technical factsheet 84

The Use of Disclaimers in Audit Reports

CONTENTS

INTRODUCTION

1 ACCA members in the United Kingdom will be aware of the court case in Scotland (Royal Bank of Scotland v Bannerman Johnstone Maclay - referred to hereafter as the *Bannerman* case), which has raised the question of whether auditors should protect themselves against possible litigation by incorporating standard disclaimers of responsibility in their UK company audit reports.

2 This information sheet provides guidance on this subject to auditors. It summarises ACCA's position with regard to auditor's duty of care to third parties and on the occasions when the use of a disclaimer may be considered appropriate.

BACKGROUND

3 Under section 235 of the Companies Act 1985 and for accounting periods beginning on or after 6 April 2008, section 495 of Companies Act 2006, the auditors of a company have a duty to report to the company's members whether in their opinion the financial statements have been properly prepared in accordance with the Act and in particular whether they give a true and fair view. The Companies Act therefore carries the clear implication that the auditor should owe a duty of care to the company's members but does not suggest that any such duty is owed to other parties.

4 However, as members will be aware, over a number of years the question of whether auditors might owe a duty of care to third parties that rely on the audited financial statements has been the subject of numerous court cases. For background information the most significant of these are outlined on the following page.

5 In *Candler v Crane Christmas* (1951), Candler sued the accountants of a company (Crane Christmas) as he had relied on the accounts they had prepared for the purposes of making a decision to invest money in that company. The accounts had been negligently prepared. The courts ruled that, although the accountants had acted negligently, they did not have a contract with Candler and therefore did not owe him a duty of care. This ruling was taken as meaning that no duty of care was owed to third parties.

ACCA UK
29 LINCOLN'S INN FIELDS
LONDON WC2A 3EE
T 020 7059 5900
F 020 7059 5959
members@accaglobal.com
www.uk.accaglobal.com

6 This contrasted with a later case, *JEB Fasteners v Marks Bloom* (1980-1982). The audited accounts of the company did not show a true and fair view of the state of affairs and the auditors were held to be negligent in stating that they did. At the time it was accepted that the auditors were aware of the plaintiffs interest in the company but not that they were contemplating a take over bid. The courts held in favour of the auditors as the plaintiffs had not suffered a loss and would have bought the share capital at the agreed price whatever the accounts had said. The duty of care issue was therefore irrelevant. What makes this case important however is that the courts stated that a duty of care will exist where the auditors:

- knew or reasonably should have foreseen at the time that the accounts were audited that a person might rely on those accounts for a particular purpose; and
- that in all the circumstances it would be reasonable for such reliance to be placed on those accounts for that particular purpose.

7 This case raised the possibility that an auditor might owe a duty of care to a third party who reads the accounts and then makes an investment or some other decision after relying on those accounts. Effectively the auditor might owe a duty of care to an unknown person.

8 Perhaps the most significant case as far as auditors are concerned came via the House of Lords decision in *Caparo Industries v Dickman and Touche Ross & Co* (1990). Caparo had alleged that it had based its decision to make a successful take over bid of Fidelity PLC on the strength of the latter's 1984 accounts which were audited by Touche Ross. Before the take over bid Caparo had been a minority shareholder in Fidelity PLC. The accounts significantly overstated the true position of Fidelity and so, subsequent to the eventual take-over, Caparo sued the auditors. The plaintiff argued that a duty of care was owed to them by the auditors. The Court of Appeal originally found for Caparo in 1989. However, on appeal the House of Lords overturned the decision and found in favour of Dickman (the Touche Ross partner).

9 The judgement against Caparo was clear that in the circumstances of this case the auditor did not owe a duty of care to potential investors. It held that the auditor's duty of care was owed to the shareholders as a body and not to individual shareholders for purposes such as to assist them in making investment decisions. In his judgement, Lord Bridge referred to the salient features of earlier cases, stating that for a duty of care to arise in respect of the advice or information given, the person who it is alleged owes that duty of care must be fully aware:

- of the identity of any third party who purports to rely on the adviser's advice;
- of the nature of the transaction contemplated by the third party;
- that the advice or information given would be passed to the third party, directly or indirectly; and
- that it was very likely that the third party intended to rely on that advice or information in deciding whether or not to engage in the transaction in contemplation.

10 In these circumstances, Lord Bridge considered that, subject to the effect of any disclaimer of responsibility, the person giving advice or information would be expected to be aware that the third party would rely on the advice or information given in deciding whether or not to engage in the transaction being contemplated.

