

**Re WYLIE and COMPANIES AUDITORS AND LIQUIDATORS  
DISCIPLINARY BOARD; AUSTRALIAN SECURITIES COMMISSION  
AND INVESTMENTS (party joined)**

ADMINISTRATIVE APPEALS TRIBUNAL

DEPUTY PRESIDENT B J MCMAHON

30 September, 1, 2, 21 October 1998 — Sydney

**Corporations — Corporations Law — Suspension of registration of auditor — Whether failure to carry out or perform adequately and properly the duties of an auditor — Corporations Law ss 1292, 1317B.**

Application was made to review a decision of the Companies Auditors and Liquidators Disciplinary Board (the board). The decision arose out of an application by the party joined, the Australian Securities and Investments Commission (ASIC) for the application to be dealt with by the respondent board under s 1292(1) of the Corporations Law (the Law). The board was satisfied that the applicant had failed to carry out or perform adequately and properly the duties of an auditor. It therefore ordered that his registration be suspended for a period of 2 years, commencing on the date upon which the order became effective.

The proceedings arose from an audit of certain financial statements of Telnet Pty Ltd for the year ended 30 June 1994. The allegations made against the applicant before the board were reduced to four. The first (the going concern matter) was that the applicant had failed to obtain sufficient appropriate evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his unqualified audit opinion on the use of the going concern basis for the preparation of Telnet's 1994 accounts. The second contention (the solvency statement matter) was that the applicant had failed to exercise due professional care in considering the unqualified directors' statement as to solvency by not reporting on the directors' failure to qualify as a defect or irregularity in the financial statements. The third contention (the directors' loan matter) was that the applicant had failed to obtain sufficient appropriate evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom, on which to base his unqualified audit opinion that the directors' loans, totalling \$1,367,580 at 30 June 1994, were fully recoverable. The fourth contention was that the applicant had failed to exercise due professional care in expressing his opinion that the accounts were properly drawn up in accordance with applicable approved accounting standards. It was said that the auditor therefore failed to comply with Australian Auditing Standards 1 (AUS1).

The statutory obligations of auditors include to provide an audit report to the members on the company's financial statements for an accounted period which is a financial year. If the auditor is not satisfied about a matter, his report must state the reason: s 331B(3). The applicant contended as to the going concern matter that the audit opinion required in an audit of special purpose accounts of a non-reporting entity was substantially different to that required in an audit of general purpose accounts. Telnet's products were purchased primarily from Osborne Computer Corporation Pty Ltd (Osborne). The two companies were associated in that they shared common directors. The applicant was instructed by the directors not to approach the auditors of Osborne directly for the purpose of compiling his own report. While the audit was in place, the financial affairs of Osborne, and consequently Telnet, were under some pressure. An investigation had been commenced by ASIC into certain aspects of Osborne's affairs. The applicant was aware of the investigation. A few weeks after the audit report of Telnet had been signed, Messrs Ernst & Young reported that, in their view, Telnet was insolvent. Shortly thereafter an

administrator was appointed to each of Telnet and Osborne. Events proved that Telnet could not have been fairly described as a going concern in April 1995. The evidence indicates that the applicant was clearly concerned about the appropriateness of the accounting basis chosen and went to considerable trouble to investigate that appropriateness.

The applicant had examined their heavily qualified 1993 accounts. In fact they were so heavily qualified that they concluded with a disclaimer. The draft 1994 accounts of Osborne, a company upon whose support Telnet entirely depended for its ongoing existence, were not available when the Telnet report was given.

**Held**, affirming the decision under review:

(i) The applicant should have been of the view that a going concern basis was an inappropriate basis for the accounts, having regard not only to events of which he was unaware, which were then taking place in Osborne, but also to the results of his own inquiries. The applicant could not rely upon the provisions of the State of Auditing Practice (AUP) 3.2 to absolve him from all responsibility when there were clear grounds upon which any reasonable and competent auditor would have concluded that the directors were wrong in choosing the reporting framework which they did. No sufficient account appeared to have been taken of the requirements of para 19 of AUP 3.2. The accounts were prepared upon the insistence of the ASIC and were referred to in the annual return as being of an unqualified nature. Users of the financial reports would have included third parties having recourse to the records of the ASIC and would have been misled.

(ii) The directors' statement formed part of the financial statements and the directors gave as their opinion that there were reasonable grounds for believing that, as at the date of that statement, the company would be able to pay its debts as and when they fell due. The auditor's duty was to form an opinion as to whether the directors' statement was in accordance with the Law. That did not mean merely that the auditor should have ensured that the statement followed a formula of words required by the Law. Although the auditor was not bound to form a view as to whether the company was solvent, the auditor was bound to form an opinion as to whether the directors' statement represented a true and fair view that could reasonably be held concerning the company's solvency.

(iii) Loans totalling \$1,367,580 appeared at face value in the financial statements. Four hundred thousand dollars of the loan ultimately proved irrecoverable. In terms of the amount, this sum was material, being almost one-third of the net asset deficiency. The applicant displayed a standard of work less than one was entitled to expect of a reasonably competent and careful auditor.

(iv) The seriousness of the deficiencies before the Administrative Appeals Tribunal (the tribunal) caused the tribunal concern regarding the protection of investors in the future.

*S Donaldson* instructed by *Phillips Fox* for the applicant.

*The Australian Government Solicitor* for the first respondent.

*F Camovale* instructed by *Australian Securities and Investments Commission* for the second respondent.

**Deputy President B J McMahon.** (1) This is an application brought under s 1317B(c) of the Corporations Law (the Law) to review a decision of the Companies Auditors and Liquidators Disciplinary Board (the board), given on 13 February 1998. The decision arose out of an application by the party joined (Australian Securities and Investments Commission (ASIC)), for the applicant to be dealt with by the respondent board under s 1292(1). Pursuant to para (d) of that subsection, the board was satisfied that Mr Wylie had failed to carry out or perform adequately and properly the duties of an auditor. It therefore ordered that his registration be suspended for a period of 2 years, commencing on the date upon which the order became effective.

(2) The proceedings arose from an audit of certain financial statements of Telnet Pty Ltd, for the year ended 30 June 1994, carried out by the applicant on behalf of the shareholders of that company. The balance sheet showed a net deficiency in shareholders' equity of \$3,120,667 as a result of accumulated losses of \$5,503,071 which were reduced by profits in that year only of \$2,382,154.

#### **Directors' statement**

(3) The statement by directors asserted, nevertheless, that there were reasonable grounds to believe that the company would be able to pay its debts as and when they fell due (the solvency statement). The full text of the statement by directors dated 27 April 1995 is as follows:

The accompanying accounts are "Special Purpose Financial Reports" which have been prepared to meet the requirements of the Corporations Law.

(a) In the opinion of the directors:

- (i) the company is not a reporting entity;
- (ii) the profit and loss account is drawn up so as to give a true and fair view of the results of the company for the year ended 30 June 1994;
- (iii) the balance sheet is drawn up so as to give a true and fair view of the state of affairs of the company as at 30 June 1994; and
- (iv) there are reasonable grounds to believe that, as at the date of this statement, the company will be able to pay its debts as and when they fall due.

(b) The accounts have been made out in accordance with the applicable accounting standards.

#### **Auditor's report**

(4) That statement directly identifies the financial reports as "Special Purpose" (the significance of which will be discussed later). The applicant reported on the same day to members of the company in these terms:

##### *Scope*

We have audited the attached financial statements being a "Special Purpose Financial Report", of Telnet Pty Ltd for the year ended 30 June 1994 as set out on pp 1-7. The company's directors are responsible for the preparation and presentation of the financial statements and the information contained therein, and have determined that the accounting policies used and described in the notes to the financial statements are appropriate to meet the requirements of the Corporations Law and are appropriate to meet the needs of the members. We have conducted an independent audit of the financial statements in order to express an opinion to the members of Telnet Pty Ltd on their preparation and presentation. No opinion is expressed as to whether the accounting policies used, and described in the summary of accounting policies in the notes to financial statements on p 3, are appropriate to the needs of the members.

