

SLEEPERS AWAKE! FUTURE DIRECTIONS FOR AUDITING IN AUSTRALIA

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I INTRODUCTION

In the last two years, Australia has experienced the collapse of several high profile companies including Paminco, Ansett Australia, One.Tel, Impulse Airlines, Harris Scarfe Holdings and HIH Insurance. Meanwhile, in the United States, investors are coming to terms with the failure of two of its largest companies, Enron and WorldCom. The world is watching closely, particularly the US failures, and asking, why have they occurred? Where were the auditors?

The immediate reaction of regulators worldwide has been to point the finger at the auditors. They have done this by seeking to tighten the laws, rules and standards governing auditor independence, and to strengthen the role of the auditor oversight mechanisms — be they regulatory or internal to the company. In the US, for example, the legislature has prohibited the provision of most non-audit services by an auditor to its audit client, mandated audit partner rotation, created a new regulatory oversight body, and prescribed the composition of the audit committee.¹ In the United Kingdom, the Secretary of State for Trade and Industry, Patricia Hewitt, has responded by establishing the Co-ordinating Group on Audit and Accounting Issues. The Interim Report of the Group has recommended tougher rules on auditor independence and partner rotation, and a review of auditor oversight bodies.²

Following this international trend, the Australian government's response has focused on auditor independence and regulation. In August 2001, the then Minister for Financial Services, Joe Hockey, commissioned leading corporations law academic, Professor Ian Ramsay (University of Melbourne) to review auditor independence regulation. Professor Ramsay's final report was released in October 2001 ('Ramsay report'). In June 2002, the Treasurer, Peter Costello, announced that the Department of the Treasury would review audit regulation as

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1 *Sarbanes-Oxley Act of 2002*, Pub L No 107-204, 116 Stat 745 (2002).

2 Co-ordinating Group on Audit and Accounting Issues, *Interim Report to the Secretary of State for Trade and Industry and the Chancellor of the Exchequer* (2002), <http://www.dti.gov.uk/cld/cga_final.pdf> at 1 October 2002.

the next phase in the Corporate Law Economic Reform Program ('CLERP'). The CLERP 9 issues paper was released on 18 September 2002,³ with more than half of the paper aimed at audit reform.

The focus on auditors is, in many respects, unsurprising. It is a response to debate that has raged in the media since it was discovered that the now defunct accounting firm, Andersen, had signed off on financial reports which overstated Enron's earnings by US\$586 million over five years, and had shredded a large volume of documents about the Enron collapse. The focus on Andersen has spilled over to the other accounting firms. A recent Australian Securities and Investments Commission ('ASIC') survey of 100 of Australia's largest companies, for example, revealed that most companies retained their audit firms to provide non-audit services. On average, non-audit fees accounted for nearly 50 per cent of the total fees paid to the audit firm.⁴

The perception of widespread auditor dependence on audit clients is a matter worthy of CLERP 9 attention. The audit function is an important mechanism for improving the reliability of the financial statements made in a company's annual and half-year reports, and perceived audit failures detract from the credibility of this function. However, reform of the auditing profession alone is unlikely to solve the problem of corporate misconduct, nor is it likely to prevent corporate collapse. While society's expectations of auditors are high, the legal position is that auditors have a very specific and, to some extent, limited role. Auditors are not the gatekeepers of corporate crime, nor are they responsible for the success or failure of the company's business operations and management.

This article explores the legal responsibilities and liabilities of auditors, and addresses some of the problems associated with the CLERP 9 audit reform proposals. Part II examines the legal obligations auditors must comply with at present, while Part III outlines the relevant proposals for reform presented in CLERP 9. Shortcomings in these measures are presented in Part IV. Part V focuses on reform issues related to audit committees.

II AUDITING TODAY

Absent from the current debate about audit reform is any thorough analysis of the legal framework governing auditors. The CLERP 9 proposals arise from a general perception that auditors have failed in their public duties. However, this perception is not tested by careful analysis of the legal obligations of auditors.

The purpose of this section is to provide an overview of that framework and the existing legal obligations of auditors in Australia. This overview reveals the limitations of the audit function and a gap between society's expectations of auditors and the true legal position.

3 Department of the Treasury, *Corporate Disclosure: Strengthening the Financial Reporting Framework* (2002) ('CLERP 9'), <<http://www.treasury.gov.au/contentitem.asp?pageId=035&ContentID=403>> at 30 September 2002.

4 Australian Securities and Investments Commission, 'ASIC Announces Findings of Auditor Independence Survey' (Press Release 02/13, 16 January 2002), <<http://www.asic.gov.au>> at 18 July 2002.

A The Statutory Function

Auditors perform a very specific statutory function. Under the *Corporations Act 2001* (Cth) ('*Corporations Act*'), companies must appoint an auditor to audit the annual and half-year financial reports (although auditor review rather than full audit is acceptable in the case of half-year reports) and to prepare an auditor's report to the company's members.⁵

In auditing the company's financial reports, the auditor has a statutory duty under s 307 of the *Corporations Act* to form an opinion about:

- (a) whether the financial reports are in accordance with the *Corporations Act*. That is, whether they comply with accounting standards, and give a true and fair view of the financial position of the company;
- (b) whether the auditor has been given all information, explanation and assistance necessary for the conduct of the audit;
- (c) whether the company has kept financial records sufficient to enable a financial report to be prepared and audited; and
- (d) whether the company has kept other records and registers as required by the *Corporations Act*.

The auditor's report must state the auditor's opinion about these matters, and if the auditor is not of the opinion that the financial reports comply with the *Corporations Act*, the report must state the reasons for this opinion.⁶ The auditor's report must also describe any defect or irregularity in the financial reports, and any deficiency, failure or shortcoming in relation to the matters listed at (b), (c) and (d) above.

Auditors also have a statutory duty to notify ASIC, in writing, if they have reasonable grounds to suspect that a company has contravened the *Corporations Act* and they believe that the contravention has not been, or will not be, adequately dealt with by commenting on it in the auditor's report or bringing it to the attention of the directors.⁷ CLERP 9 proposes to extend this duty to require an auditor to report to ASIC any attempts by an officer or director to influence, coerce, manipulate or mislead the auditor.⁸

B The Disclosure Regime

The auditor's statutory function is an element of the periodic disclosure regime pursuant to which companies (if they are disclosing entities) must:

- (a) *keep proper financial records*: keep and maintain financial records that correctly record and explain the entity's transactions, financial position and performance and that enable true and fair financial statements to be prepared and audited;⁹

5 *Corporations Act 2001* (Cth) ss 301, 302(b).

6 *Corporations Act 2001* (Cth) s 308(1).

7 *Corporations Act 2001* (Cth) s 311(1).

8 CLERP 9, above n 3, 173-4, Proposal 33.

9 *Corporations Act 2001* (Cth) s 286(1). Note that this obligation applies to all companies, registered schemes and disclosing entities.

- (b) *prepare and audit the annual report*: prepare an annual financial report and a directors' report, and to have the annual report audited;¹⁰
- (c) *send the annual report to members*: send the annual financial report, directors' report and the auditor's report to the members, put those documents to the annual general meeting, and lodge them with ASIC and the Australian Stock Exchange ('ASX');¹¹
- (d) *prepare and audit/review the half-year report*: prepare a half-year financial report, and a half-year directors' report and to have the half-year financial report audited or reviewed by the auditor;¹² and
- (e) *lodge reports with ASIC/ASX*: lodge the annual and half-year report and the auditor's report with ASIC and the ASX.¹³

Several limitations are inherent in the periodic disclosure regime. First, the audited annual and half-year reports are historical. Once published, they are already out of date and cannot be relied on as accurately reflecting the company's performance going forward. Secondly, the auditor's report is a report on the accuracy of financial records only; it does not consider other data relevant to company performance. Thirdly, the annual and half-year reports, directors' reports and auditor's reports are often criticised as formulaic and lacking meaning because they tend to adopt a tick-the-box compliance approach.

