

# CLIMATE CHANGE AND PROFESSIONAL LIABILITY RISK FOR AUDITORS: A COMPARATIVE UNITED KINGDOM/ AUSTRALIA ANALYSIS

## **PAPER 3**

### **AUDITORS' LEGAL DUTIES AND CLIMATE RISK IN ANNUAL ACCOUNTS: UNLAWFUL OR IMPROPER DIVIDENDS**

BE HEARD.  
BE RECOGNISED.



# CLIMATE CHANGE AND PROFESSIONAL LIABILITY RISK FOR AUDITORS

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## Introduction

On page 8 of *Risky business* an interest and compelling conjecture is made in the following terms:

Where accounts are approved and do not comply with the relevant legal requirements, including due to a failure to properly consider climate risk implications, **there is also a risk that any distribution or dividend made by reference to those accounts will be unlawful.** - - -

Where an unlawful distribution has been made, **directors may be personally liable to repay the company**, as may any shareholder who had reasonable grounds to believe that the distribution was unlawful. (Emphasis added)<sup>1</sup>

It is worthwhile to consider this notion of liability risk in the Australian context of statutory requirements for the paying of dividends. Seen as potentially significant is the reference in the current legislative test restricting the payment of dividends to both accounting concepts and accounting standards. These factors, once outlined, might be insightful to current understanding of the consequences of improper dividends, both generally and in relation to an auditor's civil liability, and as such, relevant to the objectives behind development of *Risky business*.

## The evolution of dividend payment rules

Based on the long-established doctrine of maintenance of capital, both case law and corporate constitutions have firmly supported the proposition that dividends could only be paid out of profits. Similarly, there is both a strong judicial and policy adherence to ideas of creditor and discrete class of shareholder protection through application of strict rules governing returns of paid-up capital to shareholders outside of a formal winding up. The 'profits test' is that which prevailed in Australian legislation with effect to dividends paid before 28 June 2010. After this time, a more flexible 'balance sheet test' applies through the following:

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<sup>1</sup> I have not in this review made any analysis, but query whether a worthwhile further line of inquiry might be an exploration of possible insight gleaned from the significant recent case law, both in the UK and Australia, dealing with the rules of knowing receipt and knowing assistance developed from Lord Selbourne's dictum in *Barnes v Addy* (1874) 9 Ch App 244.

**CORPORATIONS ACT 2001 - SECT 254T**

**Circumstances in which a dividend may be paid**

(1) A company must not pay a dividend unless:

(a) the company's assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend; and

(b) the payment of the dividend is fair and reasonable to the company's shareholders as a whole; and

(c) the payment of the dividend does not materially prejudice the company's ability to pay its creditors.

Note 1: As an example, the payment of a dividend would materially prejudice the company's ability to pay its creditors if the company would become insolvent as a result of the payment.

Note 2: For a [director's](#) duty to prevent insolvent trading on payment of dividends, see [section 588G](#).

(2) Assets and liabilities are to be calculated for the purposes of this section in accordance with accounting standards in force at the relevant time (even if the standard does not otherwise apply to the financial year of some or all of the companies concerned).

The second and third limbs of the test (s 254T(b) and (c)) deal respectively with impact on company's shareholders as a whole and prejudicing ability to pay the company's creditors, and replicates that applied to share capital reductions and buy-backs. Nevertheless, it must be stressed that whilst a dividend diminishes funds otherwise available for payment of creditors, s 254T does not permit a company to reduce its share capital through paying a dividend. Share capital reductions and share buy-backs are separately dealt with in Pt 2J.1 which, for instance, in s 256 provides precise requirements of shareholder approval of reductions in share capital. Moreover, the Pt 2J.1 statutory procedure applies only to "make reductions not otherwise authorised"<sup>2</sup>, against which s 254T precludes payment under each of its three component tests, and thus, cannot be an "otherwise authorised" reduction.

The effect of the first limb of s 254T is to enable a dividend to be paid even if the company does not have an accounting profit, though prevents payment of a dividend where there is a deficiency in

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<sup>2</sup> Section 256B, Note 1 to which provides as an example an authorised reduction being cancelling uncalled capital and Note 2 cross-references to specific statutory authorised reductions including shares in unlimited companies (s 258A) and cancellation of forfeited shares (s 258D).

net assets regardless that the company has an accounting profit, the latter circumstance of which was permissible under the former rules.