The financial statements have been prepared for distribution to members for the purpose of fulfilling the directors' financial reporting requirements under the Corporations Law. We disclaim any assumption of responsibility for any reliance on this report or on the financial statements to which it relates to any person other than the members, or for any purpose other than that for which it was prepared.

Our audit has been conducted in accordance with Australian Auditing Standards. Our procedures included examination, on a test basis, of evidence supporting the amounts and other disclosures on the financial statements, and the evaluation of accounting policies and significant accounting estimates. These procedures have been undertaken to form an opinion as to whether, in all material respects, the financial statements are presented fairly in accordance with the accounting policies described in the summary of accounting policies in the notes to the financial statements on p 3. These policies do not require the application of all Statement of Accounting Concepts and Accounting Standards.

The audit opinion expressed in this report has been formed on the above basis.

#### *Audit opinion*

In our opinion, the financial statements of Telnet Pty Ltd for the year ended 30 June 1994 are properly drawn up:

- (a) so as to give a true and fair view in accordance with the accounting policies described in the summary of accounting policies in the notes to the financial statements on p 3, of the matters required by Divs 4, 4A and 4B of Pt 3.6 of the Corporations Law to be dealt with in the financial statements; 5
- (b) in accordance with the provisions of the Corporations Law; and
- (c) in accordance with applicable accounting standards. As the company has applied AASB 1025: Application of the Reporting Entity Concept and Other Amendments, other accounting standards have only been applied to the extent described in the summary of accounting policies in the notes to the financial statements on p 3. 10

#### **Accounting policies adopted**

(5) The notes to the accounts identified the accounting standards which had been adopted in their preparation as follows: 15

##### *Summary of significant accounting policies*

The accounts are "Special Purpose Financial Reports" which have been prepared to meet the requirements of the Corporations Law. In the opinion of the directors, the company is not a reporting entity. 20

The accounts are prepared in accordance with the historical cost convention. The accounting policies adopted are consistent with those of the previous year.

The accounts are prepared on the going concern basis based on the continuing trading support of a major trade creditor. 25

Depreciation has been charged on fixed assets at rates assessed to write off the cost of each of the assets over their economic life.

The cost of warranty service provided by the company on products sold is expensed at the time the service is provided.

The following AASB [Australian Accounting Standards Board] accounting standards have been adopted for the current financial year: 30

AASB 1001 (accounting policies)

AASB 1002 (post balance date events)

AASB 1008 (finance and operating leases)

AASB 1021 (depreciation of non-current assets)

AASB 1025 (application of the reporting entity concept). 35

#### **Allegations against applicant**

(6) The allegations made against the applicant before the board, arising out of these accounts and the above report, were finally reduced to four in number. The first (the going concern matter) was that Mr Wylie had failed to obtain sufficient appropriate evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his unqualified audit opinion on the use of the going concern basis for the preparation of Telnet's 1994 accounts. It was said that the auditor, therefore, failed to comply with para 23 of AUS1 [Australian Auditing Standards 1]. 40 45

(7) The second contention (the solvency statement matter) was that the applicant had failed to exercise due professional care in considering the unqualified directors' statement as to solvency by not reporting on the directors' failure to qualify as a defect or irregularity in the financial statements.

(8) The third heading (the directors' loans matter) was that the applicant had failed to obtain sufficient appropriate evidence through the performance of 50

compliance and substantive procedures to enable him to draw reasonable conclusions therefrom, on which to base his unqualified audit opinion that the directors' loans, totalling \$1,367,580 at 30 June 1994, were fully recoverable. It was said that the auditor therefore failed to comply with para 23 of AUS1.

(9) The fourth contention was that Mr Wylie had failed to exercise due professional care in expressing his opinion that the accounts were properly drawn up in accordance with applicable approved accounting standards when the accounts did not comply with ASRB [Accounting Standards Review Board] 1008 (the leasing disclosure matter). It was said that the auditor therefore failed to comply with para 18 of AUS1.

### **General duties of an auditor**

(10) Before turning to the facts leading up to the decision under review and to the significance of AUS1, I will briefly look at the general liability of a person undertaking the appointment of an auditor.

(11) The Australian Accounting Standards Board (AASB) was established under s 225 of the Australian Securities Commission Act 1989 (Cth) as part of the machinery for providing recognition of standards set initially by the accounting profession. The board is vested with certain statutory authority. It has power to make a written accounting standard (an AASB standard) for the purposes of Pt 3.6 (Company and Disclosing Entity Accounts) and Pt 3.7 (Audit) of the Corporations Law. This power was initially conferred by s 32 of the Corporations Act 1989 (Cth) and s 21 of the Corporations (NSW) Act 1990. A standard is a form of delegated legislation which is subject to disallowance in the Commonwealth parliament under s 48 of the Acts Interpretation Act 1901 (Cth). Directors of companies have an obligation to comply with AASB standards. The terms of the standards, of course, will be subordinated to the terms of the Corporations Law. When there is a possible conflict, the obligations created by the statute must prevail. It has often been observed that a stream cannot rise higher than its source.

(12) The statutory obligations of auditors are (relevantly) to provide an audit report to the members on the company's financial statements for an accounted period which is a financial year. The report must state whether those financial statements are, in the auditor's opinion, properly drawn up so as to give a true and fair view of the matters required by Pt 3.6, Divs 4, 4A and 4B, that they are drawn up in accordance with the Corporations Law and that they are drawn up in accordance with applicable accounting standards: s 331B(1). If the auditor is not satisfied about a matter, his report must state the reason: s 331B(3). If the auditor is of the opinion that the financial statements do not accord with a particular applicable accounting standard, the report must give particulars of the quantified financial effect on the financial statements of failing to draw them up in accordance with that accounting standard: s 331B(2). Again, if the auditor is not satisfied about the stated effect, the report must give his reasons: s 331B(3).

(13) In addition to the auditor's statutory obligations, and sometimes in explanation of those obligations, certain professional standards have evolved as well as the statutory standards. They are evidence of good practice, whether or not they have a statutory basis: *AWA Ltd v Daniels* (1992) 7 ACSR 759. In civil liability terms, promulgated standards have been accepted as very strong evidence of what is the proper standard to be adopted and unless there is some justification, a departure from them will be regarded as a breach of duty: *Lloyd Cheyham & Co Ltd v Littlejohn & Co* [1987] BCLC 303. Statements of Auditing

Practice (AUPs) are issued by the Australian Accounting Research Foundation on behalf of the Australian Society of Certified Practising Accountants and the Institute of Chartered Accountants in Australia. They are generally accepted by members of both organisations as offering reliable guidance. Statements of Auditing Standards (AUSs) are issued by the Australian Society of Certified Practising Accountants and the Institute of Chartered Accountants in Australia. These statements are binding on members of both the constituent bodies and are also, of course, evidence of best practice.

(14) Section 298 of the Corporations Law obliges the directors of a company to ensure that the company's financial statements for an accounting period are made out in accordance with applicable accounting standards. These are defined in s 9 with reference to the above instruments issued by the Australian Accounting Standards Board. However, even if financial statements are made out in accordance with these standards, s 299 imposes an additional burden if a company's financial statements would not otherwise give a true and fair view of the matters with which Pt 3.6 requires them to deal. In that event, the directors must add such information and explanations as would give a true and fair view of those matters. In other words, a simple compliance with standards may not result in a true and fair view, as required by s 297: *QBE Insurance Group Ltd v Australian Securities Commission* (1992) 28 ALD 334; 8 ACSR 631.

(15) In addition to his or her statutory duties, an auditor carries obligations at common law based upon the terms of his or her engagement. These include an overall and continuing obligation to exercise due skill and care. These obligations were discussed in *Pacific Acceptance Corp Ltd v Forsyth* (1970) 92 WN (NSW) 29 at 51-3. Moffitt J observed at 52:

The situation is somewhat parallel to that in the case of a so-called statutory audit. The Act does not directly impose upon the auditor an obligation to audit, but provides that he shall be appointed to hold office for the relevant period. It also provides that at the end of the period he shall produce a report which shall go before the next annual general meeting. He cannot do this unless he does at least an audit which will enable him to form an opinion of the type defined in s 115, but he does more than merely contract to make the report with due skill and care. Upon his appointment under s 113 to hold office until the next annual general meeting, he must be taken to have directly promised at least to do such an audit of the company's affairs as will be appropriate to form the opinion already referred to, and in carrying out this audit work he further impliedly agrees that he will exercise due skill and care.

