid claims. Its secondary function is to partially insulate auditors from the financial burdens of civil liability. It is also possible that in consequence of the greater risk-sharing associated with the universal application of indemnity insurance, auditors may obtain suitable cover at more reasonable premiums than would pertain under a voluntary insurance system.

[259] While the predominant view in submissions favoured some form of compulsory insurance, a concern was expressed that this policy may encourage the courts to widen the common law liability of auditors, given their insurance backing. The Committee believes that auditors will not suffer any new detriment from any such development, should it occur, given the existence of the statutory cap. There may well be more successful claimants, but they will still have to share the same fixed maximum liability amount.

[260] The operation of a mandatory insurance scheme raises complex issues that would best be resolved by the Working Party in liaison with the insurance industry. In this Report, the Committee merely identifies some matters for their consideration:

[261] (i) The Relationship between the Statutory Cap and Indemnity Insurance. Ideally the required level of insurance should suffice to match the maximum potential exposure of an auditor under the statutory cap formula. Should significant insurance "gaps" appear whereby claimants are denied all or substantial recovery, then the policy of compulsory insurance as a counter-balance to granting limited liability may be severely compromised. For example, where auditing firms are subject to multiple claims in one year involving different audits, it would be inequitable if the first or earlier claims effectively exhausted the firm's professional cover. This problem may be overcome by the type of insurance offered eg, separate cover for each audit engagement, utilising the same formula (multiple of audit fees) as determines the statutory cap. However the feasibility of this method of insurance, both for insurers and insured, compared with a system of general insurance cover in respect of all audits in a forthcoming year, would need further examination.

[262] (ii) The Enforceability of the Indemnity Insurance Cover. Given that the primary function of compulsory insurance is to provide some guaranteed return to plaintiffs in the event of liability being made out, it would be necessary to ensure that they are not denied access to insurance funds through the actions of the insured. An example might be where an auditor, when taking out indemnity insurance, provides false or misleading information in the proposal form, such as to invalidate the policy[7]. The Working Party would need to guard against any such eventuality.

Issue 8: Residual Personal Liability: Discussion Paper [80].

[263] It was suggested in the Discussion Paper that as a "spur" to auditors performing their professional duties

7: cf. Yorkville Nominees Pty Ltd·v Lissenden (1986) 63 ALR 611.

carefully and responsibly, any insurance arrangements should require that auditors meet part of any liability from their own assets. A provision for residual personal liability might also serve as a public indication that auditors are prepared to risk at least part of their assets when performing their duties. This may help neutralise any perception that the statutory cap protection and indemnity insurance provides auditors with an immunity shield from personal liability.

[264] The submissions were strongly of the view that a residual liability obligation is unnecessary, as in practice insurers will impose excess clauses in their policies, thereby effectively achieving the same end. The Committee agrees, and considers that the matter of excess can best be left to underwriters to determine according to their risk assessment, subject to any guidelines or directions set down by the Working Party.

<u>Issue 9: Prescribed Liquidity Level:</u> Discussion Paper [81].

[265] The Discussion Paper posed the question whether it should be a condition of an auditor obtaining or retaining registration under the companies and securities legislation that the NCSC be satisfied that the auditor has and maintains a net worth of a prescribed minimum. Such a liquidity requirement could help ensure that the auditor can honour any excess required to be paid under the compulsory indemnity insurance scheme.

[266] The submissions were strongly against this proposal. It was argued that the possibility of bankruptcy and consequent loss of livelihood could itself be a strong incentive on auditors to ensure that sufficient funds are available. Furthermore there may be some difficulty in determining the necessary level of net worth, given that over a period of years a particular

audit firm may have an accumulation of unresolved claims, each subject to an insurance excess. In any event, there would be practical difficulties in monitoring compliance with any such requirement. It was also submitted that a liquidity prescription may discriminate against auditing applicants who satisfy the educational and other requirements found in s18 of the Companies Code, but who lack the financial resources, over and above their mandatory insurance payments, to meet the liquidity level.

[267] The Committee believes that these arguments have force and accordingly does not support a prescribed liquidity level as an additional requirement for obtaining or retaining registration as a company auditor.

<u>Issue 10-11: Civil Liability of Investigating Accountants:</u> Discussion Paper [82]-[91].

[268] The Discussion Paper dealt separately with the role of auditors and investigating accountants under the companies and securities legislation, on the basis that investigating accountants perform significantly different functions and are subject to different statutory liabilities and controls. In summary:

* the auditor's role is one of stewardship over the past performance of the company, including the detection of irregularities. This contrasts with the investigating accountant's task of providing accurate financial information to protect the future interests of the company, its shareholders and potential investors;

* investigating accountants are subject to statutory civil liability under s107 of the Companies Code and s44 of the Companies (Acquisition of Shares) Code. There are no equivalent provisions for auditors;

· investigating accountants fulfil an important public interest role in ensuring the accuracy of the prospectus and Part A statement.

To this may be added:

* investigating accountants are not subject to the same restrictions as auditors (Companies Code s282) as regards their retirement or resignation.

[269] It was submitted to the Committee that, notwithstanding these differences, the role and duties of investigating accountants are, in essence, similar to those of auditors and that any proposal for a statutory cap should apply to practitioners in both capacities. However the Committee believes that to fully extend the limited liability protection to investigating accountants could fundamentally compromise the statutory rights of investors under s107 of the Companies Code and s44 of the Companies (Acquisition of Shares) Code and thereby insulate one class of information providers from the general liability provisions applicable to the public offering and negotiation of securities. Also, for the reasons alluded to at [202]-[204] of this Report, the Committee does not favour allowing investigating accountants, by private agreement with client companies, to limit their civil liability for breach of their statutory obligations.