These criticisms (and others) of periodic disclosure led to the adoption in Australia, in 1994, of a statutory continuous disclosure regime to support the existing continuous disclosure rules of the ASX. Under the ASX Listing Rules, listed disclosing entities must continuously disclose material information to the market. Listing Rule 3.1 requires the immediate disclosure to the ASX of any information that a 'reasonable person would expect to have a material effect on the price or value of the entity's securities' unless:

- 3.1.1 A reasonable person would not expect the information to be disclosed [*and*]
- 3.1.2 The information is confidential [*and*]
- 3.1.3 One or more of the following applies:
 - (a) It would be a breach of a law to disclose the information;
 - (b) The information concerned an incomplete proposal or negotiation;
 - (c) The information comprises matters of supposition or is insufficiently definite to warrant disclosure;
 - (d) The information is generated for the internal management purposes of the entity; [*or*]
 - (e) The information is a trade secret.

Other provisions in chapter 3 of the Listing Rules regulate continuous disclosure of information connected with specific corporate events (eg, buy-backs, takeovers and dividends). The ASX continuous disclosure regime is supported by s 674 of the *Corporations Act*, which states that a listed disclosing

10 *Corporations Act 2001* (Cth) s 292(1), 301(1). Note that this obligation also applies to all public companies, all large proprietary companies and all registered schemes.

11 *Corporations Act 2001* (Cth) ss 314(1), 317, 319.

12 *Corporations Act 2001* (Cth) s 302.

13 *Corporations Act 2001* (Cth) ss 302, 320.

entity is subject to possible criminal and civil sanctions if it fails to make a required disclosure.

The benefits of the continuous disclosure regime vis-a-vis periodic disclosure are well-documented. Continuous disclosure is expected to 'minimize the opportunities for perpetrating insider trading or similar market abuses [and] ... improve managerial performance and accountability by providing the market with more timely indicators of corporate performance'.¹⁴

The external auditor, however, has no role to play in the continuous disclosure regime. The continuous disclosure obligations are placed directly and solely on the disclosing entity under both s 674 and chapter 3 of the ASX Listing Rules. Enforcement of the continuous disclosure obligations is the responsibility of ASIC and the ASX.

Thus, the auditor's role in Australia (as elsewhere) is limited. It is restricted to commenting on historic financial statements produced by the company twice-yearly; and it does not extend into arguably the most important area of disclosure — continuous disclosure — which is described by the CLERP 9 issues paper as 'a vital component of Australian corporate disclosure framework'.¹⁵

C The Auditor's Compliance Incentives

Market and professional integrity incentives aside, auditors are encouraged to produce high quality audits by the potential legal liability they face under the *Corporations Act*; the contract of engagement with the audit client; the law of professional negligence; and the *Trade Practices Act 1974* (Cth) ('*TPA*') and the State Fair Trading Acts.¹⁶

1 The Corporations Act

An auditor commits a criminal offence and is liable for significant fines and possible imprisonment if they contravene their statutory duties.¹⁷ In addition, they face cancellation or suspension of registration by the Companies Auditors and Liquidators Disciplinary Board ('CALDB').

An auditor is also potentially liable under the *Corporations Act*:

- for criminal sanctions for false or materially misleading statements made in the auditor's report or in other documents lodged or submitted to ASIC;¹⁸
- in conjunction with the *Criminal Code Act 1995* (Cth), as a party to offences committed by officers or employees of the audited company,¹⁹ and

14 Companies and Securities Advisory Committee, *An Enhanced Statutory Disclosure System* (1991) 7.

15 CLERP 9, above n 3, 136.

16 *Fair Trading Act 1987* (NSW); *Fair Trading Act 1999* (Vic); *Fair Trading Act 1989* (Qld); *Fair Trading Act 1987* (SA); *Fair Trading Act 1990* (Tas); *Fair Trading Act 1987* (WA); *Fair Trading Act 1992* (ACT).

17 *Corporations Act 2001* (Cth) s 1311.

18 *Corporations Act 2001* (Cth) s 1308(2), (4).

- possibly also, as an officer of the company under the definition in s 82A of the *Corporations Act* which, although it does not specifically include auditors, is a non-exclusive definition. However, this is an area of some uncertainty.

2 *The Contract of Engagement*

In every contract of audit engagement there is implied, at law, a duty to exercise reasonable skill and care in performance of the auditor's statutory function.²⁰ An auditor is liable to compensate the audit client for loss and damage caused by a breach of that duty.

3 *Professional Negligence*

The duty of care arising under the auditor's contract of engagement operates concurrently with a duty of care and skill arising as an incident of the tort of professional negligence.²¹ The contractual and tortious duty of care and skill derive from early decisions about the duties of professional persons in general. In *Lanphier v Phipos*,²² Tindal CJ decided that:

Every person who enters into a learned profession undertakes to bring to the exercise of it a reasonable degree of care and skill ... There may be persons who have higher education and greater advantages than he has, but he undertakes to bring a fair, reasonable and competent degree of skill.

Liability under the tort of professional negligence is wider than under the contractual duty because the doctrine of privity of contract does not apply. Therefore, shareholders, investors and others have a potential claim against auditors arising under tort law.

4 *Misleading and Deceptive Conduct*

Auditors also face potential liability under s 52 of the *TPA* and similar provisions of the *State Fair Trading Acts* to compensate investors, creditors and others for loss and damage caused by misleading or deceptive conduct and conduct that is likely to mislead or deceive.

19 Section 83 of the *Corporations Act* provides that 'a reference, in relation to a contravention, to a person ... in default ... is a reference to ... a person ... who is involved in the contravention'. Section 79 states that a person is involved in a contravention if the person, amongst other matters, is 'knowingly concerned in or party to the contravention'. The effect of these provisions is that 'an auditor can commit an offence by becoming aware of any contravention of the Corporations Law by an officer or employee of his or her client, and failing to properly report the matter to the directors or to the Commission': David Godsell, *Auditors' Legal Duties and Liabilities in Australia* (1993) 222-3.

20 *AWA Ltd v Daniels* (1992) 7 ACSR 759, 857.

21 See *Caparo Industries plc v Dickman* [1990] 2 AC 605; *Hawkins v Clayton* (1988) 164 CLR 539 (Deane J).

22 (1838) 8 Car & P 475; 173 ER 581.

D Avoiding Liability

The *Corporations Act* provides little guidance to auditors in the performance of their statutory function. For example, s 308 requires the auditor to express an opinion about various matters, but the *Corporations Act* does not indicate what the auditors must do to form this opinion. To what extent must they investigate the financial records of the company? What investigation and analysis is required of the company's non-financial systems and controls? To what extent can the auditor rely on information provided by management and others? These questions are left unanswered by the legislation.

The main source of guidance for auditors is the professional standards and rules developed by the audit profession through the accountants' professional associations. As a condition of membership of CPA Australia ('CPAA'), the Institute of Chartered Accountants in Australia (the 'ICAA') or the National Institute of Accountants, auditors agree to comply with the auditing and assurance standards promulgated by the Auditing and Assurance Standards Board ('AuASB') of the Australian Accounting Research Foundation (a body established and overseen by the professional associations), as well as the other professional ethical rules of each association.²³

Auditing and assurance standards differ from accounting standards as they do not have legal force; they are only binding on members of the professional associations. Those members are not subject to criminal or civil sanctions under the *Corporations Act* (or any other statute) for breach of the standards. Further, unlike the Australian Accounting Standards Board ('AASB') (which makes accounting standards), the AuASB's powers and functions are not regulated by the *Corporations Act*. The AuASB is not directly obliged to make auditing and assurance standards that are consistent with the law. In contrast, accounting standards made by the AASB have statutory backing through s 334(2) of the *Corporations Act*, and the AASB's members are appointed by the Financial Reporting Council ('FRC'), a body whose members are appointed by the Treasurer and which has a statutory obligation to oversee the accounting standard setting policies and processes.

