

# Professional liability of accountants and auditors



## Scope and status

This factsheet provides guidance on the liability for professional negligence which members may incur because of an act or default by them (or by their employees or associates) which results in a financial loss to a client or a third party to whom a duty of care is owed.

This document has no regulatory status. It is issued for guidance purposes only. Nothing contained in this document should be taken as constituting the amendment or adaptation of the *ACCA Rulebook*. In the event of any conflict between the content of this document and the content of the *ACCA Rulebook*, the latter shall at all times take precedence.

## Introduction

This factsheet is concerned only with the liability for professional. It does not deal with liability arising from other causes (for example criminal acts, breaches of trust, or breaches of contract other than the negligent performance of its terms, and certain heads of liability arising by statute independently of contract).

Negligence in this factsheet therefore means some act or omission which occurs because the person concerned has failed to exercise that degree of professional care and skill, appropriate to the circumstances of the case, which is expected of accountants and auditors. It would be a defence to an action for negligence to show:

- (a) that there has been no negligence; or
- (b) that no duty of care was owed to the plaintiff in the circumstances; or

(c) in the case of actions in tort that no financial loss has been suffered by the plaintiff.

The third defence would not be available to a claim in contract, but only nominal damages would be recoverable and in those circumstances it is unlikely that such an action would be brought.

In recent years there have been a number of cases where substantial sums have been claimed as damages for negligence against accountants and auditors. In a number of cases it appears that the claims may have arisen as a result of some misunderstanding as to the degree of responsibility which the accountant was expected to assume in giving advice or expressing an opinion. It is therefore important to distinguish between:

- (a) disputes arising from misunderstandings regarding the duties assumed; and
- (b) negligence in carrying out agreed terms.

## The use of engagement letters

There is in almost all cases a contractual relationship between an accountant and his/her client. Unless an express agreement is made between them to the contrary, the standard of work required of an accountant is defined by Section 13 of the Supply of Goods and Services Act 1982: in a contract for the supply of a service where the supplier is acting in the course of a business, therein is an implied term that the supplier will carry out the service with reasonable care and skill. The degree of skill and care required will depend principally on the nature of the work undertaken. An accountant who undertakes work of an unusually specialised nature, or work of a kind whose negligent performance is particularly liable to cause

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substantial loss, will usually be taken to have assumed a duty to exercise a higher degree of skill and care than would be appropriate to less demanding work. This will, especially, be the case if he/she holds him/herself out as being experienced in the kind of work in question. In no case, however, is the duty likely to be absolute. Opinions expressed or advice given will not give rise to claims merely because in the light of later events they prove to have been wrong.

Members must record in writing and send to their clients a letter of engagement which sets out the terms under which they are agreeing to be engaged by clients before any work is undertaken. If this is not possible, a letter of engagement must be in place as soon as practicable after the engagement commences.

Members must ensure that at the time they agree to perform certain work for the client a letter of engagement is prepared which clearly defines the scope of their responsibilities and the terms of their contract with their client. The letter of engagement should set out in detail the actual services to be performed, the fees to be charged or the basis upon which fees are calculated and the terms of the engagement should be accepted by the client so as to minimise the risk of disputes regarding the duties assumed. Where new work is to be undertaken or any terms have changed, members should send a new letter of engagement. It may also be helpful for the avoidance of misunderstandings to indicate any significant matters which are not included in the scope of responsibilities undertaken, although it will rarely be possible to provide a comprehensive list of matters excluded.

### **Excluding or restricting liability to a client**

It should be borne in mind that an agreement with a client designed to exclude or restrict a member's liability will not always be effective in law. The following are the main relevant considerations.

### **Auditors under the Companies Act**

Section 310 of the Companies Act 1985 make void any provision in a company's articles or any contractual arrangement purporting to exempt the auditor from or to indemnify him/her against any liability for negligence, default, breach of duty or breach of trust. Although Section 727 of the Companies Act 1985 empowers the court in certain circumstances to grant relief either wholly or in part from any of such liabilities, it appears that these powers have seldom been exercised and it would be prudent to assume that an auditor might not be relieved of liability.

### **Other cases**

Appropriate reference should be made in the letter of engagement to any exclusion or restriction of liability (other than as auditor of a company to which the Companies Act 1985 applies) because if an attempt is made to introduce such a provision into an existing relationship or in relation to a transaction for which instructions have already been accepted, difficulty may be experienced in showing that there is any legal consideration for the client's agreements to submit to the exemption provisions.