[270] The Committee therefore concludes that the limited liability provisions apply to investigating accountants except in civil actions against them pursuant to s107 of the Companies Code or s44 of the Companies (Acquisition of Shares) Code.

Part III
Summary of Recommendations

General Recommendation

The Committee recommends that limited liability for company auditors in respect of their functions under the companies and securities legislation be introduced in conjunction with the creation of a mandatory indemnity insurance scheme.

Specific Recommendations

The Committee recommends that:

(1) Section 237 of the Companies Code, as it applies to auditors, be retained in its current form and that there be no move to introduce "limited audits" for exempt proprietary companies free of the application of this section;

(2) The liability of auditors be limited, In respect of audits conducted pursuant to Part IV Division 6 and Part VI Division 3 of the Companies Code and Part VI of the Securities Industry Code and Part VI of the Futures Industry Code;

(3) The maximum potential liability of auditors ("the statutory cap") to all persons arising from each "event" In the nature of an audit, the subject of litigation, be a prescribed multiple of the fee charged for that audit;

(4) The statutory cap apply to all civil actions against auditors arising from the performance of their duties referred to in (2) above, except In actions of defamation against an auditor or where an auditor is fraudulent, or is aware of, or is knowingly a party to, a material mis-statement or other criminal fraud;

(5) Partners of culpable auditors, principals of culpable employees and employees of auditors, retain the statutory cap protection except where they are fraudulent, or are aware of, or are knowingly a party to a material mis-statement or other criminal fraud;

(6) A Working Party comprising the NCSC and its delegates, the Institute of Chartered Accountants and the Australian Society of Accountants, be established to consider and report to the Ministerial Council on the various issues arising from the Introduction of limited liability and compulsory indemnity insurance for auditors;

(7) Consequent upon the Introduction of a compulsory Insurance scheme, that there be no statutory requirement for residual personal liability or prescribed liquidity level for auditors; and

(8) The statutory cap provisions apply to investigating accountants except for civil actions against them pursuant to s107 of the Companies Code or s44 of the Companies (Acquisition of Shares) Code.

H.A.J. Ford (Chairman)
R.I. Barrett
D.A. Crawford
A.B. Greenwood
K.W. Halkerston

J.B. Kluver (Research Director)

September 1986

Appendix A
List of Respondents

Arthur Andersen & Co: Chartered Accountants
Ashley Forster: Chartered Accountants
Australian Institute of Credit Management; New South Wales Division
Australian Shareholders Association
Benjamin, King & Boyd: Chartered Accountants
Bentley & Co: Chartered Accountants
Bird Cameron: Chartered Accountants
C.T. Burrell
Charles J Berg & Partners: Chartered Accountants
Coopers & Lybrand: Chartered Accountants
Corporate Affairs Commission: New South Wales
Court & Co: Chartered Accountants
Day, Neilson, Jenkins & Johns: Chartered Accountants
Deloitte, Haskins & Sells: Chartered Accountants
Duesburys: Chartered Accountants
Edwards, Marshall & Co: Chartered Accountants
Ernst & Whinney: Chartered Accountants
Grahame Brown & Co: Chartered Accountants
Howarth & Howarth: Chartered Accountants
The Institute of Chartered Accountants in Australia and the Australian Society of Accountants: Joint Submission
KMG Hungerfords: Chartered Accountants
I. Langford-Smith; Lecturer in Accounting; University of Tasmania

Appendix A (cont.)

Law Council of Australia: Companies Committee of the Business Law Section
The Law Society of South Australia
The Law Society of Western Australia
Norton & Faviell: Chartered Accountants
Pannell, Kerr, Forster: Chartered Accountants
Parkhill, Lithgow & Gibson: Chartered Accountants
Dr. D.F. Partlett; Senior Lecturer in Law; The Australian National University
Peat, Marwick, Mitchell & Co: Chartered Accountants
D.H. Price
Price Waterhouse: Chartered Accountants
R. Simmett; Lecturer; Dept of Accounting & Finance; Monash University
Storey Blackwood & Co: Chartered Accountants
Thomas Davis & Co: Chartered Accountants
Thompson Douglass & Co: Chartered Accountants
Touche Ross & Co: Chartered Accountants
Trevor R. Russell: Public Accountant
R. Warren
E.J. Wilson; Dept of Accounting & Finance; Monash University

COMPANIES AND SECURITIES LAW REVIEW COMMITTEE

DISCUSSION PAPER NO. 3
CIVIL LIABILITY OF COMPANY AUDITORS

NOVEMBER 1995

COMPANIES AND SECURITIES LAW REVIEW COMMITTEE

The Companies and Securities Law Review Committee was established late in 1983 by the Ministerial Council for Companies and Securities pursuant to the inter-governmental agreement between the Commonwealth and the States on 22nd December, 1978.

The Committee's function is to assist the Ministerial Council by carrying out research into, and advising on, law reform relating to companies and the regulation of the securities industry.

The Committee consists of five part-time members, namely,

Mr. Reginald I. Barrett
Mr. David A. Crawford
Professor Harold A.J. Ford (Chairman)
Mr. Anthony B. Greenwood
Mr. Keith W. Halkerston.

The full-time Research Director for the Committee is Mr. John B. Kluver.

The Committee's office is at Level 24, M.L.C. Centre, 19-29 Martin Place, Sydney, New South Wales, 2000.

General Aims of the Committee

The Committee has identified its aims as follows:

To develop improvements of form and substance in such parts of companies and securities law as are referred to the Committee by the Ministerial Council.