Compliance with auditing and assurance standards is not a defence to legal liability. Since auditing and assurance standards do not have the force of law, it is open to a court to depart from them and impose higher, or lower, obligations on auditors. An example of such a departure is found in *Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* ('*Esanda*').²⁴ The High Court considered the effect of an accounting standard that noted the potential for creditors and other users to rely on financial statements. McHugh J decided that the standard 'may be a guide in determining the standard of care expected once a duty of care is found to exist; it does not create a duty'.²⁵

23 See, eg, the professional rules of the ICAA and CPAA on auditor independence: The Institute of Chartered Accountants in Australia and CPA Australia, *Professional Statement F1: Professional Independence* (2002), <http://www.cpaaustralia.com.au/01_information_centre/10_audit/1_10_0_f1_draft.asp> at 10 September 2002.

24 (1997) 188 CLR 241.

25 *Ibid* 290.

With the limitations of auditing and assurance standards and the scantness of the *Corporations Act* provisions on auditing, the courts are left to decide the scope of the auditor's statutory function. The main body of precedent on auditor liability deals with the auditor's common law duty to exercise reasonable skill and care. Auditor liability under *TPA* s 52 has not been tested in the courts and there have been very few prosecutions of auditors.

E The Court's View

From the auditor's viewpoint, legal precedent on auditor liability suffers from several limitations. 'It is inconceivable ... that any court of law could prescribe a complete, precise and authoritative definition of auditors' duties',²⁶ because courts make their decisions after the fact and in the context of the specific circumstances of the case. Also, the judiciary is not obliged (and in many instances, is unable) to elucidate a single test or general principle for auditor liability. This limitation is apparent in the five separate judgments of the High Court in *Esanda*.

The concept of 'reasonableness', in particular, causes uncertainty in the law of auditor liability since it is incapable of precise definition — what is reasonable skill, care and caution must depend on the particular circumstances of the case.²⁷ The court's view of what is 'reasonable' also changes to meet current circumstances. As noted by Moffit J in *Pacific Acceptance Corporation Ltd v Forsyth*:²⁸

there have been considerable changes in the organisation of the affairs of companies ... and there have been continuing and increasing experiences of and notoriety of danger signs in respect of mismanagement, fraudulent or otherwise, of companies often brought to light by 'economic squeezes' ... the legal duty, namely to audit accounts with reasonable skill and care, remains the same, but reasonableness and skill in auditing must bring to account and be directed toward the changed circumstances.²⁹

In light of these limitations, it is only possible to elucidate the following, very general, principles about the responsibilities of auditors. These principles are listed with the proviso that

it is not possible in most situations to make an absolute pronouncement as to what an auditor should do in an auditing situation stated generally. There is always some exception, or in some cases an extreme, that provides a reason for a special approach in some cases.³⁰

First, auditors are not expected to detect all fraud and error in the financial records and statements of a company. They are only expected to exercise the skill and care that a 'reasonably competent, careful and cautious auditor would use'.³¹

26 Godsell, above n 19, 4.

27 *Re Kingston Cotton Mills Co (No 2)* [1896] 2 Ch 279.

28 (1970) 92 WN (NSW) 29.

29 *Ibid* 73.

30 *Ibid* 82.

31 *Re Kingston Cotton Mills Co (No 2)* [1896] 2 Ch 279 (Lopes LJ).

Secondly, an auditor is 'not bound to be a detective, or ... to approach his or her work with suspicion ... he is a watch-dog, not a bloodhound'.³² However, if an auditor suspects, or is put on enquiry about fraud or irregularity, he or she must investigate the matter further.³³ An auditor must also pay due regard to the possibility of error or fraud in the financial records of the company:

To perform his task properly, [an auditor] ... must come to it with an enquiring mind — not suspicious of dishonesty ... but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none.³⁴

Thirdly, an auditor is not obliged to investigate the prudence or imprudence of the directors' or management's business decisions. However, 'it may well be that an auditor learns in the course of an audit that a company has entered into transactions which on their face are so imprudent that the law would impose on him a duty to inform the directors'.³⁵

Fourthly, auditors must properly appraise the company's systems of internal control.³⁶

Fifthly, an auditor must provide frank and full disclosure to senior management of all relevant matters discovered during the audit.³⁷ 'Relevant matters' could include the absence of adequate internal control systems or proper accounting records, or fraud committed by an employee or officer. The auditor has a duty to inform the directors if senior management does not respond appropriately to the knowledge of defects brought to their attention by the auditor.³⁸

F Responsible to Whom?

Since the House of Lords decision in *Caparo Industries plc v Dickman*,³⁹ (which the High Court substantially agreed with in the leading Australian decision in *Esanda*) auditors face a very low risk of liability to persons other than the audited company.

In *Esanda*, the court unanimously decided that an auditor did not owe any duty of care to a financier of the audited company, and that the liability of auditors to parties other than the company ought — in general — to be limited. Accordingly, an auditor does not owe a duty of care merely because it is reasonably foreseeable that 'a member of a class including the plaintiff might rely on the statement or advice and thereby suffer loss ... Something more is needed'.⁴⁰ The 'something more' is a special relationship between the auditor and the third party giving rise to proximity. It is unclear, however, in what circumstances this relationship will arise, as the High Court delivered its

32 Ibid.

33 *Re Thomas Gerrard & Sons Ltd* [1968] Ch 455.

34 *Fomento (Sterling Area) Ltd v Selsdon Fountain Pen Co Ltd* [1958] 1 WLR 45.

35 *BGJ Holdings Pty Ltd v Touche Ross & Co* (1987) 12 ACLR 481 (Marks J).

36 *AWA Ltd v Daniels* (1992) 7 ACSR 759.

37 Ibid; *Pacific Acceptance Corporation Ltd v Forsyth* (1970) 92 WN (NSW) 29.

38 *AWA Ltd v Daniels* (1992) 7 ACSR 759, 841.

39 [1990] 2 AC 605.

40 *Esanda* (1997) 188 CLR 241, 249, 254 (Dawson J), 271–2 (McHugh J), 301 (Gummow J).

decision in *Esanda* in five separate judgments of differing emphases. No legal action by a shareholder, investor or other party has been successful against the company's auditors since *Esanda*.

The judgments in *Esanda*, albeit to some extent disparate, are instructive of the court's view of the value of audits to shareholders and investors, and the limitations of the audit function. For example, McHugh J concluded that one of the policy reasons behind limiting auditor liability is that the conduct of the audited company and its employees is the primary cause of the loss suffered by its investors and others: 'The auditor's role is secondary ... the accounts are ordinarily prepared by the client and, in any event, are that person's responsibility'.⁴¹ Similarly, Gummow J noted that 'the alleged negligence of the auditor necessarily will be subsidiary to the failures of the corporation which prepared the accounts the auditor certified'.⁴²

The limitations of the periodic disclosure regime were also recognised by McHugh J when he said that

an audit report is out of date, so far as the business of the client is concerned, when it is published. The report gives merely a picture of the business on a particular date, which may be from six to ten weeks or more before the audit is published. By the publication date, the details of the business will have changed even if the fundamentals of the business have not. The gap between financial reality and the financial position represented by the audit increases as each week goes by.⁴³

Similarly, in *Berg Sons & Co Ltd v Adams*,⁴⁴ where the court held that the effect of the negligently unqualified audit report on the plaintiff was insignificant, Hobson J noted that '[a]udited accounts are in any event only one of the sources of information which a prudent banker takes into account ... With the passage of time ... the role of the audited accounts becomes progressively less important'.⁴⁵

Further, in *Esanda*, Toohey and Gaudron JJ concluded that it was not reasonable for the financier in that case (a sophisticated investor) to rely on the audit opinion, because:

there is nothing to suggest *Esanda* [the financier] was not itself able to have accountants undertake the same task on its behalf as a condition of its entertaining the possibility of entering into financial transactions with Excel [the audited company]. And ... there is nothing to suggest that it was reasonable for *Esanda* to act on the audit reports without further inquiry.⁴⁶

The judiciary's view of the role and responsibilities of auditors was also borne out in *AWA Ltd v Daniels*.⁴⁷ In that case, Rogers CJ Comm D decided that the negligent auditors were entitled to a deduction in the damages payable to the audited company because the company's managers and the chairman of directors had also been negligent, and their negligence was a contributing cause of the loss

41 Ibid 286.

42 Ibid 303.

43 Ibid 287.

44 [1992] BCC 661.

