

A DIFFERENT SOLUTION TO THE AUDITORS' LIABILITY DILEMMA

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Published audit reports add credibility to a company's published financial statements. This reduces the perceived risk of investment in the company, which benefits both the investor and the company itself. The fear of uninsurable liability has given rise to various proposals to limit auditors' liability for negligence, such as the imposition of a statutory cap. Some Australian cases have also treated plaintiffs harshly in their claims against auditors. This paper argues that auditors must be liable to parties who reasonably rely on their reports. This can be achieved fairly by legislation which imposes a duty of care on auditors towards general purpose users of published financial statements, and provides for proportionate liability between auditors and directors, and compulsory insurance for directors.

Introduction

There have been a number of developments recently which are relevant to the issue of auditors' liability for negligence. Since the passing of the *Professional Standards Act* in December, 1994, the accounting profession in New South Wales has begun the gradual adoption of a scheme to cap liability. On a federal level, there have been indications of a willingness by the Attorney-General to allow partners in audit firms to incorporate.

In addition, the Report of Stage Two of the *Inquiry into the Law of Joint and Several Liability*, published in January, 1995, has recommended the adoption of proportionate liability, in place of joint and several liability, in negligence claims not involving personal injury.

Auditors have long complained that they have been held liable in negligence claims for damages greatly out of proportion to the extent of their culpability. This liability has proved expensive to insure against, and one of the auditing profession's responses has been to deny that a duty of care is owed except in very limited circumstances.

The developments mentioned above are all relevant, directly or indirectly, to the question of *how much* auditors would be liable to pay in damages if a successful claim is made against them for negligence in the giving of an audit opinion. However, they fail to address the important issue of the scope of the auditors' duty of care.

This article will argue that in the case of audit opinions published with a company's annual financial statements, auditors should be liable to general purpose users of those financial statements, since these are the persons for whose benefit the statements are published.

First, the proposed reforms outlined above will be examined. Next, the purpose of external financial reporting and auditing will be looked at, followed by an analysis of recent Australian cases involving auditors. Against this background, the reforms will be examined to determine whether they solve the difficulties of auditors facing large lawsuits, while at the same time protecting the interests of parties who reasonably rely on published audit opinions.

Finally, a solution will be proposed. It will be contended that legislative recognition of a duty of care to general purpose users of published financial statements, together with the implementation of proportionate liability and compulsory insurance for directors of companies publishing their financial statements, will achieve both a reduction in the amount of damages for which auditors could be held liable, as well as satisfying the purpose of external auditing.

Recent developments

The New South Wales Parliament passed the *Professional Standards Act* in December, 1994,¹ which permits the introduction of a statutory cap on the liability of professionals, including auditors. The Western Australian Cabinet has approved the drafting of similar legislation. The New South Wales act creates a Professional Standards Council, to oversee the creation and implementation of limited liability schemes.²

In return for the benefits accruing from participation in the scheme, professionals may be obliged to carry a prescribed amount of professional indemnity insurance³ or have a minimum amount of business assets.⁴ An occupational association seeking the approval of a capping scheme must

1 Assent was given on 12 December 1994.

2 *Professional Standards Act* 1994 (NSW) Part 6.

3 *Ibid.*

4 *Ibid.*

also provide the Council with details of proposed risk management strategies.⁵

Despite the fact that, unlike earlier capping proposals, the *Professional Standards Act* allows for capped liability per individual claim and not per act of negligence,⁶ the scheme has its critics. The most recent report of the Working Party of the Ministerial Council for Corporations⁷ noted that capping in only two states could lead to forum shopping by professionals, and that unless federal legislation was introduced to overcome the effect of the *Trade Practices Act 1974* (Cth), capping may be of little benefit.⁸

Govey⁹ has also suggested that:

it is worth considering whether the call for capping of damages is really a claim that not only has the present system failed, but that it is incapable of being reformed in a manner which addresses the real problems.¹⁰

He identified these 'real problems' as¹¹, first, the solvency of the auditors, in the face of a company's insolvency, second, unrealistic expectations about the role of auditors, third, decisions made by courts and lawyers with the benefit of hindsight, fourth, the pressure to settle, even when the auditor has a strong defence, and finally, the fact that auditors are blamed for losses which were really caused by company mismanagement. In addition, he questioned whether capping would operate unfairly for joint tortfeasors where one has the benefit of a capped liability and another does not ...¹²

The Victorian Attorney-General, Mrs Jan Wade, has indicated that Victoria will not follow New South Wales' lead and permit the introduction of a statutory cap. She commented:

5 *Ibid.*

6 'A limitation imposed by a scheme in force under this Act of an amount of damages is a limitation of the amount of damages that may be awarded for single claim and is not a limitation of the amount of damages that may be awarded for all claims arising out of a single event'. *Professional Standards Act 1994* (NSW) s 29(1):*Ibid.*

7 Report of the Working Party of the Ministerial Council for Corporations *Professional Liability in respect of the Corporations Law - Consideration of Capping Regime*, October 1994.

8 *Ibid* at 23.

9 Govey I, 'Professional liability in relation to the Corporations Law: Options for Reform' Paper presented to the Corporate Law Workshop 29 to 31 October 1993, Kilmore, Victoria. Mr Govey is the Principal Adviser, Business Law, Commonwealth Attorney-General's Department.

10 *Ibid* at 9.

11 *Ibid* at 7.

12 *Ibid* at 9.

A cap means persons who suffer losses are not recompensed, and I suppose there is a thing with damages, if you reduce the impact of them, (auditors) are perhaps not as careful as they should be.¹³

Another possible reform concerning auditors and their liability to pay damages is the proposal to permit the incorporation of audit firms, which is being examined federally as part of a review by the Attorney-General of the registration and regulation of auditors. At present, accountants generally are not prohibited from forming corporations, but registered company auditors are. Under s 324(1) of the *Corporations Law*, a person is not permitted to act as an auditor of a company if (d) the person is not a registered company auditor; ...f. Section 1279 of the *Law* provides that application for registration as an auditor may be made by a natural person. Under s 324(2), firms may be appointed as auditors if at least one member of the firm is a registered company auditor.

Britain has allowed auditors to incorporate since 1991, and recently KPMG announced that it will incorporate its audit practice in Britain, reportedly in response to "horrendous" lawsuits and the "inequitable" application of the doctrine of joint and several liability.¹⁴ The main attraction of incorporation for auditors is that it protects the private assets of auditors within the audit company who were not negligent. In a partnership, each partner is jointly and severally liable for torts committed by fellow partners.¹⁵

The third major initiative to combat the unfairness of auditors carrying huge damages burdens alone is the *Inquiry into the Law of Joint and Several Liability* established by the federal Attorney-General, Mr Michael Lavarch and his New South Wales counterpart, Mr John Hannaford, and conducted by Professor Jim Davis.