(16) In Ford and Austin, *Principles of Corporations Law*, 7th ed, para 10.570, the authors (citing *Daniels* as authority) suggest that the standard of care for an auditor may be higher in the case of a large accounting firm than for a smaller firm, presumably on the basis that the contract of engagement contains an implied term setting a higher standard. Section 1292(1) under which the complaint was originally brought refers to a failure to carry out or perform the duties of an auditor "adequately and properly". In *Davies v Australian Securities Commission* (1995) 38 ALD 273; 131 ALR 295 at 313, Hill J considered that this phrase "imports an element of judgment and degree". The applicant's evidence was that his firm is a seven partner firm which generally employs between 30 and 35 professional staff.

#### **Applicant's contentions**

(17) In the present proceedings, the applicant contended as to the going concern matter that the audit opinion required in an audit of special purpose

accounts of a non-reporting entity is substantially different from that required in an audit of general purpose accounts. The applicant contended that he had required the management of Telnet to disclose expressly in a note to the accounts the fact that the going concern basis had been adopted and the assumption upon which its adoption was based. The applicant then relied upon the terms of AUP 3.2 as limiting the scope of his inquiry and therefore the extent of his liability. He pointed out that in the audit report appeared the phrase "no opinion is expressed as to whether the accounting policies used and described in the summary of accounting policies in the notes to the financial statements . . . are appropriate to the needs of the members".

(18) In relation to the solvency statement matter, the applicant denied that the directors' statement should have said that the use of the going concern basis was because of the continued support of a major trade creditor. The applicant denied that in the absence of such a qualification, that he should have reported this matter as a defect or irregularity. The applicant further asserted that there was simply no basis for him to conclude that the directors were not reasonably of the opinion expressed in their statement. Furthermore, he relied explicitly upon a practice note (PN 22) absolving him from any obligation to report on whether there were, in fact, reasonable grounds to believe that the company would be able to pay its debts as and when they fell due. In the absence of any such obligation it was asserted that the auditor was therefore not required to report a defect or irregularity in the directors' statement.

(19) In relation to the directors' loans matter, the applicant denied that he had failed to obtain sufficient appropriate evidence upon which to base his unqualified audit opinion. He said that he had carried out certain work, which will later be discussed, which justified the opinion at which he arrived. Furthermore, it was suggested that the item in the accounts was not material within the meaning of AAS 5. At the relevant time this standard stated that an item of information was material "if its admission, non-disclosure, or misstatement would cause the financial statements to mislead users when making evaluations or decisions".

(20) In relation to the fourth matter raised against him, Mr Wylie acknowledges that he did not comply with the standard, but contended that this oversight did not result in anything other than a non-disclosure of a breakdown of outgoings. He contended that this was not likely to be productive of any misunderstanding on the part of any user of the accounts and that, accordingly, his error was not such as to warrant the imposition of any sanction.

### **Standards and guidelines**

(21) In order to understand the basis upon which the applicant relies, it is necessary to refer to some of the guidelines upon which his submissions depend.

(22) It was generally agreed before the board that Telnet Pty Ltd was not a reporting entity. AASB 1025 enlarged accounting standards but recognised that such enlargement would unfairly impact on companies where the users of those financial statements did not need the protection of enhanced standards. The concept of a reporting entity was therefore defined. A non-reporting entity remains undefined but may be described as an entity other than a reporting entity. The latter requires general purpose financial reports. A non-reporting company may prepare special purpose financial reports or may comply with the obligations of a reporting entity. In the present case it was assumed, before the board, that Telnet Pty Ltd could reasonably be regarded as a non-reporting entity because its

shareholders and directors were identical and, accordingly, the shareholders would not be dependent on general purpose financial reports for their information.

(23) Relevant extracts from AASB 1025 are as follows:

3C. A company or economic entity which is not a reporting entity shall, when it prepares a financial report which is purported to be a general purpose financial report, apply this Standard as if it is a reporting entity.

“general purpose financial report” means a financial report intended to meet the information needs common to users who are unable to command the preparation of reports tailored so as to satisfy, specifically, all of their information needs;

“reporting entity” means an entity (including an economic entity) in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources, and includes but is not limited to the following;

- (a) a listed corporation;
- (b) a borrowing corporation; and
- (c) a company which is not a subsidiary of a holding company incorporated in Australia and which is a subsidiary of a foreign company where that foreign company has its securities listed for quotation on a stock market or those securities are traded on a stockmarket;

29. The following endorsed explanatory material is inserted immediately after any other endorsed explanatory material following each clause or sub-clause listed in Column 6 of the Schedule:

“Reporting entities:

“Companies other than the types identified in the definition of ‘reporting entity’ may, in particular circumstances, be reporting entities. Such companies are required to comply with this standard in those circumstances. Paragraphs 19 to 37 of Statement of Accounting Concepts SAC 1 ‘Definition of the Reporting Entity’ provide guidance for determining whether an entity is a reporting entity. “General purpose financial reports are intended to be prepared by companies which are reporting entities in accordance with all AASB Accounting Standards and Statements of Accounting Concepts, except that where there is incompatibility between a Standard and a Statement of Accounting Concepts, the requirements of the Standard prevail.”

(24) Confronted with these special purpose reports, the applicant then relied upon AUP 3.2 to justify a limited approach to his audit, particularly to the assumptions made in the accounts of a going concern basis and solvency. Relevant extracts from AUP 3.2 are as follows:

3. The purpose of this Statement is to provide guidance on the independent audit of financial information, other than a general purpose financial report, prepared by either a reporting entity or a non-reporting entity. In addition to the general requirements, specific guidance is given in the case of audits of:

- (a) financial reports prepared in accordance with a financial reporting framework other than Statements of Accounting Concepts and Accounting Standards (a special purpose financial report);

6. The guidance in this Statement is not applicable when the financial information upon which the auditor is to report is, or purports to be, a general purpose financial



report. The auditor should consider whether the financial information is intended to meet the information needs common to users who are unable to command the preparation of reports tailored so as to satisfy, specifically, all of their information needs. This consideration should be adequately documented in the auditor's working papers. When, in the auditor's opinion, the financial information is, or purports to be, a general purpose financial report the guidance contained in AUP 3 should be applied.

10. AUP 3 provides guidance to auditors on the form and content of the audit report issued in connection with the independent audit of a general purpose financial report prepared by any entity in the public or private sectors. All of the guidance in AUP 3 regarding the qualitative characteristics and basic elements of the audit report, adherence to relevant statutory and other reporting requirements, types of opinion and circumstances that may result in a qualified opinion should be applied to audit reports on financial information other than general purpose financial reports, except as noted in this Statement.

11. An audit report on either a special purpose financial report, or on "other" financial information, should clearly express the auditor's opinion as to whether the financial information is presented fairly in accordance with an identified financial reporting framework. When the audit mandate makes the use of the preferred wording of the auditor's opinion (ie "... presents fairly in accordance with ...") inappropriate, the auditor should ensure the wording required by the mandate, supplemented if necessary and read in conjunction with the scope section of the audit report, clearly advises its user of the financial reporting framework within which the professional opinion of the auditor has been reached.

### ***Special purpose financial reports***

#### ***Financial reporting framework***

16. A financial report may be prepared for a special purpose in accordance with a financial reporting framework other than Statements of Accounting Concepts and Accounting Standards (a special purpose financial report). Examples of other financial reporting frameworks are:

- (a) the cash receipts and disbursements basis of accounting;
- (b) that required of subsidiaries for interim reporting to the parent entity;
- (c) the financial reporting provisions of legislation or requirements of a governmental regulatory agency; and
- (d) that required by a grantor organisation to be used by recipients of its grants.

