

Getting it Right: Directors' assessment of information

Author 1 Name: Kerri O'Donnell
Department: School of Accounting and Corporate Governance
University/Institution: University of Tasmania
Town/City: Hobart
State (US only): Tasmania
Country: Australia

Author 2 Name: Barry Hicks
Department: School of Accounting and Corporate Governance
University/Institution: University of Tasmania
Town/City: Hobart
State (US only): Tasmania
Country: Australia

Author 3 Name: John Streeter
Department: School of Accounting and Corporate Governance
University/Institution: University of Tasmania
Town/City: Launceston
State (US only): Tasmania
Country: Australia

Author 4 Name: Paul Shantapriyan
Department: School of Accounting and Corporate Governance
University/Institution: University of Tasmania
Town/City: Hobart
State (US only): Tasmania
Country: Australia

Corresponding author: Kerri O'Donnell

Corresponding Author's Email: Kerri.ODonnell@utas.edu.au

Abstract

Purpose: The purpose of this research is to examine a role for Information and Process scepticism in non-delegable director duties. We draw upon auditing literature to guide an understanding of scepticism.

Design: This is a conceptual paper, drawing upon archival material, including statute law, case law, regulatory guidance material and media releases in Australasia.

Research Implications: We present arguments that challenge us to understand the process of information, judgment and actions of directors as a neuroeconomic phenomenon.

Practical Implications. Directors do have a different role to that of auditors, but in our view the desirability of embracing scepticism does not defeat their responsibility on behalf of shareholders. By applying information and process scepticism, directors of companies might reduce the likelihood and magnitude of litigation costs and out of court settlements.

Novelty: To date, whether or not a director has exercised an appropriate level of reasonable care and skill and/or due diligence has been a matter for courts to decide. Such retrospective analysis leaves directors vulnerable to the uncertainty of whether their individual interpretation of diligence matches up to that of the presiding judge. We provide directors with a scepticism framework to apply to information and processes provided by people on whom the directors may rely.

Keywords:

Scepticism, corporate accountability, directors' duties, non-delegable duties, decision

Classification:

Conceptual paper.

Introduction

Since the 1980s, courts have gradually imposed on company directors increasingly higher standards of care, skill and diligence in relation to their decision making and the performance of their duties. This has been a serious concern particularly for independent non-executive directors (NEDs) sitting on the boards of large public and listed companies. Director lobby groups such as the Australian Institute of Company Directors (AICD) and others have criticised the trend, complaining that the higher standards and expectations for NEDs in particular, are unrealistic and unreasonable in view of the fact they are not involved in day to day management of the business of their companies. They must of necessity rely upon senior executives, managers and others to provide them with the necessary information, advice and assurances to enable them to make decisions and judgments and to govern their company in accordance with good corporate governance practice. Interestingly, even a former Chairman of the Australian Securities and Investments Commission (ASIC), Tony D'Aloisio, has shared these concerns “wondering whether the law of negligence can really apply to NEDs that have to take risks” (ASIC 2011a, p.26; *Corporations Act* 2001(the *Act*), s.180). However, D'Aloisio further states (ASIC 2011a) that ASIC must enforce the law, and it is a policy matter for the government to decide whether to change the law in relation to s.180 to address director concerns about the scope of their duties of care, skill and diligence, the business judgment rule and reliance.

Recently, the liability of directors for their decisions and judgments has seemingly taken a turn for the worse as a result of two successful court actions taken by ASIC. In the *Centro* Cases, *Australian Securities and Investments Commission v Healey* [2011] and *Australian Securities and Investments Commission v Healey* (No 2) [2011], (hereinafter referred to as *Centro*, *Centro No 1* & *Centro No 2*) and the *James Hardie* litigation (*Australian Securities and Investments Commission (ASIC)v Macdonald* [No 11] [2009] (Macdonald (No 11), *ASIC v Macdonald* [No 12][2009], *Morley & Ors v ASIC* [2010], *James Hardie Industries NV v ASIC* [2010] and *ASIC v Hellicar* [2012] (hereinafter referred to as *James Hardie*), courts at various levels from first instance decisions to a High Court decision have seemingly attacked the right of directors, and in particular NEDs, to reasonably rely on information, advice and assurances provided by senior managers and others. This is ‘reasonable reliance’. For NEDs, their legal advisers and for the AICD, this right of

reasonable reliance might have been regarded as sacrosanct. However, encouraged by the *Centro* victory, the Deputy Chairman of ASIC, Belinda Gibson, announced after the decisions (AICD, 2011):

“Directors must consider relevant information provided to them. They must ensure they have access to board papers and use the information gained from considering all matters put to the board. The Centro decision highlights that directors must review matters against their knowledge of the company, including their knowledge obtained from different or earlier board papers.

Directors must be sceptical. ASIC expects board members to ask management questions and to challenge recommendations put to them. They must apply their minds to critically review the information given to them against their knowledge of the company. If the information is not consistent with that knowledge, they must probe management until they are satisfied. It is vital that directors do not uncritically adopt work of management and advisers on issues of fundamental importance to the company”.

In *Centro* the board approved annual financial statements that were seriously misstated and thereby misled shareholders and the securities markets. In *James Hardie* the board approved a draft stock exchange announcement in relation to a matter that was also of fundamental importance to the company that was found to be misleading and deceptive. Shareholders, the securities markets and other stakeholders were misled. In *Centro* the board and its NEDs relied upon information, advice and assurances provided by senior management and the external auditor before approving the financial statements. In *James Hardie*, the board relied upon information, advice and assurances provided by senior management and experts. In both cases, the courts found this reliance to be seriously wanting and held that the directors had breached their duties of care, skill and diligence under s.180 of the *Act*. In both cases the courts acknowledged the duties that boards and their NEDs owed not only to shareholders, but also to the wider group of corporate stakeholders. The courts were particularly concerned at the failure to keep the securities markets properly informed and the serious impact this had. The judgments in both cases were in part motivated by this concern with the consequence that ASIC could be truly pleased with the outcome of the litigation. For many years, it had been seeking to bring gatekeepers including directors and auditors to account as part of its regulatory enforcement programs.

Where do directors, and NEDs in particular, stand today in relation to reasonable reliance? How far must they drill down in order to be sure that the information they receive is complete, accurate and reliable or to ensure that the advice and assurances they receive can be reasonably relied upon? It appears that they have some serious problems to confront, and no doubt legal advisers have been called upon to assist them in developing appropriate

strategies to deal with these problems. But, are there other strategies? We submit that there are. They are to be found in the approach employed by external auditors in the performance of their professional duties when they audit company financial reports. In particular, auditors have long been required to exercise ‘professional scepticism’ in the performance of company audits. This began as a professional requirement and was subsequently recognised by the courts in decided cases. In 2004 the *Act* was amended to require auditors to comply with auditing standards issued by the Auditing and Assurance Standards Board (AUASB). Auditing Standard ASA 200 requires auditors to exercise professional scepticism, and details what is expected of them (AUASB, 2009a).

If ASIC is now asserting that it expects directors to be ‘sceptical’ in the performance of their duties in connection with matters of fundamental importance, such as approval of financial statements and release of important ASX announcements, there may be something that can be learned from examination of the manner in which auditors exercise professional scepticism and the academic literature in relation to this requirement. Admittedly, directors and NEDs are not professional auditors. Also, NEDs are not professionals and nor are they required to be, although they may possess professional qualifications and experience when they come to office. However, there may be something that NEDs can learn from auditors that could help them live up to ASIC’s expectations in relation to scepticism when it comes to making decisions and judgments, particularly those which are of fundamental importance to their company and its shareholders, the securities markets and other stakeholders.

Prior academic research on auditing has examined auditor scepticism and has considered it from the perspectives of traits and behaviours (Grenier, 2010), both of which have potential relevance for NEDs. Research has drawn upon literature in other areas such as philosophy, psychology and consumer behaviour, and therefore has potentially a wider application that could extend to the performance by NEDs of their duties. If NEDs come to the board with inherent traits that predispose them to adopting a sceptical approach to reasonable reliance, and they are mindful of their important role, responsibilities and duties, they could take action to ensure that they act at all times in an appropriately sceptical manner in relation to making decisions and judgments. On the other hand, if they do not possess these traits upon appointment, they could seek to develop and then apply sceptical behaviours as part of a sceptical approach. The academic research on traits and behaviours of external auditors, drawing as it does on the other areas, provides some useful guidance for directors as to how they can meet ASIC’s expectation of them to be sceptical in relation to reasonable

reliance in making their decisions and judgments, particularly in relation to matters that are of fundamental importance to their company.

