COMPANIES AND SECURITIES LAW REVIEW COMMITTEE

DISCUSSION PAPER NO. 3

CIVIL LIABILITY OF COMPANY AUDITORS

NOVEMBER 1985

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. Kiuver.

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 commonalities 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 sl68 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; or
(6) 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(l0) or the NCSC: s280(11)(l2). 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

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] 1 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 aiders 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 aught 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 317.

[42] By virtue of s237 of the Companies Code, a company and 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 misstatement 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 fins 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 focusing thought and discussion.

Issue 1: 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 percentage of the assessed financial loss arising from 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 be 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 misstatement 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. One approach may be to maintain the general limitation of liability principle but give to a Court a discretion to set aside this limitation in respect of a particular individual defendant where it is satisfied that the defendant had been aware of, or was party to, any wrongdoing, or in the case of partnership, where a partner had or should have had a reasonable suspicion of improper behaviour by the defaulting partner.

Issue 6: Liability of Employees

[75] If the liability of auditors were to be limited, it is arguable that this protection should extend to any person employed by the auditor to participate in the audit. It would be

inequitable if an employee were subject to the full rigours of a tort claim, while his employer was protected in whole or part.

Issue 7 Compulsory Indemnity Insurance

[76] The Institute of Chartered Accountants argues that at present, where individuals may freely divest themselves of their assets to members of their families or family trusts, it is somewhat of a misconception to believe that unlimited liability creates better protection to clients and creditors.

[77] To overcome this problem, and to act as a balance to any move to introduce limited liability, it may be appropriate to require auditors to have indemnity insurance providing cover up to a prescribed amount. Precedent is found in West Germany and some Canadian provinces which require accountants to carry professional liability insurance. Compulsory insurance would provide some guaranteed return to all plaintiffs, in the event of liability being made out, in contrast to the present system where the capacity of auditors to meet a valid compensation claim varies depending upon the amount, if any, of indemnity insurance held by the auditors and their personal assets.

[78] It may also be provided that the compulsory indemnity insurance level for each firn 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 sl6(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.

Civil Liability of the Investigating Accountant

[85] The investigating accountant is subject to duties and obligations to the client company similar to those applicable to auditors. In addition, the investigating accountant may be liable, pursuant to slO7 of the Companies Code or s44 of CASA, to pay compensation to persons who suffer loss or damage resulting from their reliance on a false, misleading or incomplete report. The elements to be satisfied in establishing civil liability, and the defences available to the investigating accountant are set out in the legislation.

Limited Liability of the Investigating Accountant

[86] It is appropriate to consider separately the liability of an investigating accountant vis a vis the client company and other plaintiffs.

Issue 10: Liability to the Client Company

[87] At common law, an investigating accountant may be subject to unlimited personal liability in contract and/or tort in the event of the client company suffering loss or damage from default in the investigating accountant's report. There are a number of ways in which limitations may be placed on this liability, if it were proposed to adopt this course

[88] One approach would be to impose a statutory maximum liability of an investigating accountant to a client company for each published report Adoption of this principle would require consideration of the various options discussed under Issue 4 [64] — [72]

[89] An alternative method of limiting liability would be to allow the accountant and the client company to determine a limitation of liability by mutual agreement. This might be achieved without modification of s237 as it appears that this section applies to auditors qua auditing and not auditors acting as investigating accountants. It is arguable that the investigating accountant's report differs from an audit in that the report is not designed primarily to assist the existing members of the company. Accordingly the reservations expressed in [52] concerning modification of liability in the context of audits may not have the same application to investigating accountant's reports. Adoption of this option may require statutory clarification to overcome doubts whether the parties could, by private arrangement, limit the civil liability of the investigating accountant for breach of statutory duties: see [43].

Issue 11: Liability to Other Plaintiffs

[90] In considering whether limitations should be placed on the liability of the investigating accountant to persons other than the client company, it is appropriate to focus on the differences between the role of the investigating accountant and the auditor. The auditor's role is that of stewardship over the past performance of the company, including the detection of irregularities in corporate financial behaviour. By contrast, the task of the investigating accountant is to provide accurate financial information to potential investors, the offeree company and its shareholders, and to that extent protect their future interests. The investigating accountant's report therefore fulfils an important public disclosure and information function.

[91] The question therefore arises whether, given the public interest in ensuring the accuracy of the prospectus and the Part A Statement, this policy may be compromised or eroded to the extent that limitations are placed on the liability of the investigating accountant to plaintiffs other than the client company. It is also necessary to consider whether in the context of s107 of the Companies Code and s44 of CASA, there is any acceptable rationale for placing limits on the liability of the investigating

accountant, given the unlimited liability of other "experts" who may be in breach under these provisions.

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].