For that purpose to develop proposals for laws:

* which are practical in the field of company law and securities regulation;

* which facilitate, consistently with the public interest, the activities of persons who operate companies, invest in companies or deal with companies and of persons who have dealings in securities; and

* which do not increase regulation beyond the level needed for the proper protection of persons who have dealings with companies or in relation to securities.

In the identification of defects and the development of proposals to have regard to the need for appropriate consultation with interested persons, organizations and governments.

CONTENTS

PART I - AUDITS

PART II -INVESTIGATING ACCOUNTANTS' REPORTS

The Reference from the Ministerial Council

[1] The Committee has received a general reference from the Ministerial Council to enquire into and review the question of the optional incorporation of accountants in the context of the law relating to companies and the securities industry.

[2] The reference originated in a submission received by the Ministerial Council from representatives of the accounting profession. The Committee notes that the submission raised the question of some limitation on the civil liability of registered company auditors when carrying out their duties under the companies and securities legislation. The submission sought to resolve this issue by suggesting legislative changes to allow for the incorporation of auditors.

[3] The Committee believes that it is beneficial to treat separately the issues of limitation of civil liability and incorporation, and to focus in the first instance on the civil liability of company auditors. This avoids the need to consider a range of matters pertaining to incorporation which are not directly relevant to questions of personal liability. The Committee also notes that incorporation of auditors will not necessarily exclude personal civil liability of individuals associated with such corporations. A director of an auditing corporation who participates in the auditing activities of the corporation may be personally liable in tort concurrently with the corporation in the event of a breach of duty by the corporation: C. Evans and Sons. Limited v Spritebrand Limited [1985] 1 WLR 317. The smaller the corporation the more likely it will be that concurrent civil liability will apply.

Purpose of this Paper

[4] The Committee's aim in preparing this paper is to raise for public discussion the issues relating to limitation of the civil liability of registered company auditors.

[5] The principal matter addressed is whether the companies and securities legislation should be changed, and if so in what manner, to modify the civil liability of registered company auditors when carrying out functions required or pursuant to that legislation.

[6] It is beyond the Committee's terms of reference to consider this issue in the context of other legislation which also imposes auditing obligations, such as State based Co-operation Acts. However the general issues and principles discussed in this paper may be equally applicable to these other Acts.

[7] The paper is in no sense a draft report. At this preliminary stage the paper adverts to suggestions for possible changes in the law but only for the limited purpose of stimulating thought on specific issues.

Invitation for Responses

[8] The Committee invites interested persons to provide their written responses on the issues raised in this paper.

[9] The Committee will assume that it is free to publish any response, either in whole or in part, unless the respondent indicates that the response is confidential. In any event, all respondents will be listed in the Committee's Report to the Ministerial Council.

[10] Replies should be sent to:

Mr. J. Kluver,
Research Director,
Companies and Securities Law Review Committee,
Level 24,
MLC Centre,
19-29 Martin Place,
SYDNEY. N.S.W. 2000

by Friday 24th January, 1986.

COMMITTEE DISCUSSION

Structure of the Paper

[11] The Companies and Securities Legislation provides for certain functions to be performed by registered company auditors. These activities may be divided into two categories:

(1) company audits;

(2) investigating accountants' reports.

The Committee considers that there are significant differences as well as commonalties between these two functions and therefore proposes to discuss them separately. Accordingly the Paper is divided into two parts: Part I - Audits; Part II - Investigating Accountants' Reports.

PART I - AUDITS

Statutory Provisions Imposing an Audit Requirement

[12] The Companies Code Part VI Division 3 requires that certain financial statements be audited by a registered company auditor before these statements are disseminated. This applies, in general, to the balance sheet and profit and loss account of a public company and of a proprietary company which is not an exempt proprietary company. The audit is required in the interests of existing and potential investors.

[13] The Companies Code s269 imposes a duty on directors to lay before the annual general meeting certain financial

statements. These are:

(1) a balance sheet as at the end of the company's financial year;

(2) a profit and loss account for the financial year of the company;

(3) under amendments currently proposed, for certain companies, a cash statement.

[14] The Companies Regulations Schedule 7 contains detailed requirements as to the form and content of the balance sheet and the profit and loss account. These, however, are part of a more broadly stated requirement that the balance sheet shall give a true and fair view of the state of affairs of the company as at the end of the financial year, that the profit and loss account shall give a true and fair view of the profit or loss of the company for the financial year, and (under amendments currently proposed) that the cash statement (where required) shall give a true and fair view of the cash movements of the company during the financial year. Under s285 of the Companies Code, the auditor is required to report to the members on the accounts required to be laid before the company at the annual general meeting and on the company's accounting records and other records relating to those accounts. Similar obligations apply to group accounts.

[15] An exempt proprietary company has a choice either to file financial data on a public register or have the accounts audited. This optional audit is regarded as an assurance that, where the company does not publicly disclose its financial affairs, it is keeping proper financial records against the day when it may fail and a retrospective examination of its affairs needs to be made in the interests of creditors and the public. Details of any qualifications to the accounts contained in the auditor's report must be disclosed in the annual return lodged at the Commission.

[16] Under the Companies Code s158, incorporating s269, the balance sheet and profit and loss account of a borrowing corporation (in general, one which has solicited loan money from the public) are required to be audited in the interests of the lending public.

[17] The Companies Code s168 requires a deed governing prescribed interests offered to the public to contain a covenant binding the trustee or a representative that he or it shall keep proper books of account and cause those accounts to be audited by a registered company auditor.

[18] Under the Companies Code s330, the NCSC may cause a receiver's accounts to be audited by a registered company auditor.