Corporate governance, directors' legal duties and reasonable reliance

Corporate governance guidelines such as the *Corporate Governance Principles and Recommendations with 2010 Amendments*, issued by the ASX Corporate Governance Council (ASX 2010), deal with the division of responsibility for corporate decision making between boards of directors and senior executives of listed and large unlisted companies. Areas of board responsibility often include (ASX 2010, pp.13-14):

... overseeing the company, including its control and accountability systems; providing input into and final approval of management's development of corporate strategy and performance objectives; reviewing, ratifying and monitoring systems of risk management and internal control, codes of conduct and legal compliance; monitoring senior executives performance and implementation of strategy; approving and monitoring the progress of major capital expenditure, capital management, and acquisitions and divestitures; and, approving and monitoring financial and other reporting.

Effective risk management is recognised as being one of the most important components of corporate governance today. The *Principles and Recommendations* acknowledge that: "it may be appropriate in the company's circumstances for the board to make additional inquiries and to request assurances regarding the management of material business risks" (ASX 2010, p.34). Acting upon such a recommendation will arguably require boards and their NEDs to focus on the process by which they make decisions and judgments with regard to these matters and in particular, the manner in which the process can be planned, structured, managed and conducted in the most effective and efficient manner so as to lead to the best outcomes for the company in terms of effective risk management. The legal duty of care, skill and diligence (the *Act*, s.180) would also require boards to act in this manner.

As far as the law of directors' duties is concerned, we will see shortly that it places a legal onus on boards to request and obtain from senior executives and others all necessary information, advice and assurances that they may reasonably require so that they can make fully informed decisions and judgments in the areas of governance responsibility such as those listed by the ASX. This is particularly the case for the NEDs because they are not part of day-to-day management of the company and must therefore rely heavily upon executive

directors and senior management in order to discharge their responsibilities and legal duties in connection with decision making.

However, directors, and especially NEDs, have always faced potential legal problems with reasonable reliance. In particular, the law, like good corporate governance expects them to carefully, diligently and skilfully evaluate information, advice and assurances as part of their decision making and judgment processes. The decisions of the courts in *Centro* and *James Hardie* have confirmed and highlighted the existence of one of these problems: In certain situations boards cannot simply rely upon senior executives, delegates and others without actively ‘applying their own minds’ to evaluating the information provided by them. Satisfying this requirement has been judged as a necessary and essential part of due process when it comes to boards making decisions and judgments in their areas of responsibility.

The notion of applying one’s own mind requires board members to individually and collectively evaluate the information, advice and assurances in the light of all information that is, or should be known to them about their company and its business operations at the relevant time. Executive directors will be in a better position to do this because of the extensive information they already have about the company’s activities. But NEDs must rely almost exclusively on the executive directors and senior management to provide this information. Accordingly for them, applying their own minds is a more difficult and onerous task in many, if not most situations involving corporate decision making. This is also a problem for corporate governance because it relies heavily upon NEDs to perform their role and responsibilities in relation to enabling the board to “provide strategic guidance for the company and effective oversight of management” (ASX 2010 p.13)).

Until the *Centro* and *James Hardie* decisions were handed down, the full implications of the requirement for directors to apply their own minds may not have been fully appreciated. However, it is now apparent that the courts are likely to expect directors to play a more active role in their decision making and judgment processes, particularly in relation to matters of fundamental importance to their company and its stakeholders and this will certainly apply to reasonable reliance. Accordingly, boards will now be well advised to exercise more care, skill and diligence in terms of establishing, maintaining, reviewing and adhering to a well-planned and structured and carefully managed process of obtaining, evaluating and using information, advice and assurances that they seek to reasonably rely upon when making their decisions and judgments in their areas of governance responsibility.

It is for courts to decide on the facts of each specific case, what constitutes reasonable care, skill and diligence and what constitutes reasonable reliance. However, these determinations are made after the fact, after a problem has arisen and importantly, after ASIC has decided to take action in the courts against directors for breach of duty. But what practical guidance (if any) arises from these court judgements to facilitate more appropriate pre-emptive director behaviours in future? That is, what are directors to do with court rulings decided on the facts of particular cases like *Centro* and *James Hardie*? The dilemma facing boards of directors is made all the more stark, when one recognises that courts do not see it as their proper role to retrospectively substitute their judgements for those made by directors and boards. That is seen to be the proper role of boards, directors and management and yet shareholders expect them to take calculated risks on their behalf in the interests of making profits and increasing shareholder value.

Arguably, any guidance that can be provided to boards, and particularly NEDs, in order to assist them undertake the process of making decisions and judgments and providing good corporate governance, will be of value in terms of helping them make good decisions and business judgments that are in the best interests of their shareholders. But, it will have the added advantage of assisting them to properly discharge their legal duties and thereby avoid enforcement actions in the courts brought by ASIC.

Scepticism and director' ability to rely others

a. The statutory duty of care, skill and diligence

Company constitutions, the general law and the *Act* give directors the power to manage the business of a company and boards of listed and large unlisted companies do this by making decisions and judgments in the areas of responsibility referred to earlier. There is commonly delegation of management power to the senior management team headed by a managing director or chief executive officer. This is permitted by law and the *Act* which also recognise that boards are expected and entitled to reasonably rely upon management to perform their management role, especially in the case of large public companies where NEDs are typically in the majority on boards because of the implementation of corporate governance recommendations such as those of the ASX (ASX 2010 Recommendation 2.1 p.16). Duties of care, diligence and skill are imposed on directors by the general law and the *Act* (s.180) when they exercise their powers, when they delegate their powers and also when they reasonably rely on delegates and others. It is appropriate to examine the relevant

statutory provisions to see how they apply to directors, particularly NEDs in relation to reasonable reliance and to understand how following the statutory provisions may call for a sceptical approach.

Section 180(1)(a) provides that directors must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they were a director or officer of a corporation in the same “circumstances”. The standard of performance of this duty is assessed objectively. In *ASIC v Maxwell* (2006 para 397) the court said that “circumstances” include the type of company, the size and nature of its business, the composition of the board, the director’s position and responsibilities, the particular function the director is performing, the experience or skills of that director and the circumstances of the specific case. In *ASIC v Macdonald* [No 11] (2009 paras 241-242) (*Macdonald No 11*) the court also acknowledged that the competence of the company’s management and its advisers were relevant considerations. Section 180(1)(b) provides that in addition to considering company circumstances, the courts must also consider the nature of the office held by directors and their “responsibilities”. In *Macdonald No 11*(paras241-242) the court said that responsibilities include arrangements flowing from the experience and skills that directors brings to their office and any arrangements within the board, or between the director and executive management affecting the work that directors would be expected to carry out. There was also the need to consider the ‘extent’ to which reasonable reliance could be placed on other directors, management and external advisers.

In considering the nature and extent of reasonable reliance on senior management, delegates and others, directors will be expected to exercise care and diligence in relation to matters such as the choice of the persons upon whom they seek to rely and the evaluation of the information, advice and assurances they provide. If they continue to rely on such persons, as will be the case with reliance on the management team, they will be required to continually monitor and review their continued capacity to provide the necessary information, advice and assurances in accordance with board requirements and to the standard required. If they fail to do so, they are likely to be in breach of their duty.