Without going into lengthy detail, the replacement of the profits test with a balance sheet test has been contentious. Two aspects of the controversy which have had follow-on impact of uncertainty around the taxation treatment of dividends are briefly mentioned. First, the authors of *Ford's* note that the language of the section expressed in prohibitions leaves begging the question of whether a dividend is lawful merely by meeting the three conditions. Secondly, the *CCH Commentary* queries whether the section is at odds with case law inasmuch as the Corporation Act does not provide a definition of 'dividend' suggesting therefore that the common law view of a share of profits still subsists.<sup>3</sup>

More germane to our direct concerns around accounting and audit, and auditor liability, are the underlying rationale for adopting the test applied in s 254T(1)(a) and the implications ensuing from the subsequent reference in s 254T(2) to accounting standards as the basis for calculation (measurement) of assets and liabilities. The authors of *Ford's* identify in the Explanatory Memorandum accompanying the reform bill which implemented the repeal of the s 254T profits test and its replacement with a balance test, three concerns which warranted the reorientation in the legislative restriction on payments of dividends<sup>4</sup>:

1. Case law which had developed over the 19<sup>th</sup> and 20<sup>th</sup> centuries concerning the concept of profits had become outdated and was increasingly at odds with the development of accounting concepts and standards applied in business and increasingly recognised in corporations legislation.
2. Relatedly, application of evolving accounting standards was making profits increasingly volatile.
3. The requirement for companies to pay dividends only out of profits was inconsistent with the trend to lessen the capital maintenance doctrine in Australia.

Again, without going into detail, the authors of *Ford's* forthrightly and persuasively argue that capital maintenance remains fundamental to Australian corporate law, evidence of which need only to be looked to in the structure and drafting of the reduction of capital and buy-back provisions described above.

Turning to the accounting related matters, the rationale for adoption of a balance sheet test in dividend rules is amply outlined in the *CCH Commentary*:

The accounting standards concept of assets and liabilities has been adopted because the nature of accounting principles for the calculation of profits has changed over time. Australian accounting standards, particularly following the adoption of International Financial Reporting Standards (IFRS), are increasingly linked to fair value (whether realised or unrealised) impacting on the profitability of the company.

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<sup>3</sup> [73-500]

<sup>4</sup> R P Austin and I M Ford, *Ford, Austin and Ramsay's Principles of Corporations Law* 16<sup>th</sup> edition LexisNexis Butterworths, Australia, 2015, [18.090] p. 1096.

This makes the profitability of Australian companies increasingly volatile with a large number of non-cash expenses being included in a net result. In these circumstances, a company may have sufficient cash to pay a dividend to shareholders but is unable to do so because the accounting profits of the company have been reduced or wiped out by non-cash expenses. The balance sheet test now embodied in this section [s 254T] eliminates this difficulty.

## Profit distributions in the context of climate risk uncertainty

The above is necessary background to insights on the possible implication for auditors' professional liability arising in relation to corporate and director practices in response to climate change risk and its disclosure, particularly as regard to how asset measurement, and disclosure thereon, flows through to consequential dividend distributions. On the matter of the consequences of improper dividends the authors of *Ford's* deal with two possible circumstances. The first, where the declaration is made not in accordance with the company's constitution, and the second, where the impugned payment is contrary to the rules and test established in s 254T. The second of these is of course that which is most germane to our immediate considerations and the following consequences potentially arise.<sup>5</sup>

First, both a creditor or member may have standing under s 1324 to seek injunction restraining the company and directors from paying the dividend, with the matter specifically dealt with as "Affected interests" under s 1324(1A) noting, as pointed out above, that a distribution contrary to s 254T comes within the constraints and approvals imposed under Pt 2J.1. Second, and in relation to the ambit of Pt 2J.1, s 256D identifies the potential for the persons, though importantly not the company, involved in the contravention being liable under both civil<sup>6</sup> and criminal<sup>7</sup> penalties. Civil penalties could similarly arise in relation to the duty of care and diligence imposed through s 180. A third form of relevant consequence identified by the authors of *Ford's* is in the form of statutory liability whereby the civil penalty regimes makes allowance for the court to order a defendant to compensate the company (s 1317H).

Significantly, the authors of *Ford's* go further – and this is the part of their analysis particularly relevant to *Risky business* – to consider the civil liability of auditors to restore to a company a dividend paid in reliance on accounts which incorrectly disclosed a profit and in which the auditor's negligent favourable reporting was a key element. While guiding case law relevant to the current balance sheet test for payment of dividends seems limited, the authors of *Ford's* are prepared to speculate:

Presumably the same principles apply after the introduction of the balance sheet test in s 254T(1)(a) in 2010: that is, if the auditor's negligent mistake overstates the excess of

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<sup>5</sup> *Ford's* [18.100] pp. 1104 to 1106.