17. For the users of a special purpose financial report to be able to command the preparation of reports tailored so as to satisfy, specifically, all of their information needs, it will be necessary for those users to be in a position to determine the framework adopted. In many cases, the framework adopted may actually be determined by the preparers of the report on behalf of the users without explicit consultation with, or endorsement by, those users. For example, when a small, not-for-profit sporting club's Committee of Management prepares a financial report required by the club's constitutions for accountability purposes, the Committee may determine the cash basis to be appropriate.

#### ***Auditor's responsibility***

18. When the financial reporting framework has been determined on behalf of the users by a party other than the addressee of the audit report, that party should be identified in the audit report. In addition, so as to avoid any connotation that the suitability of the financial reporting framework has been endorsed by the auditor, the scope section of the audit report should not normally refer to auditor evaluation of accounting policies.

19. Although the auditor's responsibility is to form an opinion regarding presentation in accordance with an identified financial reporting framework, rather than whether the

framework adopted is appropriate to the needs of users, when the framework adopted is likely to mislead the intended users of the financial report, the auditor should:

- (a) consider the steps taken by the party responsible for adopting the financial reporting framework on behalf of the users, to determine that the framework is appropriate to the needs of those users;
- (b) consider whether the users identified are the only likely users and the possibility that the financial report will be purported to be a general purpose financial report; and
- (c) give particular attention to the disclosure of the framework, including consideration of whether the use of any conventional terminology within the financial report needs to be modified or embellished.

In such cases, the auditor should seek to resolve any problems which arise and may consider it appropriate to seek legal advice or to withdraw from the engagement.

(25) As to the acceptance of the directors' assessment of a going concern basis, some attention was paid to ASRB 1001. That standard defined an acceptable basis for treating a company as a going concern. The phrase "in the absence of evidence to the contrary" received considerable attention from Mr Shanahan, an expert called on behalf of ASIC. Relevant extracts are as follows:

1001.10

...  
"going concern basis" means the accounting basis whereby in the preparation of the accounts or group accounts, the company is viewed as a going concern; that is, in the absence of evidence to the contrary, the company is expected to continue in operation without any intention or necessity to liquidate or to curtail significantly the scale of its operations;

...  
1001.30 The summary of accounting policies shall describe all material accounting policies which have been applied in the preparation and presentation of the accounts or group accounts. This requirement is subject to the exception that where the accrual basis or going concern basis has been used, those bases need not be described.

(26) In the carrying out of any audit, the criteria of AUS1 are to be observed by members of the professional bodies. Relevant extracts relating to audit evidence are as follows:

*Skills and competence*

18. The audit shall be performed and the report prepared with due professional care by persons who have adequate training, experience and competence in auditing.

*Audit evidence*

23. Auditors shall obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable them to draw reasonable conclusions therefrom on which to base their opinion on the financial information.

*Internal control structure*

24. Auditors shall gain an understanding of the internal control structure and shall study and evaluate the operation of the internal control structure or elements thereof upon which they wish to rely in determining the nature, timing and extent of other audit procedures.

*Audit conclusions and reporting*

25. The auditor shall review and assess the conclusions drawn from the audit evidence obtained as the basis for expressing the audit opinion on the financial

information. This review and assessment involves forming an overall conclusion as to whether, in all material respects, the financial information is presented fairly in accordance with an identified financial reporting framework.

26. The audit report shall contain a clear written expression of opinion on the financial information. When a qualified opinion is expressed, the audit report shall state in a clear and informative manner the reasons therefor and, unless incapable of being measured reliably, a quantification thereof.

(27) In determining whether the choice of going concern basis is appropriate, some guidance is given by AUP 7. However, Mr Bryant, the expert witness called for the applicant, was of the view that this standard was irrelevant once that basis had been chosen by the directors of a non-reporting company. The criteria are as follows:

*The auditor's responsibility with respect to the going concern basis*

11. The auditor should be satisfied that it is appropriate, based on all reasonably foreseeable circumstances facing the entity during the relevant period, for management to prepare the financial report on the going concern basis.

12. To fulfil this responsibility, when planning and performing audit procedures and in evaluating the results thereof, the auditor should be alert to the possibility that the going concern basis may be subject to question. In particular, during the audit planning process, when undertaking the overall audit risk assessment, and at the final review stage, when forming an overall conclusion, the auditor should specifically consider the potential for going concern problems. Although it is not usually necessary to design further procedures specifically to test for the existence of going concern problems, if, at any stage of the audit, a question arises as to the appropriateness of the going concern basis, the auditor should perform such extended, modified and/or additional audit procedures as are appropriate in the circumstances.

13. It is implicit in assessing the reasonably foreseeable circumstances facing the entity during the relevant period, that a judgment must be made about uncertain future events. No certainty exists nor can any guarantee be given that any entity will continue as a going concern. Hence the auditor's judgment will always involve an assessment, made at the time the audit report is signed, of the risk that the going concern basis is inappropriate.

14. Legislative requirements that members of the governing body formally state their representation on solvency as part of the financial information upon which the auditor reports, reinforces the need for adequate audit documentation. It should be recognised, however, that the auditor's opinion on such a solvency declaration, although obviously linked to going concern considerations, will not always be identical to the auditor's opinion on the appropriateness of the going concern basis. For example, an entity may be solvent in that it is capable of paying its debts as and when they fall due, but at the same time may not be a going concern because of an intention to liquidate or significantly curtail its operations within the relevant period. Conversely, while the going concern basis may be appropriate because of an entity's intention and capacity to maintain the scale of its operations during the relevant period, there may be significant uncertainty concerning its ability to pay longer term debts as and when they fall due.

...

*Significant uncertainty*

29. If the auditor concludes that going concern questions are not satisfactorily resolved, such that there remains significant uncertainty regarding the appropriateness of the going concern basis, the auditor should express a qualified opinion. The audit report should:

- (a) state clearly that there is significant uncertainty as to whether the entity will continue as a going concern and, therefore, whether it will realise its assets and extinguish its liabilities in the normal course of business and at the amounts stated in the financial report; and

- (b) adequately describe, or refer to a note to the financial statements that adequately describes:

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- (i) the principal conditions that raise doubt about the entity's ability to continue as a going concern; and

- (ii) the extent to which the financial report includes appropriate adjustments relating to the recoverability and classification of recorded asset amounts or to the amounts and classification of liabilities that might be necessary should the entity not continue as a going concern.

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(28) The general principles to be applied by auditors in considering the directors' statement are set out in AUP3 in the following terms:

***Summary of audit reporting requirements of the Corporations Law***

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***Duty to form an opinion***

1. The Corporations Law requires the auditor to form an opinion as to:

- (a) whether the financial statements are properly drawn up so as to give a true and fair view of the matters with which Divisions 4, 4A and 4B of Part 3.6 require them to deal (section 331B(1)(a));

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- (b) whether the financial statements are properly drawn up in accordance with the Corporations Law (section 331B(1)(b));

- (c) whether the financial statements are properly drawn up in accordance with applicable accounting standards (section 331B(1)(c));

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- (d) whether all the information and explanations needed have been obtained (section 331E(2)(a));

- (e) whether the company has kept proper accounting records, and other records (including registers), as required by the Corporations Law (section 331E(2)(b)); and

- (f) whether the returns received from branch offices of the company are adequate (section 331E(2)(c)).

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***Duty to express an opinion***

2. The audit report shall state the auditor's opinion in relation to the matters identified in paragraphs 1(a) to (c) above (section 331B(1)). If the auditor is not satisfied about any of those matters, the audit report must state why not (section 331B(3)).

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3. If, in the auditor's opinion, the financial statements are not drawn up in accordance with a particular applicable accounting standard, the audit report must give particulars of the quantified financial effect on the financial statements of failing to draw them up in accordance with that accounting standard (section 331B(2)).

4. While the auditor is required to form an opinion on the matters noted in paragraphs 1(d) to (f) above, under the exception basis of reporting the auditor need only report particulars of any deficiency, failure or shortcoming in respect of any of those matters (section 331E(1)).

