Auditor's Liability and the Public Sector Auditor

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Courts in various jurisdictions have struggled with defining the duty of care owed by auditors in the performance of their work and to whom that duty is owed. Australian Courts have not, however, had the opportunity to specifically examine the duty of care owed by auditors in the public sector.

This paper examines the findings of the New Zealand High Court in Dairy Containers Ltd v Auditor-General,[1] *and in doing so examines the differing roles and duties of public and private sector auditors in the detection of fraud. The impact of the New Zealand case and increased commercialism of public sector entities on Australian Auditors-General will also be examined.*

1. Introduction

At the crux of the debate surrounding the liability of auditors in negligence is the role of the auditor in the detection of fraud. Within the private sector, the auditing profession has continued to maintain that the auditor's role is to express an opinion on whether the accounts under audit present a 'true and fair' view of the financial position and the operating results of the entity under audit. The private sector auditor's role in detection of fraud is secondary. This view appears contrary to that of the general public, with evidence suggesting that the general public believe the auditor's role is to ensure that company accounts are completely fraud and error free. This divergence in beliefs is commonly referred to as the audit 'expectation gap'.[2]

It has been argued that the courts should eliminate the audit 'expectation gap' by placing more extensive and

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1 [1995] 2 NZLR 30.

2 Monroe, G S, and Woodliff, D R, "Great Expectations: Public Perceptions of the Auditor's Role" (1994) 4(2) *Australian Accounting Review* 42.

onerous responsibilities on auditors through legally imposed duties.

> "One of the risks facing the profession is that the continued existence of an 'expectation gap', and the concomitant uncertainty as to 'reasonable care and skill', will be resolved through unfavourable litigation resulting from the different perceptions as to the duties and responsibilities of auditors."[3]

It is this risk to the audit profession that has prompted much of the literature on auditors liability, with numerous arguments postulated for and against the imposition of increased audit responsibilities. Much of this literature, however, has been confined to discussion of the role of the private sector auditor in the detection of fraud. Whether a difference exists between the roles of private and public sector auditors, in terms of the tort of negligence, is an issue that has not received much discussion. Further, the Australian courts have not, as yet, had the opportunity to specifically examine the role of the Auditor-General in the detection of fraud. This paper examines the role of the public sector auditor in detecting fraud and evaluates the extent to which an Auditor-General would be held liable under the tort of negligence, should the issue ever arise in the Australian courts.

By way of example, this paper examines the role of public sector audit in relation to the Queensland public sector and the provisions of the *Financial Administration and Audit Act* 1977 (Qld). Responses were elicited from the Queensland Auditor-General in order to examine the implications of the changing role of public sector auditors, and the effect, if any, of the New Zealand litigation against public sector auditors. While there exists some differences in the various State and Commonwealth audit legislation, the provisions related to the role of auditors in the public sector are fundamentally similar.

Section 2 examines the role of the public sector audit and contrasts it to the role of the private sector auditor. Section 3 examines the role of audit, both in the private

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[3] Peirson, G, "Recent Developments in Audit Reporting: The Expectation Gap Perspective" (1989) 7(4) *Company and Securities Law Journal* 292.

and public sector, in the detection of fraud. Section 4 examines the implications of current litigation on Auditors-General in Australia.

2. The role of the public sector audit

Auditing of the public sector extends to the federal, state and local levels of government in Australia. The responsibility for auditing the accounts of public sector entities rests with the Auditors-General of each jurisdiction, with each Auditor-General being appointed in accordance with the applicable public administration legislation. In Queensland, for example, the Auditor-General is appointed under the *Financial Administration and Audit Act* and is required by s 73 of that Act to audit the public accounts and all public sector entities of Queensland. In the performance of this duty, the Auditor-General may conduct an audit in the manner that the Auditor-General considers appropriate.[4] The statutory provisions of other Australian jurisdictions are expressed in similar terms.

