

# 1. INTRODUCTION

101. During 1993, the Ministerial Council for Corporations (MINCO) decided that the present regulation of company auditors should be reviewed with a view to ensuring that an appropriate legal framework is in place for the registration, appointment, supervision and disciplining of company auditors in relation to their functions under the Corporations Law (the Law) and to ensure their independence.

102. MINCO also decided that the review should be convened by the Commonwealth Attorney-General's Department<sup>1</sup> with other members of the review team to include senior representatives from the Australian Securities Commission (ASC), the accounting profession and the States and Territories.

## MEMBERSHIP OF WORKING PARTY

103. The members of the Working Party established to undertake the review are:

- (a) Bob Grice, Partner, KPMG, Brisbane, representing The Institute of Chartered Accountants in Australia (ICAA);
- (b) Veronique Ingram, Assistant Secretary, Companies and Accounting Policy Branch, Department of the Treasury<sup>2</sup>;
- (c) Brian McPhail, Director, McPhail & Partners Services Pty Ltd, Melbourne, representing the Australian Society of Certified Practising Accountants (ASCPA)<sup>3</sup>;
- (d) Ken MacPherson, Auditor-General of South Australia (representing the States and Territories); and

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<sup>1</sup> Following the 1996 Federal Election, Ministerial responsibility for the Corporations Law was transferred from the Attorney-General to the Treasurer. As a result, the Department of the Treasury has now assumed responsibility for convening the Working Party.

<sup>2</sup> Prior to Ms Ingram's appointment to the Working Party, the Commonwealth Government was represented by Ian Govey, Principal Adviser, Business Law Division, Attorney-General's Department (August-October 1994), and Brian O'Callaghan, formerly Assistant Secretary, Companies and Accounting Branch, Attorney-General's Department (November 1994-May 1995).

<sup>3</sup> Prior to Mr McPhail's appointment to the Working Party in November 1995, the ASCPA was represented by the late Peter Edwards AM, Partner, Edwards Marshall & Co, Adelaide.

- (e) Bill Robinson, Member, ASC<sup>4</sup>.

104. The Working Party would like to take this opportunity to acknowledge the significant contribution to the work of the review made by Peter Edwards, who was a member of the Working Party prior to his death in September 1995. Mr Edwards was especially conscious of the aspirations and concerns of accounting practitioners in small and medium sized firms and his contribution to Working Party discussions did much to crystallise thinking on what could and/or should be done to assist such practitioners.

105. The Working Party would also like to acknowledge the work provided by Les Pascoe in the drafting of this report.

## TERMS OF REFERENCE

106. The terms of reference for the review are to:

- (a) examine the current system of registration, appointment and supervision (including disciplining) of auditors under the Law;
- (b) consider whether this system is adequate or needs to be revised or replaced;
- (c) consider the appropriate role of the relevant professional bodies and the ASC in the current system, having regard to overseas experience; and
- (d) prepare a report to MINCO including any recommendations for reform.

## CONSULTATION

107. The then Attorney-General requested the Working Party to consult widely with interested parties and organisations during the course of the review.

108. The Working Party decided to undertake this consultative process in three phases. In the first phase, it placed notices in the *Australian Financial Review* and the journals of the ICAA and ASCPA seeking comments on the issues to be addressed. The Working Party also wrote to government departments and agencies and selected

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<sup>4</sup> Stuart Grant, the ASC's Executive Director — Accounting Practice, advised Mr Robinson on technical matters and assisted the Working Party with the finalisation of the report.

accounting firms<sup>5</sup> seeking comments. In addition, discussions were held with representatives of peak business and professional organisations.

109. In the second phase, the Working Party circulated a discussion paper, which outlined the options that are available for reforming the requirements for the registration and regulation of company auditors, to selected groups, including peak business and professional organisations, government agencies and the larger accounting firms.

110. The third and final phase of the consultative process involved the release of the Working Party's draft report for public comment.

111. A list of the organisations and individuals who made submissions to the Working Party during the three phases of the consultative process is at Appendix A.

112. While the Working Party found the overall consultative process of significant benefit in developing and refining its proposals for reforming the legislative requirements and institutional arrangements for the registration and regulation of company auditors, the Working Party was, nevertheless, disappointed with the low number of submissions received from those most directly affected by the review — existing and potential registered company auditors (RCAs) and corporations that are users of auditing services.