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5. The audit report must describe any defect or irregularity in the financial statements and any matter that the financial statements do not set out and to which one must have regard in order to obtain a true and fair view of the matters with which the financial statements deal (section 331D).

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...

***Directors' statement***

7. Division 5 of Part 3.6 of the Corporations Law requires that a Directors' Statement be attached to the company's accounts, however there is no explicit requirement for the

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auditor to report on the Directors' Statement. The Corporations Law does, however, include the Directors' Statement as part of the financial statements and requires that the audit report:

- (a) state whether the financial statements are properly drawn up in accordance with the Corporations Law (section 331B(1)(b)); and
- (b) describe any defect or irregularity in the financial statements and any matter that the financial statements do not set out and to which one must have regard in order to obtain a true and fair view of the matters with which the financial statements deal (section 331D).

8. Given the integral nature of the Directors' Statement as part of the financial statements, and the public expectation of the auditor's duty in relation to it, the Auditing Standards Board is of the view that a company auditor should:

- (a) form an opinion on the "truth and fairness" of the Directors' Statement; and
- (b) include reference to the Directors' Statement in the identification of the accounts that have been audited.

(29) In further amplification of these provisions, ASIC has issued a Practice Note (PN22). The relevant parts of that document are as follows:

2. The definition of "accounts" in s 9 of the Law includes statements attached to or intending to be read with the profit and loss account or balance sheet. As s 301(1) requires that a directors' statement be attached to a company's accounts, such a statement therefore falls within the definition of "accounts".

...

5. Whether the directors have reasonable grounds for their opinions is to be decided on the basis of an objective test as stated by Mahoney JA in *Dunn v Shapowloff* (1978) 3 ACLR 775 at 783. It has also been held that, "unquenchable optimism" is not a reasonable ground of belief: *CCA v Daff* (1971-76) ACLC 28,756. In addition, directors should be aware of the various sanctions for failing to make a proper statement, including s 1308, False or Misleading Statements and s 1309, False Information.

...

#### *Qualified statements by directors*

8. The obligation of the directors pursuant to s 301(5) is to form an opinion whether there are reasonable grounds to believe that the company will be able to pay its debts as and when they fall due. The statement may be qualified if there are material uncertainties. An example of such an uncertainty is the ability to renegotiate loans due for repayment. Directors should not qualify their statement when the circumstances do not warrant it. A qualified statement will not of itself operate to limit the liability of the directors, nor operate as a substitute for the proper discharge of their responsibilities.

9. Situations may arise when the doubt over whether the company can pay its debts as and when they fall due becomes so great that it is not appropriate for directors to sign the directors' statement with a qualification. In these situations, the directors should make a negative statement stating that the company is unable to pay its debts as and when they fall due. It is not possible to state in precise terms when a qualification is no longer appropriate. Nevertheless, a qualification should not be an expression of hope or envisage an unlikely scenario. Commonly, the factor determining whether a company is a going concern will be the existence of financial support from a bank or shareholder. For a qualified directors' statement to be appropriate, negotiations should at least be under way with a reasonable likelihood of placing the company in a position where it is able to pay its debts as and when they fall due.

10. When a negative statement is made and a new debt is to be incurred, the directors should have regard to s 592 of the Law which makes it an offence for a director to allow a company to incur a debt when at the time there are reasonable grounds to expect that the company will not be able to pay all its debts as and when they fall due. The directors are also jointly and severally liable for the payment of the debt.

11. A qualified or negative statement must be clearly worded and in sufficient detail for the reader to comprehend the statement fully. The statement should identify the item which is the subject of the qualification and disclose monetary details where practicable. Where a qualified statement impinges upon the "going concern" assumption as the basis for preparing accounts, the directors should explain in the accounts their reasons for adopting the assumption in the light of the qualified statement.

Similarly, where directors state that there are reasonable grounds to believe the company will be able to pay its debts as and when they fall due despite prima facie indications to the contrary from the accounts, the directors should disclose the reasons for that opinion in order to ensure that the accounts disclose a true and fair view.

#### *Implications for auditors*

12. Subsection 331A(1) provides, in part, for the auditor to report on the financial statements. The definition of "financial statements" in s 9 of the Law means the "accounts" of a company. As the directors' statement is required to be attached to a company's accounts, the directors' statement is therefore regarded as forming part of the financial statements. It follows that the auditor is required to form a view as to whether the directors' statement complies with the Law.

13. The auditor's duty to report on the financial statements does not require him or her to report on whether there are reasonable grounds to believe that the company will be able to pay its debts as and when they fall due. The auditor's duty pursuant to s 331(B)(1)(b) is to form an opinion on whether the directors' statement is in accordance with the Law. In addition, the auditor has an obligation under s 331D(a) to describe in the report any defect or irregularity in the financial statements. The auditor is therefore obliged to consider the solvency statement and to provide such a description where there is reason to believe that a defect or irregularity exists.

14. Attention is drawn to the issues raised in para 14 of the Statement of Auditing Practice AUP7, Going Concern (reissued May 1991), which states:

"Legislative requirements that members of the governing body formally state their representation on solvency as part of the financial information upon which the auditor reports, reinforces the need for adequate audit documentation. It should be recognised, however, that the auditor's opinion on such a solvency declaration, although obviously linked to going concern considerations, will not always be identical to the auditor's opinion on the appropriateness of the going concern basis. For example, an entity may be solvent in that it is capable of paying its debts as and when they fall due, but at the same time may not be a going concern because of an intention to liquidate or significantly curtail its operations within the relevant period. Conversely, while the going concern basis may be appropriate because of an entity's intention and capacity to maintain the scale of its operations during the relevant period, there may be significant uncertainty concerning its ability to pay longer term debts as and when they fall due."

In forming a qualified opinion, the auditor should specify the reasons and consider the applicability of s 331E(2) of the Law.

#### **The facts**

(30) Telnet Pty Ltd was incorporated on 15 June 1987. In the 1994 financial year, its principal business activity was the sale of computer systems and the provision of support services in relation to those computer systems. Its products were purchased primarily from Osborne Computer Corporation Pty Ltd. The two companies were associated in that the only directors of each were Stanley Falinski and John Linton. Up until 30 June 1993, the arrangement between Osborne and Telnet appeared to be that of principal and commission agent. During the 1994 year, the arrangement changed as Telnet purchased computers from Osborne which became a trade creditor of Telnet and Telnet sold the computers to purchasers who became trade debtors of Telnet. The arrangements between the two companies were such that Telnet only purchased from Osborne

at the point when Telnet sold to a customer. As a result, Telnet did not carry trading stock in its accounts. At all relevant times, the auditors of Osborne were Williams Hatchman and Kean. Mr Wylie was appointed as auditor of Telnet following a successful tender for the position. In evidence before me, Mr Wylie said he saw nothing unusual in two such closely related companies having different auditors. The fact is, however, he was instructed by the directors not to approach the auditors of Osborne directly for the purpose of compiling his own report. This was to have certain consequences.

(31) Before the board it was assumed that the shareholders in Telnet and Osborne were Stanley Falinski and John Linton. Documents tendered at the hearing before me indicated that this was not the case. The 1994 annual return of Telnet discloses that the directors were Stanley Falinski and John Linton but that the shareholders were Jalana Pty Ltd and Williams Hatchman and Kean Nominees Pty Ltd, each of which held identical quantities of ordinary and redeemable preference shares. The 1994 return of Jalana Pty Ltd describes the company's business as that of a trustee company. One ordinary share was issued to each of John Linton and his wife Annette Elizabeth Linton. The two directors were Annette Elizabeth Linton and Jennifer Purdy. The annual return of Williams Hatchman and Kean Nominees Pty Ltd indicates that it too was a trustee company, apparently owned and directed by members of the auditing firm. Evidence was given by Mr Wylie of his understanding of the beneficial owners of these companies. Each was said to be trustee of a family trust associated respectively with Mr Falinski and Mr Linton. He, however, had not seen any trust deeds and was unable to say whether any particular person, either a child or an adult, had a vested interest or a discretionary interest. All that can be said with certainty is that contrary to earlier understandings, the shareholders of Telnet, even on the narrowest view, were not identical with the directors of Telnet and Osborne.

