



ASIC

Australian Securities & Investments Commission

CONSULTATION PAPER 51

CLERP 9: Authorised audit companies: Insurance arrangements

June 2004

Your comments

You are invited to comment on the proposals and issues for consideration in this paper, including the explanation sections.

We will not treat your submission as confidential unless you specifically request that we treat the whole or part of your submission as confidential.

Comments are due by 30 July 2004 and should be sent to:

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You can also contact the ASIC Infoline on 1300 300 630 for information and assistance.

What this policy proposal is about

1 The Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (the CLERP 9 Bill) will update and enhance the existing regulatory requirements in Pt 9.2 of the *Corporations Act 2001* (the Act), which apply to accountants seeking registration as company auditors.

2 Part 4 of Schedule 1 of the CLERP 9 Bill allows companies to register as authorised audit companies (AACs). It:

- (a) sets out the eligibility requirements for a company to be registered as an AAC;
- (b) makes the AAC's continued registration subject to compliance with any conditions or restrictions specified in the regulations and any other conditions and restrictions imposed by us;
- (c) requires the AAC to notify us if a condition or restriction to which the AAC's registration is subject is contravened; and
- (d) requires the AAC to lodge an annual statement with us.

3 A company may be registered as an AAC if the following legislative requirements are met:

- (a) each of the directors of the company must be a registered company auditor;
- (b) each share in the company must be held and beneficially owned by an individual or the legal personal representatives of an individual;
- (c) a majority of the votes that may be cast at a general meeting of the company attach to shares in the company that are held and beneficially owned by individuals who are registered company auditors;
- (d) the company must not be in external administration; and
- (e) we must be satisfied that the company has adequate and appropriate professional indemnity insurance for claims that may be made against it for Corporations Act audits of companies and registered schemes.

4 This policy proposal sets out what we consider are adequate and appropriate professional indemnity insurance arrangements for an

AAC under cl 1299B of the CLERP 9 Bill. For further details about the registration of auditors including AACs, see our policy proposal paper *CLERP 9 Bill: Auditor registration* (issued 5 April 2004).

5 The requirements in this paper have been proposed in the context of the particular statutory provision in cl 1299B of the CLERP 9 Bill. AACs are not prevented from obtaining additional insurance cover and should consider their own circumstances carefully in determining whether additional insurance is required. In addition, these policy proposals do not relate to individual auditors employed by an AAC. Audit clients may have a right of recourse against individual auditors in addition to rights against the AAC that employs them.

6 We may review the requirements outlined in this policy paper from time to time in light of any substantive changes in the nature or availability of professional indemnity insurance, or changes to any state or territory legislation or policy that sets out minimum insurance requirements for auditors or accountants generally. We may also review the requirements to ensure consistency with international best practice or the recommendations of relevant professional bodies.

7 We do not expect the CLERP 9 Bill to commence until 1 July 2004 at the earliest. Further, we do not expect we will issue final policy in this area until September 2004. If the CLERP 9 Bill commences on 1 July, we will apply the requirements set out in this paper to any AACs seeking registration until our policy is finalised.

8 This paper is part of a series of CLERP 9 policy publications and should be read in conjunction with *Building the CLERP 9 Administrative Framework: Policy to Implement the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003—An ASIC guide*, February 2004 (CLERP 9 Administrative Framework Guide).

Important note: This paper is based on the CLERP 9 Bill as introduced into Parliament on 4 December 2003. It refers to proposed amendments to the Corporations Act set out in the CLERP 9 Bill. This paper is not final ASIC policy. The timing and content of ASIC's policy and other publications depends on the timing of the CLERP 9 Bill's progress through Parliament and whether amendments are made to it during the legislative process.

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Policy proposals

This paper discusses what we regard as adequate and appropriate professional indemnity insurance arrangements for AACs. We have set out proposals and identified issues we would like you to comment on. Where necessary we have also included some explanations of our proposals.

Special note: There may be other issues that you consider important. We are keen to hear from you on our general approach and any other issues you consider important, as well as your answers to our specific questions.

Adequate and appropriate insurance

Policy proposal	Your feedback
<p>What is adequate and appropriate insurance?</p> <p>A1 Under cl 1299B, a company is only eligible for registration as an AAC if it has adequate and appropriate professional indemnity insurance cover. We consider that this insurance should be:</p> <ul style="list-style-type: none"> (a) for an amount sufficient to cover claims reasonably anticipated to arise from Corporations Act audits of companies and registered schemes; (b) fit for its purpose and on usual commercial terms; and (c) reasonably available in the marketplace. <p>Adequacy (Quantum)</p> <p>A2 In framing our policy as it applies to AACs, we have taken into account research on the claims history of accountants generally along with other matters that affect the risk of a claim, such as:</p> <ul style="list-style-type: none"> (a) the qualifications and experience required to be an auditor; (b) the regulatory framework for auditors; and (c) the ongoing training and quality assurance obligations of auditors. <p>A3 For the purposes of cl 1299B, the minimum insured amount will depend on the largest Corporations Act audit engagement fee that the directors of the AAC reasonably believe the AAC will charge.</p> <p>We will require a director of the AAC to estimate this fee when the AAC applies for</p>	<p>A1Q1 Are there other requirements that adequate and appropriate insurance should meet? If so, what are they and why are they important?</p> <p>A3Q1 Should the amount of insurance cover required be based on the audit engagement fee? If not, please give your reasons.</p> <p>A3Q2 Do you agree with the proposed formula for</p>