### **The Unfair Contract Terms Act 1977**

This Act introduces extensive restrictions upon the enforceability of exclusions of liability for negligence and breaches of contract. Section 2 of the Act, which applies in England, Wales and Northern Ireland, makes void any contractual exclusion or restriction of liability for negligence, even in a case where the client has agreed to it and where legal consideration exists, unless the person seeking to rely on that exclusion or restriction can show that it was reasonable. Part II of the Act contains somewhat similar provisions applying as part of the law of Scotland. There is, at present, little case law which affords guidance as to what exclusions or restrictions of liability for negligence will be regarded as reasonable. However, unless

the work undertaken presents unusual difficulties or is required to be carried out in unusually difficult circumstances, it would be prudent to assume that an exclusion of liability for negligence may be treated by the courts as unreasonable. A limitation of liability for negligence to a particular sum, will more readily be treated by the courts as reasonable, particularly if the accountant relying upon it can show that he/she would have difficulty in obtaining professional indemnity insurance for any greater sum. A contract between an accountant and his/her client may also be subject to the Unfair Terms in Consumer Contracts Regulations 1994 which make unenforceable any "unfair term" in a contract between a supplier and a "consumer"; but if a term limiting liability has been found to be "reasonable" for the purposes of the 1977 Act it is thought unlikely that it would be held to be "unfair" for the purposes of the 1994 Regulations.

An exclusion or restriction of an accountant's liability will not generally avail him/her against a third party. Third party liability is dealt with separately below.

#### **Advice on limited information**

Besides reporting under the Companies Act 1985 accountants are called upon to give opinions and advice, including financial advice, in connection with many other matters, for example, investigations or management consultancy assignments, the preparation or audit of the accounts of sole traders, partnerships and charities, and in the field of taxation. Members undertaking to carry out work of this nature should make clear to their clients the extent of the responsibility they agree to undertake, making particular reference to the information supplied to them as a basis for their work and to those areas (if any) to be excluded from their examination. In particular, if clients require "snap" answers to complicated problems, members would be well advised to record in writing (or alternatively to state orally and forthwith confirm in writing) that the problems are complicated, that they have been given a

very limited time in which to study them, that further time is required in order to consider them in depth and that the opinion or advice tendered might well be revised if further time were available to them. Members should also state that the client is responsible for the accuracy of the information supplied to the accountant. Except in the case of a genuine emergency the client should be warned against acting on the "snap" advice tendered before further investigation has been carried out.

Statements and warnings of the kind considered in the preceding paragraph are not exclusions or restrictions of liability, but definitions of the work undertaken, and will protect an accountant from a claim for negligence based on the contention that his/her enquiries should have been more extensive than those so defined.

There is an increasing tendency for accountants to be required to express an opinion on financial statements relating not to past (and therefore ascertainable) results but to the expected results of future periods.

#### **Liability to third parties**

An accountant may be liable for negligence, not only in contract but in tort, if a person to whom he/she owed a duty of care has suffered loss as a result of the accountant's negligence. An accountant will almost always owe a duty of care to his/her own client, but that duty is likely to be coextensive with his/her contractual duty. In practice, the possibility of liability in tort will be important mainly in the context of claims by third parties (although it may also be significant in relation to the question of whether claims by the client are barred by the Limitation Act 1980, as a longer period will in certain cases be available for a claim in tort to be brought as opposed to a claim in contract).

Recent decisions of the courts, including several important decisions of the House of Lords, have expanded the classes

of case in which a person professing some special skill (as an accountant does) could be liable for negligence to someone other than his/her own client: see in particular *Hedley Byrne and Co Ltd v Heller and Partners* (1964) AC 465, *Smith v Eric S Bush* (1990) 1 AC 831 and *Caparo Industries plc v Dickman and others* (1990) 2 AC 605.

Such liability may arise whenever a professional person does work for his/her client in circumstances where he/she knows or ought to know:

- (a) that his/her work is liable to be relied upon by a third party; and
- (b) that the third party may suffer financial loss if the work in question has been done negligently.