Auditors, with their personal indemnity insurance, are obvious targets in litigation despite the fact that their negligence may have only been minor compared to that of the company's directors. Since insurance for directors is not compulsory, directors may choose not to be insured, expressly to deter plaintiffs from suing them. With joint and several liability, there is no incentive for a plaintiff to chase the few personal assets of an uninsured director, when full recovery can be had from the professional indemnity insurance of the auditor.

13 Accountancy Hotline, 'Auditors Get a Blast in Victoria', *Business Review Weekly* 17 April 1995 at 75.

14 'KPMG starts new era with incorporation' *Business Review Weekly* 1 May 1995 at 74.

15 This is according to the largely uniform partnership legislation in each state of Australia. For example, pursuant to s 14 of the *Partnership Act 1958 (Vic)*: Where by any wrongful act or omission of any partner acting in the ordinary course of business of the firm or with the authority of his co-partners loss or injury is caused to any person not being a partner in the firm the firm is liable therefor to the same extent as the partner so acting or omitting to act. Section 13 provides that: Every partner in a firm is liable jointly with the other partners for all debts and obligations of the firm incurred while he is a partner.....

As a result of this recognised injustice,¹⁶ auditors have long considered¹⁷ that the rule should be amended to provide that each defendant only compensate the plaintiff in proportion to the degree of individual negligence.¹⁸ The joint and several liability rule, also known as solidary liability, operates by allowing plaintiffs suffering loss to recover damages from all the tortfeasors responsible for their loss, or from any of them.

The justification for the joint and several liability rule lies in its emphasis on recovery by an innocent plaintiff who is more deserving of the court's concern than a defendant who is at least partly blameworthy. Proportionate liability alone means that a plaintiff suing an insured auditor and an uninsured director would be uncompensated for the loss caused by the director if he or she were unable to meet the damages bill.

In July 1994 the Report of Stage One of the Inquiry into the Law of Joint and Several Liability was published.¹⁹ The report examined a number of aspects of joint and several liability, including liability imposed by the *Trade Practices Act 1974* (Cth),²⁰ the law relating to the building industry and the current law in comparable jurisdictions overseas. It pointed out²¹ that Victoria, South Australia and the Northern Territory all have legislation²² governing defective building work which provides for proportionate liability between such parties as the builder, architect, engineer and local council.

After examining various combinations of proportionate and joint liability, which depend on factors such as co-defendant solvency and contributory negligence, the 1994 Stage One Report was unable to determine which of the variations was to be preferred.²³ It recommended further consideration of changes to the law.

16 The unfairness of the situation was acknowledged by Rogers C J Comm D in *AWA Ltd v Daniels t/a Deloitte Haskins & Sells & Ors* (1992) 10 ACLC 933 at 1022.

17 For example, a special committee of the American Institute of CPAs examined the issue in 1985: R Mednick 'Accountants' Liability: Coping with the Stampede to the Courtroom (1987) *Journal of Accountancy* 118 at 120.

18 Presently, auditors can join other blameworthy parties as co-defendants or, if left bearing the full amount of a damages bill, can sue them for contribution, but if those other parties are uninsured or insolvent, such actions will be fruitless.

19 Report of Stage One of the *Inquiry into the Law of Joint and Several Liability*, July 1994 hereinafter referred to as the 1994 Stage One Report.

20 There is considerable doubt whether notions of contributory negligence are applicable in a claim made under s 82 of the *Trade Practices Act* or its equivalent in the fair trading legislation: 1994 Stage One Report at 15.

21 *Ibid* at 14.

22 *Building Act 1993* (NT) s 155; *Development Act 1993* (SA) s 72; *Building Act 1993* (VIC) s 131.

23 1994 Stage One Report at 29.

The Report of Stage Two of the *Inquiry into the Law of Joint and Several Liability* was issued in January, 1995.²⁴ The Report recommended that:

joint and several liability be abolished, and replaced by a scheme of proportionate liability, in all actions in the tort of negligence in which the plaintiffs claim is for property damage or purely economic loss.²⁵

The Report also recommended that proportionate liability which apportions fault amongst all those responsible be adopted. This means that if one of the defendants is insolvent, the unrecovered loss will fall on the plaintiff, not the remaining solvent defendants. Any contributory negligence by the plaintiff is taken into account in deciding the degrees of liability to be apportioned amongst all those responsible for the loss. The other forms of apportionment canvassed by the 1994 Stage One Report were considered to be unfair to solvent defendants,²⁶ arbitrary²⁷ and involving concepts of cause [which are] notoriously difficult to apply with any precision.²⁸

However, if proportionate liability is adopted it will result in undercompensated plaintiffs in many cases involving claims against auditors, directors and the audited company. Auditors are often sued for negligent misstatement by shareholders and creditors of companies because those companies are now insolvent and unable to meet their obligations. While directors are permitted to be insured, there is no obligation on them to do so, and they may choose to be uninsured precisely to deflect litigation to the well insured auditor.²⁹

The purpose of a published audit opinion

The focus of this article is on the audit report attached to a company's published annual report. The aim of the company's published financial

24 Report of Stage Two of the *Inquiry into the Law of Joint and Several Liability* January 1995 (1995 Stage Two Report).

25 1995 Stage Two Report at 34. The report also recommended that claims against professionals for misleading and deceptive conduct under s 52 of the *Trade Practices Act 1974* (Cth) and the state fair trading equivalents also be subject to proportionate, instead of joint and several, liability (Ibid at 39).

26 Ibid at 37.

27 Ibid at 38.

28 Ibid at 36.

29 Auditors who are members of the two leading professional societies are obliged to have professional indemnity insurance, for the compensation of persons suffering loss as a result of the act or default of an auditor. For example, the Institute of Chartered Accountants in Australia By-laws paragraph 407 provides that each principal in public practice is required by the professional associations to have a minimum level of insurance of \$250,000. Such insurance must cover 'either any civil liability or any act, error or omission of an insured providing the services for which a current Certificate of Public Practice is required.'and must be maintained for seven years after the person has ceased to practice.

reports, such as the balance sheet and the profit and loss statement, is stated in Statement of Accounting Concepts SAC 2³⁰ as follows:

General purpose financial reports shall provide information to users that is useful for making and evaluating decisions about the allocation of scarce resources.³¹

SAC 2 confines the parties for whose benefit general purpose financial reports are published by stating that the reports focus

... on providing information to meet the common information needs of users who are unable to command the preparation of reports tailored to their particular information needs. These users must rely on the information communicated to them by the reporting entity.³²

This article will refer to those information users as general purpose users of published financial statements. The information needs of users of general purpose financial statements as outlined in SAC 2 was given judicial recognition in *Mazda Australia Pty Ltd v Australian Securities Commission*.³³ Despite the concept's lack of statutory force, the Administrative Appeals Tribunal relied on SAC 2 to deny an application for relief from compliance with an accounting standard concerning related party transactions.³⁴

General purpose users of published financial statements should be distinguished from other parties having dealings with companies in reliance on an audit report but which are in a position to demand the production of specific information to meet their needs. These parties would include large lenders, such as banks, and substantial investors in companies. They do not need to rely on general purpose published financial statements in making lending and investing decisions.