registration and to update this estimate each year in the annual statement made by the AAC to ASIC under cl 1299G. To determine the required insured amount, we propose the following formula:

- (a) if the maximum engagement fee is estimated to be *less than \$50,000*, the insured amount will be \$500,000 for any one claim and in the aggregate; or
- (b) if the maximum engagement fee is estimated to be *more than \$50,000*, the insured amount will be ten times the estimated maximum engagement fee up to a maximum figure of \$20 million for any one claim and in the aggregate.

A4 We will impose a condition on the registration of all AACs requiring them to maintain ongoing insurance for an insured amount calculated in accordance with this policy. This means an AAC may need to obtain extra cover if it receives an engagement fee for a Corporations Act audit that exceeds the fee estimated at the time of registration, or if it makes a claim that reduces its existing cover.

Appropriateness (Terms and Conditions)

A5 To be considered adequate and appropriate insurance under cl 1299B, the insurance must have the following features:

- (a) the policy must cover claims made for Corporations Act audits of companies and registered schemes;
- (b) run-off cover should be provided for a minimum of seven years after the AAC ceases to operate;
- (c) the policy should only be subject to usual or standard exclusions for policies of that type;
- (d) the policy should cover costs and

determining the amount of insurance cover required? If not, give your reasons and suggest an alternative method of calculation with reasons why it should be adopted.

A3Q3 Will this approach cause practical difficulties? How could these difficulties be remedied?

A4Q1 Do you agree with this approach? If not, how else can we be sure an AAC maintains adequate and appropriate insurance?

A5Q1 Do you agree with this approach? If not, please give reasons.

A5Q2 Should the required insurance have other features? If yes, state what else you believe should be required and why.

A5Q3 Would an AAC require retroactive insurance cover? If yes, please state your reasons for this.

A5Q4 Should fraud cover be

<p>expenses, including legal costs and expenses of investigating, defending and settling claims against the insured;</p> <p>(e) the policy should cover fraud by the insured or the employees of the insured;</p> <p>(f) the policy should be on usual commercial terms offered by insurers for this type of insurance at the time of the AAC's registration; and</p> <p>(g) unless we otherwise agree, the policy must be written by an insurer subject to Australian Prudential Regulatory Authority (APRA) supervision.</p> <p>A6 The insurance may (if the AAC wishes):</p> <p>(a) have a deductible or excess (however, the amount of any deductible must be covered by the value of the net tangible assets of the AAC (NTA));</p> <p>(b) cover claims for audits other than audits under the Corporations Act.</p> <p>A7 The insurance must not be cancellable by:</p> <p>(a) the insurer for innocent non-disclosure or misrepresentation; or</p> <p>(b) the insured for any reason.</p> <p>Assessment by ASIC</p> <p>A8 In assessing whether insurance arrangements are adequate and appropriate, we will require a director of an AAC to confirm that its insurance arrangements comply with our policy.</p> <p>A9 We will also require the AAC to lodge a statement by an insurance broker or insurer to the effect that the policy only contains standard or usual exclusions for policies of that type and that it is made on usual commercial terms and conditions.</p>	<p>required? If no, please state your reasons for this.</p> <p>A5Q5 Will requiring the insurance to be written by an ARPA regulated insurer limit the quantum or cover of insurance available to AACs? Should this requirement be broadened?</p>
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Explanation

Adequate and appropriate insurance

1 We consider that the purpose of the ‘adequate and appropriate insurance’ requirement, set out in the CLERP 9 Bill, is to ensure that AACs can meet claims reasonably anticipated to arise from their work auditing companies and registered schemes under the Act.

2 Companies, unlike individuals, may have limited liability. Without adequate and appropriate professional indemnity insurance arrangements, a client may experience difficulty claiming against the AAC where the AAC’s professional services have caused the client economic loss. The Bill seeks to ensure that a client obtaining services from an AAC is in a position, in terms of the client’s ability to recover for economic loss, similar to that of a client obtaining like services from an individual registered company auditor or a firm of auditors.