## **BACKGROUND TO THE REVIEW**

113. In July 1992, MINCO established a Working Party of MINCO officers (the MINCO Working Party) to prepare a report concerning professional liability in respect of claims arising from the Law or under related common law remedies. The decision to establish the MINCO Working Party was made against the background of proposals in some jurisdictions to introduce legislation limiting professional liability by providing a maximum cap on such liability. The mandate of the MINCO Working Party was to examine the position in comparable jurisdictions overseas, to take into account the views of interested parties, and to outline any alternative options to a capping scheme of limitation of liability identified as a result of the examination of the position in overseas jurisdictions and the views of interested parties.

114. The MINCO Working Party presented its report to MINCO in June 1993.<sup>6</sup> The report concluded that, of those professionals who might be subject to claims under the Law, only accountants (primarily auditors) and directors face a significant level of

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<sup>5</sup> The six largest accounting firms, plus four or five small/medium firms in each State and Territory, were targeted by the Working Party in the first phase of the consultative process.

<sup>6</sup> Working Party of the Ministerial Council for Corporations, 'Professional liability in relation to Corporations Law matters', 1993.

liability specifically related to actions or functions under the Law. The major alternative option to capping of liability identified in the report was to permit auditors, operating through a company, to be registered as company auditors under the Law.

## **Regulation of Company Auditors**

115. The 1993 report of the MINCO Working Party also recommended that a review should be undertaken of the present regulation of company auditors with a view to ensuring that an appropriate legal framework is in place for the supervision, independence and disciplining of company auditors in relation to their functions under the Law.

116. The rationale for this recommendation was that a solution to the problems associated with professional liability should be accompanied by reasonable assurance that:

- (a) institutional arrangements in place ensure that only adequately qualified and experienced accountants are registered as company auditors; and
- (b) auditors are genuinely independent of the companies that they audit.

117. MINCO endorsed the recommendation that there should be a review of the regulation of company auditors and the Audit Review Working Party was established in the second half of 1994 to undertake the review.

## **Joint and Several and Proportionate Liability**

118. The MINCO Working Party's report further recommended that 'the arbitrary and unfair consequences of the present rules regarding joint and several liability of auditors should be addressed in a review of the law which takes into account the implications of changes in these rules beyond their impact on Corporations Law matters'.

119. An inquiry into the law of joint and several liability was subsequently established by the then Commonwealth and New South Wales Attorneys-General in February 1994. The inquiry was conducted by Professor Jim Davis from the Australian National University. It concluded with a report released in January 1995 recommending that joint and several liability of defendants in actions for negligence causing property damage or purely economic loss be replaced by liability which is proportionate to each defendant's degree of fault.

120. The report also noted that because of the similarities between professional liability for negligence and liability under section 52 of the *Trade Practices Act 1974* (Cth) and section 995 of the Law, it would be anomalous if, in the case of multiple wrongdoers, any one of them should be exposed to different liability depending

upon whether an action is brought under the common law or one of the statutory provisions. The report therefore also recommended that liability for loss arising from misleading conduct in contravention of the Trade Practices Act, the State and Territory Fair Trading Acts<sup>7</sup> or the Law be proportionate to each defendant's degree of responsibility for that loss.

121. Draft model provisions designed to implement the report's recommendations were released on 14 July 1996 by the New South Wales Attorney-General and Minister for Industrial Relations, Mr Shaw, and the former Parliamentary Secretary to the Treasurer, Senator the Hon. Brian Gibson AM, for public exposure for a period of three months. If adopted, the draft model provisions would amend the common law, State and Territory fair trading legislation, the Trade Practices Act and the Corporations Law. The draft legislation was prepared with the agreement of the Standing Committee of Attorneys-General (SCAG) on the basis that it did not involve any jurisdiction committing itself to the conclusions in the Davis report.

## **Other Significant Issues**

122. Since the commencement of the National Corporations Scheme in 1991, a number of concerns have been raised about various aspects of the regulation of company auditors. These issues have been addressed by the Working Party during the course of this review.

123. The most frequent complaint has concerned the difficulty that prospective company auditors, who are either resident in provincial centres or members of small firms, are having in meeting the Law's requirements on practical experience in auditing. This issue is considered in detail in chapter 5.

124. Another issue concerns the supervision of RCAs. The Working Party notes the lack of a legislative requirement for the maintenance of technical skills by such auditors. The Working Party also notes the view expressed in some submissions that the main post-registration reporting requirement contained in the Law, the triennial statement, serves little useful purpose in its present form. These matters are examined in chapter 6.