A SUMMARY OF THE *BANNERMAN* CASE

Royal Bank of Scotland v Bannerman Johnstone Maclay (Scottish Court of Session)

11 The defendants were auditors of a company which in 1998 went into receivership with debts of around £13 million owing to Royal Bank of Scotland (RBS). RBS claimed that, due to a fraud, the accounts of previous years had misstated the true financial position of the company and the defendants had been negligent in not detecting it. RBS was the company's main banker/lender and, over a period of time, had also exercised options to subscribe for a majority of the company's shares. A requirement of the lending agreement was that monthly management accounts and audited accounts were to be sent to the bank as soon as was practicable.

12 The court's held in favour of RBS on the basis that the auditors knew the identity of the third party, the use to which the information would be put and that the bank intended to rely on it for the known purpose. The court dismissed the defence's arguments that, for a duty of care to exist, there must be an express assumption of responsibility to the third party by the auditor.

13 Significantly, Lord Macfayden commented that, having become aware of the details of the requirements of the lending agreement, the auditors could have disclaimed responsibility to the bank.

14 The case was appealed by Bannerman but the Scottish Court of Session dismissed the appeal in 2005. The Court agreed with the pronouncements of the judge at first instance and confirmed that a duty of care can be established even in the absence of such an intention by the auditors, provided that there was actual or deemed knowledge that the information was likely to be relied upon by the third party for a known purpose. The case raises questions about the duty of care to third parties.

DEVELOPMENTS POST-*BANNERMAN*

15 ACCA's Council and technical Committees have monitored developments subsequent to the Bannerman ruling closely.

16 The following events have occurred:-

- PricewaterhouseCoopers (PwC) decided to alter the wording of its standard audit reports to incorporate a disclaimer which expressly disclaims liability to third parties
- ACCA e-mailed interim guidance to all contact partners of ACCA UK firms in December 2002. ACCA expressed the view that the decision in the Bannerman case did not set any new precedents and that the case was decided on the specific facts and in accordance with existing Caparo principles. ACCA did not believe that the case had the effect of extending the auditors duty of care in all circumstances
- in January 2003, following the lead set by PwC, The Institute of Chartered Accountants in England & Wales (ICAEW) issued a technical release (Audit 01/03) which recommended that its members incorporate a disclaimer to third parties in their standard audit reports.
- In September 2007 the outcome of the case MAN v Freightliner v Ernst & Young UK confirmed the relevance of the pre-existent judicial principles in establishing the occurrence of a duty of care by auditors to a third party. The decision that found E&Y not owing a duty of care to a third party was based on the framework of the Caparo principles. The case demonstrated that, to determine whether a duty of care had arisen to someone other than the auditor's client, specific circumstances, as highlighted in Caparo, need to be objectively verified. Even in the absence of the auditor's intention that audited accounts could be communicated to and relied upon by the third party, it can be found, by objectively looking at circumstances, that the auditor had assumed a duty of care to a third party. However the Court of Appeal pointed out that mere knowledge or foresight that the third party would rely on the audit statement would not be sufficient to establish a duty of care and that "something more" would be required but it did not define what that would be.

ACCA'S VIEW

17 Since the Caparo judgement, banks and other lenders have sought ways to establish that a direct and sufficient relationship exists between themselves and their customers' auditors so as to entitle them to place reliance on audit reports on financial statements prepared for statutory purposes.

18 ACCA's initial reaction to the *Bannerman* decision was to conclude that, given that the case was decided on existing principles, no new basis of liability had been introduced. It has always been the case, post Caparo, that professional advisers can assume a duty of care provided that proximity to a third party is established. If there is anything new in *Bannerman* it is that it serves to highlight that proximity can exist even where the adviser has no actual knowledge (as opposed to constructive knowledge) that the third party intends to rely on the advice (although this aspect was not fully argued through by the court).

19 ACCA's Council, at its meeting on 27 February 2003, confirmed the initial view communicated to members in December 2002. Council stated "while it remained open to members to include disclaimer paragraphs in the auditors report, ACCA would not encourage this".

20 Standard disclaimers are not seen as an appropriate or proportionate response to the Bannerman decision. Their incorporation as a standard feature of the audit report could have the effect of devaluing that report and could also cause problems for third parties and regulators. In fact the Securities and Exchange Commission, the chief United States financial regulator, has prohibited, in its rules applicable to foreign issuers of securities, the use of Bannerman style disclaimers for audit reports filed with the Commission. As the US regulator does not allow such disclaimers on UK accounts filed in the US, then this seriously undermine the basis of their use in the UK.