Liability will arise when the work in question is of a kind which it was reasonable for the third party to rely on for his/her particular purpose. If these conditions are satisfied, the third party is a person whom in the eyes of the law the professional person ought to have in mind in applying his/her skills to the work in question. The decision in *Law Society v KPMG Peat Marwick* (2000) 4 All ER 540 confirmed that the accountant has a duty of care to third parties where the three criteria specified below are satisfied. As a result practitioners preparing financial reports on members of regulatory bodies, for example the Law Society, will owe a duty of care to such bodies. The case of *Royal Bank of Scotland v Bannerman Johnstone Maclay* (Scottish Court of Session) has reinforced the principle that an auditor can have a duty of care towards a third party even where he has no actual knowledge (but has constructive knowledge) that the third party intends to rely on his advice. Whilst members may wish to make specific disclaimers of responsibility in appropriate, defined circumstances, ACCA does not encourage the use of standard disclaimer clauses in audit reports. Such clauses could have the effect of devaluing the report in the eyes of many and should not be necessary in order to protect auditors' interests if the audit has been properly carried out.

The decision of the House of Lords in the case of *Caparo Industries plc v Dickman and others* (1990) 2 AC 605 has clarified the extent of auditors' liability by defining three criteria for the imposition of a duty of care as follows:

(i) It must be reasonably foreseeable by the defendant that the statements will be relied on by the plaintiff.

(ii) There has to be a "relevant degree of proximity" between the parties.

(iii) It must be just and reasonable to impose a duty of care on the part of the defendant to the plaintiff.

(b) While it followed from this ruling that the auditors in question did not owe a duty of care either to individual shareholders or to potential investors, auditors will continue to have a duty to shareholders as a group, presumably as represented by the company. Nor will the decision reduce the exposure of accountants who produce or report upon financial statements of various kinds (whether for a fee or not) which are liable to be relied upon by persons other than those for whom they were originally prepared.

An accountant may sometimes be informed, before he/she carries out certain work, that a third party will rely upon the results. An example likely to be encountered in practice is a report upon the business of a client which the accountant has been instructed to prepare for the purpose of being shown to a potential purchaser or potential creditor of that business. In such a case it would be prudent for an accountant to assume that he/she will be held to owe the same duty to the third party as to his/her client.

Even where the accountant is not specifically informed that a third party will rely upon the results of his/her work, he/she would be wise to consider whether this is likely to be the case. Where the accountant knows the purpose of the work and identity of the third party, to whom the information prepared or reported on will be shown, he/she may be held to owe a duty of care to that third party. An example of such circumstances would be involvement in

the production of management accounts or projection for presentation to a bank in support of a loan application.

### **Avoiding liability to third parties**

In many cases there are no steps which an accountant can reasonably take to limit the circulation of his/her work or the use which is made of it. Some documents, such as the reports of auditors of public companies are by their nature incapable of being restricted in this way. In other cases, however, there may be steps which an accountant can take to reduce his/her exposure to the claims of third parties. These cases cannot be exhaustively defined but the following are some of the more important examples of them.

### **Documents published generally**

An accountant may publish a document which is prepared neither in response to the instructions of a particular client nor for any statutory or public purpose: e.g. a textbook or a newsletter. In such cases, the circumstances will not usually be such as to enable the third party to assume that the originator of the document was intending that the third party should act on it without more advice, and substantial reliance upon it would not be reasonable. An accountant can reinforce his/her legal position in relation to documents of this kind by including a disclaimer of liability in the document itself. The form of the disclaimer will depend upon the nature of the document. In many cases a disclaimer along the following lines will be found appropriate:

“Whilst every care has been taken in the preparation of this document, it may contain errors for which we cannot be responsible.”

### **Work done for special purposes**

An accountant may be instructed to prepare or report upon financial material for some particular purpose. He/she will not usually be liable to a third party who relies on it for any other purpose for which it is or may be unsuitable. In such a case the accountant would usually have no reason to suppose that such reliance would be placed upon it. Moreover, it would be unreasonable for a third party to rely on it for such a purpose. Members would, however, be well advised to make the position clear by including in the document itself a short statement of the purpose for which it was prepared, if that is not apparent.

### **Confidential reports**

Certain reports or statements may appropriately include a rubric specifically restricting its circulation. For example:

“CONFIDENTIAL.

This report (statement) has been prepared for the private use of X (the client) only and on condition that it must not be disclosed to any other person without the written consent of Y (the accountant).”

Current practice is that clients will respect a rubric of this kind. Accordingly, when a document is so marked but is nevertheless relied upon by a third party without the accountant's consent, the accountant will as a general rule be able to resist liability on the basis that the third party was not a person whom he/she should have had in mind as being likely to suffer loss by his/her negligence. Such a rubric should be introduced only where the circumstances warrant it, as it would tend to be devalued by indiscriminate use in connection with documents which by their nature must receive a wide distribution. Where a document is prepared in the first instance for discussion with or approval by the client or others, and is liable to be altered before it appears in its final form, this fact should be made clear so as to prevent persons from placing undue

reliance upon it. This may be done by over-stamping the document on each page: "Un-revised draft".