45 Ibid 674.

46 *Esanda* (1997) 188 CLR 241, 266.

47 (1992) 7 ACSR 759, 833-4.

and damage suffered by the company. Rogers CJ Comm D noted that:

The second, to me, surprising feature of the plaintiff's case is the proposition that, even though it would seem that senior management had permitted Koval to conduct the company's FX trading with a complete lack of supervision, without regard to elemental principles of internal control, without a proper system of books and records, none of that should be taken into account in allocating fault because it was the duty of the auditors to draw to the attention of the board of directors the failure of management to maintain proper records and to implement proper principles in internal control. I cannot accept that a corporation is entitled to abdicate all responsibility for proper management of the financial aspects of its operations and then, when loss is suffered, to seek to attribute the entirety of the blame to its auditors.⁴⁸

G The Expectation Gap

The case law on auditor liability reveals the limitations of the audit function. Auditors do not guarantee the accuracy of financial information; they are required only to exercise a reasonable degree of skill and care in forming an opinion about whether the company's financial reports comply with accounting standards and give a true and fair view of the company's financial position and performance. Further, auditors are not the guardians of good corporate conduct. Their liability to shareholders, other investors and the audited company for a failure to detect fraud and misconduct by company employees is limited. The courts have made it clear that companies and their boards of directors are primarily responsible for good corporate management; they are not entitled to abdicate this responsibility to the auditors.

The recent focus on auditors, however, suggests that there are misconceptions about auditor's responsibilities and, in particular, their ability to protect against corporate failure. A common catchcry in the fact of corporate collapse is 'where were the auditors?'. The so-called auditor 'expectation gap' — the gap between society's expectations of auditors and the reality of their obligations (as decided by the legislature, the courts and the accounting profession) — is not a new phenomenon. David Godsell reports that

in the aftermath of the 1987 stock market crash ... there was widespread feeling that 'somebody should be made accountable' for financial disasters ... Simply stated, it is widely perceived that any person who has any pecuniary interest in the affairs of a company should be able to rely on its audited accounts as a form of guarantee of the company's solvency, propriety and future viability.⁴⁹

The Australian Treasurer, the Hon Peter Costello MP, more recently referred to the expectation gap when he noted that 'most of the public believes auditors are sort of there to stop fraud ... I am not sure that that is what the actual legal position, as understood by auditors, is'.⁵⁰

While the expectation gap persists, attention is diverted from other causes of corporate misconduct and failure. Blame is pinned solely, or disproportionately, on auditors and, in response, audit reform becomes the focus of the

48 Ibid.

49 Godsell, above n 19, 2.

50 Karen Murphy and Tony Walker, 'Costello: Audit Crisis of Confidence', *Australian Financial Review* (Sydney), 8 February 2002, 1.

government's proposals for corporate law reform. The CLERP 9 proposals are subject to the same criticism. More than half of CLERP 9 is concerned with audit reform. The remaining reform proposals deal with the continuous disclosure framework, analyst independence and shareholder participation and information. These proposals, however, are not as developed or as extensive.

III AUDITING TOMORROW — THE CLERP 9 AUDIT REFORM PROPOSALS

In its CLERP 9 issues paper, the government proposes to tighten the rules and standards governing auditor independence and broaden the duties of oversight bodies in the following ways:

- A general statement of principle requiring auditors to be independent will be included in the *Corporations Act*.⁵¹ The *Corporations Act* will also prohibit several financial and employment relationships.⁵² For example, an audit firm will not be independent if a former audit partner who was directly involved in the audit of a client becomes a director or senior manager of the client within a period of two years of resigning as partner of the audit firm.
- The provision of non-audit services will be governed primarily by the professional rules of the accounting profession's associations⁵³ (which are not legally binding).
- The role of the FRC will be expanded.⁵⁴ It will become the peak body for auditor oversight. Auditor discipline, however, will be left to the CALDB.
- Companies will have to disclose in their annual report the fees paid for any non-audit services provided by the auditor. The audit committee will have to state in the annual report whether it is satisfied that the provision of non-audit services is compatible with independence.⁵⁵
- The AuASB will be reformed. It will become a statutory body under the oversight of the FRC and the auditing standards it develops will have the force of law.⁵⁶
- The ASX Listing Rules will be amended to require the top 500 listed companies to have audit committees. The composition and responsibilities of the audit committee will be dealt with by best practice standards developed by the ASX Corporate Governance Council.⁵⁷

51 CLERP 9, above n 3, 46, Proposal 2.

52 Ibid 47–57, Proposals 4,5.

53 Ibid 68, Proposal 6.

54 Ibid 28, Proposal 1.

55 Ibid 69, Proposal 7.

56 Ibid 28, Proposal 1.

57 Ibid 77–9, Proposal 8.

- The audit firm's lead engagement partner and review partner for an audit client will have to rotate every five years.⁵⁸ There is no suggestion, however, of compulsory audit firm rotation.
- The CALDB will have increased powers. The majority of CALDB members will have to be non-accountants.⁵⁹

Auditors' statutory function will be extended by the following requirements:

- The auditor will be required to attend the annual general meeting of a listed company and answer reasonable questions.⁶⁰
- Auditors will have to make an annual declaration of independence.⁶¹
- The statutory duty of auditors to report to ASIC will be extended. Auditors will be required to report any attempt by the audit client's officers or directors to influence, coerce, manipulate or mislead the auditor.⁶²

There are also 'sweeteners' for the audit profession proposed in CLERP 9. These include permission for auditors to incorporate⁶³ and the introduction of proportionate liability.⁶⁴

IV PROBLEMS WITH THE CLERP 9 REFORM PROPOSALS

There is a risk that the CLERP 9 proposals will be largely ineffective in deterring fraud and misconduct by company employees and in reducing the likelihood of corporate collapse. This is because:

- the cause of the recent spate of corporate collapses has not yet been properly investigated;
- the proposals do not address the larger issues of the investor/auditor 'expectation gap', the uncertainty of the bounds of the auditor's legal responsibility and liability, and how that responsibility/liability dovetails with that of the company's directors and officers; and
- the auditor independence reforms proposed are, arguably, a light touch — more could be done to enhance auditor independence.

Further, the reform proposals do not properly address the overall framework for financial disclosure and the auditor's oversight role in that framework.

Finally, a greater role is envisaged for audit committees comprised of independent directors. However, CLERP 9 does not consider the practical implications of this increased role for audit committee members and the market for independent directors.