Traditionally, government entities at a Commonwealth and State level comprised primarily of departments, with the administrative responsibility of the department being assigned to the relevant minister. However, the commercial climate of the public sector is rapidly changing, with a movement away from the traditional forms of public sector administration and a push towards economic rationalism.[5] Government entities now perform a myriad of activities through a variety of legal structures, ranging from the traditional department to commercial type entities, such as government owned corporations, which are required to operate and compete with the private sector. Regardless of their legal form or degree of autonomy, however, public sector entities are accountable to parliament for the effective operations of their functions.

The role of the Auditor-General is an integral component of the Westminster system of Parliamentary democracy and it

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4 *Financial Administration and Audit Act* 1977 (Qld), s 79.

5 Broadbent, J, and Guthrie, J, "Changes in the Public Sector: A Review of Recent 'Alternative' Accounting Research" (1992) 5(2) *Accounting, Auditing & Accountability Journal* 3.

is often argued that the public sector audit is one of the prime mechanisms for ensuring that public sector accountability has been properly discharged. Accountability is a broad concept which has been defined frequently in literature on public sector administration. Thus it has been said that:

> "Accountability is about giving an answer for the way in which one has spent money, exercised power and control, mediated rights and used discretions vested by law in the public interest. It is fundamental to our system of government that those to whom such powers and responsibilities are given are required to exercise them in the public interest (which would also embrace concepts of efficiency and effectiveness), fairly, and according to law."[6]

In other words, public sector entities should be held accountable not only for the dollar amount of funds they spend, but for the manner in which those funds are utilised. For this reason, the audit mandate[7] of the Auditor-General is, generally speaking, more comprehensive than that of the private sector auditor. While public and private sector auditors are both required to conduct financial audits, which are primarily concerned with attestation of financial statements, there is an additional obligation on public sector auditors to perform compliance audits, which involve ascertaining whether the proper procedures and controls over funds are exercised by the entity under audit. This additional obligation is generally specified by legislation.[8]

Further differences between public and private sector auditors exist in the objectives or scope of the audit. Audit legislation generally requires that Auditors-General table in Parliament the Auditing Standards that will be applied to the audit of public sector audits,[9] and these Standards may

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6 Waterford, J, "A Bottom Line on Public Service Accountability" (1991) 50(3) *Australian Journal of Public Administration* 414, p 415.

7 The term "audit mandate" generally refers to the duties imposed upon the Auditor-General and the powers necessary to perform those duties.

8 See, for example, s 81 of the *Financial Administration and Audit Act* 1977 (Qld) for the Queensland provision.

9 s 97.

or may not be in accordance with the auditing standards as issued by the relevant professional bodies.[10] In addition to the objectives of private sector audits, as defined in the Australian Auditing Standards, public sector Auditing Standards generally incorporate audit objectives related to probity, propriety and compliance.

> "It should be recognised that auditing in the public sector has a dual focus when compared to auditing in the private sector. Besides adding credibility to reported financial information by expressing an opinion on such information, public sector auditors report on matters of probity, propriety and legislative compliance to the Parliament."[11]

By implication, these additional audit objectives place an added emphasis on the role of public sector auditors in ensuring that the entity under audit has, as far as can be determined, managed public moneys in a manner which is honest, moral and appropriate. This role is discharged by the performance of compliance audits and other forms of audit review, such as performance audits.

When discussing the differences between public and private sector audit, certain characteristics of an Auditor-General's appointment also need to be considered. Firstly, legislation imposes upon the Auditor-General the sole responsibility of auditing the public sector. For example, s 73 of the *Financial Administration and Audit Act* states that the Auditor-General must audit the public accounts and all public sector entities in relation to each financial year. An Auditor-General may also be appointed auditor of corporate public sector entities.[12] Staff may be appointed by the Auditor-General in assisting with the public sector audit.[13] However, staff so appointed are subject only to the direction of the Auditor-General in relation to the manner in which audits are to be exercised and the priority given

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10 s 79, which grants the Queensland Auditor-General legislative power to conduct an audit 'in the way the Auditor-General considers appropriate'. Similar provisions are found in the mandates of other Auditors-General.