Adequacy (Quantum)

3 Our proposed method for calculating the amount of insurance cover required by an AAC has been influenced by the research and public consultation carried out by the Professional Standards Council (NSW) before their approval of the Accountants’ Limitation of Liability Scheme (NSW) (the NSW Scheme). In approving the NSW Scheme, the claims history of accountants generally (including some auditors) was considered.

4 The NSW Scheme, which is approved under the *Professional Standards Act 1994* (NSW), limits the civil liability of accountant members. In return, members of the scheme are committed to achieve and maintain the appropriate level and currency of professional qualifications and experience, to adhere to a prescribed code of ethics and to maintain business assets and/or insurance to meet claims made against them to a certain limit. We understand similar schemes are likely to be established in some other states following the passage of similar legislation.

5 Similar to the NSW Scheme, under the CLERP 9 Bill the directors of an AAC will be required to have certain levels of professional qualifications and experience. In addition, we may impose conditions on the registration of an AAC covering quality assurance mechanisms or other matters. Further, in considering what are adequate and appropriate professional indemnity insurance

arrangements for AACs, we have taken into account research on the the claims history for the accounting profession as a whole.

6 Unlike the NSW Scheme, however, our policy does not limit the liability of AACs. It simply sets out certain minimum insurance requirements needed for registration as an AAC.

7 The NSW Scheme first came into effect on 9 October 1997 (although it has been amended and updated since). It limits the maximum liability for damages arising out of a cause of action for occupational liability (the 'Limitation Amount') which may be awarded against a person. It includes the following features:

- (a) if the fee payable for the service to which the cause of action relates, being a reasonable charge for the service provided or which was failed to be provided, is less than or equal to \$50,000, the Limitation Amount is \$500,000;
- (b) if the fee exceeds \$50,000, the Limitation Amount is a multiple of ten times the fee, up to a monetary ceiling of \$20 million; and
- (c) members of the scheme must have compulsory insurance and business assets of a combined value of not less than the Limitation Amount.

8 We consider that the level of insurance required by the NSW Scheme is a useful guide as to what is adequate cover for AACs. From a practical perspective, there is no discernible difference (in terms of risk or otherwise) between the audit services (or the fees for such services) provided by an AAC and audit services provided by an audit firm. Audit firms using the NSW Scheme calculate their required minimum insured amount using the formula in paragraph 7(c) above.

Appropriateness (Terms and Conditions)

9 Clause 1299B of the CLERP 9 Bill requires that an AAC have appropriate and adequate 'professional indemnity insurance'. We consider that this insurance is in the form of a 'claims-made' contract. It should cover the insured against liability that is incurred by, or a loss arising from, a claim that is made as a result of a negligent act, error or omission in the conduct of the AAC's business. It should also cover contractual claims against the AAC.

10 As noted above, we consider that insurance cover meeting the requirements of the NSW Scheme will generally be suitable for the purposes of cl 1299B of the CLERP 9 Bill, subject to some alterations. In particular, we will require the insurance to:

- provide run-off cover;
- have broad coverage subject to limited, reasonably common exclusions; and
- cover costs and expenses of defending, investigating and settling a claim against the insured.

11 In addition, the insurance must not be cancellable by the insurer for innocent misrepresentation by the insured, or by the insured for any reason.

12 We will require AACs to maintain run-off cover for a minimum of seven years after the AAC ceases to operate. This requirement is consistent with the best practice requirements for some professional accounting bodies, which recommend that members ensure that a valid and binding contract of professional indemnity insurance is maintained, for a period of not less than seven years after ceasing practice as an accountant.

13 We may provide further guidance as to terms and conditions allowed under our policy at the time it is finalised. In particular, we may be guided by what are adequate insurance terms and conditions under professional standards legislation.

Claims covered

14 We note that, in general, auditors do not have any contractual relationship with third parties and the extent to which their statutory obligations embrace the interests of third parties is limited. However, adequate and appropriate insurance should cover claims made by those parties to the extent they can be made.

15 The CLERP 9 Bill indicates that the insurance required of an AAC is to extend only to claims made for the audit of companies and registered schemes for the purposes of the Corporations Act.

16 We consider that this includes claims made arising from audits of companies or registered schemes under a statutory provision of the Act. This also includes audits conducted as a result of ASIC relief or policy relating to the Corporations Act, and audits conducted in accordance with operating rules of a licensed financial market: see s793C of the Act.

17 We will require that the policy cover fraudulent conduct of the insured or the insured's employees to ensure that the AAC can compensate consumers in the event of a defective audit. We believe requiring fraud cover is consistent with the policy aims of cl 1299B. We also note that professional indemnity insurance covering fraud

is a condition of membership of many professional accounting bodies.

Assessment by ASIC

18 In assessing whether insurance arrangements are adequate and appropriate for the purposes of cl 1299B, we will require a director of an AAC to confirm that its insurance arrangements comply with our policy.