[19] If a scheme of arrangement under Part VIII of the Companies Code comes into operation, the requirements of Part VI Division 3 will continue to apply. In addition, under s315(11), incorporating Section 330, the NCSC may require a scheme administrator's accounts to be audited.

[20] In the case of a company placed under official management, s342 of the Companies Code provides that an official manager's statement of assets and liabilities is required to be accompanied by an auditor's statement, where the company is otherwise required to appoint an auditor. Even if an auditor's statement is not so required, the NCSC may cause the official manager's statement to be audited: s342(7). During the course of an official management, a company which is required by Part VI Division 3 to have its accounts audited remains subject to that requirement and the relevant obligations imposed on directors are imposed on the official manager.

[21] Under s422 of the Companies Code, the NCSC may cause a liquidator's accounts to be audited.

[22] The Securities Industry Code s75 requires a licensed dealer to appoint an auditor. Section 104 of that Code requires a securities exchange to appoint a registered company auditor to audit the accounts of the fidelity fund established under Part IX.

Appointment of the Auditor

[23] A company (other than an exempt proprietary company under s279) is required within one month after incorporation to appoint an auditor: s280. The auditor may be appointed by the directors and, if so appointed, holds office until the first annual general meeting: s280(2). The annual general meeting then makes the appointment after proper notice of nomination: s281. The auditor appointed by the annual general meeting holds office until:

(1) death;

(2) removal under s282 by ordinary resolution of a general meeting, after special notice;

(3) resignation in accordance with s282;

(4) ceasing to be capable of acting by reason of loss of a qualification required under s277;

(5) a special resolution is passed for the voluntary winding-up of a company;

(6) or the Court makes an order for the winding-up of the company: s280(4); s283.

[24] A casual vacancy may, according to the circumstances, be filled by the Directors: s280(5), by a general meeting: s280(10) or the NCSC: s280(11)(12). A casual appointee holds office only until the next Annual General Meeting: s280(13).

[25] A company is not free to choose any person as auditor. The public interest requires that the auditor be properly qualified in terms of expertise and independence from the company. An appointment may be made only from persons who are registered company auditors, that is to say, persons holding prescribed qualifications who have been registered by the NCSC and who satisfy certain tests of independence from the company. These are set out in s277.

[26] An auditor's appointment is a matter between the auditor and the company, acting in the first instance by its board of directors and subsequently by the members in general meeting. As such, the appointment may be regarded as a private contract between the auditor and the company. The parties to the contract are free to stipulate the rights and duties of each of them under the audit contract subject, however, to the auditor having certain irreducible statutory rights, powers and duties prescribed by the companies legislation e.g. s285; see also s237.

Nature of an Audit

[27] The role of an independent audit is to provide members, creditors and the public with reasonable assurance that the representations of management reflected in the company's financial statements and related disclosures are properly drawn up so as to constitute a true and fair view of the matters required by statute to be dealt with in the accounts and that they comply with the requirements of the Companies Code and applicable approved accounting standards.

[28] The auditing of any sizeable business involves consideration of the legality and proper recording of a multitude of commercial transactions. This review, if carried out in respect of every transaction, would be so

costly and time-consuming as to prevent the audit being cost effective. Accordingly, it has been accepted in the auditing profession that there should be selective testing of transactions. The practice is to study and evaluate a company's system of internal control to decide on the nature, timing and extent of tests to be performed. That done, it is a matter of performing the tests decided upon on a selective basis. Legal liability can arise at either of these two stages.

[29] In developing a system of sampling, the auditor's legal obligation is to act with reasonable care and skill. The law does not make the auditor a guarantor that the system will always be effective to detect fraud, illegality or defective recording. If, for example, a fraud goes undetected for a time, it may later appear that the system of sampling was defective. However, if the system, when adopted, was one which an auditor exercising reasonable care and skill would have adopted, the subsequent failure would not result in liability, simply on the basis of that faulty system.

[30] The sampling technique involves a further obligation to take reasonable care to review this system of sampling from time to time. The frequency of review required could be influenced by various factors including changes in the nature of the company's business, new developments in financing, alterations or innovations in recording systems, or the emergence of new forms of fraud.

[31] At this review stage, the legal standard is again that of a reasonably careful auditor. The application of Judgment is required as many important items in financial records cannot be measured precisely but have to be estimated, e.g., the amount of stock which should be classified as obsolete or the useful life of an object of plant. Different auditors

might arrive at different decisions but if they are arrived at honestly and after reasonable consideration, in light of what was reasonably ascertainable at the time, there would be no breach of duty.

[32] Complete accuracy is also rendered impossible as financial statements may be issued at times when certain of the underlying transactions are still not complete and important events that may have an effect on them have not yet or may never take place.

Statutory Duties Arising from the Audit

[33] The auditor's statutory duties in preparing the audit are:

(1) to report to the members on the accounts;

(2) if the company is a borrowing corporation:

(a) to supply the trustee for debenture holders with reports, certificates and other documents which the auditor has to supply to the company;

(b) to report to the trustee on any matter, likely in the auditor's opinion to prejudice the interests of debenture holders;

(3) to report to the NCSC:

(a) any breach or non-observance of the Code coming to his knowledge where it will not be adequately dealt with by comment in his report or by notification to the directors.

[34] The report to the members must show:

(1) whether in the auditor's opinion the accounts are properly drawn up so as to give a true and fair view of the matters required by the legislation to be shown by the accounts;

(2) whether they have been drawn up in accordance with the Code;

(3) whether they have been drawn up in accordance with applicable approved accounting standards;

(4) whether in the auditor's opinion, the company's accounting records and other records and registers required to be kept by it have been properly kept in accordance with the Code: s285.