58 Ibid 83, Proposal 9.

59 Ibid 177–8, Proposal 34.

60 Ibid 85, Proposal 10.

61 Ibid 47, Proposal 3.

62 Ibid 173–4, Proposal 33.

63 Ibid 90–3, Proposal 12.

64 Ibid 93–6, Proposal 13.

A We Don't Yet Have All of the Answers to What Went Wrong and Why

In the area of audit reform, the CLERP 9 issues paper is relatively highly developed, at least when compared with other areas of corporate governance concerns highlighted by recent commentary. The proposals do more than just highlight potential issues such as auditor independence and oversight of the audit profession — they put forward the legislative and other mechanisms for dealing with many, if not all, of the audit-related issues that have been discussed so extensively in the US, Australia and elsewhere since the Enron collapse.

This developed government response arises, however, in the absence of any investigation into and report on the causes of the recent spate of corporate collapses. Most of the CLERP 9 audit reform proposals derive from the Ramsay report into auditor independence, which did not investigate whether the auditors contributed to the collapse of HIH, One.Tel and other Australian companies. Professor Ian Ramsay recognised this limitation of the Ramsay report when he said:

the actions of the auditors involved in recent corporate collapses, and the question whether any failings in the area of audit independence contributed to those collapses, are outside the scope of this report. Such issues will undoubtedly be considered by the Australian Securities and Investments Commission (ASIC) as part of its inquiries into the corporate failures and by the Royal Commission examining the circumstances surrounding the collapse of HIH Insurance Ltd.⁶⁵

The only thorough investigation of the recent spate of corporate collapses is the ongoing Royal Commission into the collapse of HIH Insurance Ltd. The final report of the Royal Commission, however, is not due until February 2003 — well after the consultation period for CLERP 9 closes in November 2002. The government expects to introduce CLERP 9 legislation into Parliament in early 2003, so it is doubtful if the findings of the Royal Commission will come to bear on the proposals for audit reform.

The risk associated with focusing on auditors without an understanding of the reasons for corporate collapse is obvious. In light of the limitations of the audit function outlined above, it is likely that failures in the audit function (perceived or real) are not the cause, or even a substantial cause, of the problem. Indeed, recent studies by Horwath (NSW),⁶⁶ Institutional Analysis,⁶⁷ and Ernst & Young⁶⁸ suggest a cause entirely outside the scope of the statutory audit — a failure of boards of directors to comply with national and international best practice guidelines and standards on corporate governance.

65 Ian Ramsay, *Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform — Report to the Minister for Financial Services and Regulation* (2001) 6, <<http://www.treasury.gov.au/contentlist.asp?classification=14&titl=Publications>> at 23 July 2002.

66 Jim Psaros and Michael Seamer, *Horwath 2002 Corporate Governance Report*, Horwath (NSW) (2002), <<http://www.newcastle.edu.au/school/newc-business/horwath.html>> at 1 October 2002.

67 Institutional Analysis, *A Report on Corporate Governance at Five Companies that Collapsed in 2001* (2002).

68 Ernst & Young, *Survey of Top 200 Companies' Compliance with New NYSE Listing Rules*, Corporate Governance Series (2002).

Corporate governance is defined as 'the system by which companies are controlled',⁶⁹ or the 'process by which organisations are directed, controlled and held to account'.⁷⁰ In Australia, the main body of corporate governance regulation is contained in the standards and guidelines developed by stakeholders. These include:

- the guidelines of the Bosch Working Group in *Corporate Practices and Conduct*.⁷¹ The Bosch Working Group represents the Australian Institute of Company Directors, the Australian Society of Certified Practising Accountants, the Business Council of Australia, the Law Council of Australia, the Institute of Chartered Accountants in Australia and the Securities Institute of Australia;
- the recommendations of the Investment and Financial Services Association ('IFSA') (previously the Australian Investment Managers' Association);⁷²
- the standards and recommendations of the newly formed ASX Corporate Governance Council.⁷³ The Corporate Governance Council is convened by the ASX and attended by many representative bodies including the Australian Chamber of Commerce and Industry, the Business Council of Australia and the Securities Institute of Australia; and
- the corporate governance standards developed by stakeholders in other jurisdictions, for example, the standards embodied in the Listing Rules of the New York Stock Exchange ('NYSE') and the Combined Code of the Listing Rules of the UK Listing Authority ('UKLA').

Recent studies indicate that the level of compliance of Australian companies with these standards is quite poor. The Horwath (NSW) report analyses the governance structures in Australia's top 250 listed companies and concludes that only nine companies demonstrated outstanding corporate governance structures that met all best practice standards, 108 companies had corporate governance structures that were generally good and met most of the best practice standards, but 73 companies had corporate governance structures that were deficient.⁷⁴ The Institutional Analysis report reveals a high level of non-compliance by recently failed companies. Of the failed One.Tel, HIH, Pasminco, Harris Scarfe and Centaur companies, 60 per cent had a single shareholder with effective control, the boards of directors tended to contain a below average number of independent directors and founders and family members were over-represented, and audit committees were comprised of an above average number of audit firm personnel

69 Working Group on Corporate Practices and Conduct (chaired by Henry Bosch), *Corporate Practices and Conduct* (3rd ed, 1995) 7.

70 Joint Committee of Public Accounts and Audit, *Corporate Governance and Accountability Arrangements for Commonwealth Government Business Enterprises*, Report 372 (1999) 7.

71 Working Group on Corporate Practices and Conduct, above n 69.

72 IFSA, *Corporate Governance — A Guide for Investment Managers and Corporations* (2nd ed, 1997).

73 See ASX Corporate Governance Council, 'Statement by Participants' (Press Release, 19 September 2002), <<http://www.asx.com.au/shareholder/pdf/CorporateGovernanceCouncil190902.pdf>> at 4 October 2002.

74 Psaros and Seamer, above n 66, 21.

and former audit firm personnel.⁷⁵ The Ernst & Young survey of the 2001 annual reports of the top 200 companies indicates that, while 90 per cent of the companies have a majority of non-executive directors, many of those directors would fail the independence test recently set by the NYSE and considered to be the high watermark of corporate governance regulation.⁷⁶

The results of these studies accord with the views recently expressed by Henry Bosch, a former chairman of the National Companies and Securities Commission and chairman of the Bosch Working Group, who reported that:

There is a wide gap between the maximum possible and the minimum excusable, and the whole spectrum is observable in Australian corporate governance; the best of our boards are performing well, but there is a long tail of boards in which little thought is given to governance, and in which more attention is given to personal gain than fiduciary duty.⁷⁷

This variance could be attributed to several factors which underlie the Australian corporate governance environment. To begin with, there is no regulatory supervision of the stakeholders that currently develop corporate governance standards for Australian companies (the ASX Corporate Governance Council, the Bosch Working Group and IFSA). There is, for example, no requirement that these bodies cooperate to produce consistent standards that are regularly updated.

Further, Australian companies are under no legal obligation to comply with corporate governance standards or even to explain why they do not comply with particular standards — the ASX Listing Rules merely require a listed entity to disclose its main corporate governance practices in its annual report. The incentives for a company to comply with these standards are currently market-based. In this respect, Australia differs from other jurisdictions (particularly the US and the UK). In the US, the NYSE and the NASDAQ prescribe corporate governance standards as a condition of listing. Recent amendments to the NYSE Listing Rules will require listed companies to appoint boards comprised of a majority of independent directors, and to appoint a nominating/corporate governance committee, a compensation committee and audit committee comprised solely of independent directors. In the UK, the UKLA takes a slightly more lenient approach by requiring companies to disclose whether or not they have complied with a list of corporate governance standards known as the Combined Code, and the reasons for any non-compliance.