Clearly, any or all of the above factors relating to the circumstances of the company or the responsibilities of the director may, or should, be relevant when it comes to considering when, and the extent to which, directors, particularly NEDs, can have reasonable reliance. They will also be relevant when considering the need for directors to exercise scepticism in

connection with reliance. For example, NEDs' assessment of the competence of management or advisers may be such that they will or should be more or less sceptical when they rely. Similarly, if NEDs have accounting knowledge and experience, arguably they should be more sceptical in relying upon accounting and financial information provided to them by management if it appears to be at odds with their own understanding when they apply their own minds to the matter. Their legal duty would require them to act in this manner and for this reason it is possible to argue that there is and always has been a requirement for director scepticism. The degree of scepticism will vary depending on the circumstances of the company and the skills and responsibilities of the particular director. These will include situations where matters of fundamental importance are being dealt with that arguably require 'heightened' scepticism in order to comply with the requirements of the legal duty.

b. Scepticism and reasonable reliance under the Act

In an effort to reduce legal uncertainty associated with the 'reasonableness' of reliance, s.189 was introduced into the Act in 1999 and provides:

If:

(a) a director relies on information, or professional or expert advice, given or prepared by:

- (i) an employee of the corporation whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned; or*
- (ii) a professional adviser or expert in relation to matters that the director believes on reasonable grounds to be within the person's professional or expert competence; or*
- (iii) another director or officer in relation to matters within the director's or officer's authority; or*
- (iv) a committee of directors on which the director did not serve in relation to matters within the committee's authority; and*

(b) the reliance was made:

- (i) in good faith; and*
- (ii) after making an independent assessment of the information or advice, having regard to the director's knowledge of the corporation and the complexity of the structure and operations of the corporation; and*
- (c) the reasonableness of the director's reliance on the information or advice arises in proceedings brought to determine whether a director has performed a duty under this Part (cf s180) or an equivalent general law duty;*

the director's reliance on the information or advice is taken to be reasonable unless the contrary is proved.

The meaning of "independent assessment" in s.189(b)(ii) was considered by the Companies and Securities Advisory Committee (2000, pp. 4-5):

... In order to satisfy the requirement ... the director must at least consider relevant views and material and bring his or her own judgment to bear in relation to the matter ... [Independent assessment] does not of course require the director to obtain an assessment of the information or advice by some independent expert, such as an accountant, although should the circumstances be

serious enough, this might be necessary. Rather, it is suggested that what the section contemplates is an analysis of the information or advice in a way that is unbiased. ... Inevitably, some information or advice will be given greater scrutiny by a director than other information or advice. ... The more likely interpretation of the requirement is that each director must personally assess the information and advice provided by others, but not have to seek external advice, unless the circumstances are serious enough to require this.

This interpretation of the requirement downgrades the need for external verification of information, advice and assurances unless the circumstances warrant such verification. However, it still requires directors to “bring their own judgment to bear” on the matter at hand and it acknowledges that in some cases “greater scrutiny” will be called for. The section calls for directors to have regard to their own knowledge of the corporation and the complexity of its structure and operations. This approach calls for active rather than passive involvement by directors in the decision making process, especially when greater scrutiny is called for, and so arguably here is an important and necessary role for scepticism on the part of boards, and particularly NEDs, who rely so heavily on senior management.

The situations that arose in *Centro* and *James Hardie* were seen by the courts to demand greater scrutiny. They required directors to have regard to their existing knowledge of the corporation and its operations and circumstances, and this called for more scepticism when they were called upon by senior executives to approve the annual financial report and an important draft ASX announcement. Interestingly, in the *James Hardie* case, the advice of an expert actuary was secured by management for the board in order to determine the amount that should be set aside to fund future asbestos claims. This was a matter of fundamental importance for the company demanding critical and detailed attention, and house counsel reflected upon whether a second opinion should have been obtained in such circumstances. This was not done. But, mindful of the requirements of s.189(b)(ii), arguably it should have been because the circumstances were serious enough. The failure to take such action made it more difficult for directors and NEDs to have the benefit of reasonable reliance under the section. With the benefit of hindsight, one might ask whether securing a second opinion would have been a desirable course of action.

c. **Business Judgment Rule**

Section s.180(2) of the *Act*, the so-called ‘business judgment rule’ provides protection for directors in respect of their business judgments, subject to compliance with its requirements. As mentioned earlier, boards of listed and large unlisted companies make judgments in the areas of responsibility that corporate governance guidelines allocate to

them. For example, the final approval of a corporate strategy developed by management in *James Hardie* was a business judgment, although approval of the annual financial report in *Centro* was not, because it involved the board performing a duty imposed by the Act; a statutory duty.

One of the requirements for protection under the business judgment rule that is relevant to reasonable reliance and scepticism is contained in s.180(2)(c). Typically, boards, and particularly NEDs, will be relying upon information, advice and assurances provided by senior management and others to inform themselves about the subject matter of the business judgment. They will have the protection provided by s.189 when they so rely, subject to compliance with the requirements of that section. But, s.180(2)(c) provides that directors must satisfy themselves to the extent that they reasonably believe to be appropriate. This imposes an objective test which means that they can rely subject to s.189, but they will need to decide upon the nature and extent of the information that they would reasonably require. In other words, they will have to ‘apply their own minds’ to this issue as with s. 189, and they will be judged in so doing by what a court regards as reasonable in the particular circumstances of the case. If for example the matter is of fundamental importance to the company calling for greater scrutiny, such as the adoption of a corporate strategy as occurred in *James Hardie* or the approval of financial report as occurred in *Centro*, the expectation as to what is reasonable in the circumstances is likely to increase.

Also, there is the prospect for boards, and particularly NEDs, that satisfying the requirements of s.189(b)(ii) will become more onerous because they must have regard to their knowledge of the corporation and the complexity of its structure and operations. If the matter before them is acknowledged to be of fundamental importance demanding greater scrutiny and scepticism, their independent assessment will require them to be more careful and diligent in deciding whether or not to rely. If they fail to act in this manner, a court may well find that their reliance was unreasonable and they will have breached their duty under s.180(1) and will not have the protection of the business judgment rule, nor the protection provided by s.189.

Clearly, there is a strong case for directors to employ a sceptical approach in all of these situations, and for this reason it can be argued that scepticism and a sceptical approach are an integral part of proper performance of the statutory duty of care, skill and diligence.

d. Scepticism and the general law in relation to reasonable reliance

In the case of *Daniels v Anderson* (1995 pp. 500-50) the court said that directors:

...are required to take reasonable steps to place themselves in a position to guide and monitor management of the company. This required them to become familiar with the business of the company and how it is run and ensuring that the board has available to it the means to audit management so that it can satisfy itself that the company is in fact being properly run.

However, it had been firmly recognised in the general law well before this case that boards and directors, particularly NEDs, were entitled to place reasonable reliance on senior executives, delegates and others except where they knew, or by the exercise of ordinary care should have known, facts that would have denied them the opportunity for reliance (*Centro No 1* paras.166-7). In other words, the reasonableness of reliance was judged in accordance with the standards required by the duty of care, skill and diligence and directors “were expected to take a diligent and intelligent interest in information either available to them or which they might with fairness demand from management or others” (*Statewide Tobacco Services Ltd v Morley* [1990] p.431).

Recent cases have shed further light on the general law requirements for reasonable reliance. In *Australian Securities Commission v Adler* (2002, para. 372) the court said that on the one hand a director is entitled to rely without verification on the judgment, information and advice of management and other officers appropriately entrusted, “but on the other, reliance would be unreasonable where directors know, or by the exercise of ordinary care should have known, any facts that would deny reliance on others”. In *Australian Securities and Investments Commission v Maxwell* (2006, para 731) the court confirmed that the degree of permissible reliance will turn on similar considerations as those that determine the overall standards of care and diligence for directors:

They focus particularly on the characteristics of the company, the skills and experience of the director concerned and the delegate, and the reasonable anticipated risks entailed in so doing. What is expected is a level of scrutiny as befits supervision, not the detailed direct involvement that is associated with operational responsibility... where there is no cause for suspicion, nor circumstances demanding critical and detailed attention, it is reasonable for an officer to rely on advice, without independently verifying the information or scrutinising the data or circumstances upon which the advice is based.

Again, it can be argued that these qualifications on reasonable reliance link directly to the need for scepticism and a sceptical approach to information, advice and assurances. Whilst suspicion has long been recognised by the courts as demanding a sceptical approach,

what is receiving more attention in recent cases such as *Centro* and *James Hardie* is the need for scepticism in situations demanding ‘critical attention’, such as the making of decisions and judgments of fundamental importance to the company. When this is linked to the areas of responsibility that corporate governance guidelines allocate to boards for their decision making, the potential impact and importance of this requirement becomes all the more apparent and significant. Today, many judgments and decisions of boards will or may be of fundamental importance and perceived as such. The clear implication is that the process of decision making calls for a sceptical approach in relation to reasonable reliance. Boards need to get the process right, because without a good process, good decisions and judgments cannot be necessarily expected to follow and this can harm the interests of shareholders and stakeholders and expose directors to liability.