Standard of Care of Auditors

[35] AS indicated, the Companies Code s285 sets out some of the duties of an auditor, a number of which involve no discretion, while others, such as the duty to report whether the company' s accounts are, in the auditor's opinion, properly drawn up so as to give a true and fair view on the matters required by the legislation to be dealt with in the accounts, call for the exercise of Judgment. There is an implied requirement that any judgment be arrived at only after the exercise of care.

[36] The Companies Code does not expressly state the standard of care required in particular circumstances. The absence from the legislation of any detailed prescription of care is probably inevitable given the wide range of circumstances that can arise. Instead the broad common law standard of the reasonably careful auditor is impliedly referred to.

Civil Liability of the Auditor

[37] An auditor is under a contractual duty to exercise reasonable care and skill in conducting the audit and reporting. This obligation arises either expressly or by necessary implication in the contract between the auditor and the company. The failure to use reasonable care could relate to a matter falling within the irreducible statutory duties of the auditor, or be referable to some other contractual duty, if the contract extends beyond these statutory duties. A breach of that contractual duty which causes loss to the company may lead to a claim for damages at the suit of the company. The company may sue pursuant to a resolution of the board of directors, at the behest of a liquidator or receiver, or in some limited cases, where a member brings a derivative action on behalf of the company.

[38] The fiduciary duties set out in s229 of the Companies Code do not apply to an auditor. However an auditor is an officer of the client company for some purposes: R v Shacter [1960] I All ER 61; Companies Code s289(1). The auditor may thus be liable as an officer in some circumstances e.g. s564, and civil action could be taken under s574 for breach of that duty. An auditor may also be amenable to civil proceedings under s542. Where the auditor is liable under a statutory obligation incorporation would not assist, since if the primary default were that of a corporation, its agents may be equally liable as alders and abettors pursuant to the Companies and Securities (Interpretation and Miscellaneous Provisions) Act s38 and accordingly amenable to s574 civil proceedings.

[39] An auditor who fails to use reasonable care and skill in the performance of auditing duties may be liable in tort to pay damages to a person who suffered economic loss as a result. That liability may extend beyond the company to its members and various other persons. The limiting factor in respect of tortious liability is that the plaintiff, in order to succeed, must persuade the Court that the auditor owed to

the plaintiff a duty to take reasonable care and to exercise reasonable skill. The principle which determines whether a duty of care is owed to a particular plaintiff is whether the auditor ought reasonably to foresee that a person in the plaintiff' s position is likely to rely on the auditor's report. For instance, in Scott Group Limited v McFarlane [1978] 1 NZLR 553, the New Zealand Court of Appeal, by majority, ruled that the company auditor owed a duty to a potential bidder for that company, where the accounts were prepared in the context of a likely takeover bid, and where it was virtually certain that the bidder would rely on these accounts; see also JEB Fasteners Limited v Marks Bloom & Co. [1981] 3 All ER 289; [1983] 1 All ER 583.

[40] There are differences between contractual and tortious liability. First, the period in which proceedings must be commenced after the right of action accrues may differ under the law of the State or Territory in which the action is brought. Secondly, the measure of damages for loss caused by the breach will differ. Damages in tort are restitutionary so as to place the plaintiff in the same monetary position as before the commission of the tort; whereas damages in contract seek to place the plaintiff in the same monetary position had the contract been performed without breach. Thus damages in contract can extend to compensation for failure to realise an anticipated profit.

[41] A failure by an auditor to exercise reasonable care and skill could give the company both a right of action for breach of contract and an alternative right of action in tort: Employers Corporate Investments Pty. Ltd. v Cameron (1977) 3 ACLR 120. The conjunction of a claim in contract with a claim in tort would also be significant if auditors were permitted to incorporate. In that situation, the contract would be with the auditing company. A failure to exercise reasonable care and skill could give rise to a claim in contract against the auditing company, and, concurrently,

a claim in tort against any director of that company who was so identified with the failure as to be concurrently liable with the auditing company: C. Evans and Company Limited v Spritebrand Limited [1985] 1 WLR 117.

[42] By virtue of s237 of the Companies Code, a company a td an auditor are prohibited from entering into an agreement by which the auditor's liability for any negligence, default, breach of duty or breach of trust with the company is limited. This section invalidates any such term so far as it would exempt the auditor from any liability to the company in these circumstances. Clearly s237 prevents the contract giving the auditor any exemption in respect of the statutory duties. On one view, the section also prevents an exemption in respect of auditing duties provided for in the contract which go beyond the statutory duties.

[43] There is authority at common law for the proposition that a person will not be liable in tort for a negligent mis-statement where that person, at the time of the statement, disclaimed liability in relation to it. A disclaimer brought to the knowledge of other persons before they act in reliance on the statement would normally negate the existence of a duty of care to those persons and deny them a remedy in tort. However, the extent to which a disclaimer could be effective in relation to a tort action arising from the auditor's performance of his statutory duties is not clear. It is arguable that a person under a statutory duty must do what the Act requires; he cannot disaffirm that duty in whole or part by use of a disclaimer, nor can he reserve the liberty to discharge the duty in a negligent manner, as this may not be a discharge at all. On this reasoning, no form of disclosure can be effective to obviate tort liability where the duty of care is imposed by statute. In any event a disclaimer would not protect against contractual liability in respect of the statutory duties.

Insurance

[44] There is no legal barrier to an auditor taking out professional indemnity insurance against liability to pay damages for breach of duty either in contract or tort. Even where the breach of duty is in relation to a company whose accounts have been audited, s237 of the Companies Code does not prevent indemnity by way of a contract of insurance, provided that the premiums are not paid by the company subject to the audit or a related company: s237(3).