(32) The applicant completed the audit of the 1992 financial statements of Telnet in February 1993. Almost 2 years elapsed before he was asked to undertake the audit of the 1993 and 1994 financial statements. Because of that delay, Mr Wylie wrote to the ASIC on 20 April 1995, reporting that the company had not held its annual general meeting in relation to the year ending 30 June 1993. After that letter, Telnet was under some pressure to produce the 1993 and 1994 accounts and to file appropriate annual returns. The audit of financial statements for both years commenced in January 1995. For the 1994 accounts, audit opinions were formed on or about 27 April 1995. The report was signed on the same day.

(33) As appears from the text of the report set out above, the financial statements were expressed to be special purpose financial reports to the members as the directors took the view that Telnet was a non-reporting entity. Although there was a substantial net asset deficiency shown in the statements (including a debt of \$9,858,464 to Osborne) the accounts were expressed to be prepared on a going concern basis. This financial reporting framework had been chosen by the directors. The relevant accounting standards AASB 1001, 1008 and 1025 were shown as the standards adopted.

(34) While the audit was in place, the financial affairs of Osborne, and consequently Telnet, were under some pressure. An investigation had been commenced by ASIC into certain aspects of Osborne's affairs. In his evidence before me Mr Wylie said that he heard of the investigation but knew "nothing concrete". His only definite contact with ASIC in this matter was when he saw

a standard letter reminding Telnet that no annual returns had been filed for the relevant years. He said that he had been told by his partner about the ASIC investigation. He said that he did not mention the ASIC investigation in his work papers as "it played no part in our decisions". The investigation may have caused other consequences in Osborne and its associated company. The directors of both companies instructed a third firm of accountants, Messrs Ernst and Young, to produce an independent report on their solvency. On 19 June 1995, a mere few weeks after the audit report of Telnet had been signed, Messrs Ernst and Young reported that, in their view, Telnet was insolvent. On 26 June 1995, an administrator was appointed to each of Telnet and Osborne.

### **The going concern matter**

(35) Events proved that Telnet could not have been fairly described as a going concern in April 1995. How then could an auditor accept financial statements prepared on such an unsuitable basis (viewed in retrospect) and without more qualifications than appear above? The submissions of Mr Wylie on this matter depend almost entirely upon reliance on AUP 3.2. Telnet was thought not to be a reporting entity and was not, therefore, required to prepare a general purpose financial report. The directors' statement, summary of significant accounting policies and the audit report, all identify the 1994 financial statements as being a special purpose financial report. Accordingly, Mr Wylie relied upon the guidance given by AUP 3.2 (as he now says) in framing his report upon these special purpose financial statements. In particular, Mr Wylie relied upon appendix 4 and upon paras 16 and 18 above quoted. Paragraph 17 affirms that an auditor is not responsible for the appropriateness to users' needs of the financial reporting framework applied in a special purpose financial report. Mr Wylie pointed to the provisions absolving him from the duty to question the use of a particular framework (as he understood the guideline) because the users are in a position to command the preparation of information to satisfy their individual information needs. Mr Wylie's report identifies the financial statements as a special purpose financial report and points to the accounting policies used and described in the notes to the financial statements. He expressly refrains from expressing an opinion as to whether the accounting policies used are appropriate to the needs of members. He also adds that the notes to the financial statements defend the basis chosen by stating that the accounts were prepared on a going concern basis "based on the continuing trading support of a major creditor".

(36) It was Mr Wylie's case that AUP 3.2 did not contain exculpatory provisions. The effect of the guidelines was, he said, to limit the scope of his inquiry. It seems to me, however, that this is a defence which he has raised after the event. The contemporaneous evidence indicates that he was clearly concerned about the appropriateness of the accounting basis chosen and went to considerable trouble to investigate that appropriateness.

(37) The working papers made available to ASIC provide a valuable contemporary record of the processes leading to the applicant's report. Mr Shanahan, called on behalf of ASIC, pointed out that in the definition of "going concern basis" in accounting standard AASB 1001, such a basis is appropriate only where there is an absence of evidence to the contrary. Whether or not that phrase appeared then or appears now in the definition of going concern basis seems to me to be irrelevant. It is always implicit that there must be some credible basis upon which one can assume that a concern is ongoing. Paragraph 6 of AUP 3.2 recognises that an auditor may not simply wash his or her hands of



responsibility. The paragraph advises an auditor to consider whether the financial information was likely to satisfy the information needs of users.

(38) A going concern basis for the preparation of financial statements cannot be adopted arbitrarily, while there is an overriding obligation to present a true and fair view. The contemporaneous working papers appear to support the proposition that this was also Mr Wylie's line of thinking at the time. They show a significant effort on his part in attempting to determine whether or not reasonable evidence existed that Telnet had the ability to continue as a going concern. In the report, Mr Wylie said that he attempted to follow the formula of words set out as an example in attachment 1 to AUP 3.2. That example refers to the auditor's "evaluation of significant accounting estimates", whereas Mr Wylie's report refers to his "evaluation of accounting policies and significant accounting estimates". Mr Wylie said that this was a mere oversight and points to the fact that it is possibly inconsistent with his earlier disclaimers in the report. Whether or not it was intended, the fact is, however, that there was such an evaluation and this is borne out by the working papers.

(39) The first of them, dated 19 April 1995, is headed "Going Concern Review". Other working papers forming part of this review consist of a comparison of 1994 results by month to 1995, a comment on Telnet's results to the end of February 1995, a comment on Telnet's forecasted results to 30 June 1995, a report on confirmation of continuing financial support from Osborne, a review of the qualifications to Osborne's audited reports for 1993, a review of Osborne's ability to provide support and a conclusion on the results of work done.

(40) At Mr Wylie's request, the two directors signed a letter dated 19 April 1995, addressed to the directors of Telnet Pty Ltd (the same people) in these words:

Osborne Computer Corporation Pty Ltd confirms that in the event Telnet is unable to repay any trading debts within normal trading terms Osborne Computer Corporation will not call for the repayment of these debts until Telnet is in a position to repay same.

(41) Nine days later, on 28 April 1995, Mr Wylie sent a fax to the chief financial officer at Osborne in these terms:

As discussed by telephone, I set out briefly the basis for the going concern disclosure in Telnet's 1994 accounts.

- Accounts show a deficiency of \$3.2 million.
- Accounts have been prepared by directors on a going concern basis.
- Reason that going concern is applicable is that major trading supplier, OCC will not collect full amounts owing until Telnet has funds to pay. This does not represent a formal guarantee from OCC but reflects actual commercial position and is consistent with proposed disclosure in OCC 1994 accounts.
- To show "true and fair view", accounts should explain why going concern basis has been applied despite deficiency.
- Disclosure as in 1993 would be minimum acceptable for clean, ordered opinion. Otherwise disclosure required in audit report.

(42) In a conclusion note following what must have been intense negotiations and investigations, the manager involved in the audit prepared a note on 27 April 1995 in these terms:

A clean audit report was given on the following basis:

- (1) as a result of additional audit work performed at 700.1;
- (2) OCC has given assurance that it will support Telnet P/L;

- (3) notwithstanding disclaimer opinion given by OCC auditors, we are satisfied that OCC is a going concern and can support Telnet; and
- (4) we sighted a recent offer of \$15 million for OCC which was dated 9 May 1995.