It is apparent from the above overview of the *Act* and the general law, that boards of listed and large public companies today, especially NEDs, can reasonably rely upon the information, advice and assurances provided by senior executives, delegates and others. Further, they are expected and required to do so when making their decisions and judgments. But, it is also very clear that there are limitations imposed upon reasonable reliance and if they are not complied with, there may be ‘over-reliance’ that will disentitle directors and NEDs to the legal protection that is otherwise available to them. The *Maxwell* case confirms the long established limitation based on suspicion. However, more recent cases like *Centro* and *James Hardie* give more attention to the limitation based on circumstances demanding critical and detailed attention, such as matters of fundamental importance to the company. In these circumstances, boards and their NEDs will be required to bring their own minds to bear on the matter, and their processes for decision-making and reasonable reliance must take account of this.

James Hardie

James Hardies Industries Ltd (JHIL) manufactured asbestos products, which are injurious to health. The senior executive team over a lengthy period developed a plan to establish a trust, the Medical Research and Compensation Foundation Ltd, to manage the liabilities to those who had contracted asbestos related diseases during the operations of the company and its subsidiaries. In 2001, the board of JHIL approved the plan and also a Draft ASX announcement which stated, amongst other things, that the foundation would have sufficient funds to meet all anticipated legitimate compensation claims; that it would be fully

funded; and, that it would provide certainty for both asbestos claimants and shareholders. It later became apparent that the Foundation was substantially underfunded and this gave rise to a public controversy. The NSW State Government established a special Commission of Inquiry (the Jackson Inquiry), (Parliament of NSW, 2004), which reported (at Vol 1, p. 10) that the ASX announcement conveying the idea of certainty with respect to funding was seriously misleading. ASIC subsequently instituted court proceedings against the directors and officers of JHIL for breach of s180(1) in connection with the board approval of the Draft ASX announcement.

The judge at first instance (*Macdonald No 11*) was required to determine whether the NEDs had breached their duties under s180(1) by approving the draft announcement. He held that the board had approved it, they knew or should have known that it was misleading and, that they knew or should have known that it would have a negative impact on the securities market. Accordingly, they had breached their duties. The decision was appealed on the grounds that there was insufficient evidence to establish board approval. The appeal succeeded, but the court commented that if the board had approved the announcement, they would have breached their duties. There was a further appeal to the High Court and it overruled the appeal court and effectively restored the judgment at first instance with the result that *Macdonald No 11* has become an important case for directors on breach of s180(1). One legal commentator (Hargovan 2009 at 1013) said of the case:

The important lesson which emerges from Macdonald is that directors cannot substitute reliance upon the advice of management in place of their own attention and examination of a strategic matter that falls within the board's responsibilities. The facts of the case demonstrate that management had made it plain that they entrusted the board with the specific task of vetting the draft ASX announcement, which on the face of it was misleading. Consequently, each member of the board was charged with the responsibility of attending to and focusing upon an important strategic matter and under these circumstances, could not delegate or 'abdicate' that responsibility to others.

Macdonald [No 11] confirms the long established limitation on reasonable reliance based on suspicion. On the facts, the board had been provided with information over a long period that would or should have indicated to them that the wording of the announcement was at odds with what they knew or ought to have known about the adequacy of the funding. Accordingly, they would or should have been suspicious and consequently they needed to act on their suspicion by refusing to approve the announcement until it had been amended to accord with the information and advice previously made available to them.

But, more relevant for our purposes, the case emphasises the importance of the other limitations on reasonable reliance that we have considered. When there are circumstances demanding critical and detailed attention, more care, skill and diligence will be required before there can be reasonable reliance. And finally, in such circumstances, boards and NEDs will be required to bring their own minds to bear on the matter.

Centro

Centro was divided into two listed groups, Centro Properties (known as CNP) and Centro Retail (CER). The boards of the companies were called upon by management to approve the annual financial statements and notes for the year ended 30 June 2007 as required by the *Act*. These of course had been prepared by management over a period of time, during which revisions had been made. Section 295(4) of the *Act* required the boards to form and declare whether in their opinions the statements and the notes were in accordance with the *Act* including whether they complied with accounting standards (s.296), gave a true and fair view (s297) and whether, the boards had been given the declarations by the CEO and Chief Financial Officer required for listed companies by s.295A. The boards made these declarations. However, it was later found that the financial statements and notes did not comply with accounting standards, did not give a true and fair view and that they had failed to disclose the existence of significant guarantees in the case of CNP, required by AASB 110 (AASB, 2009), which meant that the directors' report for CNP did not comply with ss.299(1)(d) and 299A. In particular, the accounts for both companies misclassified liabilities that were current as non-current. This was despite the fact that a note to the accounts provided the correct basis for classification of current liabilities in accordance with the relevant accounting standard in force at the time. However, it was also despite the fact that the external auditor had not alerted the directors to the non-compliance with accounting standards.

Expert evidence accepted by the court (*Centro No 1* para 473) indicated that:

if the accounts for CNP had been correct, it would have disclosed to the market a net current asset deficiency (calculated as total current assets less total current liabilities) of \$1.93 billion at 30 June 2007 compared to a net current surplus of \$0.44 billion as 31 December 2006. This meant that as at 30 June 2007, CNP's current assets could only meet 41% of its current financial obligations.

Accordingly there was a serious risk that the company could not meet its debts as they fell due. Short term debt funding (less than 12 months) had increased from 0% as at 31 December 2006 to 72% as at 30 June 2007. There were also guarantees post balance date of US\$2.6 billion (A\$3 billion) that had not been disclosed and if they were called for, there would have been serious financial consequences for CNP. The expert evidence also indicated that CER's statements were likewise misstated in relation to current and non-current liabilities. They classified all short term debt as non-current whereas in fact about \$600m was current. The error concealed a net current asset deficit of approximately \$630m. The company's short term funding position had increased from 0% as at 31 December to 41% as at 30 June 2007.

The court found that the misstatements were very significant and seriously misled shareholders and the securities markets. Not surprisingly, ensuring the accuracy of financial statements was unquestionably a matter of fundamental importance for all companies as far as the court was concerned, especially for listed companies. The directors should have complied with their duty under s.344 to take all reasonable steps to comply with, or secure compliance with the accounts provisions of the *Act* contained in Parts 2M.2 and 2M.3. They should not have approved the accounts and in doing so they breached their s.180(1) duty.

The court held that before forming their opinions and making the declarations required by s.295(4), the directors were duty bound to read, understand and focus upon the financial statements bringing to bear the knowledge that they had or should have had by virtue of their position. In view of the knowledge they had gained at prior board meetings from management in relation to the maturities of the current liabilities of the companies, they would or should have known that the information in the financial statements in relation to current liabilities was incorrect. Therefore, they should have questioned management about this apparent discrepancy and refused to approve the accounts until they were corrected. They should have applied their own minds to the matter. Furthermore, they should have obtained the declarations from the CEO and Chief Financial Officer as required by the *Act* under s.295A.

This case, like *James Hardie*, again confirms the limitation on reasonable reliance based on suspicion. The board had been provided with information over several months prior

to approval of the financial statements that would or should have alerted them to the fact that the information in relation to current and non-current liabilities was at odds with what they knew or ought to have known. Accordingly, they would or should have been suspicious and taken appropriate action. But, it also emphasises the importance of the other two limitations discussed earlier. Firstly, ensuring the accuracy of the financial statements was a matter where the circumstances demanded critical and detailed attention. It was of fundamental importance to shareholders and the securities market to ensure that financial statements were accurate and not misstated. More care, skill and diligence was required before there could be reasonable reliance by directors on management and the external auditor.

Secondly, the NEDs were required to 'bring their minds to bear on the matter'. There was a clear need for scepticism on their part. A sceptical approach to reliance upon information, advice and assurances provided by senior management and the external auditor was called for. NEDs could not simply rely on management. The errors in the Centro accounts would or should have been 'obvious' to the directors if they had applied their minds to the matter, in the same way that the wording of the draft ASX Announcement in *James Hardie* did not require any more than an understanding of plain English language and its effect would or should have been 'obvious'. In each case, they had a duty to perform, to approve the accounts and to approve the draft ASX Announcement, and they could not delegate this duty, it was theirs to discharge. It was non-delegable in these particular circumstances.

Discussion of the component concepts

The remainder of this paper explores concepts which form the foundation of our argument that there is an important role for scepticism in director decision making particularly when matters of fundamental importance to the company are being dealt with that require critical and detailed attention. In such situations scepticism is required for the proper performance of directors' legal duties of care, skill and diligence under s.180 and the general law.