19 In particular, we will require a director of the AAC to:

- (a) make a reasonable estimate of the maximum anticipated Corporations Act audit engagement fee the AAC will charge and to advise us of this upon application for registration;
- (b) provide us with such information or documents about or in evidence of the AAC's professional indemnity insurance arrangements as we may request from time to time;
- (c) lodge a document from an insurance broker or insurer certifying that any exclusions contained in the policy are standard or usual exclusions for a policy of this type and that the policy is made on standard commercial terms; and
- (d) provide us with a signed statement from the AAC's accountant verifying the value of the AAC's NTA, if the AAC wishes to have a deductible or excess under its insurance policy.

Ongoing requirements

20 To ensure that adequate and appropriate professional indemnity insurance arrangements are maintained after registration of an AAC, we will impose a condition of registration that the AAC must have insurance in accordance with our policy. This means that the AAC may need to obtain extra cover if the AAC receives a Corporations Act audit engagement fee that exceeds the estimate provided by the directors of the AAC at the time it is registered.

21 We may undertake targeted or random surveillance of AAC professional indemnity insurance arrangements to ensure they comply with our policy.

Regulatory and financial impact

We have considered the regulatory and financial impact of the policy proposals in this paper. Based on the information currently available to us, we believe that implementing the proposals will strike an appropriate balance between ensuring that insurance is adequate and appropriate and that it is commercially available. So that we can more fully assess the financial and regulatory impact of our proposals, in seeking your views we specifically invite you to comment on:

- (a) the likely financial impact of the proposals, including the impact on small business and existing registered company auditors; and
- (b) whether the proposals provide sufficient investor protection, including the extent to which the proposals will ensure that clients obtaining audit services from an AAC may recover from the AAC in the event of a defective audit.

Development of policy proposal

We have developed this policy proposal paper by considering:

- (a) the *Corporate disclosure: Strengthening the financial reporting framework* discussion paper issued by Treasury in September 2002 and submissions received in response to that discussion paper;
- (b) the Exposure Draft CLERP 9 Bill and public submissions made in response to that Bill;
- (c) transcripts of public hearings held as part of the inquiry into the Exposure Draft CLERP 9 Bill by the Parliamentary Joint Committee on Corporations and Financial Services;
- (d) the Explanatory Memorandum to the CLERP 9 Bill and the Second Reading Speech in the House of Representatives on the introduction of the CLERP 9 Bill into Federal Parliament and subsequent Parliamentary debate about the CLERP 9 Bill;
- (e) existing ASIC procedures, policies and practices relevant to the registration of auditors under the Act; and
- (f) the *Professional Standards Act 1994* (NSW) and schemes approved under that Act.

Key terms

In this policy proposal, terms have the following meaning:

AAC Authorised audit company.

Act *The Corporations Act 2001* (Cth).

aggregate Indicates the total amount of coverage that the insured has under the insurance policy, irrespective of the number of separate claims that may occur.

ASIC Australian Securities and Investments Commission.

claims-made contract A contract that provides cover for claims made against the insured during the period of cover, though these may have arisen from conduct of the insured before acquisition of the policy.

clause 1299B or **cl 1299B** (for example) A clause of the CLERP 9 Bill (in this example, cl 1299B).

CLERP 9 Bill or **Bill** The Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, as introduced into the House of Representatives on 4 December 2003.

deductible or **excess** The first part of a loss which is borne by the insured. The insured is responsible for the loss up to the deductible amount and the insurer pays the remainder of the loss, up to the policy limit.

Exposure Draft CLERP 9 Bill The Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, as published by Treasury on 8 October 2003.

net tangible assets (NTA) An AAC's NTA is calculated as:

- (a) the aggregate of the AAC's liabilities and tangible assets, determined in accordance with Australian Accounting Standards, whether or not those standards apply to the AAC; provided that
- (b) the AAC's liabilities and assets are determined on a single entity basis; and
- (c) the calculation excludes amounts receivable directly or indirectly from, or invested directly or indirectly in, any person who is an associate of the AAC for the purposes of the Corporations Act, unless the amount is a receivable that

is adequately secured by a registered first mortgage over real estate that has a fair market valuation at least equal to 120 per cent of the amount owing.

NSW Scheme Accountants' Limitation of Liability Scheme (NSW).

policies or policy publications ASIC policy statements and practice notes.

retroactive date A date on a 'claims-made' policy which extends cover into the past to cover a period of time before the policy was obtained.

run-off cover Cover in respect of claims made after the insurance policy has ended which have arisen from the acts or omissions of the insured during the period of insurance cover.

What will happen next?

Stage 1

16 June 2004

ASIC policy proposal paper released

Stage 2

30 July 2004

Comments due on the policy proposal

Stage 3

September 2004

Policy statement released

Your comments

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