(43) This working paper was initialled and dated by Mr Wylie although he now says that he did not agree with it. There is no evidence in the working papers of any such disagreement. The reference to the auditors of OCC is a reference to the fact that Mr Wylie had been prohibited by the directors from contacting the directors of Osborne directly, although he had examined their heavily qualified 1993 accounts. In fact they were so heavily qualified that they concluded with a disclaimer. The draft 1994 accounts of Osborne, a company upon whose support Telnet entirely depended for its ongoing existence, were not available when the Telnet report was given. 5 10

(44) A thorough analysis of all the working papers was carried out by Mr Shanahan, whose report was tendered in evidence. I agree with the conclusions expressed in paras 92 and 93 of his report as follows: 15

92. This analysis, in my opinion, shows that Mr Wylie failed to gather sufficient appropriate audit evidence with regard to Osborne's forecasted results for the four months to June 1995 from which to draw reasonable conclusions as to Osborne's projected net asset position as at 30 June 1995. It is that projected net asset position set out in WP 706 which led Mr Wylie to conclude that Osborne was in a position to provide continuing support. In my opinion, the evidence in the Telnet 1994 audit file does not support this conclusion, for the reasons set out in the course of the above analysis. In my opinion, a reasonably competent and careful auditor would not have been entitled to draw the conclusion drawn by Mr Wylie on the basis of the audit evidence in the Telnet 1994 audit file. 20 25

93. If Osborne was not in a position to provide continuing support, the preparation of Telnet's 1994 financial statements on the basis that Telnet was in fact a going concern, in my opinion, was in error. In my opinion, Mr Wylie correctly determined that Telnet's ability to continue as a going concern was dependent on support (the comfort letter) from Osborne and correctly determined that he was required to assess whether or not Osborne was in a position to provide that support. In my opinion, however, Mr Wylie failed to gather sufficient appropriate audit evidence from which to draw reasonable conclusions on this matter. Further, there are considerable and significant shortcomings in his review and evaluation of the evidence which he gathered. I do not believe that a proper analysis of that evidence supports his conclusions nor is it capable, in my opinion, of leading any reasonably competent and careful auditor to those conclusions. 30 35

(45) If Mr Wylie was not of the view that a going concern basis was an inappropriate basis then he certainly should have been, having regard not only to events of which he was unaware, which were then taking place in Osborne, but also to the results of his own inquiries and those of his staff. In my view, he cannot now rely upon the provisions of AUP 3.2 to absolve him from all responsibility when there are clear grounds upon which any reasonable and competent auditor would have concluded that the directors were wrong in choosing the reporting framework which they did. 40

(46) Furthermore, no sufficient account appears to have been taken of the requirements of para 19 of AUP 3.2. Even if one agrees that an auditor is entitled to restrict his opinion and to accept an identified financial reporting framework, rather than express a view whether the framework adopted is appropriate to the needs of users, he is under an obligation to take the steps outlined in para 19 if the framework adopted is "likely to mislead the intended users of the financial report". Mr Wylie was under a curious misapprehension that the users of the 45 50

financial report were the same two people who had chosen the reporting framework. In fact the evidence indicates that this is not so. Family trusts, possibly involving the financial interests of children and their spouses and certainly controlled by trustee companies whose directors were not the same as the directors of Telnet, were clearly users who had taken no part in the choice of the financial framework. As the framework itself was shown to be misleading when viewed objectively, it is reasonable to assume that these family users are likely to have been misled. Even if the trusts were of a discretionary nature, the potential beneficiaries would have had the right to seek and obtain from the trustee information concerning the trustee's management of the trust fund, including its approach to valuation of trust assets: *Spellson v George* (1987) 11 NSWLR 300.

(47) Furthermore, the accounts were prepared upon the insistence of the ASIC and are referred to in the annual return as being of an unqualified nature. Users of the financial reports would include third parties having recourse to the records of the ASIC. Having regard to the reporting framework adopted, it is likely that they would have been misled. The financial statements presented a picture of a company with a substantial deficiency, nevertheless described as a going concern. The truth, however, was that its solvency and continuity depended to a major extent on the solvency and continuity of Osborne, a company whose accounts for the same period were subsequently heavily qualified. Mr Wylie should have followed the guidelines laid out in para 19 of AUP 3.2. He cannot choose that part of the guidelines which now suits his interests and ignore all other parts. Having regard to the financial fragility of Telnet at the time the audit was carried out, the provisions of AUP 7 would have represented a safer and more reliable set of guidelines for a competent and careful auditor. Paragraph 29 of AUP 7 is of special significance.

(48) When considering whether intended users of the financial report are likely to be misled it is, furthermore, appropriate in my view to consider the effects of the accounts on persons other than members and those having recourse to the records of the ASIC. In *Re Mazda Australia Pty Ltd and Australian Securities Commission* (1992) 29 ALD 57; 16 AAR 276 at 287, the phrase "users of the accounts" in general purpose accounts was given "the widest possible meaning". In *Davies*, Hill J noted, at ALR 303, that users of special purpose accounts prepared in accordance with requirements of workers' compensation legislation were held by the tribunal to extend beyond the shareholders to members of the public who held shares in the insurer's parent company, creditors, securities analysts, competitors and the like. His Honour did not dissent from that view, but did not find it necessary to affirm it. In the present case, one cannot discount the possibility of persons other than shareholders relying on special purpose financial reports for their information. Just such a possibility is contemplated by paras 6 and 19(b) of AUP 3.2.

### **The solvency statement**

(49) The directors' statement forms part of the financial statements: s 301(5). On 27 April 1995, the directors gave as their opinion that there were reasonable grounds to believe that, as at the date of that statement, the company would be able to pay its debts as and when they fell due. In fact, subsequent events proved that the company did not have that capability. ASC practice note 22 (PN 22), quoted above, points out that where directors make such a statement, notwithstanding prima facie evidence to the contrary in the accounts, the

directors should disclose the reason for their opinion in order to ensure that the accounts disclose a true and fair view: para 11. The reference in Telnet's summary of accounting policies was not a sufficient disclosure in accordance with PN 22.

(50) Faced with this defective statement, Mr Wylie relied upon para 13 and noted that it was no part of the auditor's duty to report whether there were, in fact, reasonable grounds to believe that the company would be able to pay its debts as and when they fell due. The auditor's duty pursuant to s 331B(1)(b) is to form an opinion on whether the directors' statement is in accordance with the Law. In addition, the auditor has an obligation under s 331D(a) to describe in the report any defect or irregularity in the financial statements. The only obligation, Mr Wylie said, was for an auditor to consider the solvency statement and to disclose whether, in his opinion, a defect or irregularity existed. The directors' statement, as shown above, contains assertions on all matters required by the Law. According to Mr Wylie, he was therefore under no obligation to go further. I do not agree with this view of his duties.

(51) It is true that the auditor's duty is to form an opinion as to whether the directors' statement is in accordance with the Law. This, however, does not mean merely that he or she should ensure that the statement follows a formula of words required by the Law. Although the auditor is not bound to form a view as to whether the company is solvent, he or she is bound to form an opinion as to whether the directors' statement represents a true and fair view that could reasonably be held concerning the company's solvency. I again accept the conclusions arrived at by Mr Shanahan in these terms:

103. In the situation of Telnet's 1994 accounts, the directors made an unqualified solvency statement. Mr Wylie was aware that Telnet had a deficiency of net current assets and net assets, that its projected 1995 profit would not cover the deficiency of net current assets as at 30 June 1994 and that it was relying upon the support of a major trading creditor in the form of a "comfort letter" confirming that creditor's intention not to seek repayment of its debt while Telnet was unable to meet it. Telnet's accounts were at least 10 months after balance date.

104. In assessing the ability of the major creditor to provide support, Mr Wylie's audit working papers show that the last audited accounts of that creditor were heavily qualified, were late, showed positive net current assets and net assets only with the inclusion of the Telnet debt the subject of the "comfort letter", and its projected sound net asset position as at 30 June 1995 was based on unsupported forecasts for a final 4 months trading that would more than recoup the losses incurred in the previous 20 months. It also assumed that the "conservative" budget for that 4-month period would be met despite Telnet's failure to meet budget (with the same directors and chief financial officer) and Osborne's "ahead of budget" performance being less robust when analysed closely.

105. There is no evidence in the Telnet 1994 audit working papers that Mr Wylie considered whether the directors had reasonable grounds for making their unqualified positive solvency statement. A careful and proper review of the available evidence would have raised the issues noted above and directed Mr Wylie's attention to a consideration of the directors' "reasonable grounds".