Resource gap

This gap is about decision inputs and the evaluation thereof arising from failings in the legal definitions of the terms *reasonable care*, *skill* and *diligence* as they apply to directors' duties. Definitions determined and applied by courts on the basis of each case's

particular facts (as in *Centro* and *James Hardie*) may be too late to be of practical use to boards and their NEDs during the process of making decisions and judgments. A proactive approach is to explore existing definitions which encompass the legal expectations of director and NED performance as identified in court cases in the light of the professional scepticism required of external auditors. This is the aim of the remainder of this article.

For an external auditor, who has contractual, tortious and statutory duties to “exercise reasonable care and skill” in the performance of company audits (*London and General Bank* (1895); *Kingston Cotton Mills Co* (1896); *Irish Woollen Co* (1900); *Pacific Acceptance* (1970)), adherence to the Auditing Standards is a statutory duty (ss.307A, 308(3A) & 309(5A) of the *Act*). It represents a minimum level of performance. As such, it provides a defence to actions for breach of duty (*Pacific Acceptance* (1970)). This means that factors such as an enquiring mind, scepticism and reasonable care, skill and diligence are already accommodated in regulatory guidance matter in the form of mandatory requirements for external auditors, whose role it is to provide assurance on the assertions of company management and those charged with governance (ss.308(1) & 309(1) of the *Act*). The assertions are inherent in the financial report approved by the board of directors in accordance with the *Act*.

Therefore, to allow us to understand some of the elements of the process by which boards and their NEDs make decisions and judgments for the purpose of complying with their corporate governance responsibilities and their legal duties, we turn to audit regulation to gain an understanding of the “professional scepticism” required of external auditors as it pertains to the discharge of their duties and their decisions involving risk. It has been argued that scepticism is not only the domain of external auditors but also “everyone else involved in preparing financial statements” (White, L. in Butler, 2011) and these persons of course include senior management and directors who approve the financial statements

The internationally aligned Australian Auditing Standard AUS 200 defines “professional scepticism” as “an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence” (AUASB, 2009a, para 13(1)). In *Centro No 1* the court said that the directors should have approached the financial statements in a similar manner ie: with a questioning mind ((*Centro No 1* at para 20).

In the audit definition of professional scepticism, a distinction is drawn between questioning of information and questioning of one's own judgment. This is consistent with a dictionary definition of scepticism that can be applied to directors, NEDs and others (Merriam-Webster, 2012):

...an attitude of doubt or a disposition to incredulity either in general or toward a particular object; [or] the method of suspended judgment, systematic doubt, or criticism that is characteristic of sceptics.

Consistent with the international auditing standards adopted in Australia (AUS200), the United States Securities and Exchange Commission (SEC) regards professional scepticism as an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence (SEC 2010, p 84). It regards professional scepticism as a requirement of due care (SEC 2010, p. 308). It is not biased or suspicious (Nelson, 2009) but the individual is highly sensitive to negative evidence (Hogarth & Einhorn, 1992). Therefore, professional scepticism of external auditors is not entirely neutral either, but rather the auditor exhibits presumptive doubt (Nelson, 2009). If there is presumptive doubt, the external auditor needs convincing that an assertion is correct, rather than simply assuming so; particularly for decisions and judgments involving risk. This is consistent with Grenier's (2010) asserted correlation between non-specialist knowledge, high litigation risk, and need for increased scepticism of both the evidence and the judgement process.

External auditors' "questioning mind and objective approach to assessing evidence is critical where entities are required to make estimates and/or judgements in significant and material areas of a financial report" (ASIC, 2011, paras. 103–104). We suggest that directors and NEDs who apply the same principles to matters of compliance with the accounting standards for the purpose of financial reporting to shareholders and stakeholders, reduce the possibility of signing off noncompliant financial reports and thereby increase the likelihood of establishing a defence if they are accused of failing to exercise reasonable care, skill and diligence and taking all reasonable steps to comply with the accounts provisions of the *Act*. Similarly, if directors and NEDs apply this approach to the process of making decisions and judgments in relation to matters of fundamental importance to the company that require critical and detailed attention, such as determination of corporate strategy and risk management strategies, they also increase the likelihood of having an effective defence to allegations of breach of their general law and statutory duties of care, skill and diligence.

It is argued that directors' and NEDs' decisions and judgments involve diverse knowledge, experience and expertise, and therefore they need to rely on the information, advice and assurances provided by senior management, delegates and others. In *Centro* the court said that NEDs in particular, are entitled to rely upon such information, advice and assurances but they and all directors must still exercise a "questioning mind" (*Centro No 1* para 237). In *James Hardie* the directors and NEDs were likewise entitled to rely but again needed to exercise a questioning mind when it came to reliance. In this light, we propose that reliance upon information, advice and assurances received from others is not the problematic aspect of the issue: The problem is whether the information, advice and assurances are appropriately evaluated by directors and NEDs in particular, in terms of whether or not they are adequate for the proper discharge of their responsibilities in relation to making decisions and judgments and their statutory and general law duties of care, skill and diligence. This means that directors, and NEDs in particular, need only develop an appropriately sceptical attitude in general, much less onerous than demanding that they acquire, as individuals, knowledge, skills and experience in every aspect of the operations of their company.

Scepticism in more detail

The next sections draw on an existing body of literature which can help us to understand the two discreet aspects within definitions of scepticism, and to develop a skills development framework in terms of its two facets and the behaviours which could be developed in the individual director or NED.

Information scepticism

From an information systems perspective, data are facts while information is data which derives meaning from the decision makers experience and understanding of reality (Rowley 2007; Fricke 2009). These arguments centre on the 'Data, Information Knowledge, Understanding, Wisdom' pyramid that has been the centre of substantial debate since Ackoff, 1986 (Fricke, 2009). What we are trying to understand is the process of transformation that is needed to move data to information, which in turn become sources for evidence based judgment in an accounting and corporate governance perspective, given the wealth of data in a financial report (eg: *Centro*) or in other reports (eg: *James Hardie*) that come to boards.

But what constitutes 'sufficient' or 'appropriate' evidence for boards and their NEDs upon which to base informed decisions and judgments? Qui et al (2012) argue that the

‘nature’ of evidence is information that has probative value – demonstrating a quality or function to discriminate against competing hypotheses. This nature of evidence is quite distinct from the ‘extent’ of evidence. The extent of evidence addresses the quantum of information (Qui et al 2012).

Both evidence gathering and evidence evaluation take time. Time pressure on external auditors to complete a company audit may see automatic processing (Nelson, 2009), which is the antithesis of scepticism (Grenier, 2010) and ASIC is not alone in undertaking enforcement actions against external auditors. Messier, Kozloski, and Kochetova-Kozloski (2010) review the SEC enforcement actions against engagement quality reviewers. They note that 23 of 28 studied cases involved a lack of professional scepticism.

Time pressure may also have been a significant factor for the board and its NEDs in the Centro case. A NED, Mr Jim Hall, stated that the financial statements he read on September 2 and 3, 2007, just four days before the 2007 accounts were signed, did not include a line item referring to the \$1.1 billion short term bank debt (Wood, 2011b). On September 4th, he received via email a copy of the accounts which contained the \$1.1 billion dollar debt item. Clearly, between the 2nd and the 4th, the financial statements had changed. Hall told the court that he did not read the emailed versions as he believed that he had read the final versions as laid out on the table at the company’s head office. He maintained that the line item was “absolutely not” in the final version he read (Wood, 2011b). This is consistent with research findings in relation to external auditors that prior knowledge and expertise is an impediment to the exercise of professional scepticism if that automatic processing reduces the search for new information and evidence (Nelson, 2009; Grenier, 2010).

But time pressure is unlikely to be a defence for directors and NEDs for failing to exercise an enquiring mind, especially in relation to decisions and judgments concerning matters of fundamental importance demanding critical and detailed attention. Irrespective of volume and complexity of information, time must be invested to read and understand financial statements in particular (*Centro No 1* para 229). This is recognised in the Conceptual Framework underpinning Accounting Standards (AASB, 2004, para 44) in terms of a balance between cost and benefit:

The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgemental process. Furthermore, the costs

do not necessarily fall on those users who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information is prepared...