11 Gill, S G, and Cosserat, G W P, *Modern Auditing in Australia* (3rd ed), John Wiley & Sons, Milton, 1993, p 689.

12 *Financial Administration and Audit Act* 1977 (Qld), s 76.

13 s 63.

to audit matters.[14] By contrast, private sector audits are performed by various accounting firms. The auditor of the private sector is not specifically appointed by the *Corporations Law*, which simply requires that corporate financial statements are audited by a registered auditor.

While audit legislation provides that an Auditor-General may appoint staff in order to assist him or her with the task of auditing the public sector, the Auditor-General will generally not have absolute control over the financial resources needed to perform his or her statutory duties. Offices of Auditors-General are funded by Treasury and financial resources are, to a large degree, controlled by the very entity upon which the Auditor-General is required to report on. Therefore, while the Auditor-General may have a legally imposed monopoly over the audit of the public sector, restrictions over funding may greatly impact on the manner in which public sector audits are performed.

The real difference between public and private sector auditors, however, may lie in something much less tangible than legislative mandates. Historically, public sector audit offices have operated in a culture which is vastly different from that of the private sector. For example, the Queensland Audit Office has been described as an "organisation which had enshrined a work ethic based upon long hours of unpaid overtime, and a threadbare economy which once made the loss of a pencil a reportable offence..."[15] It is arguable, therefore, that public sector auditors are traditionally conservative, performing their work in a frugal and fastidious manner. By contrast, private sector auditors, such as the 'big six', operate in a commercial environment, dominated by risk and monetary demands, and are much less inclined to be concerned with detailed audit review.

When discussing the factors that may have precluded actions of negligence being initiated against public sector auditors, the Auditor-General of Queensland suggested that the very fact that there is so little case law in anywhere, such as the Westminster system of Auditors-General being

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14 s 65.

15 Longhurst, R, *The Plain Truth: A History of the Queensland Audit Office*, Queensland Audit Office, Brisbane 1995, p 193.

sued suggests a number of things. Firstly, it may be that there is a reluctance for the public to 'take on' Auditors-General given their high profile in Government. Secondly, there is the fact that the predominance of an Auditor-General's work is in relation to the Crown (ie audit of government Departments, etc), and therefore actions of negligence would simply result in the Crown suing itself. However, the third option may well be that the very manner in which an Auditor-General performs his or her duties eliminates the avenues for actions of negligence.

> "We do all this fraud detection type work so well that there is no avenue [for litigation]. We are so stringent, and some might say obsessed, with controls and checks and systems, that we are all the time forcing the recognition of failure... It's the approach that we have to do the work which again is not profit driven."[16]

The Auditor-General went on to state that Auditors-General do, in their fulfilment of the mandate, pay greater attention to systems controls and prevention. While it may be that most Auditors-General will argue that the detection of fraud is not necessarily their primary role, they have not reduced the public sector audit to a balance sheet approach, as with the private sector auditors.

In describing the difference between public and private sector auditors, a former NSW Auditor-General, Mr. J O'Donnell stated:

> "Private sector auditors are at pains to point out in their engagement letter that their role is not one of fraud finding. It would be nice and comfortable for me to adopt the same position, but I believe the public expects more of me."[17]

Whether, in fact, there exists a legally imposed difference between private and public sector auditors in relation to

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[16] Interview with Barrie M Rollason, Auditor-General of Queensland, Queensland Audit Office, 6 June 1996.

[17] Thomas (1984), cited in Hardman, D J, "Towards a Conceptual Framework for Government Auditing" 1996, p 30.

the detection of fraud is not so clear. This issue is examined in the next section.

3. The duty to detect fraud

Fraud, in relation to an audit of financial information, generally refers to the "deliberate misrepresentation of financial information or misappropriation of assets by employees or officers of the firm."[18] The auditors' legal role in the detection of fraud is found in a pot-pourri of auditing standards, statutory provisions and related case law.