<sup>6</sup> Section 256D(3) and s 1317E Item 4

<sup>7</sup> Section 256D(4) and Schedule 3 Item 86



assets over liabilities and the company relies on the auditor's report to pay the dividend, the auditor may be liable to the company to restore the dividend.<sup>8</sup>

Before providing some remarks on the respective UK and Australian approaches to the duty and liability of auditors to third parties, it is relevant to give some deeper consideration to the legal standing of accounting standards relevant to the operation of s 254T(2). There is little doubt that initiatives such as the FSB's TCFD would, if they have not already, compel directors' minds towards both physical and transition climate-related financial risks in the context of AASB 136 para. 12(b). This, amongst sources of external information an entity shall consider as to whether an asset may be impaired, states:

Significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.

Treatment of the carrying amount of assets, once the impact of climate change risk flows through to an appropriate level of awareness amongst companies and their directors, will fall squarely into those categories of fair value treatment contributing to non-cash expense volatility at the centre of the rationale for adoption of a balance sheet test for payment of a dividend. The likelihood of 'instability' in profit and loss statement numbers will be all the more evident when allowance is given to the further opportunity (compulsion) afforded in AASB 136 to reverse an impairment on an asset other than goodwill (paras. 109 to 125).

As previously mentioned, the authors of *Ford's* devote significant attention to the guidelines which have evolved through case law which explain the character of profits available for distribution under the former s 254T. As to the relationship with relevant accounting standards, Austin and Ramsay go on to cite case law on the interpretation of s 337<sup>9</sup> which suggests that the guidelines should prevail, particularly in those instances where something allowed to be done by a standard is forbidden by the guidelines. They nevertheless observe in more general terms:

The guidelines are not legal definitions in the ordinary sense because courts rely upon the opinions of accountants and persons of business in determining the application of the fundamental conception. Hence, as accountancy concepts and business needs change, guidelines can change. It is on this basis that accounting standards issued by the Australian Accounting Standards Board may be influential in shaping the concept of "profit" as used in s 254T.

Turning to 'interpretation' and application of the current balance sheet test, it is clear that accounting standards will be more than merely influential, but rather determinative, in the calculation of 'assets' and 'liabilities' under s 254T(1)(a) for payment of a dividend. Such effect is

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<sup>8</sup> [18.100] p. 1106 Auditor's civil liability.

<sup>9</sup> Section 337 Interpretation of accounting and auditing standards.

likewise clear from the wording of s 254T(2), and thus, the technical details within the standards should carry considerable weight.

Applied then to our consideration of auditor liability risk, the failure to appropriately scrutinize impairment and other fair value measurements when physical assets ought to have been written down, may form a basis of negligence exposure on the part of an auditor, particularly given the notion that continued payment of dividends in the face of a need to write-down assets would, I argue, offend the doctrine of capital maintenance which, as the authors of *Ford's* observe, is still fundamental to Australian corporate law.

Relating further to possible influence of the doctrine of capital maintenance in the context of accountants', directors' and auditors' professional judgments as to climate risk impairment of assets, the authors of *Ford's* provide further valuable analysis of case law dealing with depreciation and the character of underlying assets and the ability to pay dividends. Caution as to firm insights should of course be applied as the cases dealt with are of some remoteness in time and deal with the distribution of profits as dividends. The critical point analysed by Austin and Ramsay concerns the evident capacity to pay dividends because of an excess of trading receipts over trading expenses, regardless of the relationship between net assets and paid-up share capital. The first case considered is *Lee v Neuchatel Asphalte Co* (1889) 41 Ch D 1. There the matter dealt with was decline in value through use or otherwise of fixed assets ("property of a wasting nature") and that there should not be a compulsion for replacement of capital lost before a dividend could be paid. In this case Lindley LJ stated:

- - - nothing whatever in the Act to prevent any excess of money obtained by working the property over the cost of working it, from being divided amongst shareholders, and this in my opinion is true, although some portion of the property itself is sold, and in some sense the capital is thereby diminished. If it is said that such a course involves payment of a dividend out of capital, the answer is that the Act nowhere forbids such a payment as is here supposed. (at 24)

The principle in *Lee* has been applied with approval by courts in Australia and the authors of *Ford's* refer to the decision of Kitto, Taylor and Owen JJ in *Glennville Pastoral Co Pty Ltd (in liq) v FCT* (1963) 109 CLR 199 where at 207 their Honours stated:

Profits may, of course, be distributed by a company while a going concern even though a loss of paid-up capital previously incurred has not been made good.