The poor corporate governance record of a number of Australian companies suggests that there is a place for greater regulation of the process for setting corporate standards and of compliance with those standards. The ASX Corporate Governance Council recently announced that it would develop a set of corporate governance principles and would require companies to report in the annual report on their compliance with those principles.⁷⁸ This follows the approach

75 Institutional Analysis, above n 67, 5.

76 Ernst & Young, above n 68, 3.

77 John D Adams et al, *Collapse Incorporated: Tales, Safeguards and Responsibilities of Corporate Australia* (2001) 5.

78 ASX Corporate Governance Council, above n 73.

taken by the UKLA and is a step towards more consistent compliance with corporate governance standards. It does not, however, answer the concerns about regulation of the process of standard setting. The ASX Corporate Governance Council is not a body overseen by ASIC or any other corporate regulator. It is also questionable whether the ASX, a listed for-profit company itself, is the appropriate body to lead the process of setting corporate governance standards for other listed entities. These are all matters, which ought to be considered by CLERP.

B Whither the Expectation Gap?

The CLERP 9 audit reform proposals are largely designed to improve performance of the auditor's existing statutory functions. While the auditor's obligations to report to ASIC are extended slightly, the core statutory duty to audit companies' periodic financial reports is unchanged. The government has not, therefore, attempted to align auditor duties with society's expectations. CLERP 9 barely touches on the 'expectation gap'. Instead, auditor independence and better oversight of the audit profession is presented as the government's answer to a perceived crisis in the credibility of the audit function.

The real reason for any such crisis, however, is likely to be at least partly the expectation gap. Auditors are currently under fire because members of society expect something that the law does not. Without clearly addressing this issue, increased auditor independence and oversight of the audit function are unlikely to achieve long-term improvements in the credibility of the audit function. This need to address the auditor expectation gap was recently recognised by David Knott (chairman of ASIC) who said:

community expectations of audit need to be examined from a broad perspective, not by assuming that independence is the only — or necessarily the most important — issue at stake. It is logical to assume that lack of independence may lead to a bad audit. But it is a non sequitur to deduce that an independent audit will be a good audit. We need to question just how rigorous and investigative we want our audits to be; what we are prepared to pay for them; and how strictly we will hold the accounting profession to account for failing to detect and report when financial statements do not reflect and true and fair view of the enterprise.⁷⁹

C Auditor Liability: CLERP 9 Will Not Clear the Muddy Waters

A common complaint heard from auditors is that they are exposed to unlimited liability for professional default and a commensurate burden of obtaining professional indemnity insurance, a burden that continues to spiral ever higher as plaintiffs apparently focus on the auditors' relatively 'deep pockets'. In connection with the CLERP 9 issues paper, and the recently released report of the Joint Committee of Public Accounts and Audit,⁸⁰ auditors raised

79 David Knott, 'Corporate Governance — Principles, Promotion and Practice' (Speech delivered at the Monash Government Research Unit (Inaugural Lecture), Melbourne, 16 July 2002), <<http://www.asic.gov.au>> at 1 October 2002.

80 Joint Committee of Public Accounts and Audit, Parliament of Australia, *Review of Independent Auditing by Registered Company Auditors* (2002).

concerns about unlimited liability. They suggested, for example, that 'the future of the profession will necessitate dealing with the unlimited liability position ... without addressing that position, the ability to attract the best and brightest into the profession ... might be affected'.⁸¹

The proposition of unlimited auditor liability is somewhat misleading, however, in light of the decisions in *Esanda, Daniels v Anderson*⁸² and other decisions on auditor liability. As noted above, since *Esanda*, auditors are generally not liable under the tort of negligence to parties other than the audit client. In *Daniels v Anderson*, the New South Wales Court of Appeal applied principles of contributory negligence and decided that the negligent auditor was entitled to a reduction in the damages payable because the company, through the conduct of its directors and employees, had also been negligent.

The current application of principles of contributory negligence, proximity, causation and reasonableness suggest that auditor liability is, in fact, limited. However, the extent of this limit is unclear. This is due to a number of reasons. First, the *Corporations Act* provides very little detail on the responsibilities of auditors and there is ambiguity in the application of the legislative provisions. In particular, it is unclear whether auditors are exposed to liability as officers of the company under the broad definition in s 82A. Secondly, the law of professional negligence is uncertain. No clear statements of legal principle can be derived from the five judgments of the High Court in *Esanda*, and the concept of 'reasonable skill and care' is inherently ambiguous. Thirdly, liability under the *TPA* is untested but potentially wider than liability for professional negligence. Unlike liability for the tort of professional negligence, liability under *TPA* s 52 is strict, does not depend on any relationship of proximity between the third party and the auditor, and does not require the third party to prove that the auditor acted negligently. If the auditor's conduct is misleading or deceptive or is likely to mislead and deceive, they could be liable to compensate any person who has suffered loss and damage by the conduct.

Uncertainty as to the responsibilities of auditors and the application to auditors of the law of professional negligence might, to some degree, be addressed by the CLERP 9 proposal to give legal force to the auditing and assurance standards, and to make the AuASB a statutory body.⁸³ When determining whether an auditor has exercised reasonable skill and care, a court is more likely to be persuaded by compliance with auditing and assurance standards that have statutory backing — through being subject to disallowance by Parliament and promulgated by a body overseen by the government (through the FRC) — than compliance with non-binding standards promulgated by a non-statutory body. That said, it is still open to a court to require of an auditor something more than is expected under the auditing and assurance standards. Also, the CLERP 9 proposal does not address potential liability under the *TPA*.

81 Evidence to Joint Committee of Public Accounts and Audit, Parliament of Australia, Sydney, 8 July 2002, 144 (Anthony Harrington, PricewaterhouseCoopers).

82 (1995) 37 NSWLR 438.

83 CLERP 9, above n 3, 25–7, Proposal 1.

The other CLERP 9 response to auditor liability is to propose the introduction of proportionate liability.⁸⁴ Under this system, auditors would be required to compensate a plaintiff only to the degree that the auditor was at fault. The plaintiff would be left to recover, as part of a separate action, the proportion of the loss suffered for which the company or some other defendant was individually responsible. This differs from the current system of joint and several liability under which claimants have the discretion to recover damages from all tortfeasors, or from only one of them (namely, the auditor). Auditors may join other parties such as company directors and the company itself, or may claim contribution from them. However, as is often the case, these other parties are uninsured and insolvent and joining them or claiming contribution from them is likely to bring nothing.

The push toward proportionate liability is not new. In 1996, the Commonwealth Attorney-General and the New South Wales Attorney-General on behalf of the Standing Committee of Attorneys-General released draft legislation to introduce proportionate liability. This followed the adoption by the Standing Committee of Attorneys-General of the recommendations of an inquiry conducted by Professor Jim Davis of the Australian National University.⁸⁵ The draft legislation was not enacted, however, because it did not receive the support of the States. In September 1997, the New South Wales Law Reform Commission rejected a system of proportionate liability⁸⁶ as did the Victorian Attorney-General's Law Reform Advisory Council.⁸⁷

The controversy surrounding the introduction of proportionate liability is not surprising. Such a system is perceived to have several defects which, some would suggest, far outweigh the benefits. Under a system of proportionate liability, the defendant benefits merely because there are other wrongdoers, whereas if there were no other wrongdoers, he or she would be liable for all of the loss suffered by the plaintiff. It is said to be absurd and arbitrary that 'the mere existence of other wrongdoers ... prejudice[s] a plaintiff's chance of full recovery'.⁸⁸ It has also been argued that proportionate liability is unnecessary because justice amongst wrongdoers is currently achieved by rights of contribution,⁸⁹ and in the context of the tort of professional negligence, by principles of proximity, remoteness and causation. Further, joint and several liability can be seen as an incentive for proper performance of legal duties,⁹⁰ and it recognises the fact that the defendant is often better placed to identify and track down other potential defendants than the plaintiff. Other potential shortcomings of proportionate liability are that the risk of an insolvent defendant

84 Ibid 93 ff, Proposal 13.

85 Jim Davis, *Inquiry into the Law of Joint and Several Liability: Report of Stage Two* (1995).

86 New South Wales Law Reform Commission, *Contribution Between Persons Liable for the Same Damage*, Discussion Paper No 38 (1997).