3.1 The duties of the private sector auditor

The duties and responsibilities of private sector auditors in relation to fraud are found in the *Corporations Law* and the various Australian Accounting and Auditing Standards. When an auditor is appointed under the *Corporations Law* to report on a company's financial statements, the auditor is to report on a range of matters, including:

1. whether proper accounting records have been kept;[19]
2. whether the financial statements have been drawn up so as to comply with applicable accounting standards and the requirements of the *Corporations Law*, that is, to give a true and fair view of the company's state of affairs;[20] and
3. whether the financial statements include any defects and irregularities, and if so to form an opinion, after investigation, as to the nature of the deficiency.[21]

This final requirement clearly states that private sector auditors have a legal responsibility in the reporting of corporate fraud. However, while the requirement to report on fraud is clearly stated, the role of audit in the detection of fraud is not so clear. It appears that the auditing profession views the duty to detect fraud as a secondary function of audit, the primary purpose being to express an opinion on the audit clients' financial statements, as

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18 Gay, G E, and Pound, G D, "The Role of the Auditor in Fraud Detection and Reporting" (1989) 7(2) *Company and Securities Law Journal* 116.

19 *Corporations Law*, s 331E(2)(b).

20 s 331AA(1), s 331A(1)(a), s 331B(1), and s 332A.

21 s 331D, and s 331E.

shown by the Australian Auditing Standards. Paragraph .02 of Auditing Standard AUS 202 *Objective and General Principles Governing an Audit of a Financial Report* states that:

> "The objective of an audit of a financial report is to enable the auditor to express an opinion whether the financial report is prepared, in all material respects, in accordance with an identified financial reporting framework."

Paragraph .09 of AUS 210 *Irregularities, Including Fraud, Other Illegal Acts and Errors* states:

> "The responsibility for the prevention and detection of irregularities rests with *management* [emphasis added]. Through the implementation and continued operation of an adequate internal control structure, management aims to derive reasonable assurance that irregularities are prevented as far as is possible, and detected if they occur."

Furthermore, paragraph .10 of AUS 210 states:

> "The auditor is not legally or professionally responsible for preventing irregularities. However, the auditor has a legal and professional duty to exercise reasonable skill and care in the planning and conduct of the audit so as to have a reasonable expectation of detecting material misstatements arising as a result of irregularities. In the absence of a specific requirement of the audit mandate however, the auditor does not have a responsibility to plan and conduct the audit so as to have a reasonable expectation of detecting irregularities that do not have a material effect on the financial report."

In examining the audit expectation gap, Monroe and Woodliff[22] found that the most significant difference between user expectations and the audit profession related to the role of audit in detecting fraud, notifying management of malpractice, ensuring that the efficient

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22 Monroe, G S, and Woodliff, D R, already cited n 2.

operations of the entity being audited and assessing the entities future viability. In a similar study in New Zealand, Porter[23] found that users viewed the audit's role as being society's corporate watchdog. The results of other studies have showed that a significant number of investors believe that auditors have an obligation to detect all fraud and errors when performing their duties.[24] Given that the public and the profession are at odds, the ultimate resolution of whether auditors in the private sector have a responsibility to detect fraud is likely to depend upon the court's interpretation of the auditor's fundamental role.

The courts have historically applied the principle of 'reasonable skill and care' when determining whether private sector auditors have adequately discharged their responsibilities in relation to fraud. The principle of auditors' liability was first stated by the House of Lords in the case of *Hedley Byrne & Co Ltd v Heller & Partners Ltd*,[25] where it was held that professionals owe a duty of care when it is known, or ought to be known, that a person seeking advice or information from them would rely upon that advice or information. In considering those circumstances which give rise to a duty of care, Lord Reid stated:

> "I can see no logical stopping place short of all those relationships where it is plain that the party seeking information or advice was trusting the other to exercise such a degree of care as the circumstances required, where it was reasonable for him to do that, and where the other gave the information or advice when he knew or ought to have known that the inquirer was relying on him."[26]

The standard of skill and care that constitutes 'reasonable' is a question of law that remains complicated and the principles that have emerged over recent years have been

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23 Porter, B A, "An Empirical Study of the Audit Expectation-Performance Gap" (1993) *Accounting and Business Research* 49.