The function of general purpose financial reporting in Australia is thus not confined to reporting to current shareholders on stewardship as

30 Statement of Accounting Concepts SAC 2 'Objective of General Purpose Financial Reporting' reissued August 1990. Statements of Accounting Concepts are issued by the Australian Accounting Standards Board and by the Australian Accounting Research Foundation on behalf of the Australian Society of Certified Practising Accountants and the Institute of Chartered Accountants in Australia. Their purpose is to provide guidance, both in the preparation of accounting and auditing standards, and for preparers of accounts and their auditors where no standards exist.

31 Statement of Accounting Concepts SAC 2 paragraph 43.

32 Statement of Accounting Concepts SAC 2 paragraph 7.

33 (1992) 10 ACLC 1479.

34 Ibid at 1484.

suggested by Lord Bridge in *Caparo Industries Plc v Dickman & Ors*,³⁵ but rather is intended to meet the information needs of both present and future shareholders and creditors, who cannot obtain the information they require elsewhere.

The *Corporations Law* requires many companies to appoint an auditor,³⁶ whose duty it is to report on the company's financial statements, and accounting and other records.³⁷ Statement of Auditing Standards AUS 1 states:

The objective of an audit of financial information is to enable an auditor to express an opinion on such financial information.

The auditor's opinion helps establish the credibility of the financial information.³⁸

By establishing the credibility of the company's financial statements, those statements become more useful than unaudited statements would be.³⁹ This is because investors and creditors are able to trust the truth and fairness of the company's financial data once it has been audited.

Rogers⁴⁰ has recognised that a wide class is intended to benefit by the audit opinion. He quoted with approval the Chief Justice of the Supreme Court of the United States in *United States v Arthur Young & Co.*⁴¹

By certifying the public reports that publicly depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public.⁴²

35 [1990] 2 AC 605 at 626: The shareholders of a company have a collective interest in the company's proper management and in so far as a negligent failure of the auditor to report accurately on the state of the company's finances deprives the shareholders of the opportunity to exercise their powers in general meetings to call the directors to book and to ensure that errors in management are corrected, the shareholders ought to be entitled to a remedy.

36 Public companies and large proprietary companies are required by s 327 of the *Corporations Law* to appoint an auditor. Small proprietary companies are also required to appoint an auditor in limited circumstances, pursuant to s 325.

37 *Corporations Law* s 331A(1).

38 Statement of Auditing Standards AUS 1 paragraphs 7 and 8.

39 Robertson J, 'A Defense of Extant Account Theory' (1984) 3 *Auditing: A Journal of Practice and Theory* 57 at 59.

40 Rogers A, 'Today's Plaintiff - Tomorrow's Defendant: A Proper Allocation of Liability', RJ Chambers Lecture delivered at the University of Sydney Accounting Research Foundation 16 October 1992.

41 (1984) 465 US 805 at 817.

42 Rogers above n 40 at 10.

By providing an opinion as to the truth and fairness of the company's financial report, as well as reporting on compliance with the accounting requirements of the *Corporations Law* and applicable accounting standards, the auditor reduces the risk that such information will contain errors.⁴³ One study⁴⁴ found that 94 per cent of respondents to a survey would buy shares in a company only if it was audited.

Research has established that the use of audited accounting information improves the estimation of risk.⁴⁵ This benefits the company since the cost of both debt and equity capital decreases as the perceived risk of the investment decreases.⁴⁶ The savings made by the company from cheaper capital more than offset the cost of the audit,⁴⁷ arguably making an audit desirable to the company even in the absence of statutory requirements for its performance.⁴⁸

Therefore it can be concluded that auditing serves both parties external to the company as well as the company itself. Shareholders and creditors gain by the audit opinion making the company's financial statements more reliable and credible. The company benefits by a favourable audit opinion decreasing the perceived risk attaching to an investment in it. To argue that auditors should not be liable for negligence to general purpose users of their audit reports when the auditors fail to discharge their responsibilities is to undermine both their economic function as well as their statutory and professional duties.

Recent Australian cases involving auditors

Each of the initiatives discussed above seeks to remedy the problem of auditors' extensive liability by limiting in some way the damages payout to any successful plaintiff. Yet they fail to redress the unfortunate trend of

43 Pound G, 'Audit Report Readability' in Pound G (Ed) *The Audit Reporting Function - Some Issues*, Armidale: Financial Management Research Centre (1980) 1 at 4. Also Gilling D, 'Auditors and Their Role in Society - The Legal Concept of Status' (1976) 14 BLR 88 at 97.

44 Beck G, 'The Role of the Auditor in Modern Society: an empirical appraisal' (1973) *Accounting and Business Research* 117 at 119.

45 Beaver Kettler and Scholes 'The Association Between Market-Determined and Accounting-Determined Risk Measures' (1970) *Accounting Review* 654.

46 Fama and Laffer, 'Information and Capital Markets' (1971) *Journal of Business* 289.

47 Wallace W, 'The Economic Role of the Audit in Free and Regulated Markets' University of Rochester 1980 reprinted in *Auditing Monographs* McMillan (1985) 16.

48 There is evidence of voluntary auditing from 500 B C - Wallace *Auditing* (2nd ed) Boston PWS-Kent Publishing Company (1991) 26; Moyer also reports considerable voluntary auditing in the United States prior to its statutory requirement - Moyer *Early Developments in American Auditing* (1951) *Accounting Review* 3.

recent cases involving auditors which severely restrict the scope of their duty of care. These cases have also been influenced by arguments about wide and uninsurable liability.

A successful negligence claim requires the plaintiff to prove a number of matters. First, the defendant must owe the plaintiff a duty of care, based upon the reasonable foreseeability of the defendant's act or omission causing the plaintiff loss, as well as physical, causal or circumstantial proximity between the two. Secondly, the defendant's behaviour must fail to reach an objectively determined standard of care. Thirdly, the defendant's failure to reach the standard of care must cause the plaintiff's loss, and, finally, the loss caused must be reasonably foreseeable. The recent cases discussed below concern the proximity requirement of the duty of care.