[45] The level of premiums payable for professional indemnity insurance rises according to the frequency of claims against auditors and the level of awarded damages. The Committee understands that the current insurance arrangements for larger firms of auditors are likely to involve insuring for claims (without limit as to number) up to a total cover with one reinstatement of that cover per year. Smaller firms are apparently able to procure insurance on an "each and every claim" basis. It appears that the insurance industry is becoming increasingly reluctant to provide extensive cover to the auditing profession. Larger firms are reputed to have had their cover reduced by underwriters for the year 1985/86 by up to one-third and all firms have had significant increases in premiums.

[46] A recent case demonstrates the difficulty of adequately insuring against liability. In Cambridge Credit Corporation v Hutcheson (1985) 9 ACLR 545; 3 ACLC 263, a highly geared property development company claimed in its 1971 accounts to have shareholders' funds of $12.3M. Auditors were held by the Court to have been negligent in not requiring appropriate provisions for bad debts. If the auditors had acted according to the standard applied by the Court, the shareholders' funds would have been only $3.1M. In these circumstances, the company would have exceeded the borrowing limitation in its debenture trust deed by $40M and so have been in default under the debenture trust deed. The

natural consequence would have been the immediate appointment of a receiver to enforce repayment of the debentures. If that had happened, the debenture holders would have been paid in full. However, a receiver was not appointed until 1974, by which time the demand for land had slackened. The receiver realised the company' s assets in depressed conditions and consequently there was a deficiency of assets against liabilities of $175M. Debenture holders were able to recover only a small part of their investment.

[47] A civil action was commenced against the auditors. It was argued in their defence that any breach of duty by them in 1971 did not cause the losses in 1974. That argument was rejected by the Court on the basis that the auditors' omission to detect the company's weak position in 1971 was causally linked to its later failure once the land boom ended; if the company's true position had been known, its high level of vulnerability to a possible collapse in the land boom would have been appreciated. A judgment of $145M was given against the auditors. The trial Judge, Rogers J. in an extra-curial comment in Forbes Business Magazine said that the judgment, if sustained on appeal, demonstrates that the financial consequences of an auditor's negligence may not emerge for some years, and that when they do, they may far exceed any amount contemplated at the time of the negligent act.

The Introduction of Limited Liability

[48] Recent developments under which auditors may become subject to personal liability, for which insurance is either unobtainable, or available only by payment of burdensome premiums, prompts the question whether, in relation to their professional duties, auditors should have the benefit of some limitation of their liability to pay damages. The traditional rationale for unlimited personal liability is that auditors, like other professionals, should accept personal responsibility for their work and be required to

recompense those who in proper reliance thereon suffer loss. It may be contrary to this principle of professional responsibility if auditors could shelter behind limited liability. However it is questionable whether unlimited liability necessarily creates better protection for clients and creditors; this policy is sound only if the available assets of the auditor suffice to meet all or a substantial proportion of valid claims and damages awarded. In this context, one objective may be to determine a rational extent of liability that reflects adequately the right of innocent parties to obtain compensation for economic loss on the one hand, while recognising the finite nature of accounting responsibility and capacity to pay on the other.

[49] Limiting the liability of auditors is not novel. In West Germany, the auditor's liability in the case of a statutory audit is set out in Article 168 of the German Stock Corporation Act. The liability is limited to 500,000 Deutsche Marks per audit.

Article 168 provides that:

(1) the annual auditors, their assistants, and the legal representatives of any auditing firm participating in the audit shall make their audit conscientiously and impartially, and shall maintain secrecy. They may not make unauthorised use of any trade or business secrets they have learned in connection with their activities. Whoever, intentionally or negligently violates his duties shall be liable to the company, as well as to any affiliated group of companies or controlling or controlled enterprise which has been injured, for any damage arising from any such violation. If more than one person was involved, they shall be liable jointly and severally.

(2) the liability of persons who acted negligently shall be limited to 500,000 German marks per audit. The same shall apply if more than one person participated in the audit or if several acts giving rise to liability were committed, and irrespective of whether other parties involved acted intentionally.

(3) where an auditing firm acts as annual auditor, the obligation of secrecy shall extend also to the supervisory board and the members of the supervisory board of such firms.

(4) the liability for damages specified in these provisions can be neither waived nor limited by contract.

(5) claims arising from these provisions shall be barred after the expiration of five years.

Issues Arising from Limitation of Liability

[50] In order to gauge public views on the matter of auditor's civil liability and the possible introduction of limitations to it, the Committee now sets out a number of issues. The Committee does not at present hold a firm view on any of these issues. They are posited simply as a convenient way of focussing thought and discussion.

Issue 11; Indemnification of the Auditor

[51] It is necessary to consider whether it is desirable to maintain the existing provision in s237 which prevents an auditor obtaining, by contractual arrangement with the client company, a limitation of civil liability in relation to that company.

[52] One argument in favour of exempting auditors from the operation of s237 is that this would allow companies and

auditors greater flexibility in determining the terms upon which auditing activities were undertaken. On the other hand, audits may be seen as primarily for the benefit of investors who often have no direct control over the making of company contracts. In these circumstances, it may be undesirable to allow for the possibility of improvident contracts being negotiated by directors. A possible middle course may be to allow auditors and their client companies to modify their legal relationships where this is approved by the members, with dissident shareholders and creditors having rights of appeal: cf s129(10)-(12) procedure.

