

13 February 2012

Mr Daniel Cameron  
Senior Advisor  
Corporate Law and Governance  
Ministry of Economic Development  
33 Bowen Street  
**WELLINGTON**

Dear Mr Cameron

**SUBMISSION ON THE MED CONSULTATION PAPER – REMOVING PROHIBITIONS ON AUDIT FIRM INCORPORATION**

The Insurance Council of New Zealand ("the Insurance Council") appreciates the opportunity to comment on MED's consultation paper regarding removing the prohibitions on bodies corporate from carrying out audits.

**1 The Insurance Council**

The Insurance Council is the industry representation body for fire and general insurance in New Zealand. The Insurance Council has 25 members which write the substantial majority of New Zealand's insurance business.

The Insurance Council is active in self-regulating the insurance industry. We promote the Fair Insurance Code that requires Insurers to act ethically. We fund the Insurance & Savings Ombudsman Scheme that offers independent review of decisions and we apply an Insurance Council solvency test that confirms the financial stability of our members. We also require members to be independently rated and to publish these ratings. We perform an important role in informing and educating consumers about key insurance issues and risks.

**2 Insurance Council Recommendations**

- We believe that the best option for the implementation of mandatory insurance, as set out at paragraph 24 of the consultation paper, would be to adopt a system similar to that proposed under option B - i.e. establish a system modelled on the approach adopted in Australia.

Our further thoughts are outlined below.

**3 Insurance Council Concerns**

Our members' specific concern relates to the following suggested requirement in the consultation paper:

"...that auditing firms should be able to incorporate under the Companies Act 1993 subject to... requirements to have adequate and appropriate professional indemnity insurance (PI insurance)." [emphasis added].

### 3.1 Background – Purpose of PI insurance

Firstly, it is important to understand the purpose of PI insurance cover. MED state in the consultation paper that:

“A number of jurisdictions which provide for the incorporation of audit firms also require incorporated firms to have adequate levels of PI insurance. This obligation aims to protect clients by ensuring that the limited liability offered by incorporation does not affect the ability of plaintiffs to obtain adequate redress.”

However, it is important to understand and recognise that ***PI insurance is not provided as a protection for investors or consumers; it is purely a protection for the Insured.*** In the case of professional accounting bodies it represents personal protection for the assets of the partners who would otherwise be liable.

PI Insurance can indirectly provide some benefit to a claimant/consumer, but its real purpose is to defend and protect the auditor. These policies can indirectly provide some benefit to consumers/claimants, because the policy will cover the auditor’s legal liability to compensate third parties for losses caused by a breach of professional duty or negligence in the performance of their professional services. Indirectly then, payments may be made to the Insured following a civil action which would ultimately transfer through to the claimant/consumer.

However, the policy will also usually cover legal costs incurred in defending that claim. This could potentially reduce the amount able to be paid under the policy to the Insured auditor and so reduce the amount of protection available to any claimant/consumer. For example, subject to the economics of the situation and the relative strength of arguable defences, the Insureds and Insurers may potentially use all available insurance funds (subject to Section 9 of the Law Reform Act 1936) to defend a claim. In this case an investor or consumer would certainly not have benefited from the requirement for an auditor to have a set level of PI insurance.

Accordingly, PI insurance may not always be the best way to ensure the protection of investors or consumers. Nevertheless, we do agree with MED that mandatory PI insurance would still likely be the best way to ensure some form of protection for investors and consumers, under this proposal.

### 3.2 Adequacy and appropriateness of PI insurance

MED state at paragraph 27 of the consultation paper that:

“...we would welcome views on the extent to which the insurance market would currently support the different options we have noted for mandatory professional indemnity insurance.”

Essentially Insurers would support the compulsory nature of PI for these firms, for the wider benefit of the industry and the public. Nevertheless, the Insurance Council has some concerns regarding the options proposed in the consultation paper, as expressed below.