*R Lowe Lippman Figdor & Franck v AGC (Advances) Ltd*⁴⁹ involved the provision by auditors of negligently prepared audited accounts to the client company in the knowledge that the company would probably supply a copy to their lender, AGC, which required the accounts for loan review purposes. Despite holding⁵⁰ that the auditors had this knowledge, the Full Court of the Victorian Supreme Court⁵¹ held that:

the auditor who supplies his report to the company in the usual way cannot be liable unless his purpose, or one of his purposes, in making the statement in question is to induce the plaintiff, or a class which includes the plaintiff, to act on it.⁵²

In reaching this decision, Brooking J relied on the majority judgment from *San Sebastian Pty Ltd v Minister Administering the Environmental Planning and Assessment Act 1979*⁵³. The speech of the majority of the High Court quoted⁵⁴ by him refers to a number of ways in which a maker of a statement can come under a duty of care:

The author, though volunteering information or advice, may be known to possess, or profess to possess, skill and competence in the area which is the subject of the communication. He may warrant the correctness of what he says or assume responsibility for its correctness. He may invite the recipient to act on the basis of the information or advice, or intend to induce the recipient to act in a particular way.⁵⁵

49 [1992] 2 VR 671.

50 Ibid at 682.

51 The principal judgment was given by Brooking J, with whom Gobbo J concurred. A Short separate judgment was also given by Tadgell J, also agreeing with Brooking J.

52 [1992] 2 VR 671 at 684. Tadgell J agreed that reliance by the plaintiff, even if known to the defendant, was not enough to establish a duty of care ibid at 685.

53 (1986) 162 CLR 340.

54 [1992] 2 VR 671 at 680.

55 (1986) 162 CLR 340 at 357.

Brooking J implies⁵⁶ that these ways are not alternatives since the High Court in *San Sebastian* then stated⁵⁷ that the appellants must prove intention to induce reliance. But this conclusion by Brooking J overlooks the fact that the appellants in *San Sebastian* had pleaded their case on the basis of such an intention, and not on any of the other alternatives specifically mentioned by the majority as being available to found a duty of care.

The Supreme Court of New South Wales decision in *Columbia Coffee & Tea Pty Ltd & Anor v Churchill & Ors t/a Nelson Parkhill*⁵⁸ concerned, inter alia, the liability of auditors to a third party which had relied upon a negligently audited set of accounts. While counsel for the auditors admitted that errors had been made in relation to the recognition of liabilities, they denied that the plaintiff had relied upon the audit report containing the breach in making its decision to purchase shares in the audited company.

The Audit Manual of the defendant referred to 'responsibilities to ... interested parties who read and rely on our reports ... beyond the persons who employ us in the first instance or those to whom the report is addressed initially.' Rolfe J held that there was an assumption of responsibility by the auditors 'to anyone who may reasonably and relevantly rely upon the audited accounts for the purpose of ordering their business affairs'.⁵⁹ Although Rolfe J drew no conclusion on the class to whom the duty would have been owed in the absence of such a provision, he indicated that the '... recognition by the audit manual is nothing more than a commonsense approach to the way in which business affairs are conducted'.⁶⁰

However, having established that a duty of care was owed to the plaintiff, Rolfe J held that on the facts, there was no reliance on the audited accounts, and the plaintiff thus failed to prove that the defendant had caused its loss.

Another decision involving an auditor and an outsider who relied on an audit report is *Esanda Finance Corporation v Peat Marwick Hungerfords*.⁶¹ This case concerned a finance company which lent money to the audited company in reliance on the company's published financial statements and audit report. The Full Court of the Supreme Court of South

56 [1992] 2 VR 671 at 681-2.
57 (1986) 162 CLR 340 at 358.
58 (1992) 29 NSWLR 141.
59 Ibid at 172.
60 Ibid at 173.
61 (1994) 61 SASR 424.

Australia found for the auditors who had applied to have the plaintiff's negligence claim struck out.

King CJ looked extensively at *San Sebastian*, as well as its application in *AGC*. He concluded that:

to my mind the judgments in *San Sebastian* indicate that a duty may arise from other circumstances. Nevertheless circumstances, in order to give rise to a duty of care, must demonstrate a relevantly close relationship and will generally, although I think not always, include an intention that the statement be acted upon by the plaintiff.⁶²

Since the plaintiff was not a shareholder in the company at the time the audit report was prepared, nor was there any evidence of knowledge by the auditors of the proposed financial transaction between the plaintiff and the company, he found that:

in the absence of some feature indicating an assumption of responsibility to the plaintiff to exercise care in the preparation of the audit certificate, an auditor is not under a duty of care to the plaintiff unless the auditor intended to induce the plaintiff to act in reliance on the audit certificate.⁶³

The reasonable foreseeability of the fact that someone like the plaintiff might rely on the published financial statements and the audit report was held not to be sufficient to establish the proximity necessary for a duty of care.⁶⁴

Plaintiff's counsel submitted that the auditors were members of the Institute of Chartered Accountants in Australia and were therefore subject to an accounting standard on materiality⁶⁵ which referred to

consideration of the users, or likely users, of financial statements, the information needs of those users and, therefore, of the objectives of financial reporting ... Users of financial statements of a private sector entity would include the present and potential providers of equity and loan capital, and creditors.⁶⁶

However, King CJ rejected the argument that the defendant's membership of the Institute gave rise to a duty of care to the plaintiffs.⁶⁷ He also found himself unable to agree with Rolfe J in *Columbia Coffee*

62 Ibid at 431.

63 Ibid at 431.

64 Ibid at 431.

65 Statement of Accounting Standards A A S 5 - Materiality in Financial Statements, reissued November 1986.

66 Ibid at paragraph 7 discussed in *Esanda* (1994) 61 SASR 424 at 432.

67 (1994) 61 SASR 424 at 432.

regarding the assumption of responsibility stemming from the defendant's Audit Manual in that case:

I do not think that the mere inclusion in a manual or set of standards of an acknowledgement of a professional responsibility to have the interests of users other than the client in mind in determining what is to be included in the accounts or in carrying out the audit, can have the effect of enlarging the area of legal duty by creating a legal duty of care to persons to whom it would not otherwise be owed.⁶⁸

Olsson J who, along with Millhouse J, concurred with the Chief Justice, concluded that 'the mere plea of assumption of responsibility (based on general audit standards) is simply not enough'.⁶⁹ An application has been made by the plaintiff for special leave to appeal to the High Court,⁷⁰ but the Court has reserved its judgment on the application.

The recent decision of a single judge in interlocutory proceedings in Victoria in *Hong Kong Bank of Australia Ltd v BPTC Ltd (in liq)*⁷¹ did not concern a general purpose user of a published financial statement but rather an on-going lender to a trustee of unit trusts. Therefore again the case is not directly in point but it does strongly support the findings of the High Court in *San Sebastian* and the Victorian Full Court in *AGC*.