125. Ensuring the independence of auditors from company management is another issue that is being raised more and more frequently in representations to the Government. While these representations do not necessarily mean that company auditors lack independence, it may, at best, indicate that some company auditors

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<sup>7</sup> *Fair Trading Act 1992 (ACT), Fair Trading Act 1987 (NSW), Consumer Affairs and Fair Trading Act 1990 (NT), Fair Trading Act 1989 (Qld), Fair Trading Act 1987 (SA), Fair Trading Act 1990 (Tas), Fair Trading Act 1985 (Vic) and Fair Trading Act 1987 (WA).*

perform their functions in a manner that gives the perception that they lack independence. This question is examined in chapter 7.

126. A further area of complaint has been the operation of the Companies Auditors and Liquidators Disciplinary Board (CALDB). Complaints have included that the Board is too legalistic; that the costs of both presenting and defending cases are too high; that the range of penalties that may be imposed by the Board are inadequate and that too much of the Board's time is spent dealing with minor administrative matters. These concerns are addressed in chapter 8.

## UNDERTAKING THE REVIEW

127. In undertaking this review, and in preparing this report, the Working Party has been conscious of the highly skilled and significant responsibilities of auditors.

128. The independent external audit is a fundamental element of the world's capital market system. A report of the Public Oversight Board of the SEC<sup>8</sup> Practice Section, American Institute of Certified Public Accountants (AICPA),<sup>9</sup> sums it up in this way:

The independent audit fills an essential role for the investing public and creditors by enhancing the reliability of an operation's published financial statements and giving assurance of that reliability to users of those financial statements...

Strengthening the professionalism of the auditor requires an environment in which boards of directors and management of client companies have high expectations about the auditing firm's integrity, objectivity and professional expertise in which the auditor, in meeting these obligations recognises an overriding public responsibility...

**[Accounting] firms need to emphasise to all professional staff...that auditing is not just one of the many services offered to clients. It is special. It involves a 'public responsibility...'**

Auditing is different from other services the accounting firms render. It imposes special and higher responsibilities...

129. The Working Party considered the following key issues during the course of its deliberations:

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<sup>8</sup> Securities and Exchange Commission (USA).

<sup>9</sup> Advisory Panel on Auditor Independence, 'Strengthening the professionalism of the independent auditor — Report to the Public Oversight Board of the SEC Practice Section, AICPA', Public Oversight Board, Stamford, 1994.

- (a) Who should perform the registration and supervisory functions?
- (b) What should be the appropriate pre-requisites for registration?
- (c) What form should post registration supervision take?
- (d) How should the appointment of company auditors be undertaken and their subsequent independence be ensured?
- (e) What are the appropriate procedures for the removal of a company auditor?
- (f) Who should undertake the disciplinary function and what should be the disciplinary body's functions and powers?
- (g) The resource implications of the Working Party's preferred approach to performing the registration and supervisory functions and undertaking the disciplinary function.

130. Prior to formulating the recommendations set out in this report, the Working Party, as noted above, consulted extensively with parties having an interest in the outcome of the review.

131 In formulating its recommendations, the Working Party also had regard to developments within the accounting profession since 1981, when the forerunner of the existing legislative provisions was introduced. In addition, the Working Party noted the recommendations contained in the research study on bridging the expectation gap and the action taken by the ICAA and the ASCPA in respect of those recommendations.<sup>10</sup>

132. Wherever appropriate the Working Party has endeavoured to ensure that safeguards are built into the recommendations it has made. For example, the proposal to delegate the registration and supervision functions to authorised accounting bodies by way of an MOU will allow the ASC to review and, if necessary, resume control of these functions in the event of inadequate performance by those bodies.

133. The Working Party believes that, with the safeguards built into its recommendations, the proposed self regulatory approach will provide significant benefits including allowing the authorised accounting bodies to perform the registration and regulation functions with optimum efficiency and in an environment which will allow continuing advances in standards to be made.

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<sup>10</sup> For further information about these recommendations, see: ICAA and ASCPA, 'A research study on financial reporting and auditing — bridging the expectation gap', 1994; and ICAA and ASCPA, 'Beyond the gap', 1996.

134. It is important to note that the work and recommendations of this Working Party constitute only one element in the process of strengthening the role of the external auditor. The work of other bodies and organisations, such as the Auditing Standards Board (AuSB), the accounting bodies, the Australian Stock Exchange (ASX), the ASC and the Australian Institute of Company Directors (AICD) all continue to play a part in the overall objective of strengthening the role of the independent external auditor.