87 Megan Richardson, *Economics of Joint and Several Liability versus Proportionate Liability*, Victorian Attorney-General's Law Reform Advisory Council, Expert Report 3 (1998).

88 New South Wales Law Reform Commission, above n 86 [2.20].

89 Ibid.

90 Jane Swanton and Barbara McDonald, 'Reforms of the Law of Joint and Several Liability — Introduction of Proportionate Liability' (1997) 5 *Torts Law Journal* 109.

rests with the plaintiff who is the innocent party; it increases the likelihood of under-compensation of plaintiffs; and is likely to exacerbate the problems of uncertainty in the law of auditor liability by requiring a court to decide the exact percentage of loss and damage that the auditor ought to be liable for.

The CLERP 9 paper suggests that proportionate liability will assist an audit profession that is currently facing high insurance premiums. It does not, however, quote any evidence of a connection between high insurance premiums and joint and several liability. Further, it does not refer to evidence that a system of proportionate liability will have a positive effect on the cost of insurance. These are matters requiring further investigation.

The Australian government has recently established a review of the law of negligence relating to personal injuries and medical negligence.⁹¹ A similar review would be appropriate before changes to the law of negligence applicable to auditors (and other advisory professionals) are made and proportionate liability is set in stone.

D Auditor Independence

While CLERP 9 can be criticised for focusing too narrowly on audit reform and failing to identify other problems of corporate governance, it cannot be criticised for overlooking auditor independence. The importance of auditor independence to the credibility of the audit function is widely recognised. This notion has been the subject of various academic studies that were considered by the Ramsay report. A review of these studies led Professor Ramsay to conclude that 'the important of independence in the auditing context has become such that the terms "independent" and "auditor" can no longer be separated — independence appears to be endogenous to auditing'.⁹²

It is widely recognised that auditor bias, perceived or real, necessarily detracts from the value of the audit function:

Independence is an essential auditing standard because the opinion of the independent accountant is furnished for the purpose of adding justified credibility to financial statements which are primarily representations by management. If the accountant were not independent of the management of its clients, his opinion would add nothing.⁹³

The CLERP 9 proposals for auditor independence regulation include:

- amendments to the *Corporations Act* to require auditors to remain independent of their audit client;
- a tightening of the current restrictions in the *Corporations Act* on financial and employment relationships with the audit client;
- a requirement in the *Corporations Act* that auditors make an annual declaration of auditor independence;

91 The panel was appointed by the Minister for Revenue and Assistant Treasurer in July 2002 and is chaired by Justice David Ipp: see generally *Review of the Law of Negligence* <<http://revofneg.treasury.gov.au/content/home.asp>> at 1 October 2002.

92 Ramsay, above n 65, 101.

93 Robert Kane Jnr (ed), *CPA Handbook* (1952) ch 13, 8.

- support for the immediate application of revised ethical standards on auditor independence;
- compulsory audit partner rotation every five years; and
- requiring companies to disclose, under the continuous disclosure regime, the removal of an auditor.⁹⁴

These proposals, however, fall short of the reforms adopted recently in the US Congress under the *Sarbanes-Oxley Act of 2002*⁹⁵ in one area of significance — the provision of non-audit services. Under the *Sarbanes-Oxley Act of 2002*, audit firms are prohibited from providing a list of high-risk non-audit services, and an audit committee consisting of independent directors must approve the provision of all other non-audit services. Under CLERP 9, however, there is no legal restriction on the provision of non-audit services. This is a matter left to the professional associations and their ethical rules, which do not have the force of law and are currently binding only on their members. This is a significant departure from the approach taken in the US, and as CLERP 9 otherwise imposes quite onerous restrictions on relationships with the audit client, a legislative restriction on the provision of non-audit services — or, at the very least, a legally binding audit and assurance standard on the provision of non-audit services — is worthy of further investigation.

The tension underlying most of the CLERP 9 proposals for audit reform also necessitates further discussion. Auditors are said to be in a 'unique position ... where a for-profit business is central to the public interest'.⁹⁶ While this might be an overstatement of the audit function, it validly recognises a problem inherent in the audit function. Since auditors are paid by their clients, it is 'psychologically impossible for an auditor to be free from bias'.⁹⁷ The CLERP 9 auditor independence proposals are no substitute for an independent, publicly funded body, or auditors who are appointed and removed by a corporate regulator. These are also suggestions worthy of greater attention.

V AUDIT COMMITTEES

A Mandatory for the Top 500

There is currently no requirement under statute or the ASX Listing Rules for a company, listed or otherwise, to form an audit committee. The only requirement relating to audit committees is that in Listing Rule 4.10.2 that a listed entity state in its annual report whether or not it has an audit committee, and if not, why not. A listed entity is also required by Listing Rule 4.10.3 to disclose its key corporate governance practices.

94 CLERP 9, above n 3, 41–86.

95 Pub L No 107–204, 116 Stat 745 (2002).

96 CLERP 9, above n 3, 33.

97 Ramsay, above n 65, 106, referring to Max H Bazerman, Kimberly P Morgan and George F Loewenstein, 'The Impossibility of Auditor Independence' (1997) 38(4) *Sloan Management Review* 89, 91.

CLERP 9, however, proposes amendments to the Listing Rules to require the top 500 listed companies to have audit committees. This reform will go some way towards bringing Australia's regulation of audit committees up to the standard in other jurisdictions.

In the US, for example audit committees are a condition of listing on the New York Stock Exchange ('NYSE'), the American Stock Exchange and the NASDAQ. In the case of the NYSE, this requirement has existed since 1978. In Canada, audit committees are compulsory for a corporation which has issued securities that are or were part of a distribution to the public and remain outstanding and are held by more than one person.⁹⁸

The CLERP proposal to mandate audit committees, however, is insignificant in a practical sense, since most companies listed on the ASX currently have an audit committee.⁹⁹ It is the regulation of the composition and responsibilities of audit committees that will have the greatest impact. As recognised by Professor Ramsay, 'having an audit committee per se is not enough; it is essential that the audit committee have the necessary attributes to render it an effective corporate governance mechanism'.¹⁰⁰ CLERP 9 does not propose regulating the composition or function of audit committees, leaving it instead to the ASX Corporate Governance Council to develop 'best practice standards for audit committees'.¹⁰¹ However, these best practice guidelines will suffer from the same limitations as any corporate governance standards drafted by the ASX Corporate Governance Council — they will not be legally binding and will be drafted by a body not overseen by ASIC or any other corporate regulator. The effect of these limitations will only become apparent over time. But the importance of the audit committee's function in the overall corporate governance framework suggests a role for the legislature in determining the responsibilities of audit committees, or, at the very least, the responsibilities of the ASX Corporate Governance Council.

B Problems that Boards and Audit Committees will Continue to Face

Consistent amongst stakeholders is the view that the audit committee ought to be comprised of, at the very least, a majority of directors who are all independent, with many stakeholders arguing that the audit committee should be comprised only of independent directors. For example, the recently amended NYSE Listing Rules and the *Sarbanes-Oxley Act of 2002* require that the audit committee be comprised solely of independent directors, and the Ramsay report recommends that at least three of the audit committee members are directors and all of the members are independent. The federal government also suggests that the ASX Corporate Governance Council's guidelines on audit committees should state that all members should be independent of company management.¹⁰²

98 *Canada Business Corporations Act*, RS C 1985, c 44, s171(1).

99 See the results of the survey reported in Australian Securities and Investments Commission, above n 4. It should be noted that, of the 100 companies surveyed (all large public companies), only 67 responded.

100 Ramsay, above n 65, 76.

101 CLERP 9, above n 3, 77–8.

102 *Ibid* 78.