The facts of *AGC* were held to be indistinguishable from those in *Hong Kong Bank*, despite the fact that in *Hong Kong Bank* the auditors were virtually certain of supply of their audit report to the plaintiffs. In finding for the defendant auditors Batt J upheld the requirement that the auditors must *intend* to induce the plaintiffs to act in a particular way in reliance on their statement.⁷²

In contrast, the Full Court of the Supreme Court of Western Australia in *Edwards Karwacki Smith & Co Pty Ltd v Jacka Nominees Pty Ltd (in liq)*⁷³ looked at whether there was an arguable duty of care owed by auditors to investors in a finance broking firm. No final determination was made since the case involved an application for summary judgment, but the court refused to grant the application on the ground that there was an arguable duty of care.⁷⁴ Nicholson J was anxious:

68 Ibid at 433.

69 Ibid at 445-6.

70 13-14 December 1995.

71 (1995) ATR 81-358.

72 Ibid at 62,638.

73 (1995) 13 ACLC 9.

74 Ibid at 13 per Malcolm C.

not to risk stifling the development of the law by summarily rejecting a claim where there is a reasonable possibility that, as the law develops, it will be found that a cause of action will lie.⁷⁵

Despite the lack of a direct precedent, he found the respondent's arguments thoroughly arguable⁷⁶ - these related to the auditor's statutory duty to report; the fact that the investors were persons whom the statute was enacted to protect; the plaintiff's small and circumscribed class; and the ascertainable amount of their claim.⁷⁷

Soon after the *Jacka Nominees* decision similar issues were analysed by a single judge of the Supreme Court of South Australia in *Executor Trustee Aust Ltd v Peat Marwick Hungerfords*.⁷⁸ The case concerned a striking out application of the claims made by plaintiffs who were banks and debenture holders. Bollen J quoted extensively⁷⁹ from the *Esanda* decision.

In particular, he considered part of the judgment of King CJ to be of utmost importance where the Chief Justice acknowledges that an assumption of responsibility may contribute to the finding of a duty of care, and that an intention to induce reliance is not an essential ingredient of liability for negligent misstatement cases.⁸⁰

It can be concluded that legal liability in Australia of auditors to general purpose third parties which rely on a negligently prepared audit opinion is far from clear. On the one hand, the Full Courts of both the Victorian Supreme Court⁸¹ and the Supreme Court of South Australia⁸² endorse the requirement of an intention to induce reliance. On the other hand, a single judge of the New South Wales Supreme Court has adopted the dual test of assumption of responsibility and known reliance, but this case is capable of being distinguished on its facts due to the provisions of the audit manual.⁸³ In addition, courts in both South Australia and Western Australia have found arguable the tests of assumption of responsibility and knowledge of reliance as elements which help to constitute proximity in cases of this kind.⁸⁴

The position of auditors towards general purpose users of published financial statements is complicated further by s 52 of the *Trade Practices*

75 Ibid at 29 per Nicholson J with whom Pigeon J concurred.

76 Ibid at 29.

77 Ibid at 28.

78 (1994) 63 SASR 393.

79 Ibid at 395, 396.

80 Ibid at 398.

81 *AGC* followed in Victoria by *HongKong Bank*.

82 *Esanda* endorses the intention to induce reliance test in the absence of a feature indicating an assumption of responsibility.

83 *Columbia Coffee*.

84 *Executor Trustee, Jacka Nominees* and *Esanda*.

Act (Cth) 1974⁸⁵ and the state Fair Trading Act equivalents.⁸⁶ A number of recent actions against auditors has made claims under these provisions as alternatives to negligence.⁸⁷ It can be argued that the misleading and deceptive conduct sections demonstrate legislative willingness to clarify and simplify the cause of action for a plaintiff who has suffered loss as a result of misleading conduct. However, the absence of a successful claim to date, as well as doubts as to whether the expression of an audit opinion is within the ambit of the term 'misleading or deceptive conduct',⁸⁸ suggest that s 52 and state equivalents are not adequate to provide a clear remedy for general purpose users of published financial statements.

If auditors are not held liable for negligence to the very parties whom their audit reports are designed to benefit, credibility in the audit function will be lost. The main problem with extending liability to general purpose users of published financial statements is that they are not identified, or even identifiable, prior to the giving of the audit opinion, except in the loosest sense of being present and potential shareholders and creditors.

However, auditors are in a unique position in that their reports have a huge impact on the capital market since an unqualified opinion can lower the risk of investing in, or lending to, a company. The social desirability of maintaining the credibility of the audit function is, in my opinion, of sufficient importance to differentiate the position of auditors from others making negligent statements, and to make unnecessary the requirement of identifying precisely the persons to whom a duty is owed.

The majority in *San Sebastian* stated⁸⁹ that a duty of care could arise from the known skill and competence of the speaker, which applies to auditors due to their professional status. *San Sebastian* also referred to the

85 'A corporation shall not, in trade or commerce, engage in conduct that is misleading or deceptive or likely to mislead or deceive.'

86 *Fair Trading Act 1992 ACT* s 12; *Fair Trading Act 1987 NSW* s 42; *Consumer Affairs and Fair Trading Act 1990 NT* s 42; *Fair Trading Act 1989 Qld* s 38; *Fair Trading Act 1987 SA* s 56; *Fair Trading Act 1990 TAS* s 14; *Fair Trading Act 1985 VIC* s 11, 12; *Fair Trading Act 1987 WA* s 10.

87 For example, the *Esanda* case discussed above; the \$1 billion claim against Peat Marwick Hungerfords by the Victorian state government in relation to Tricontinental; the \$320 million suit by the liquidator of the Linter Group against Price Waterhouse; and most recently (September 1995) the claim by Southern Cross Holdings against Arthur Andersen.

88 The Full Court of the Federal Court held in *Global Sportsman Pty Ltd & Anor v Mirror Newspapers Pty Ltd & Anor* (1984) 2 FCR 82, a case involving a misleading newspaper report about a famous cricketer, at 88 'An expression of opinion which is identifiable as such conveys no more than that the opinion expressed is held, and perhaps that there is basis for the opinion. At least if those conditions are met, an expression of opinion, however erroneous, misrepresents nothing.'

89 (1986) 162 CLR 340 at 357.

speaker warranting the correctness of, or assuming responsibility for the correctness of, his statement. It should be recalled that the objective of an audit is the expression of an opinion⁹⁰ which helps establish the credibility of the company's financial information,⁹¹ which in turn is published to meet the common information needs of users who are unable to command the preparation of reports tailored to their particular information needs.⁹²

Therefore, given that the purpose of the external publication of the auditor's report is to provide information to general purpose users of published financial statements, it can be argued that auditors know of reliance on their opinions by those users, and thus that they assume responsibility for the correctness of their reports to them.

Why recent developments will not solve the problem

The imposition of a statutory cap does nothing to address the issue of the parties to whom auditors owe a duty of care. It only deals with the excessive damages problem. A plaintiff would still have to argue, and a defendant auditor defend, the questions of duty of care, breach of the required standard of care and causation, so the significant costs of litigation are not reduced by the cap.