21 In the wake of high profile auditing failures, it is vital that auditors worldwide win back the confidence of shareholders and investors. The inclusion of blanket disclaimers and limitations on an audit report will not help in this regard.

22 The work of an auditor should be carried out in accordance with the International Standards on Auditing (ISAs) (UK and Ireland). This is required no matter how big or small the entity is and auditors should strive to carry out their work with accuracy and professionalism. As part of this process the auditor must identify all major risk areas and design audit procedures which are sufficient to address them. In all the legal cases referred to above including the *Bannerman* case, the Courts have judged that the auditor has been negligent. As a rule therefore, if the auditor follows the ISAs, he reduces the possibility of being held to be negligent, whether to shareholders or third parties, known or unknown.

ACCA recommendation

23 ACCA's council would not encourage the inclusion in audit reports of standard disclaimer clauses which could have the effect of devaluing the report in the eyes of many. It accepts that members may wish to make specific disclaimers of responsibility in appropriate, defined circumstances but does not encourage their use on a regular basis, nor does ACCA believe that, where an audit is properly carried out, such clauses are necessary in order to protect auditors interests.

24 In ACCA's view the best way of restricting liability is for auditors to carry out their audit work in accordance with auditing standards. Where work is properly conducted, the auditor should not need to subject it to blanket disclaimers.

FURTHER GUIDANCE ON THE OCCASIONAL USE OF DISCLAIMERS

25 ACCA, on behalf of CCAB, issued technical factsheet 53 'Firms reports and duties to lenders in connection with loans and other facilities to clients and related covenants' in August 2000. (The factsheet can be accessed from the following link: http://www.accaglobal.com/pubs/members/publications/technical_factsheets/downloads/53.pdf*)* This statement gives guidance, based on the law at present, on the matters that should be considered by firms regarding the extent of their duty of care in respect of audit and review reports and ancillary reporting services in connection with loans and other facilities made available to their clients.

26 One example is the situation where a lender, in seeking to document a relationship of proximity so as to enable it to rely on the audited financial statements, includes a clause in the conditions precedent to the granting of loan facilities which seeks to require the auditor of the borrower to provide written acknowledgement to the lender that, in connection with the facilities offered, the bank may rely on the audited financial statements of the borrower. The lender would therefore establish a direct duty of care. Such a duty of care might also be established if the lenders wrote to a firm expressing their intention to rely on audited or reviewed financial statements in connection with a proposed transaction.

27 Auditors who are in receipt or aware of a request to provide acknowledgement of their responsibility to their client's lenders should not allow it to go unanswered. Appendix I of technical factsheet 53 provides an example of a response which might be appropriate in this situation. Where the firm is thinking of signing a statement from a

lender, and it does not respond in such a manner as suggested in Appendix I, it should consider obtaining legal advice regarding the consequences.

28 If a firm decides that it is able and prepared to provide specific assurances to a lender regarding the financial statements, whether audited or not, or on any other matters it should be as part of a separate engagement between the firm and the lender and the terms should be specifically agreed in a letter of engagement. For further information and guidance members should refer to technical factsheet 53.

29 ACCA has developed an engagement letter CD-ROM which gives examples of many different types of wording of engagement letters covering most types of organisation. In conjunction with SWAT Training Limited ACCA has developed a Quality Assurance based procedures programme (the *General Practice Procedures Manual*) to help manage the risk of non-audit based work. Further information on these products can be found on ACCA's website (www.accaglobal.com).

30 ACCA's Rulebook *(section* 3.18*,* Professional liability of accountants and auditors) also contains advice for members on the circumstances in which third party disclaimers of liability can effectively be made *.*

Disclaimers on audit reports in exceptional cases

31 In some exceptional cases, ACCA appreciates that its members would want to issue a specific (as opposed to a standard) disclaimer on or in respect of its audit report. An example of this would be where the auditor had identified the fact that the audited accounts would be used or relied on by third parties but, for various reasons, those third parties were not known to the firm. In these exceptional cases, ACCA suggests two examples of appropriate wording:-

> ***I. Example where third party has been identified***
>
> *Independent auditors report to the Shareholders of ABC Ltd*
>
> *Respective responsibilities of directors and auditors*
> Under section 235(1) of the Companies Act 1985 (or "Under section 495(1) of Companies Act 2006") we have a duty as auditors to report on the annual accounts of the company. This duty only extends to a report to the members of the company as a whole and not to an individual shareholder or group of shareholders or to a third party. We are therefore responsible only to the shareholders as a whole for our audit opinion.
>
> *Normal audit report from this stage*