Issue 2: Liability of Auditors - Primary or Secondary

[53] The original cause of loss to investors through inadequate or misleading financial statements will, in most instances, be some act or omission on the part of directors or persons for whom they are responsible. Auditors carry, generally, only a secondary liability. It may be conducive to the development of a higher level of commercial responsibility amongst entrepreneurs if members or creditors were encouraged to pursue their claims against the persons primarily responsible, in preference to auditors. This policy might be carried into effect in various ways.

[54] The first option would be to require that a plaintiff exhaust all remedies available against the directors or other relevant parties carrying primary liability, before having recourse against the auditor. Under existing law, this may not be practicable, particularly with respect to insolvent companies, since in many cases it is likely that directors or other relevant persons will be prosecuted over the same matter, and this may effectively bar preceding common law civil action against those persons on the same set of facts. Because of the complexity of the legal process in criminal prosecutions, there will usually be a long delay before those proceedings are concluded. Civil proceedings under the Companies Code are not subject to this inhibition: s543.

[55] A second option would be to enable the amount of the loss for which an auditor is liable to be ascertained in a manner different from that by which any loss attributable to directors or other relevant persons is determined. This differential may be justified on the basis that the auditor is not the party whose initiative began or maintained the activity which caused the loss. The auditor should not be seen as the guarantor of the proper conduct of the company.

[56] The second option raises the question whether the law should be changed to give the Court, when assessing damages against an auditor, a discretion to fix damages at any point between:

(1) the amount of the loss caused at the date of the breach; and

(2) the amount of the loss apparent at the date that the breach is discovered, where the latter exceeds the former.

[57] The Court might be directed that in exercising its discretion it should do what is just and equitable in all the circumstances, including taking into account such factors as any change in general economic conditions between those two dates and the manner in which the company was conducted between those two dates. This discretion might be applicable in all instances or alternatively be called into play only where the auditor's liability exceeds a prescribed limit assessed by reference to some suitable criterion, such as the auditor's gross auditing fees for that year. Admittedly arguments on the way in which the discretion should be exercised could lengthen civil litigation, but it is debatable whether the time occupied on this matter would be any greater than that about causation under existing law.

[58] A third approach, which is a variation of the second, would be to give the Court a discretion to apportion

liability between the directors or other relevant parties and the auditor, having regard to the differing degrees of blame-worthiness. For example, where the persons carrying primary liability were fraudulent, a higher proportion of the loss would be attributed to them, and the defaulting auditor would be liable only for the residue of the loss.

[59] A fourth approach would be to legislate to the effect that an audit report has only a limited period of effectiveness and losses arising subsequently cannot be attributed to the audit. That would be a more arbitrary solution.

[60] A fifth way in which the secondary nature of the auditor's liability might be recognised is to impose an upper limit on the liability of an auditor, while leaving the liability of other parties unlimited. The rationale for this option is further discussed at [61] - [63], while the various methods of limiting liability are outlined at [64] - [72].

Issue 3: Statutory Limited Liability

[61] In performing the various statutory duties under the companies and securities legislation, the auditor is acting as part of the regulatory machinery provided by government for the protection of investors. The clearest manifestation of the auditor's role in this regulatory system is found in s285(10) under which an auditor has duties to report certain irregularities to the NCSC.

[62] In performing statutory duties, Commission officers are protected against actions for damages provided they act in good faith: National Companies and Securities Commission Act 1979 (Commonwealth) s41(4). It may be consistent with this approach to place a limit on the civil liability of auditors in respect of those activities which form part of the regulatory system. It is also relevant that an auditor, unlike other professional persons, is prevented by virtue of

s237 of the Companies Code from negotiating a contractual limitation of liability with the company regarding these statutory duties.

[63] Under this approach the limitation would apply in respect of the various audits required to be provided by auditors by or under the provisions of the companies and securities legislation, or by or under the order of a Court made in exercise of the power conferred by that legislation.

Issue 4: Method of Fixing a Liability Limitation

[64] There are a number of ways in which the liability of auditors in respect of their statutory duties may be limited, if it were decided to adopt this course: for various alternatives see [53] - [60]. The grounds of civil liability and available heads of damages would remain unaltered, but the maximum compensation available to successful plaintiffs could be restricted in various ways, depending upon which of the following limiting formula is adopted.

[65] A first option is to follow the West German model and prescribe a certain maximum monetary level of compensation per audit. This has the benefit of simplicity and, if the maximum is set high enough, may provide adequate compensation in the majority of cases.

[66] A possible drawback with this approach is that it requires an arbitrary determination of the maximum liability which should apply to auditors generally, regardless of their practice size or the complexity of their client companies. Such a figure, if fixed too low, may deprive plaintiffs of their right to reasonable compensation, though this problem might be partly offset by allowing auditors and client companies to increase that figure by private negotiation. Alternatively, if the maximum liability figure was fixed too high, its protective purpose may not be achieved in that all, or a disproportionate part, of the personal assets of some auditors may remain vulnerable, even given liability insurance.

[67] A second option is to determine maximum liability as a percentage of the assessed financial loss arising from a faulty audit. This contrasts with the fixed figure approach under the German legislation. Various proportioning methods are available, involving either a fixed or sliding scale, and applicable either to all loss assessments or where the quantum exceeds a stipulated amount.

[68] A third option is to determine the maximum liability as some multiple of the fee charged for the audit or other task, the subject of litigation. The purpose of this approach would be to maintain a connection between the extent of liability and the worth of the task performed as reflected in the fee paid for it. At present, there is no necessary relationship between the extent of liability and the time expenditure or fees charged. A possible consequence of introducing a direct equation between liability limit and fee for task is that it may invite lower fees with commensurately less time spent on the audit in order to ensure lower potential liability. Conceivably this may create an incentive for corner cutting in professional work.