The CLERP 9 paper does not adequately address a number of questions and practical problems facing boards and audit committees of listed entities who seek to comply with these recommendations. These problems include the interaction of the audit committee with the rest of the board and the expectations of independent directors generally held by investors, the legislature and the courts.

An audit committee is a committee of the board of directors which, if it is properly convened and well-functioning,

can play a key role in assisting the board of directors to fulfil its corporate governance and overseeing responsibilities in relation to an entity's financial report, internal control structure, risk management systems, and the internal and external audit functions.¹⁰³

As a committee of the board, however, the audit committee does not have legal existence independent of the board or the company. Indeed, the *Corporations Act* itself imposes responsibilities on directors who seek to delegate their powers to board committees, particularly in ss 189, 190 and 198D. Directors who do not serve on such committees are not permitted to simply abdicate their responsibilities for the committees' work. CLERP 9 does not explain how the responsibilities of directors on audit committees will differ from directors who do not serve on such committees. Nor does it clarify the role of the board, or the role of independent directors on it in relation to the company's financial disclosure and audit processes. Will all directors still be liable for ensuring that the company's financial records and statements comply with the *Corporations Act* requirements, as is presently the case? What of the role of the executive directors, especially the chief executive officer and the chief financial officer? Should they have greater responsibilities for financial disclosure than the non-executive directors, as is apparently now the case in the US? These questions are not addressed in the CLERP 9 paper.

A further issue not adequately addressed by the CLERP 9 proposals is the practical one of finding the right people to serve on audit committees. The Ramsay report and CLERP 9 recommendation that the audit committee be composed only of independent persons is quite onerous, made more so by the recommendation that all (or at least three) members of the committee be independent directors of the company.

Under the definition of independence proposed by the Ramsay report, any non-executive director who is a substantial shareholder of the company, was within the last three years employed as an executive of the company or a related entity of the company, is a member of the immediate family of a person who was so employed, has a significant contractual relationship with the company or the company's related entity and so on, would be excluded from audit committee membership.¹⁰⁴ The obvious problem arising from the requirement of independence is a problem of resources. Where will listed companies in Australia find enough directors who fit this description? In the US, which has a

103 The Auditing and Assurance Standard Board of the Australian Accounting Research Foundation, the Australian Institute of Company Directors and the Institute of Internal Auditors — Australia, *Audit Committees: Best Practice Guide* (2nd ed, 2001) 2.

104 See Ramsay, above n 65, 153–4, for a definition of an 'independent' committee member.

much larger market for independent directors, companies have already faced this problem: 'a genuine shortage of competent people together with increased director liability has made good non-officer directors difficult to find'.¹⁰⁵

Even assuming that there is an adequate pool of independent directors, it is possible that very few persons in this pool will be willing to take on the range of responsibilities and liabilities suggested of an audit committee member. It is likely that a significant leap in non-executive director remuneration would be required to bring such persons to the task. One must question, however, whether a large salary would begin to erode the director's independence. Further, even with the carrot of increased remuneration, non-executive directors could be reluctant to take a position on the audit committee. There is uncertainty in the law regarding directors' duties, and trends which suggest that audit committee members might be required to exercise a higher level of care and diligence (compared to ordinary non-executive directors) in the performance of their audit committee responsibilities.

The current legal position is that all directors are expected to exercise a minimum standard of care, skill and diligence in their directorships. All directors must 'take reasonable steps to place themselves in a position to guide and monitor the management of the company'.¹⁰⁶ However, it is possible that some individual directors have a duty to exercise more care, skill and diligence than the minimum. As reiterated in the recent case of *Australian Securities & Investments Commission v Adler*,¹⁰⁷ 'in determining whether a director has exercised reasonable care and diligence one must ask what an ordinary person, with the knowledge and experience of the defendant, might have been expected to have done in the circumstances if it was acting on their own behalf'.¹⁰⁸ The standard of care expected of a director will also vary according to the type and size of business, and the manner in which the work of the company is distributed.¹⁰⁹

The subjective elements of the duty of care, skill and diligence are also recognised in s 180(1) of the *Corporations Act*, which is a codification of the common law duty. Section 180(1) requires a standard of care and diligence that a reasonable person who occupies the office held by, and has the same responsibilities within the corporation as the director concerned, would exercise. These subjective elements led Rogers CJ Comm D in *AWA Ltd v Daniels* to decide that, in the context of a large public company, the managing director and the chairman have greater responsibilities than the non-executive directors: 'In contrast to the managing director, non-executive directors are not bound to give continuous attention to the affairs of the corporation'.¹¹⁰ This view, however,

105 Joel G Siegel and Murty Mukkavilli, 'Corporate Audit Committees: Making Them Work' (1981) 51 *The Australian Accountant* 400.

106 *Daniels v Anderson* (1995) 37 NSWLR 438, 501.

107 *Re HIH Insurance Ltd (in prov liq) and HIH Casualty & General Insurance Ltd (in prov liq); Australian Securities and Investments Commission v Adler* (2002) 41 ACSR 72.

108 *Ibid* 166 (emphasis added).

109 *Re City Equitable Fire Insurance Co* [1925] Ch 407 (Romer J); *AWA Ltd v Daniels* (1992) 7 ACSR 759, 864.

110 *AWA Ltd v Daniels* (1992) 7 ACSR 759, 867.

was based on the assumption that 'a chief executive is a director to whom the board of directors has delegated its powers of management of the corporation's business' and that the duties of non-executive directors 'are of an intermittent nature'.¹¹¹

If companies are required to populate their audit committees with independent non-executive directors, at least some of whom have financial expertise, these assumptions may no longer be accurate. The board would be encouraged to delegate many of its responsibilities (and some of the current responsibilities of management) to the audit committee. Applying the legal principles outlined above, it is foreseeable that audit committee members, particularly as they would have a level of financial literacy generally and a more in depth knowledge of the company's financial position in particular, would be required to exercise a higher degree care, skill and diligence than ordinary non-executive directors.

The problems highlighted by this discussion indicate that, before implementing any proposal requiring audit committees to be comprised of independent directors, the Australian government, the ASX, and other stakeholders should consider more generally the role of non-executive directors. In the UK, this broader review is already underway. The Secretary of State for Trade and Industry, Patricia Hewitt and the Chancellor, Gordon Brown, have appointed Derek Higgs to lead an independent review into the role and effectiveness of non-executive directors. This review will consider the attraction, the recruitment and appointment of non-executive directors.

In Australia, the Corporations and Markets Advisory Committee will consider directors' duties and personal liability following a reference on 9 July 2002 from Ian Campbell, Parliamentary Secretary to the Treasurer.¹¹² Reform of the composition and responsibilities of audit committees should be undertaken with the insight given by these reports into the responsibilities and the effectiveness of non-executive directors.

VI CONCLUSION

CLERP 9, and the regulatory initiatives flowing from it, needs to fully consider the legal framework governing auditors. It needs to consider that framework in the overall context of the obligations of and liabilities faced by directors — particularly non-executive directors — and auditors of public listed companies in Australia. The uncertainty and lack of clarity in the law for auditors, and the ever present 'expectation gap', are matters that ought to be addressed from the outset.

More importantly, however, the Australian government and the various corporate stakeholders need to directly confront the wider corporate governance issues which Australian listed entities presently face. In particular, we need a clear analysis of the reasons for the various recent corporate failures, followed

¹¹¹ *Ibid.*

¹¹² Corporations and Markets Advisory Committee <<http://www.camac.gov.au>> at 4 October 2002.

by an informed debate on the respective expectations and responsibilities of directors, officers and auditors. The focus solely or primarily on improving auditor independence is unlikely to be even half of the solution to the ongoing problem of Australian corporate governance.