In that light, it is a matter for boards and their NEDs to decide whether the costs of non-compliance with the Accounting Standards (*Centro*) and other business regulation in general (*James Hardie* – misleading and deceptive conduct), or indeed the financial, ethical, social and/or environmental costs of making any decisions and judgments on the basis of incomplete or flawed information, is offset by the benefits of making faster decisions, or decisions that are easier by virtue of involving less information analysis. But, undue prioritisation of time costs is a high risk approach, especially when it comes to making decisions and judgments about matters that are recognised as being of fundamental importance to the company, as occurred in *Centro* and *James Hardie*. Therefore, boards of directors and their NEDs must recognise that the decisions and judgments they make under time pressure must not be framed only in terms of time pressure on them, but also in terms of the needs of end users such as the securities markets (acknowledged to be very important in both *Centro* and *James Hardie*) and the need to ensure that they properly perform the legal duties of care, skill and diligence imposed upon them

Process scepticism

In addition to determining an efficiently sceptical approach to information for directors and NEDs, one must also consider how to effectively *apply* that approach (Grenier, 2010). While professional scepticism of external auditors can be targeted at evidence (information scepticism), there is the argument for scepticism to include an individual's judgment and decision making (Bell, Schwartz and Solomon, 2007). That is, sceptical thinking involves three distinct elements:

1. withholding judgement and allowing the evidence to suggest a decision; *and*
2. evaluating the quality of the information used as evidence for the decision; *and*
3. reviewing the neutrality of one's own approach whilst analysing that information.

The third of these elements is arguably the most important. This fits with prior auditor studies which found an inverse relationship between trust and scepticism (Shaub, 1996; Hurtt, 2007; Quadackers Groot & Wright, 2009), that great knowledge may hinder scepticism “due to increased automaticity of decision processing” (Grenier, 2010, p.7), and

more experienced auditors are less sceptical to enable efficiency or automatic processing (Nelson, 2009). Indeed, in the *Centro* case, the misclassification of current and non-current liabilities was detected by an audit junior (Wood, 2011c).

In practice, all individuals including directors and NEDs are subject to cognitive biases and shortcuts, necessary because, if we were to take all steps in every decision, very few decisions would ever be made. Such shortcuts, or heuristics, are informed by experience and training that teaches us what to expect in future situations, on the basis of reasonably consistent past outcomes (Grenier, 2010). In the *Centro* case, for example, one director noted that the companies had raised debt for over 15 years and directors and management did not see any difficulty in continuing to do so (*Centro* para 417). This suggests that prior knowledge and expertise may have led the *Centro* directors to believe that conditions had not changed and additional scrutiny was not warranted, despite the hints offered by an emerging Global Financial Crisis and growing pressure on organizations to refinance short-term corporate paper by October 2007 (Xu et al, 2011).

We have seen that the audit literature recognises various degrees, or levels, of scepticism for external auditors; ranging from a neutral ‘enquiring mind’ through a ‘questioning attitude’, to the more demanding stance of ‘presumptive doubt’. The neutral former is consistent with the audit perspective of withholding judgement until an opinion is suggested by the evidence; whereas the latter may be more consistent with a fraud examination predicated on the basis that the information *is* materially misstated. Therefore, it may be that the most effective approach to scepticism for directors and NEDs is a balance between these perspectives, with the more rigorous approach applied to director and NED decisions and judgments relating to matters recognised as being of fundamental importance to the company and therefore requiring critical and detailed attention.

Grenier (2010, p.59) posits that one can have a low sceptical disposition and also be proficient at evaluating evidence. However, we argue that this arises from misuse of terminology within his own work in that he also clarifies proficiency as “automatic processing... effortless, non-conscious... intuitive”. Rather than *proficient*, we argue that this rapid processing gives an *illusion* of being *efficient*.

However, efficiency is one point at which director and external auditor obligations diverge.

External auditors perform a reasonable assurance, or checking function, which involves various means of evaluating risks of misstatement to reduce the risk of issuing an inappropriate audit opinion to an acceptably low level (AUASB, 2009a), based on an established framework of accounting framework/standards and statutory reporting requirements, within the guidance of the Auditing Standards. This represents a significant body of guidance material. External auditors are equipped with a reasonably straightforward audit risk model (AUASB, 2009a) whereby when control risk for a particular assertion is assessed as high, the audit process will involve a greater amount of substantive (evidence) testing. This method enables external auditors to balance the amount of time/effort required to complete the audit with an acceptable level of risk, representing an effective level of efficiency.

In contrast, it seems much less straightforward for directors and NEDs to discharge their responsibilities and duties both effectively and efficiently. For example, if directors rely on others to design, monitor *and* evaluate controls (corporate governance recognises board responsibility for risk management including internal controls), they will always be exposed to some level of risk.

Directors and NEDs commonly rely on the information, advice and assurances provided by senior management, delegates and others. The *Centro* case again provides us with a clear example, because despite the basic nature of accounting treatment for current and non-current liabilities, the defence would argue that directors relied on the information, advice and assurances in relation to the financial report provided to them by the external auditor and senior management and others. The question was whether the nature and extent of reliance was reasonable in the circumstances of that case?

In a written report submitted for the defence, Mr Hullah (an accounting expert witness) argued it would not be reasonable to expect the NEDs to engage in "micro-management" of the group's statements (Wood, 2011b). Mr Hullah also said it was "appropriate" for the NEDs to rely on senior management and the external auditor and not appropriate "to second-guess or ignore the expert advice" they provided (Wood, 2011b). Furthermore, the defence counsel for the NEDs would argue that the internal accountants and the external auditor for the company wrongly classified current liabilities as non-current and failed to alert the board (Wood, 2011a) *Centro No 2* para 174)

One of the key features of the board's corporate governance practices and procedures in relation to financial reporting was the presence of a number of safety nets designed to ensure that the accounts presented to the Board for approval were correct. As I have observed the non-executive directors reasonably expected that accounts produced by the accounting staff of the Centro Group would comply with AIFRS and that, if they did not for any reason comply, PwC or Centro's accounting staff would identify the error.

However, ASIC would argue in *Centro* that the spectre of 'blind freddy', where he who could see the glaring error or obvious mistake even if blind, had been raised many times in the case (Wood, 2011a). To this extent, the court agreed. A somewhat similar situation arose in *James Hardie* in relation to the particular words used in the draft ASX announcement presented to the board for their approval. The directors and NEDs already knew when they approved the draft that there was obvious uncertainty as to whether the proposed funding for future asbestos claims would be adequate. The words in the announcement on any plain English interpretation indicated certainty where non-existed. For this reason the draft should have been rejected.

While time and cost can constrain the decision and judgment making processes of gatekeepers such as directors and external auditors, there is the inevitable reliance on senior management, delegates and others (Quadakers et al 2009). However, the degree to which auditors rely upon or trust other parties such as senior management, without questioning, is viewed as low professional scepticism (Shaub, 1996; Hurtt, 2007). Whilst this has a role in increasing efficiency, it must be consciously offset against the risk of increasing liability exposure. The same warning must be heeded by directors and NEDs.

One means of reducing the risk of liability exposure resulting from reliance on others is to exercise information scepticism as described above, and to apply process scepticism as described in this section. For example, one might question: a) how do we know the information provided is reliable, and b) how do we know it is complete (the full story)?

Sceptical behaviours

Nelson (2009) conceptualises a thirteen stage model of professional scepticism for auditors. One of the stages deals with the move from sceptical judgment to action. Sceptical action has been viewed as "actions to resolve all unanswered questions and to validate answers received" (McCoy et al 2011, p.4).

Hurtt (2010, p.151) identifies characteristics that constitute sceptical behaviour of auditors: “a questioning mind, a suspension of judgment, a search for knowledge, interpersonal understanding, self-esteem, and autonomy”. However, definition of scepticism as an ‘attitude’ suggests that exercising scepticism involves a mix of conditions, both cognitive and behavioural. A person might exhibit more or fewer of Hurtt’s (2007, 2010) trait characteristics at different times and/or in different situations (Nelson, 2009).

We draw upon Hurtt’s (2010) characteristics as a framework to help elucidate the problems for directors and NEDs of reasonable care, skill and diligence and the enquiring mind by cross-referencing with the characteristics of scepticism in terms of the expectations of external auditors. The *Centro* cases and the *James Hardie* cases establish an obligation standard for executive directors that falls between the mandatory obligation of external auditors, and the lower obligation applied to NEDs.