**Question 6 in the Consultation Paper - What is the best option in relation to PI insurance (see paragraph 25)?**

and

**Question 7 - What are your views on the specific features of the Australian system?**

### **3.3 Options proposed by MED at paragraph 24**

#### **3.3.1. Minimum limits for PI insurance (Options B and D)**

**Option B:** Establish a system modelled on the approach adopted in Australia.

and

**Option D:** Set a mandatory level of insurance that must be held by all firms.

We would prefer option B to D, as there may be discrepancies between what is appropriate and adequate for a large auditing firm and a small auditing firm. Nevertheless, we would still have some serious concerns around requiring minimum limits for PI insurance as proposed under option B.

MED's proposal to set minimum limits, and we assume, minimum conditions for coverage may not provide the intended consumer protection sought. Historically attempts by government agencies to set minimum standards of cover have failed – e.g. building certifiers that were seen as uninsurable in the leaky homes environment, as insurance markets do not generally subscribe to this approach.

Furthermore, in the insurance cycle, times may occur when the full amount of cover may not be available, or the cover may be extremely constricted in breadth. This may affect the ability to enforce a minimum level of cover on accounting bodies.

Also, MED makes no contemplation of including some form of limited liability for audit services. Limited liability schemes are sometimes utilised in other jurisdictions. In Australia, there has been a modification to Joint and Several Liability to allow for Proportional Liability. Further, some states have introduced caps on liability for qualifying professionals. In other jurisdictions limitation of liability agreements are used. Not having any limited liability effectively makes insurers more vulnerable in the PI insurance market and will inevitably affect the long term availability, cost and coverage afforded under PI policies.

MED should be aware that the above significant issues will likely affect the availability and cost of PI coverage.

##### **3.3.1.1. Availability and affordability of cover**

If a minimum level of cover was implemented as under option B, the minimum level required should not be determined by its affordability.

At paragraph 27 of the consultation paper, MED makes reference to the affordability of insurance and its relationship to the level of mandatory insurance cover required. No company should be allowed to operate without cover simply because it is expensive. The affordability of cover will depend on the pricing of the liability faced by the insurer. If the company structure is allowed the only real "asset" will be insurance cover, so the price of insurance cover should not affect the minimum level of cover required.

Furthermore, the \$500,000 minimum suggested at paragraph 21 of the consultation paper appears too low to provide any meaningful protection. A more realistic amount would likely be around the \$1,000,000 mark. However, this would require further consideration and development. Also, using estimated audit fee income (as per paragraph 21) as a basis for appropriate PI insurance may not be appropriate in some circumstances. Fee income from audit work may have no relationship with the amount being claimed against an auditor, as a claim will likely relate to the amount of funds lost rather than the fee charged.

### 3.3.1.2. Summary – Minimum limits for PI insurance

While insurers would prefer Option B to D, MED needs to be aware that setting minimum levels of cover may not be achievable and may not help achieve its intended outcomes.

### 3.3.2. Disclosure of limits (Option A)

**Option A:** Requiring audit firms to disclose to their clients the amount of professional indemnity insurance they hold.

The Insurance Council believes that disclosure should not be mandatory.

Setting minimum levels of cover is logical, but Insurers will not typically want the full limit publicised, as international practice shows this may then become a target for claimants.

Furthermore, disclosing the actual limit bought is not really of any use because the limit may be large but the coverage may be relatively restrictive (even if minimum conditions for coverage were required). Such an approach would only serve to create an incentive for customers to seek firms who carry a larger limit, to the detriment of those that can't afford large limits (and despite not necessarily receiving any better coverage than from a policy with a lower limit).

## 4 Conclusion

As stated above:

- We believe that the best option for the implementation of mandatory insurance, as set out at paragraph 24 of the consultation paper, would be to adopt a system similar to that proposed under option B - i.e. establish a system modelled on the approach adopted in Australia.

Thank you again for the opportunity to provide input on this consultation paper. The proposals are of significant interest to our members. We appreciate that this proposal is very much in its early stages, nevertheless, we would be happy to discuss any issues raised in our submission or arrange a meeting between MED and our Liability Committee. Please contact Simon Wilson on (04) 495 8008 or at [simon@icnz.org.nz](mailto:simon@icnz.org.nz).

Yours sincerely



Simon Wilson  
**Legal Advisor**