24 See, for example, Beck, G W, "The Role of the Auditor in Modern Society: An Exploratory Essay" (1973) *Accounting and Business Research* 117; Gwilliam, D, "The Auditor's Responsibility for the Detection of Fraud" (1987) 3 *Professional Negligence* 6.

25 [1964] AC 465.

26 id, at 486.

inconsistent. A comprehensive view of the standard of care owed by auditors was set out in the New South Wales case *Pacific Acceptance Corporation Ltd v Forsyth*,[27] where Moffitt J held that auditors must exercise reasonable skill and care during the conduct of an audit. However, what is considered reasonable care will depend on the circumstances. Moffitt J held that:

> "The legal duty, namely, to audit the accounts with reasonable skill and care, remains the same, but reasonableness and skill in auditing must bring to account and be directed towards the changed circumstances referred to. Reasonable skill and care calls for changed standards to meet changed conditions or changed understanding of dangers and in this sense standards are more exacting today than in 1896. This the audit profession has rightly accepted, and by change in emphasis in their procedures and in some changed procedures have acknowledged that due skill and care calls for some different approaches. It is not a question of the court requiring higher standards because the profession has adopted higher standards. It is a question of the court applying the law, which by its content expects such reasonable standards as will meet the circumstances of today, including modern conditions of business and knowledge concerning them. However, now as formerly, standards and practices adopted by the profession to meet current circumstances provide a sound guide to the court in determining what is reasonable."[28]

In relation to the auditors duty to detect fraud or error, Moffitt J held that auditors have a duty to pay due regard to the possibility of fraud, and to actively investigate the possibility of fraud in those circumstances where suspicions are, or should be, aroused, although auditors have no duty to detect fraud or error in the absence of those circumstances. He stated:

> "Once it is accepted that the auditor's duty requires him to go behind the books and determine the true

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27 (1970) 92 WN (NSW) 29.
28 id, at 74.

> financial position of the company and so to examine the accord or otherwise of the financial position of the company, the books and the balance sheet, it follows that the possible causes to the contrary, namely, error, fraud or unsound accounting, are the auditor's concern."[29]

This view was followed by the Full Court of the Western Australian Supreme Court in the case of *Arthur Young & Co v WA Chip and Pulp Co Pty Ltd*[30] and similarly by the Victorian Supreme Court in the case of *BGJ Holdings Pty Ltd v Touche Ross & Co*[31] where the auditors were held liable for not informing the appropriate directors when it was suspected that the managing director was engaging in speculative foreign currency transactions.

In the New South Wales Supreme Court case of *AWA Ltd v Daniels*,[32] Rogers CJ (Comm D) discussed the standard of care and skill that constituted 'reasonable', and the audit work that must necessarily be performed in order to discharge that level of care and skill. The provisions of the Australian Accounting and Auditing Standards, along with the auditors own methodology, as described in their Audit Manual, were some of the factors that Rogers CJ (Comm D) considered when ascertaining the manner in which the auditor should perform his or her audit duties. Specifically, Rogers CJ (Comm D) referred to paragraph 22 of Statement of Auditing Standards AUS 1[33] which stated:

> "The auditor should gain an understanding of the accounting system and related internal controls and should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures."[34]

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29 id, at 63.
30 (1988) 13 ACLR 283.
31 (1987) 12 ACLR 481; 6 ACLC 449.
32 (1992) 10 ACLC 933; (1992) 7 ACSR 759.
33 The Statement of Auditing Standards AUS 1 recently codified, along with the Statements of Auditing Practice (AUP's) into Australian Auditing Standards (AUS's). Similar provisions are now found in AUS 402.
34 *AWA Ltd v Daniels* (1992) 7 ASCR 759, at 797.