In addition, the auditing profession may not welcome the statutory cap if it leads to a significant decrease in audit fees. Not only would auditors have smaller professional indemnity premiums to pass on to their clients, but, more importantly, the companies being audited may be unwilling to pay for "audit credibility" which they do not get. If the trustworthiness of the company's financial statements is undermined by a "limited" audit report,⁹³ companies may well have to pay a higher premium to compensate for risk to shareholders and creditors and they will not want to pay their auditors as much as they do at present for a "fully backed" audit report. And why should auditors be saved from financial ruin if their negligence has caused financial ruin to the innocent general purpose users of their audit opinion?

90 Statement of Auditing Standards AUS 1, reissued September 1993 (AASB) paragraph 7.

91 Ibid at paragraph 8.

92 SAC 2 Objective of General Purpose Financial Reporting, reissued August 1990 (ASRB) paragraph 7. This argument can be distinguished from the unsuccessful one raised by plaintiffs counsel in *Esanda*, where the needs of users were mentioned as incidental to a discussion of materiality. The SAC referred to above is the basis upon which accounting standards for published financial statements are developed. For the registered company auditors who are members of the two main professional societies, adherence to applicable accounting standards is mandatory.

93 An audit report with capped liability would imply that auditors are saying: The financial statements are true and fair, but only to the extent of our professional indemnity insurance; we are not so convinced of the fact that we will stake our partnership and private assets as well.

The proposal to permit auditors to incorporate does nothing to solve the problem of plaintiffs looking to "deep pocket" well insured auditors for compensation, rather than spreading liability between all the parties who contributed to the loss. The actual negligent party would remain fully at risk notwithstanding the limitation on the liability of the firm. Yet at the same time, incorporation, by removing the personal assurances and asset backing of all the partners of the audit firm, may result in plaintiffs being undercompensated for their losses. This may in turn partly undermine the credibility of the audit report.

A successful claim against an audit company could result in the liquidation of the audit company and the destruction of its reputation and goodwill. Although non-negligent partners' personal assets would be protected from a judgment, nonetheless the winding up of the audit company would be just as undesirable as a judgment against auditors in a partnership.

Therefore neither proposal is entirely beneficial to auditors, nor to the parties for whose benefit the audit opinion is published. In the case of the statutory cap, auditors would have their maximum liability fixed at the capped amount, and would be insured to that limit as a condition of participation in the scheme. With incorporation, firm assets as well as insurance would be available, with the maximum amount set as the total of these two. Whether the amounts currently paid in judgments and settlements exceed either of these maxima is irrelevant to the validity of either of these proposals. It is the message that they send to the users of the audit reports which is crucial, and while auditors convey the impression that they are not prepared to stand behind their published audit opinions, the credibility of the audit will be reduced.

Unlike the statutory cap and incorporation, the proposal to reform the rule of joint and several liability does not aim to deny a plaintiff full recovery where damages exceeded a limit considered acceptable to the auditor, but instead aims to attribute to the parties responsible only their share of the blame for the plaintiff's loss.

Proportionate liability does not involve a reduction of the auditor's responsibilities in relation to the conduct of the audit and the production of the audit report. The liability of auditors is not reduced because proportionate liability allows them to rely blindly on information supplied by management. Rather, it is reduced because errors in the financial statements are at present partly due to the auditor's negligence in failing to detect them and partly due to the negligence of the company and its directors in failing to prevent their inclusion.

However, while the introduction of proportionate liability will allow for a fair outcome for auditors in the event that audit liability is extended to general purpose users of published financial statements, on its own it does nothing to give effect to the purpose of publishing audit reports. It neither provides a right of action for parties who are forced to rely on a company's published financial statements in making investment or lending decisions, nor does it ensure that any plaintiff suing for losses will be adequately compensated. In my opinion, this can only be achieved by the statutory reforms outlined below.

The solution

The difficulty in developing a solution to the auditors' liability dilemma is reconciling the apparently contradictory considerations of disproportionate and expensive liability on the one hand, and extending that liability to a wider class of plaintiff than the common law currently permits on the other.

In my opinion, the amount of damages payable in a successful claim and the parties who can make such a claim are separate issues which can be accommodated by legislation. This would provide, first, for a duty of care owed by auditors to those who reasonably rely on a published opinion, secondly, for proportionate liability between all those responsible for the loss, and thirdly, for compulsory professional indemnity insurance to be held by directors of companies which published their financial statements.

If both auditors and directors are insured, it could be argued that holding directors severally liable would produce the same result as currently occurs, namely that one or more insurance companies would pay for the plaintiffs' losses, but this ignores both the deterrent effects of personal civil liability, as well as the issue of who is in a better position to prevent losses occurring.

Directors can better ensure that the company's financial statements are true and fair. First, employees for whose actions they are responsible deal with every transaction which contributes to the final financial statements, as opposed to the auditors who scrutinise only a sample of transactions. Secondly, directors are in a position to implement internal controls to prevent fraud and error occurring. Finally, directors know their own business thoroughly and are thus more able to anticipate high risk areas than auditors who cannot be specialists in all types of business.

Compulsory insurance for directors alone will not necessarily achieve a fair outcome for auditors if the joint and several liability rule remains. It is still easier and cheaper to sue one defendant rather than two, so plaintiffs who

choose to sue the auditor and who can recover entirely from the auditor have no incentive to chase the company's directors, even if they are insured.

Possible legislation

In drafting legislation to address the deficiencies in the law relating to auditors' liability, there are a number of important points to bear in mind. First, the focus of this article has been on the rights of general purpose users of published financial statements, and therefore the legislation suggested below excludes large investors from its protection. Liebman and Kelly declare:

When an investor or creditor ponies up a large stake for an enterprise, he is on notice that special precautions are in order. If he is content to rely entirely on management's audited financial statements, he had better be prepared for serious risk sharing. On the other hand, a smaller investor or creditor is not as economically well positioned to make independent financial investigations - thus, there is a rational basis for a classification system that promises greater protection for smaller stakes than larger ones.⁹⁴

The second important issue to be considered is the objective of the Corporations Law Simplification Program. In its plan of action the Task Force states:⁹⁵

The central objective of the program is to simplify the Corporations Law and make it capable of being understood so that users can act on their rights and carry out their responsibilities.⁹⁶

The desired drafting style is uncomplicated plain English, focusing on the practical instructions for the intended audience, rather than abstract principles. Purpose statements are recommended, as well as the organisation of the information in a manner which makes it easy for the user to follow.⁹⁷ Therefore, any legislation drafted in relation to auditors' responsibilities needs to meet these requirements.