Austin and Ramsay proceed then to draw out a distinction in case law between fixed assets and circulating assets. Again, the relevant authority is that of Lindley LJ:

- - - fixed capital may be sunk or lost, and yet that the excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up, as

otherwise it will enter into and form part of such excess, in which case to divide such excess without deducting the capital which forms part of it will be contrary to law.<sup>10</sup>

Relying on the interaction of s 254T with Pt 2J.1 and Austin and Ramsay's remark that accounting standards generally support the distinction drawn by Lindley LJ<sup>11</sup> as a basis for guarding against improper dividends, in my assessment, creates too great a burden on the professional judgment of auditors, noting the earlier observations as to auditor civil liability relating to overstatement of assets over liabilities under the balance sheet test in s 254T(1)(a).<sup>12</sup>

Moreover, on the type of capital distinction, the authors of *Ford's* observe: "In the absence of a direction in legislation or the corporate constitution as to whether a particular kind of asset is to be treated as fixed or circulating, its classification depends on the nature of the particular company's business."<sup>13</sup> To emphasise the point, Austin and Ramsay briefly analyse a number of contrasting case facts. In *Bond v Haematite Steel Co* [1902] 1 Ch 353 a mining lease was deemed to be treated as a circulating asset largely, it would seem, as it was acquired to meet supply contracts to a third-party steel smelting company. It is important to mention in passing that AASB 6 (Exploration for and Evaluation of Mineral Resources) would support capitalisation of the costs of acquiring leases or similar rights at an *area of interest* level, subject then to impairment assessments.

Financial assets are considered to two further cases. First, the earlier referred *Verner* decision in which a distinction is drawn between a company specifically formed to invest in securities (fixed assets) and what would be the case with a company whose business was that of dealing in securities (circulating assets). Secondly, in *QBE Insurance Group v ASC* (1992) 32 FCR 270, argument centred on the validity and adverse impact on earnings fluctuations under accounting standard AASB 1023<sup>14</sup> associated with applying balance date adjustment to the value of insurance contracts. Ultimately, it was decided in this case that the financial accounting rule treatment would prevail indicating that the investments were circulating assets. In pointing to these cases, I observe that the distinction drawn in accounting is between current and non-current assets<sup>15</sup> rather than fixed or circulating, though economic and commercial factors can be brought to bear ('particular company's business') and that whilst accounting standards have legislative weight, issues of interpretation will nevertheless arise in a litigation setting.<sup>16</sup>

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<sup>10</sup> *Verner v General and Commercial Insurance Trust* [1894] 2 Ch 239 at 266.

<sup>11</sup> [18.170] p. 1111.

<sup>12</sup> Without examining in detail, it may be that UK dividend rules (Companies Act 1985 (UK) ss 264, 275) discussed briefly by Austin and Ramsay ([18.170] p. 1111 'Law Reform') which further restrict distributions when net assets are less than the aggregate of called-up share capital and undistributable reserves, would afford greater certainty, and thus, protection for those involved distribution decisions.

<sup>13</sup> [18.180] pp. 1111-1112.

<sup>14</sup> General insurance contracts

<sup>15</sup> Refer AASB 101 Presentation of Financial Statements para. 60 generally and para. 66 specifically.

<sup>16</sup> As referred elsewhere, the relevant statutory rule is s 296. Concerning the impact of this formalisation, the authors of *Ford's* state "Good accounting practice has gone beyond the case law." [18.160 p. 1110]

## Conclusion

In a contemporary setting these contrasts in treatment are all the more problematic, given what must be the seminal or evolving application of accounting standards in the context of climate change risk. Also, though it probably goes without saying, case law developed around either a statutory and corporate constitution profits test for dividends can provide only limited guidance as to how the balance sheet test might be interpreted. As the application of IFRS was critical to profit and loss statement volatility undermining confidence in the former profits test for dividend recognition, volatility of a similar nature within balance sheets may just as equally raise concerns about dividend payment assessments as companies come to grips with the financial measurement impact of climate change. As it stands, on this point, auditors in Australia may be at greater liability risk than their counterparts in the UK.