Thus it was held that:

> "The auditor, in forming his opinion on financial information, needs reasonable assurance that transactions are properly recorded in the accounting records and that transactions have not been omitted...The auditor obtains an understanding of the accounting system to identify points in the processing of transactions and handling of assets where errors or fraud may occur. When the auditor is relying on internal control, it is at these points that he must be satisfied that internal control procedures applied by the entity are effective for his purpose."[35]

Thus, Rogers CJ (Comm D) held that auditors have a legal duty to assess the adequacy and reliability of internal controls regardless of whether any irregularities have actually been discovered during the course of the audit. Further, the auditor must report any significant deficiencies in the design or operation of the internal control structure to an appropriate level of management.

It must be noted that in all of the above cases, there was no necessity to draw a distinction between private and public sector auditors. Whether there is a legal difference between the duties of private and public auditors in relation to fraud has not, as yet, been examined by an Australian court.

3.2 The duties of the public sector auditor

While the role of the public sector auditor in relation to fraud has not been examined in Australia, the issue was raised in the New Zealand High Court case of *Dairy Containers Ltd v Auditor-General*.[36] This case involved the negligent failure of the New Zealand Auditor-General in detecting ongoing management fraud during his audit of Dairy Containers Ltd. In finding the Auditor-General negligent, Thomas J held that the standards of care expected of auditors could not be less than that which was reasonably necessary to enable them to perform their

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35 id, at 798 per Rogers CJ.
36 [1995] 2 NZLR 30.

statutory duties and contractual obligations related to the audit. It was stated:

> "They must perform the audit with such care and skill as is necessary to reach the opinion, albeit subject to the reservations expressed in the Companies Act, that the financial statements give a true and fair view of the state of the company's affairs and its profit and loss for the financial year. If the audit fails to meet this standard, the auditors have failed to safeguard the interests of the shareholders to whom they must report. They have failed to fulfil their basic function."[37]

Dairy Containers Ltd was a wholly owned subsidiary of the New Zealand Dairy Board and was a private company incorporated under the *Companies Act* 1955 for the purpose of manufacturing cans at the lowest possible price for the New Zealand Dairy Board. Dairy Containers Ltd later became a substantial investment company.

All the members of the company's board of directors were senior executives of the New Zealand Dairy Board. The New Zealand Dairy Board prescribed that the company would not make a profit, and the group's perception of the company was that it was a totally internal operation. The general understanding was that the company's investments would be in the short-term money market and restricted to approved trustee investments.

Over a period of five years to 1989, the three managers of Dairy Containers Ltd committed a diverse range of frauds on the company which included a series of unauthorised investments and misappropriation of funds through the conversion of the company's cheques drawn on the ANZ Bank. All three managers were dismissed in August 1989 and subsequently pleaded guilty to criminal charges of fraudulent collusion and misappropriation of company funds.

Throughout the period of the fraudulent misappropriations, the accounts of Dairy Containers Ltd were audited by the New Zealand Auditor-General. In

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[37] id, at 54 per Thomas J.

performing the audit, the Auditor-General voluntarily undertook a number of duties in addition to his statutory duties, which included conducting a periodic review of the company's system of accounting and internal controls, and ensuring that the company's books and accounts were faithfully kept. In his terms of engagement, the Auditor-General expressly stated that the audit examination should not be relied upon to disclose defalcations.

Dairy Containers Ltd brought proceedings against the Auditor-General for $11.8 million, being the amount of losses through the misappropriation of its funds, on the ground that the Auditor-General had been negligent in failing to detect these frauds. While conceding that the audit of Dairy Containers Ltd was defective in certain respects, the Auditor-General denied liability on the grounds that any breach of his duties in undertaking the audit did not cause the company's losses. In denying liability, the Auditor-General further contended that the fraudulent collusion of the managers of Dairy Containers Ltd would have defeated the Auditor-General in the performance of his duties. The Auditor-General claimed that the company was contributorily negligent on the basis that its board of directors had been negligent in failing to monitor and control the activities of management and enforce its investment policies.

