

QON: 006

Mr Falinski MP

Question

1. Please provide the committee with:
 - a. the background to Section 311 of the *Corporations Act 2001*;
 - b. when it was introduced;
 - c. its purpose;
 - d. the reasons for its introduction; and
 - e. any relevant case studies.

Answer

1a) to d)

Section 311 is derived from s167(9) of the *Uniform Companies Acts 1961*. Subsection 167(9) required an auditor to report contraventions of the legislation to the relevant State or Territory Corporate Affairs Commissioner as follows:

“... if an auditor, in the course of the performance of his duties as auditor of a company, is satisfied that—

- (a) there has been a breach or non-observance of any of the provisions of this Act; and
- (b) the circumstances are such that in his opinion the matter has not been or will not be adequately dealt with by comment in his report on the accounts or group accounts or by bringing the matter to the notice of the directors of the company or, if the company is a subsidiary, of the directors of its holding company—

he shall forthwith report the matter in writing to the Commissioner.”

In 1998, the requirement for an auditor to report matters to the Australian Securities Commission (ASC) was amended by the *Company Law Review Act 1998*. An auditor was no longer required to be satisfied of a contravention but rather to report suspected contraventions. Section 311 of the amended *Corporations Law* provided as follows:

“311 Reporting to ASC

The auditor conducting an audit or review must, as soon as possible, notify the ASC in writing if the auditor:

- (a) has reasonable grounds to suspect that a contravention of this Law has occurred; and
- (b) believes that the contravention has not been or will not be adequately dealt with by commenting on it in the auditor’s report or bringing it to the attention of the directors.

Note: Section 1289 gives an auditor qualified privilege for a notification to the ASC under this section.”

The Explanatory Memorandum to the *Company Law Review Bill 1997* explained these changes as follows:

“13.52 ... an auditor must report to the ASC if the auditor is satisfied that there has been a contravention of the Law (current s 332(10)). The words ‘is satisfied’ in section 332 were considered by the House of Representatives Standing Committee on Legal and Constitutional Affairs in its November 1991 report, *Corporate Practices and the Rights of Shareholders*. The Committee concluded that those words were undesirable as they require too high a degree of satisfaction before an auditor must report a contravention of the Law. To alleviate this concern, and in accordance with the recommendations of the Committee, the Bill requires an auditor to report to the ASC if they have ‘reasonable grounds to suspect’ that a contravention of the Law has occurred (Bill s 311(a)). This reduces the level of satisfaction required before an auditor must report and introduces an objective element into the test.”

Section 311 in its current form was introduced by the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004*. The new s311 required auditors to report:

- (i) All suspected contraventions that are “significant”, irrespective of whether the matter could be adequately addressed by commenting on it in the auditor’s report of bringing it to the attention of the directors or through the auditor’s report. The requirements for reporting non-significant suspected contraventions remained unchanged;
- (ii) Suspected contraventions as soon as practicable and within 28 days;
- (iii) Attempts by any person to unduly influence, coerce, manipulate or mislead a person involved in the conduct of the audit; and
- (iv) Attempts by any person to otherwise interfere with the proper conduct of the audit.

The Explanatory Memorandum to the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003* explained that:

“5.241 As a result of the discretion of auditors to deal with any breaches in their report or by raising them with directors, there are concerns that the provision [s311] has not been used as effectively as it could have otherwise been.

5.242 The amendments [to s311] ... balance the need to ensure the profession is able to conduct its business in a flexible way, but at the same time recognise the important role that auditors play as the principal external check on the veracity of companies' financial statements. As such, auditors are in a unique position to determine whether there has been a contravention of the law. The provisions harness the role of auditors by encouraging the timely disclosure of possible breaches of the law.

5.243 ... Proposed subsection 311(1) provides that an ... auditor ... must notify ASIC in writing where the auditor has reasonable grounds to suspect a significant contravention of the Corporations Act. The auditor must do so as soon as practicable but in any case within 28 days. ...

5.244 ... in the case of a breach which is not significant, where the auditor believes that the matter could be adequately dealt with by comment in the auditor's report or by raising it with directors, the auditor need not

report the matter to ASIC. If, however, the auditor does not believe that a breach would be adequately dealt with in this way, it must be reported.

5.245 In determining whether a breach is significant, the auditor should consider the penalty applying in the event of a contravention and the affect of the contravention on, or the adequacy of information available about, the financial standing of the company (subsection 311(4)). Issues which could be considered in determining whether a contravention is significant include:

- insolvent trading by the company;
- a breach of accounting standards or the true and fair view requirement ;
- a breach of Division 2 Part 2 of the ASIC Act;
- suspected dishonest or misleading and deceptive conduct; and
- a breach that may cause a significant loss to any person or class of persons”

1e)

The appendix to ASIC Regulatory Guide 34 *Auditor’s obligations: Reporting to ASIC* (RG 34) provides examples of suspected contraventions that ASIC considers would be reportable, and those examples reflect the paragraph 5.245 above. RG 34 is attached for the information of the Committee.

The types of matters reported by auditors under s311 are summarised in Appendix D to ASIC’s submission to the PJC’s Inquiry into the Regulation of Auditing in Australia. The largest numbers of suspected contraventions reported by auditors in descending order relate to:

- (a) Non-compliance by Australian Financial Services (AFS) licensees with their obligations as licensees;
- (b) Non-lodgement of financial reports;
- (c) Instances where errors in the prior year’s financial report has already been addressed by the company;
- (d) Instances where the auditor has issued a qualified audit report, a disclaimer of opinion or an emphasis of matter paragraph; and
- (e) Fraud or misconduct by management/employees.

Examples of actions that have been taken by ASIC in response to suspected contraventions notified by auditors include:

- (i) Following up non-compliances by an AFS licensee with the financial or other requirements of the licence. Where the licensee does not adequately address the non-compliance, ASIC has cancelled the licence;
- (ii) Following up non-lodgement of financial reports with a company and serving notice under s1274(11) of the *Corporations Act 2001* for the company to lodge the report within 14 days. Where the report is not lodged, ASIC applies to the court for a direction that the company lodge the report and seeks costs. In many cases, companies lodge financial reports before the matter is brought to court.

ASX listed companies may be suspended or delisted by ASX and details of such actions are publicly available on the ASX website;

- (iii) Following up on the accounting treatment by a company, ascertaining whether it is incorrect, and requiring changes so that the market is properly informed; and
- (iv) Using information on instances where errors in the prior year's financial report have already been addressed by the company as intelligence in selecting reviews of audits conducted by the prior year auditor.

A recent example of a matter addressed by ASIC where we had received a s311 notice is as follows:

- The auditor of ASX-listed [REDACTED] notified ASIC of the non-lodgement of audited financial reports for the years ended [REDACTED] [REDACTED] within the three months required by the *Corporations Act 2001* (the Act). ASIC restricted [REDACTED] from using the following disclosure exemptions when making public offers of securities until [REDACTED] for failing to lodge financial reports:
 - a. the disclosure exemptions for sale offers of securities and for rights issues (s 708A and s708AA of the Act); and
 - b. the reduced prospectus content requirements for continuously quoted securities (s713 of the Act).

The company's securities had also been suspended from trading on ASX.

[REDACTED]

[REDACTED]

As the individual notifications by auditors are not public and any public outcomes do not generally refer to a notification by the auditor, we request that the PJC keep the name of the company above and its auditor confidential.

We do consider enforcement action for matters reported under S311 and under ASIC's 'why not litigate' approach and new Office of Enforcement we are likely to take more enforcement actions on these matters.