94 Liebman J and Kelly A, 'Accountants' Liability to Third Parties for Negligent Misrepresentation: The Search for a New Limiting Principle' (1992) 30 *American Business Law Journal* 345.

95 Commonwealth Attorney-General's Department 'Corporations Law Simplification Program Task Force Plan of Action' December 1993 (1993 Task Force Plan of Action).

96 *Ibid* at 1.

97 *Ibid* at 2.

The format of the prospectus provisions of the *Corporations Law* has been chosen, since it allows a clear recognition of the primary responsibility to avoid a misstatement but also permits defences to be raised. The proportionate liability of directors, also with possible defences, has been set out as well for the sake of uniformity and clarity.

Proposed amendments to the Corporations Law

Part 3.7

Division 2A - Auditors' Civil Liability

s 331AA A published audit report adds credibility to the published financial statements which it accompanies for the benefit of persons who have no other reasonable means of obtaining this information. The object of this Division is to confirm the right of such a person to take action against an auditor where the auditor's conduct in preparing an audit report has caused the person reasonably foreseeable financial loss.⁹⁸

s 331AB An auditor shall not publish, or permit to be published, an audit report on a company's financial statements for an accounting period which is misleading or deceptive.⁹⁹

s 331AC Subject to the following sections of this Division, a person who suffers loss or damage due to reasonable reliance on the conduct of an auditor in contravention of s 331AB may recover the amount of that loss or damage by action against the auditor and against any other person engaged in the contravention.¹⁰⁰

s 331AD The Court may have regard to the following matters in determining whether it is reasonable for a person to rely on the audit opinion:

- (a) the availability of other sources of information to lend credibility to the company's financial statements,
- (b) the ability of the person to seek other sources of information, and
- (c) any other matter which the Court deems fit.

98 This provision would still allow courts to consider issues of causation and reasonable foreseeability of damage according to common law principles.

99 This is based loosely on s 995 of the *Corporations Law*.

100 This is based on s 1005 of the *Corporations Law*. This provision covers the duty of care point, subject to the reasonableness of reliance test in s 331AD.

s 331AE An auditor shall not be liable in an action under s 331AC for a misleading or deceptive statement in, or omission from, a published audit report if it is proved that the auditor:

- (a) was competent to give the audit report,
- (b) carried out reasonable auditing procedures in accordance with applicable professional standards,
- (c) exercised due care, skill and diligence, and
- (d) believed that the audit report was true and not misleading.¹⁰¹

s 331AF In determining an award of damages in an action under s 331AC, the court must give judgment against the auditor, who is found to be jointly or severally liable for damages, for such proportion of the total amount of damages as the Court considers to be just and equitable having regard to the extent of the auditor's responsibility for the loss or damage.¹⁰²

s 331AG Where an action is brought against an auditor under s 331AC by a person who is found in such action to have been guilty of contributory negligence and it is held to be just and equitable that the plaintiff's damages should be reduced due to the contributory negligence, the court shall determine the respective degrees of fault of the plaintiff and of any other person or persons whose negligence contributed to the plaintiff's loss, and shall give the plaintiff a several judgment against the auditor for such apportioned part of the plaintiff's total damages as the Court thinks just and equitable having regard to the auditor's degree of fault determined as aforesaid.¹⁰³

Part 3.6

Division 4C - Directors' Civil Liability

s 300A The object of this Division is to ensure that persons who reasonably rely on the published financial statements of a company and who suffer loss as a result of misleading or deceptive statements

101 This is based loosely on ss 1009(3) and 1011(1) of the *Corporations Law*. This provision covers the standard of care point.

102 This is based on s 131 of the *Building Act 1993* (Vic).

103 The phraseology of this section is based on s 38(1) of the *Civil Liability Act 1961* (Republic of Ireland), although the intent of the section is different to the Irish provision. Section 331AG does not alter the proportionate liability of the auditor as provided by s 331AF, but serves merely to clarify the auditor's position if the plaintiff is guilty of contributory negligence.

in them may take action against a director who was responsible for their preparation under Division 4 of this Part.

s 300B The directors of a company shall ensure that the company's financial statements for an accounting period are not misleading or deceptive.

s 300C Subject to the following sections of this Division, a person who suffers loss or damage due to reasonable reliance on the conduct of a director in contravention of s 300B may recover the amount of that loss or damage by action against the director and against any other person engaged in the contravention.¹⁰⁴

s 300D (1) A director is not liable in an action under s 300C for a misleading or deceptive statement in, or omission from, a company's financial statements if it is proved that the misleading statement or the omission:

- (a) was due to a reasonable mistake;
- (b) was due to reasonable reliance on information supplied by another person; or
- (c) was due to the act or default of another person, to an accident or to some other cause beyond the defendant's control, and that the defendant took reasonable precautions and exercised due diligence to ensure that the company's financial statements were true and not misleading and that there were no material omissions from the company's financial statements.

(2) In paragraphs (1)(b) and (c):

“another person” does not include a person who was a director, servant or agent of the company, the financial statements of which company are the subject of the action against the director.¹⁰⁵

(3) In paragraph (1)(c):

“reasonable precautions” includes adherence to applicable accounting standards in accordance with s 298(1) of this Law.

s 300E In determining an award of damages in an action under s 300C, the Court must give judgment against the director, who is found to be jointly or severally liable for damages, for such proportion of the total amount of damages as the Court considers to

104 This is based on s 1005 of the *Corporations Law*.

105 This is closely modelled on s 1011 of the *Corporations Law*.

be just and equitable having regard to the extent of the director's responsibility for the loss or damage.¹⁰⁶

s 300F Where an action is brought against a director under s 300C by a person who is found in such action to have been guilty of contributory negligence and it is held to be just and equitable that the plaintiff's damages should be reduced due to the contributory negligence, the court shall determine the respective degrees of fault of the plaintiff and of any other person or persons whose negligence contributed to the plaintiff's loss, and shall give the plaintiff a several judgment against the director for such apportioned part of the plaintiff's total damages as the court thinks just and equitable having regard to the director's degree of fault determined as aforesaid.¹⁰⁷

Other necessary reforms

As discussed above, to ensure that plaintiffs are not undercompensated as a result of proportionate liability, insurance for both registered company auditors and public company directors should be made compulsory.

While most, if not all, registered company auditors would already be compulsorily insured as a result of membership of a professional society, the *Corporations Law* does not make such membership mandatory for all registered company auditors.¹⁰⁸

Since it may be considered undesirable to force all registered company auditors to be members of professional bodies, it is recommended that s 1280 of the *Corporations Law* be amended to require auditors to have insurance to a prescribed amount and in the prescribed form as a condition of their registration, as follows:

s 1280(2) ...