Relying on the decision in *Pacific Acceptance v Forsyth*,[38] the New Zealand High Court found the Auditor-General liable for the losses incurred by Dairy Containers Ltd. Specifically, the Auditor-General had neglected the fundamental step of planning the audit, and had failed to confirm the company's investments with third parties and review its system of accounting and internal control. Thomas J stated:

> "Planning an audit is recognised as being of crucial importance...Such planning had to have regard to the question of materiality, relative risk, and the competence of evidential material. It would necessarily have regard to the client's systems of internal control...The pertinence of these requirements...is that there was little or no effective

[38] (1970) 92 WN (NSW) 29.

> planning or review of the audits carried out in the years in question."[39]

As with *AWA Ltd v Daniels*,[40] the standard of care owed by the Auditor-General was determined by reference to various auditing standards and to the Auditor-General's own office manuals. After referring to the June 1986 Auditing Guideline and the Auditor-General's Philosophy and Concepts Manual, Thomas J stated:

> "It is confirmed that the objective of an audit is to enable auditors to express an opinion on the financial information based on a reasonable assurance that it is properly stated in all material respects. Thus, auditors are to seek a reasonable assurance that fraud or error, which may be be [sic] material to that financial information, has not occurred. They should, it is stated, plan the audit so that there is a reasonable expectation of detecting material misstatements in the financial information resulting from fraud or error. The assurance of detecting errors would normally be higher than that of detecting fraud since fraud, it is observed, is usually accompanied by acts specifically designed to conceal its existence. Unless examination reveals evidence to the contrary, auditors are entitled to accept representations as truthful and records and documents as genuine. But auditors should plan and perform the audit with an attitude of 'professional scepticism' recognising that conditions or events may be encountered during the examination which would lead to questioning whether fraud or error exists. They should not assume that an instance of fraud or error is an isolated occurrence."[41]

The court also found that the negligence of the company's board of directors in failing to review and control the company's investment activities had clearly contributed to the loss incurred by Dairy Containers Ltd and damages against the Auditor-General were consequently reduced by

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39 *Dairy Containers Ltd v Auditor-General* [1995] 2 NZLR 30, at 56.
40 (1992) 10 ACLC 933.
41 [1995] 2 NZLR 30 at 58.

40 percent. In determining whether the company had been contributorily negligent, Thomas J stated:

> "Indeed, it is arguable, that where the management of a company is seriously defective, as in this case, the defect must necessarily affect the auditor's ability to perform the audit and report the truth. The auditor is still required to exercise reasonable care, of course, but if he or she fails to do so that does not mean that the company's gross laxity will not have contributed to that failure."[42]

4. Implications for Australian Auditors-General

What is interesting to note is that there is virtually no difference between the reasoning of Thomas J in the case of *Dairy Containers Ltd v Auditor-General*,[43] Moffitt J in the case of *Pacific Acceptance v Forsyth*[44] and Rogers CJ (Comm D) in the case of *AWA Ltd v Daniels*.[45] In all three cases it was held that auditors owe a duty to perform their work with that level of care and skill that is considered reasonable, and so that there is a reasonable expectation that material misstatements in the financial information resulting from fraud or error will be detected. The appropriate level of care and skill was determined by reference to applicable Auditing Standards and the auditors own audit manual. Adequate performance of audit work will necessarily involve gaining an understanding of the accounting system and related internal controls and the evaluation of the operation of those internal controls upon which the auditor wishes to rely.

There was no distinction drawn by Thomas J in the case of *Dairy Containers Ltd v Auditor-General*[46] between the role of the Auditor-General and that of a private sector auditor. While not binding on Australian courts, there is no logical reason why the judgment of Thomas J would not be applied in Australia. Audit failure should be recognised by the courts as such, regardless of whether the auditor operates in the public or private sector.

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42 id, at 75.
43 [1995] 2 NZLR 30.
44 (1970) 92 WN (NSW) 29.
45 (1992) 10 ACLC 933.
46 [1995] 2 NZLR 30.