[69] A fourth option is to determine maximum liability as a percentage of gross professional fees over a set period. Under this option, the maximum liability of an individual or firm of auditors would be limited to some factor of the gross amount of auditing fees earned by that individual or firm either in the current year or the immediate preceding year. This liability limitation formula would be related to professional fee income in a particular period, rather than seeking to create a direct equation between maximum liability and fee for each task.

[70] Under this fourth option it is necessary to consider whether the maximum liability formula should apply to each audit the subject of separate litigation or be employed to determine a maximum gross liability of the individual or firm for a particular year. In the latter case, provision would need to be made for pro rata satisfaction of successful claims arising from all litigation involving auditing activities of the˜ individual or firm in that particular year. The benefit of the latter approach is that the maximum liability of an individual or auditing firm for each year could be accurately determined and suitably insured against by reference to the gross annual auditing fees. The main shortcoming of this approach is that the maximum compensation available to litigants may be dependent upon the outcome of other unrelated auditing litigation against the individual or firm. This would appear to be both inequitable and possibly unworkable in practice. Accordingly it may that the maximum liability formula should apply to each event independently, and not take into account claims arising, from other unrelated auditing events within that year. This raises further issues discussed at [72].

[71] This fourth option also raises a number of practical considerations. The first is whether the auditor should be required to disclose to the directors or the general meeting of the company to be audited the current liability limitation. A second and more fundamental question is whether use of this limitation formula could act to the detriment of clients of smaller auditing firms, whose gross auditing fee income and therefore liability maximum, would be proportionately lower. The problem of a low liability maximum might be overcome by creating a two-tier liability system comprising a fixed liability maximum and a flexible liability maximum linked to gross professional fees. The maximum potential liability of an auditor would be the greater of these two amounts.

[72] An issue common to the second, third and fourth options: [67] - [69], is whether the maximum liability formula should apply to each litigant, each separate civil action, or (as in the West German Act) each event the subject of possible litigation. The first alternative would involve the greatest potential liability for auditors while the third alternative (the West German model) the least potential liability. However it may be that the principle of limited liability could be seriously eroded by adoption of the first or second alternative, particularly if there were multiple litigants or multiple independent actions involving the same event. The third option would involve the court in settling the ambit of each "event" which attracted liability and the class of potential as well as actual litigants to that event.

Issue 5: Ambit of the Limited Liability Protection

[73] It is arguable that any limitation of liability provision concerning the performance of an auditor's statutory duties, if adopted, should apply in respect of all civil causes of action arising out of an act or omission of the auditor, or a person for whom the auditor is vicariously liable in carrying out the audit, whether the cause of action is in contract, tort (excluding an action for defamation with malice: see Companies Code s30) or otherwise.

[74] It is necessary to consider the operation of the liability provision where it is established that the auditor was aware of, or party to, a material mis-statement or fraud. On one view, knowledge of or involvement in a breach of common law or statutory duty should be an exception to the principle of limited civil liability. However to exclude the limitation of liability protection in such instances may act to the detriment of innocent partners of the auditing firm.

[78] It may also be provided that the compulsory indemnity insurance level for each firm of auditors be determined by the same formula as establishes the liability limitation, though this would not necessarily suffice to meet all litigated compensation awards: see [70]; [72].

[79] An argument against compulsory indemnity insurance is that audit default is but one of the risks faced by investors, many others of which are practically uninsurable. This raises the questions whether a distinction can be drawn between the risk that an auditor will not exercise proper care and skill and other investment risks and if so whether it is possible for Courts to unerringly distinguish between losses flowing from ordinary investment risks and losses flowing from an auditor's failure?

Issue 8: Residual Personal Liability

[80] One underlying rationale for personal liability that is advanced, is that it constitutes a spur to the professional to perform carefully and responsibly. This "spur" theory may constitute a Justification for a substantial excess in compulsory indemnity insurance policies. Accordingly, it is necessary to consider whether any insurance arrangements involving an auditor should be required to provide for the auditor to meet part of any liability from the auditor's own resources, to a proportion of the compulsory insurance cover. It is also necessary to consider whether, if this policy is adopted, auditors should be entitled to take out separate insurance to cover this excess.

Issue 9: Prescribed Liquidity Level

[81] The question arises whether it should be a condition of a registered company auditor obtaining or retaining registration that the NCSC be satisfied that the auditor has and maintains a net worth of a prescribed minimum. This may help ensure that the auditor can honour any excess required to be paid by him in the event of litigation.

PART II.
INVESTIGATING ACCOUNTANTS REPORTS

Statutory Provisions Requiring a Report

[82] A company seeking to raise funds from the public by the issue of securities must register and issue a prospectus pursuant to Part IV Division 1 of the Companies Code. The prospectus must contain a report by a registered company auditor, to be headed an "Investigating Accountant's Report", setting out information prescribed by the Companies Regulations Part IV Division 1 and Schedule 4, and any other matters as required by the Commission e.g. NCSC Release 334; Companies code s98(1) (e).

[83] The task of the investigating accountant is to assist potential investors by providing them with a true and fair view of the profits and losses, assets and liabilities of the prospectus company and related companies.

[84] In the context of takeover bids, an investigating accountant's report must accompany a Part A Statement where the consideration specified in the offer is or includes shares or marketable securities of the offeror corporation: CASA s16(2A) (a); Reg. 5A. The purpose of this report is to assist the offeree company and its shareholders in considering the merits of the bid by providing them with a true and fair view of the financial position of the offeror.

Request for Responses

[92] The Committee seeks comments by interested persons on all or any of the issues presented in this paper, and furthermore invites submissions on any other matters impinging on the liability of company auditors and possible avenues of reform. For further details see [8] - [10].