106 This is based on s 131 of the *Building Act* 1993 (Vic).

107 As stated with s 331AG above, the phraseology of this section is based on s 38(1) of the *Civil Liability Act* 1961 (Republic of Ireland), although the intent of the section is different to the Irish provision. Section 300F does not alter the proportionate liability of the director as provided by s 300E, but serves merely to clarify the director's position if the plaintiff is guilty of contributory negligence.

108 *Corporations Law* s 1280(2) and *Corporations Regulations* 9.2.02 and 9.2.03 permit registration as a company auditor of applicants who are either members of prescribed professional bodies or who have a prescribed tertiary qualification.

(d) the Commission is satisfied that the applicant has, or is a partner of or employee of a firm which has, professional indemnity insurance which complies with the minimum prescribed requirements.¹⁰⁹

Regulation 9.2.08

For the purposes of s 1280(2)(d), the following professional indemnity requirements are prescribed:

(Here, it is recommended that the format adopted by the Institute of Chartered Accountants in Australia be used as a basis for the regulation. Briefly, it deals with the parties which must be insured, authorised insurers, the period of insurance, the minimum amount of insurance and the liability which must be covered. Matters of verification are also dealt with).

Since general purpose users of published financial statements are necessarily dealing with companies which are obliged to, or which choose to, publish their annual reports externally, only directors of those companies should be obliged to carry professional indemnity insurance for the protection of those users.

Generally speaking, the *Corporations Law* requires lodgment with the ASC of financial statements, auditor's report, directors' statement and directors' report for companies which are not small proprietary companies.¹¹⁰

There will be instances of reliance by shareholders on financial statements which are not externally published or audited.¹¹¹ The proposed amendments to Part 3.6 are broad enough to make directors liable to these shareholders of large and small proprietary companies.¹¹² The question therefore arises whether insurance should be compulsory for directors of all companies, or only for those which have externally published, audited financial statements.

Without wishing to sidestep the question, no conclusion can be drawn on it in this article, which has been confined in its scope to the law and policy issues concerning liability for the audit report general purpose users of *published* financial statements. Since many small proprietary

109 This is based on by-law 407.3 of the Institute of Chartered Accountants in Australia's 'Regulations Relating to Certificates of Public Practice'.

110 *Corporations Law* Division 1A of Part 3.6.

111 Under s 315(3A) of the *Corporations Law*, large proprietary companies and certain small proprietary companies must supply the documents outlined above to eligible persons, who are defined under s 315(1) as persons who are 'entitled to receive notice of general meetings of the company', such as shareholders, trustees for debenture holders and the company's auditor.

112 Even without the proposed amendments, the close proximity of shareholders and creditors of small proprietary companies would probably be sufficient to found a duty of care at common law.

companies would have no shareholders who were separate from management and therefore in need of the protection of the information contained in the financial statements, it is suggested that insurance for all directors would be unnecessary and perhaps prohibitively costly for small businesses.

Therefore it is recommended that compulsory directors' professional indemnity insurance be confined to companies which externally lodge their financial statements, which have been audited pursuant to s 331A(1) of the *Corporations Law*.

The other issue to be addressed is the problem of liability arising from wilful breaches of duty, improper use of position and improper use of inside information by directors. The law has recently been reformed to *allow* companies to pay insurance premiums for directors, but the Parliament has shown a clear desire to exclude from such protection deliberate wrongful acts by directors. While this can be justified on the grounds that directors could abuse their positions by arranging full insurance for themselves and then using it to escape the consequences of fraud, a lack of insurance for wilful breach of duty leaves those who have suffered loss as a result with no means of recovery from a possibly asset-less director.

It is submitted that the policy consideration of allowing an innocent plaintiff¹¹³ to recover from a deliberately fraudulent director is very compelling. As a means of ensuring that directors do not abuse insurance against wilful breaches of duty, legislation could be enacted to ensure that insurance companies would have a right of action against deliberately fraudulent directors to recover from the directors' personal assets any amount paid out by the insurance companies to plaintiffs who have suffered loss. This threat of personal liability and potential bankruptcy, together with the fact that an act of dishonesty by a director could result in the director being prohibited from managing a corporation,¹¹⁴ should act as a sufficient deterrent against such behaviour.

Therefore, it is recommended that legislation be amended as follows:

s 241A (1) The directors of a company (not being a small proprietary company) must have professional indemnity insurance in the prescribed form.

113 It will be recalled that with proportionate several liability, a plaintiff would be uncompensated in respect of the director's portion of liability if the director is uninsured or has no assets against which judgment can be executed.

114 *Corporations Law* s 230(1)(d).

As mentioned above in relation to auditors, the regulations could then prescribe the required conditions of the directors' insurance. The Institute of Chartered Accountants in Australia By-law No 407.4 which, it was suggested, could be a model for auditors' compulsory insurance, expressly states that 'the insurance must cover the insureds against claims arising from a dishonest act or omission of an insured'.¹¹⁵ With minor alteration, these by-laws could be adapted to prescribe professional indemnity insurance for directors.

Conclusion

To deny that small shareholders and creditors have the right to sue when they suffer loss as a result of their reasonable reliance on a published audit report is to undermine the credibility which the audit report is intended to provide. The High Court of Australia has never dealt with a claim against an auditor by a general purpose user of a published financial statement.¹¹⁶ The state Supreme Courts have usually dealt harshly in cases involving auditors but it is doubtful, especially in the *AGC* and *Esanda* decisions, whether the plaintiffs could be categorised as general purpose users, who by definition are parties who have no other means of obtaining information about the company. In denying their right to sue the auditors for admittedly carelessly prepared audit reports the courts are perhaps tacitly reflecting community attitudes that large finance companies, who choose to rely on an audit report when they could have, for example, sought personal guarantees from the company's directors, are not deserving of legal redress.

The law of joint and several liability, which allows a plaintiff to recover entirely from any of the tortfeasors who caused the loss, causes injustice where insured auditors are sued rather than the more blameworthy but uninsured directors of the company. However, in my opinion, the recent recommendation to introduce a system of full proportionate liability will only shift the risk of an insolvent co-defendant director from the insured auditor, who is at least partly responsible for the plaintiff's loss, to the plaintiff, who may be entirely innocent.

Therefore this article has recommended that legislation be introduced, not only to give a right of action to general purpose users of published financial statements, with appropriate safeguards for auditors, but also to make professional indemnity insurance for directors mandatory. With the implementation of proportionate liability these reforms will ensure

115 The Institute of Chartered Accountants in Australia 'Regulations Relating to Certificates of Public Practice' By-law 407.4 paragraph (f)(ii).

116 Since this article concerns general purpose users of published financial statements the High Court application in *Esanda*, discussed above, would not be relevant.

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that the company and the users of the audit report will benefit from its publication as intended. At the same time the insurance and litigation crisis which auditors face will ease as liability to ěunworthyĚ plaintiffs is excluded and justified claims are shared with the other negligent party, the companyĚs directors.