> ***II. Example where there may be an unknown third party***
>
> *Independent auditors report to the Shareholders of ABC Ltd*
>
> *Respective responsibilities of directors and auditors*
> Under section 235(1) of the Companies Act 1985 (or "Under section 495(1) of Companies Act 2006") we have a duty as auditors to report on the annual accounts of the company. This duty only extends to a report to the members of the company as a whole and not to an individual shareholder or group of shareholders or to a third party. We cannot be held responsible by any third party who uses or places reliance on our opinion in order to make a decision to enter into any type of transaction with the company.
>
> *Normal audit report from this stage*

High risk audit issues

32 Occasionally members may be faced with difficult issues surrounding a particular audit. They may be considering resigning from their appointment as auditor or qualifying the audit report. ACCA stresses that in these situations ISA 700 should be followed and if this means resigning or issuing a qualification then members should not be afraid to do so. Members should not avoid addressing contentious issues merely by including in their audit report a blanket disclaimer.

Engagement procedures

33 ACCA encourages its members to employ proper client engagement procedures to ensure that the terms of the engagement are clearly expressed and agreed between the two parties. Guidance on these matters is given in the *General Practice Procedures Manual* and also in ISA 210. By using proper procedures members can identify where new clients are, or intend to be, involved with third parties and can also clarify exactly what work they will be involved in and which parties will be interested in that work. This will help in avoiding the use of disclaimers.

Mixed partnerships between ACCA and ICAEW members

34 ACCA recognises that difficulties may arise when a mixed practice consisting of both ACCA and ICAEW members wishes to issue an audit report. In this case the partners need to discuss the respective guidance issued by the two bodies and decide their firm's policy in the light of the guidance.

Audit reports under legislation other than the Companies Act 1985 or 2006

35 Many ACCA members will have clients who need an audit report prepared under different legislation. Examples are a report to an unincorporated charity under the Charities Act 2006 and a report on a defined benefit pension scheme under the Pensions Act 1995. However, ACCA's guidance is unchanged and the use of standard disclaimers is not encouraged. ISA 700 requires the auditor to state the person or persons to whom the report is addressed. Therefore there is the same implication that no duty of care is owed to any party not included in this statement. If, in exceptional circumstances, the members consider that a disclaimer is needed, the same approach, as set out above, should be used. It should be noted however that regulatory bodies such as the Charity Commissioners or the Pensions Regulator have the power to investigate charities and pension schemes and, where an auditor has been negligent in their audit, the courts would have to decide whether a standard or specific disclaimer would protect the auditor.

QUESTIONS AND ANSWERS

36 The following are examples of questions that may be raised by practitioners.

Specifically who is a statutory audit carried out for?
Under section 235 of the Companies Act 1985 and section 495 of Companies Act 2006 the auditors of a company have a duty to make a report to the company's members on all financial statements of the company of which copies are to be laid before the company in general meeting. If a private company does not hold a general meeting then the auditors must still report on all financial statements sent to the members. Therefore the report is to the members and no one else.

Would the inclusion of a disclaimer on the audit report automatically avoid any liability to third parties?
No. The inclusion of a blanket disclaimer will not automatically protect the auditor. As mentioned above, the auditor must be careful not to create or assume any duty of care to a third party. Where it is known that a third party will be using or relying on the accounts, the guidance given above, and contained in technical factsheet 53, regarding disclaimers of responsibilities should be followed.

What is the effect on the professional indemnity insurance (PII) of a firm if disclaimers are issued?
This has been discussed with Alexander Forbes (now Lockton) who are ACCA's endorsed brokers. Their view is that the implementation of any changes to the audit report wording resulting from Bannerman would not have any direct impact of the cost of PII. Clearly any improved risk management or limitation measures that firms may adopt can only help minimise potential risk exposure.

Would it help if the auditor wrote to all possible third parties, such as existing or potential lenders, with an express disclaimer of responsibility to them in advance of any audit report being issued?
The practicalities of this would outweigh any possible benefits derived. It would be extremely hard, if not impossible, to identify all third parties who might be interested in the audit opinion expressed. A precedent might also be accidentally set where an interested party was not written to. They could claim that, in the absence of a disclaimer, there was a proximity and duty of care established.

If the auditor becomes aware of lending agreement requirements relating to an audit client, what action is required?
Lord Macfayden in the *Bannerman* case stated that the auditors could have disclaimed responsibility to the bank (lender). It is recommended that members follow this guidance and also the guidance contained in technical factsheet 53 when considering issuing a suitable specific disclaimer to the lender.

Technical Factsheet 84
Issued 03/03
Updated 09/08