Whilst NEDs are entitled to trust others, they must still exercise a questioning mind, but together these aspects constitute a form of judgement that is short of scepticism in its formal sense. In contrast, whilst scepticism is not specifically mandated for executive directors, it would be a prudent judgment skill for discharge of their duties and responsibilities under the *Act*; especially regarding the asking of questions.

Conclusions

The *Centro* and *James Hardie* cases highlight the fact that case precedents are narrowing to a benchmark of reasonable care skill and diligence. This includes an explicit *requirement* for directors to exercise an enquiring mind. This requirement is not new but it has taken on seemingly added significance. Certainly, in situations involving board decisions and judgments of fundamental importance to the company that demand critical and detailed attention, directors and NEDs must exercise an inquiring mind. Scepticism is called for in varying forms and to varying degrees depending on the facts of the case, the circumstances of the company and the responsibilities of the director or NED concerned.

Today, boards of large public and listed companies will be expected to undertake a careful and diligent process to obtain and properly evaluate all relevant information, advice and assurances received from senior management, delegates and others, before finally arriving at their ultimate decisions and judgments. If there is later litigation resulting from

these decisions and judgments, whether it be enforcement actions brought by regulators, or class actions brought by shareholders and other stakeholders, courts may decide that decisions and judgments made by the boards related to matters of fundamental importance. Consequently, more active involvement in the judgment and decision making process will be expected and required of the boards concerned. Detailed and critical attention will be called for and expected by the courts. Arguably this is fair and reasonable in corporate governance terms because boards of large listed and public companies, in particular, are well remunerated today, especially if they hold the office of chairman of the board or chair of one of the board committees. This fact was noted by the courts in *Centro* and *James Hardie* and was one of the factors taken into account by the courts when considering the standards of care, skill and diligence required. With higher remuneration goes higher expectation of performance. Directors, including NEDs, must ensure at all times that the interests of company shareholders and other stakeholders are protected and promoted.

It may be appropriate and possible for boards and their NEDs, as we have suggested, to adopt and employ an approach or method to seeking, receiving, evaluating and acting upon information, advice and assurances that is familiar to that employed by external auditors who must exercise professional scepticism. For external auditors, a sceptical approach is the intended result of professional training and experience. For directors and NEDs however, a sceptical approach in relation to reliance may result from a sceptical disposition which they possess when appointed to the board. Alternatively, they could choose to employ techniques and methods that they perceive as being more likely to result in them becoming and remaining sceptical, if they were not already sceptical by nature. The use of these techniques and methods could be of value, especially when it comes to boards making decisions and judgements that are acknowledged to be of fundamental importance to the company, requiring them to adhere to higher levels of care, skill and diligence because critical and detailed attention is expected and required.

The following table illustrates that in the *Centro* case, the problems might have been circumvented by reference to the professional scepticism of external auditors:

[INSERT TABLE 1 HERE]

Together, the Auditing guidelines referred to in this paper may provide an appropriate basis for interpreting a generic, yet comprehensive, information processing approach which could be useful for boards and their NEDs when making decisions and judgments.

There are many incentives for directors to move to a sceptical approach in their decision making including: damages claims against them by their company and/or shareholders for breach of duty (as mentioned earlier, class actions by shareholders are becoming more common and the claims made are increasing in size); actions by enforcement agencies such as ASIC, the ACCC and State and Federal environmental protection agencies, potential loss of equity in their company as a result of litigation (it has become increasingly common for directors and NEDs to hold shares in their company), loss of reputation, and advancement (Nelson, 2009). The testimony of one Centro NED, Mr Scott, noted (*Centro No 2 para. 205*):

I was dismissed from Centro in January 2008. Since then, I have approached a recruitment firm and a number of business associates to seek out any employment or consulting opportunities. Initially, I was advised by the recruitment firm that it would probably be at least 18 months to 2 years after me leaving Centro before I could secure employment elsewhere... that it would not be possible for me to seek alternative employment until the outcome of the ASIC proceedings became known. In any event, I have been applying all of my efforts to the ASIC case over the last year and would have not been able to work in full time employment in any event. As such, the existence of the ASIC proceedings has operated in a practical sense to bar me from seeking alternative employment or consulting opportunities.

The court further noted (para 206):

The last few years, I know, have been calamitous for Mr Scott. He ... has lost his career, most of his wealth and his future employability and business repute have been damaged substantially.

It is clear that decisions in cases like *Centro* and *James Hardie* will have a profound and lasting effect on directors and NEDs. Financial position, employability and even health are factors that can be seriously affected. The incentives for scepticism and sceptical behaviours on the part of directors and NEDs are both clear and substantial. They are all the more obvious in situations where boards are called upon to make decisions and judgments in relation to matters of fundamental importance to the company that call for detailed and critical attention, as occurred in *Centro* and *James Hardie*. It must be remembered that company boards are called upon annually to approve the company accounts prepared by management. Consequently they face critical decision making every year according to the

Centro decision. In *James Hardie* the board was called upon by management to make a critical decision. The board is the governing body and it, not management, is ultimately responsible to shareholders and stakeholders for such decisions. Today, with developments in corporate governance practice it will not be uncommon for boards to be so called upon and they need to be prepared.

Research implications & future research opportunities

Future research opportunities might include construction of a normative framework for corporate decision processing, in the form of generic information-scepticism and process-scepticism guidelines based on academic literature on professional scepticism of auditors, the International Auditing Standards, existing corporate governance guidelines and case law, to facilitate more sceptical action (McCoy et al 2011) in decisions involving risk. Such an approach could benefit directors and NEDs in particular, as well as shareholders and other stakeholders in all forms of high risk matters. These matters are of course not limited to matters of regulatory compliance only, but include all high risk decisions, including those involving corporate social and environmental responsibility.

References

Ackoff, R.L. 1989 'From data to wisdom,' *Journal of Applied Systems Analysis* 16 3–9.

ASX Corporate Governance Council, 2010, *Corporate Governance Principles and Recommendations with 2010 Amendments*, 2nd edition, <http://www.asx.com.au/governance/corporate-governance.htm>, Accessed 24/10/12.

Auditing and Assurance Standards Board (AUASB), 2009a, *ASA 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*, <http://www.auasb.gov.au/Standards-and-Guidance/Australian-Auditing-Standards.aspx>. Accessed 26/10/12.

Auditing and Assurance Standards Board (AUASB), 2009b, *ASA 620: Using the Work of an Auditor's Expert*, <http://www.auasb.gov.au/Standards-and-Guidance/Australian-Auditing-Standards.aspx>. Accessed 26/10/12.

Auditing and Assurance Standards Board (AUASB), 2011a, *ASA 500: Audit Evidence*, <http://www.auasb.gov.au/Standards-and-Guidance/Australian-Auditing-Standards.aspx>. Accessed 26/10/12.

Auditing and Assurance Standards Board (AUASB), 2011b, *ASA 102: Auditing Standard ASA 102 Compliance with Ethical Requirements when Performing Audits, Reviews and Other Assurance Engagements*, <http://www.auasb.gov.au/Standards-and-Guidance/Australian-Auditing-Standards.aspx>. Accessed 26/10/12.

Australian Accounting Standards Board, 2004, *Framework for the Preparation and Presentation of Financial Statements*, <http://www.aasb.gov.au/Pronouncements/Current-standards.aspx>, accessed 28/10/12.

Australian Accounting Standards Board, 2011, *AASB 101: Presentation of Financial Statements*, <http://www.aasb.gov.au/Pronouncements/Current-standards.aspx>, accessed 28/10/12.

Australian Institute of Company Directors (AICD), 2011, 'ASIC Report: What ASIC expects of NEDs', *Company Director Magazine*, November, ASIC, <http://www.companydirectors.com.au/Director-Resource-Centre/Publications/Company-Director-magazine/2011-back-editions/November/ASIC-Report-What-ASIC-expects-of-NEDs>. Accessed 26/10/12.

Australian Securities and Investments Commission Act 2001

Australian Securities and Investments Commission (ASIC), 2011a, 'Q&A with Tony D'Aloisio', *Company Director Magazine*, March, [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Q&A-Tony-Company-Director-Magazine-march2011.pdf/\\$file/Q&A-Tony-Company-Director-Magazine-march2011.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Q&A-Tony-Company-Director-Magazine-march2011.pdf/$file/Q&A-Tony-Company-Director-Magazine-march2011.pdf). Accessed 26/10/12.