By applying the reasoning of Thomas J, it is arguable that auditors in the public sector of Australia will, at the very least, owe the same duty of care in relation to the detection of fraud as is currently owed by private sector auditors. However, there is also the possibility that public sector auditors have a greater responsibility in relation to the detection of fraud, given their traditional role in the discharge of public sector accountability (as discussed in section 1). When queried in regard to this proposition, it was the Queensland Auditor-General's view that the public sector auditor most certainly has a greater responsibility in relation to the detection of fraud. This responsibility is the direct result of the legislative mandate of the Auditor-General.

Historically, one of the factors that has prevented an action of negligence being brought against an Auditor-General is the fact that it would simply result in the Crown suing itself. Today's public sector, however, operates in a climate where the public, in general, is demanding a more effective and efficient allocation of public funds, and this has influenced many of the economic theories which extol the virtues of commercialisation. Consequently, public sector entities are becoming more commercially focused than has been the case in the past and the risk associated with public sector auditing is escalating. The impact of the commercialisation of the public sector is twofold. Firstly, more and more public sector entities are adopting corporate structures and functions, as was the case of Dairy Containers Ltd, and are thus operating in an environment of increased risk. Secondly, Auditors-General are being increasingly pressured into reducing the cost of audit and adopting private sector methodologies. Consequently, there is an increased risk of audit failure on the behalf of public sector auditors and a corresponding likelihood of more litigation involving Auditors-General.

In discussing the commercialisation of the public sector audit, the Auditor-General of Queensland stated that the public sector audit has now been taken into an arena which is somewhat the same arena as the private sector auditors find themselves in. There are now clients who are not going to take too willingly the audit fee imposed upon them and who are, therefore, more likely to initiate an action should audit failure occur.

Commercialisation of the public sector does, however, have its advantages. There is much support for the argument that increased commercialism does, in fact, result in a more efficient and effective public sector.[47] However, the question remains as to whether a complete adoption of the private sector model of public sector audit offices, as occurred in New Zealand, is appropriate for public sector auditing and is good *per se* for the public sector.

One of the key differences between public and private sector auditors lies in the legislation governing the audit of public sector entities. For example, as stated in section 2 above, the *Financial Administration and Audit Act* requires that the audit of public sector entities be performed by the Auditor-General. While the *Corporations Law* dictates that companies must be audited, it does not require that the audit be performed by a particular organisation. Private sector auditors must, therefore, compete in the market place for audits of corporations if they are to remain in the business of auditing. This often results in cost cutting measures, which in turn could affect the quality of the audit work performed by the private sector auditor.[48]

If auditors in the public sector are to continue to perform their work at a level of care and skill which is considered reasonable in safeguarding the public purse, then the practice of cutting costs related to auditing should be frowned upon by the auditing profession. This is not to say that audit costs should increase disproportionately to the audit work performed. Essentially, both public and private sector auditors should ensure that sufficient resources are available so that their audit duties can be adequately performed. Resources will necessarily be required to ensure the audit is properly planned and, in circumstances where evidence suggests the possibility of fraud, in such a way that the auditor can carry out such further tests or

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47 See, for example, Rimmer, S J, "Competitive Tendering, Contracting Out and Franchising: Key Concepts and Issues" (1991) 50(3) *Australian Journal of Public Administration* 292.

48 While in principle public sector audit offices are being forced by the current economic climate to 'cut the cost of audit', the Auditor-General has retained a monopoly which, to a certain extent, enables him or her to ensure that public sector audits are performed to a certain standard.

inquires to be satisfied that, in fact, no material fraud exists. The cost of audit in both the private and public sector should reflect the cost of these additional resources.

With the increased commercialisation of the public sector comes an increased risk that the public sector auditor will be exposed to litigation as the result of audit failure. This risk can be reduced by ensuring that there are appropriate procedures in place, such as the adoption of suitable audit methodologies, the recruitment of suitably qualified staff, the proper training of audit office staff and the imposition of external review procedures. The public sector auditor must attempt to achieve a balance between cost containment and satisfaction of the public interest.