106. If Mr Wylie had found that the directors did not have reasonable grounds for making their unqualified positive solvency statement, he was required under s 331B(1) to state whether, in his opinion, the financial statements are "properly drawn up . . . in accordance with [the] Law . . .". If the directors' solvency statement is not based upon reasonable grounds — and all of Mr Wylie's work on his review of going concern effectively encompassed this matter — then the accounts will not have been properly drawn up and he would be required to report this in his audit report.

107. If a solvency statement is based on other than reasonable grounds and appears to have been drawn up in a manner contrary to available evidence, the auditor should consider this as a "defect or irregularity" which he [sic] is obliged to report under s 331D. In my opinion, Mr Wylie's failure to consider making such a report flows from his failure to gather sufficient appropriate audit evidence from which to draw reasonable conclusions and his failure to properly consider the limited evidence which was available to him. In my opinion, a proper consideration and evaluation of that evidence would have disclosed significant problems in portraying Telnet as a going concern. It would also have disclosed significant problems in treating Osborne as being able to continue to trade without calling up the Telnet debt. Since the continuing deferral of that debt was critical to Telnet's solvency, and since it was highly uncertain and doubtful that the deferral could continue, it should have been obvious to a reasonably competent and careful auditor, in my opinion, that the directors' solvency statement appeared to lack reasonable grounds.

#### **Directors' loans**

(52) Loans totalling \$1,367,580 appear at face value in the financial statements. They represented sums relating to a single advance made. Mr Wylie was of the view that the advance had been made to Mr Linton with the knowledge of Mr Falinski. As both of them would have been aware of the circumstances, then it was reasonable to treat the loans as not being a material item as there was no likelihood of a misstatement of information contained in the financial statements serving to mislead users of those statements. In fact, later inquiries showed that the moneys were paid by way of cheque signed by Mr Falinski in favour of a firm of solicitors. The money was subsequently invested in a house, purchased in the name of Mrs Linton, subject to a prior registered mortgage to secure repayment of \$400,000. The loan ultimately proved to be irrecoverable. In terms of amount, clearly the sum was material, being almost one-third of the net asset deficiency. The lack of materiality alleged is based upon Mr Wylie's opinion that users of the statement were unlikely to be misled.

(53) The working papers do not support Mr Wylie's statement that he made a search at the Land Titles Office to ascertain the above information. However, even if he carried out this work, it would not have been sufficient to base an unqualified audit opinion that the loan was fully recoverable. Mr Wylie's evidence indicates that he appeared to rely largely on his knowledge of Mr Linton's supposed financial position to support any opinion he may have formed that the loan was recoverable. The users of the financial statements were not, as I have pointed out, restricted to Messrs Linton and Falinski. An acceptance of this loan at face value without any qualifications is misleading in objective terms and is misleading to actual and potential users of the statements, a class of persons much wider than the two directors. Paragraph 6 of AAS 5, therefore, cannot be relied upon by Mr Wylie. Having regard to his evident concern, shown in his working papers, about the very basis of the chosen financial reporting framework, the absence of any documentation as to a consideration of the recoverability of loans to directors and director related entities displays a standard of work less than one is entitled to expect of a reasonably competent and careful auditor.

#### **The leasing disclosure matter**

(54) In 1994, Telnet had operating lease rental expenses in relation to various properties totalling \$1,029,000. This was a material amount and was required to be disclosed under para 51 of AASB 1008. It was not so disclosed, notwithstanding the fact that the accounts explicitly adopt AASB 1008 as one of

the standards governing their preparation. Under s 331B of the Corporations Law an auditor is required to disclose any contravention of an applicable accounting standard. Under s 332A he or she must also inform the AASB of such non-compliance. These requirements apply whether the company is a reporting entity or a non-reporting entity and notwithstanding that the contravention relates only to disclosure and not to the truth or fairness of the reported profit.

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(55) Mr Wylie is therefore in breach of his obligation to express a qualified opinion in relation to the departure from the relevant standard. The fact that he did not do so, does not necessarily render the net financial results misleading. Failure to separate out the lease rentals expenses does not affect the final profit or loss result, nor the structure of the balance sheet. Nevertheless it was a failure of a clear duty and is one that ought to be taken into account.

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### Conclusion

(56) Suspension of registration for a period of 2 years is a serious matter for a person in Mr Wylie's position. He is a partner in a respected firm of accountants in Sydney and has had lengthy audit experience. He has been a Fellow of the Institute of Chartered Accountants since 1987 and a Fellow of the Institute of Certified Practising Accountants since 1984. He is also a member of the Institute of Chartered Accountants of Scotland and a member of the Institute of Chartered Accountants of England and Wales. He was originally trained in Glasgow and subsequently worked in London and elsewhere in Europe in the audit field. He has been with his present firm since he came to Australia in 1986. The audit work of that firm is generally the responsibility of Mr Wylie and one other partner. He was a member of the Australian Auditing Standards Board as a representative of the Australian Society of Certified Practising Accountants from 1993 until 1995. He has not previously been disciplined by the respondent or, so far as I am aware, any of his professional bodies.

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(57) Nevertheless, the breaches alleged against him are serious in nature. I did not hear evidence from either Mr Falinski or Mr Linton, nor indeed from any other person concerned with the audit. I am, therefore, unable to say how some of the conclusions were arrived at, nor what motivated either of the directors in choosing their financial reporting framework or Mr Wylie in signing his largely unqualified report. On the objective facts, however, there has been a failure to observe the overriding obligation of an auditor to report whether the directors' financial accounts represent a true and fair view of the company's financial health. There has been a potential for quite misleading information to be acted upon. I cannot (for example) assume that the interests of the wives of Mr Linton and Mr Falinski are identical with those of their husbands. I certainly cannot assume that the interests of children, be they infant children or otherwise, are similarly identical. If one accepts that the class of users is even wider, then the potential for misleading information could be considerable. Mr Wylie seems to have made no inquiry as to the identity of possible users of the accounts. He appears to have contented himself with instructions from the two directors whose position could not be said to be impartial.

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(58) It is Mr Wylie's long experience which characterises his conduct as more reprehensible than that of a young graduate. He came to a scene replete with warning signals. The lateness of the accounts, the fact that there were separate auditors for Osborne, with whom he was forbidden to communicate, the fact that he was under time constraints, the fact that his own instincts told him to pursue the appropriateness of the chosen financial reporting assumptions, and the fact

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that Osborne was under investigation, all indicate a failure to take particular care which suggests an appropriate sanction.

(59) The nature of the sanction must be governed by the scope and purpose of the Act. Section 1(2) of the Australian Securities Commission Act 1989 (Cth) obliges ASIC, in performing its functions and exercising its powers, to strive to maintain the confidence of investors in the securities markets by ensuring adequate protection for such investors. The scope and purpose of the audit provisions of the Corporations Law have parallel objects. Protection of investors, rather than punishment, should guide the fixing of any necessary sanction. Nevertheless, the conduct of the person concerned should be taken into account to determine the likelihood of possible future offences and to serve as an example to the community of the protection to which investors are entitled.

(60) In his conduct of the audit, Mr Wylie failed in his duty to observe proper care. In his defence he has not seen fit to acknowledge this fact in any respect, except in relation to the leasing non-disclosure. He has not sought to justify his report by reference to limited time, difficulty of obtaining instructions, poor records or any other factor that might be considered ameliorative. Instead, he has relied upon disingenuous interpretations of selected portions of accounting guidelines which, he would submit, absolved him from liabilities if read in isolation. Such an approach does not engender confidence in Mr Wylie's ability to recognise overall responsibilities. The effect of his reliance upon these selected passages has been to seek to justify suppression rather than disclosure of relevant information. In doing so, he has sought to refine, limit and reduce the overriding requirements of the Corporations Law and the overriding responsibilities of auditors referred to in general terms above. I have concluded that the seriousness of the deficiencies, and the manner of the attempts to defend them, would leave the tribunal apprehensive concerning the protection of investors in the future were the suspension decided upon by the board, not affirmed.

(61) All in all, I consider that the respondent board came to the correct conclusion and I will affirm the decision under review.

CHRIS ROBSON  
SOLICITOR