Australian Securities and Investments Commission (ASIC), 2011, *Licensing: Meeting the general obligations (Regulatory Guide*

104), [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg104.pdf/\\$file/rg104.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg104.pdf/$file/rg104.pdf). Accessed 26/10/12.

Australian Securities and Investments Commission v Adler (2002) 168 FLR 253.

Australian Securities and Investments Commission v Healey [2011] FCA 717.

Australian Securities and Investments Commission v Healey (No 2) [2011] FCA 1003.

Australian Securities and Investments Commission v Hellicar [2012] HC 1.

Australian Securities and Investments Commission v Macdonald [No 11] (2009) NSWSC 287.

Australian Securities and Investments Commission v Maxwell (2006) NSWSC 1052.

Australian Securities and Investments Commission v Macdonald [No 12] [2009] NSWSC 714.

Birnberg, J.G., and Ganguly, A.R. (2012) 'Is neuroaccounting waiting in the wings?', *Accounting, Organizations and Society*, vol. 37, pp. 1–13

Butler, B., 2011, "ASIC Warns Auditors to Back Judgments with Evidence", *The Sydney Morning Herald* (online), June 30, <http://www.smh.com.au/business/asic-warns-auditors-to-back-judgments-with-evidence-20110629-1gr2b.html>. Accessed 26/10/12.

Centro Properties Ltd, Annual Report 2007.

Companies and Securities Advisory Committee, 2000, *Report to the Minister for Financial Services and Regulation on Sections 181 and 189 of the Corporations Law*, [http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2000/\\$file/ss181_189_CorpLawOct2000.pdf](http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2000/$file/ss181_189_CorpLawOct2000.pdf), accessed 28/10/12.

Corporations Act (Cth) 2001.

Daniels v Anderson (1995) 37 NSWLR 438.

Department of Premier and Cabinet (NSW), "Report of the Special Commission on Inquiry into the Medical Research and Compensation Foundation", (2004). Vol 1.

Fricke, M. 2009 The knowledge pyramid: a critique of DIKW hierarchy *Journal of Information Science* pp 131 – 142.

Grenier, J., 2010, *Encouraging Professional Scepticism in the Industry Specialization Era: A dual-process model and an experimental test*, Doctoral Dissertation, http://www.google.com.au/url?q=http://www.ideals.illinois.edu/bitstream/handle/2142/16041/1_Grenier_Jonathan.pdf%3Fsequence%3D3&sa=U&ei=hjs3T53GHsqOmQXwvt2UAg&ved=0CB8QFjAG&usq=AFQjCNHgA7Dz84OnMByEsb2Uu_CIWMImsQ. Accessed 26/10/12.

Hargovan, A. 2009, 'Case Note: Australian Securities and Investments Commission v Macdonald [No 11]: Corporate Governance and Lessons from James Hardie (2009)',

Melbourne University Law Review

984(33). www.mulr.law.unimelb.edu.au/go/33_3_12_Hargovan. Accessed 26/10/12.

Hogarth, R. M., and H. J. Einhorn, 1992, 'Order effects in belief updating: the belief-adjustment model', *Cognitive Psychology*, 24, 1–55.

Hurtt, R. K. 2007. Professional scepticism: An audit specific model and measurement scale. Working paper, Baylor University.

Hurtt, R.K., 2010 'Development of a Scale to Measure Professional Scepticism' *Auditing: A Journal of Practice and Theory* 29, 1, pp 149 – 171.

International Public Sector Accounting Standards Board, 2008, *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: The Objectives of Financial Reporting The Scope of Financial Reporting The Qualitative Characteristics of Information Included in General Purpose Financial Reports The Reporting Entity*, AASB consultation paper, http://www.aasb.gov.au/Download.aspx?file=IPSASB_Consultation_Paper_Conceptual_Framework_Phase_1.pdf&path1=content102&path2=c3. Accessed 26/10/12.

Irish Woollen Co. Ltd v. Tyson and Others (1900) 26 Acct LR 13.

James Hardie Industries NV v Australian Securities and Investments Commission [2010] NSWCA 332.

Kingston Cotton Mills Co (1896), FN12 [1896] 1 Ch. 331 (UK).

London and General Bank (1895), No. 2 (2) (UK).

McCoy, N., Burnett, R.D. Friedman, M.E. and Morris, M., 2011 'Internal Audit: How to Develop Professional Scepticism' *The Journal of Corporate Accounting & Finance* May-June pp 3 14.

Merriam-Webster, 2012, *Webster's New International Dictionary of the English Language*, Second Edition, Unabridged, W.A. Neilson, T.A. Knott, P.W. Carhart (eds.), <http://www.merriam-webster.com/dictionary/scepticism>. Accessed 26/10/12.

Messier, W.F., Kozloski, T.M., and Kochetova-Kozloski, N., 2010, 'An Analysis of SEC and PCOAB Enforcement Actions' *Auditing: A Journal of Practice and Theory* 29, 2, pp 233 – 252.

Morley & Ors v Australian Securities and Investments Commission [2010] NSWCA 331.

Nelson, M.W., 2009, "A model and literature review of professional scepticism in auditing", *Auditing: A Journal of Practice & Theory*, 28(2), pp. 1–34.

Pacific Acceptance Corporation Ltd. V. Forsyth and Others (1970) 92 W.N. (N.S.W.) 29.

Parliament of New South Wales, 2004, *Special Commission of Inquiry (James Hardie Records)*

Bill, <http://www.parliament.nsw.gov.au/prod/PARLMENT/hansart.nsf/V3Key/LA20041019023>, accessed 28/10/12.

Quadakers, L., Groot, T., Wright, A., 2009, 'Auditors Sceptical Characteristics and Their Relationship to Sceptical Judgments and Decisions', http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1478105, 28/10/12.

Qui, C., Kelly, K., and Salterio, S., 2012 ' Do changes in audit actions and attitudes consistent with increased auditor scepticism deter aggressive earnings management? An experimental investigation' *Accounting Organization and Society* 37, pp 95 – 115.

Rowley, J. 2007, The wisdom hierarchy: representations of the DIKW hierarchy, *Journal of Information Science* 33(2) pp 163–80.

Shaub, M.K. 1996. Trust and Suspicion: The Effects of Situational and Dispositional Factors on Auditors' Trust of Clients. *Behavioral Research in Accounting* 8: 154-174.

Simon, H. A., 1957, *Models of man: Social and rational*. New York: Wiley.

Statewide Tobacco Services Ltd v Morley [1993] 1 VR 423.

Wood, L., 2011a, "Centro Case Tests Duty of Directors", *Sydney Morning Herald (online)*, April 26, <http://www.smh.com.au/business/centro-case-tests-duty-of-directors-20110425-1du3n.html>. Accessed 26/10/12.

Wood, L., 2011b, "Centro Accountant Tells of Discrepancies in Statements", *Sydney Morning Herald (online)*, May 12, <http://www.smh.com.au/business/centro-accountant-tells-of-discrepancies-in-statements-20110511-1eix7.html>. Accessed 26/10/12.

Wood, L., 2011c, 'Centro's final accounts adjusted', *Sydney Morning Herald (online)*, April 13, <http://www.smh.com.au/business/centros-final-accounts-adjusted-20110412-1dco0.html>. Accessed 26/10/12.

Xu, Y., Jiang, A.L., Fargher, N., and Carson, E., 2011a, "Audit Reports in Australia during the Global Financial Crisis", *Australian Accounting Review* 56, 21, pp 22 – 31

Table 1: Scepticism guidance applied to Centro breaches

Breaches described in the Centro case <i>SOURCE: (ASIC v Healey [2011] No.2)</i>	Scepticism guidance
[The Centro directors knew, or] ought to have known that the CPL Reports did not comply with the Act...	Process scepticism Information scepticism
failed to properly read, understand and give sufficient attention to the content of the CPL Reports...	Process scepticism Information scepticism
failed to consider or properly consider the content of the CPL Reports...	Information scepticism
failed to raise or make enquiry or adequate enquiry with management, the Board Audit and Risk Management Committee and other members of the Board...	Process scepticism
failed to have the apparent failures with respect to the CPL Reports corrected... [and]	Process scepticism
failed to exercise the degree of care and diligence required by s 180(1) by failing to take each of the steps referred to in paragraphs 1(f) to 1(k)	Process scepticism