#### **Documents intended to be checked; accounts prepared for tax purposes**

An accountant may prepare a report or statement to be issued by his/her client in circumstances where he/she can reasonably expect his/her client to check it for fairness or accuracy before any use is made of it involving third parties. Accounts prepared for the purpose of being submitted to the Inland Revenue or the assessment of taxation will frequently, although not invariably, fall within this category. In such cases, the effective cause of any loss suffered by a third party will ordinarily be the negligence of the person in whose name it was issued and who ought to have checked the document, and not that of the accountant. It is a sensible precaution in such a case for the accountant expressly to draw the attention of the client to the need to check the document before submitting it.

#### **Disclaimers of liability to third parties**

A disclaimer of liability to third parties may sometimes be made in circumstances where liability would or might otherwise arise. Such a disclaimer might, for example, be introduced along the following lines:

"This report is prepared for the use of X (the client) only. No responsibility is assumed to any other person."

Members should, however, be aware that such a disclaimer will often be inappropriate or ineffective. Disclaimers will be inappropriate in circumstances where their use will tend to impair the status of practising accountants by indicating a lack of confidence in their professional work. It would not, for example, be proper to endorse copies of accounts filed in accordance with Sections 226 and 241 of the Companies Act 1985 with a disclaimer by the auditor of liability to persons other than shareholders.

The following paragraphs deal with those cases in which there are no professional objections to the use of disclaimers, but in which reservations must be made as to their effectiveness.

#### **Information prepared for the client and passed to third parties**

Where a statement or report is prepared by an accountant for his/her client, which is not confidential and can be expected in the ordinary course to be relied upon by third parties, a disclaimer which purports to apply only as against the third parties presents particular difficulties as a matter of law. By it, the accountant seeks in effect to assume a dual standard of care, the one applicable in so far as his/her work is read by the client and the other in so far as it is read by the third party. Since the third party will normally rely on the report because he/she expects the accountant to have performed his/her duty to the client, and since that expectation will normally be reasonable, the attempt to assume such a dual standard is unlikely to succeed.

#### **Information passed directly to third parties**

Where an accountant (necessarily with the authority of his client) passes information directly to a third party there is no question of a dual standard of liability because the third party is generally the only person who is intended to rely on the accountant's work. In such a case the effectiveness of a disclaimer will depend upon the nature of the information. For example, when giving references or assurances regarding credit-worthiness or similar matters, the normal commercial practice is to state that although the reference or assurance is given in good faith the accountant accepts no financial responsibility for the opinion he/she expresses. Such disclaimers will generally be effective because such references or assurances are not information of the kind which is expected to be the result of extensive research by the accountant. Sometimes, however, an accountant may supply directly to a third

party information of a kind which the third party (unless he/she is told otherwise) can reasonably expect to be the result of a more or less extensive kind. As applied to such information, a disclaimer will generally be ineffective in England (although not in Scotland) because of Section 2 of the Unfair Contract Terms Act 1977 (see the following paragraph).

### **Unfair Contract Terms Act 1977, Section 2**

The effect of this provision is that where a person is in principle liable for negligence, he/she cannot exclude that liability by a reference to a notice, except where the notice is reasonable. If an accountant prepares a report or statement in circumstances where it can reasonably be expected that a third party may rely on it, a notice excluding liability to him/her would only exceptionally be regarded as reasonable. The law on this point is different in Scotland, because the equivalent section of the Act which applies as part of Scots law, Section 16, does not refer to notices but only to terms of contract. Accordingly, in Scotland an appropriately worded disclaimer may be effective to exclude liability to third parties whether or not it is reasonable.

### **Inclusion of the accountant's name on a document issued by a client**

Members should endeavour to ensure that no statement or document issued by their client (other than unabridged accounts which have been reported on by them as auditors) will bear their name unless their prior consent has been obtained. It is often desirable for a suitable paragraph to be included in the engagement letter.

There have been occasions when the use of a member's name in a document (other than accounts reported on by him/her as auditor) has been interpreted by third parties as implying that the company is financially sound and well conducted, whether or not this is in fact the case. If a member learns that a client proposes to cite his/her name

he/she should inform the client that his/her permission must first be obtained and in appropriate cases he/she should withhold his/her permission.

### **Specialist advice**

In expressing an opinion or giving advice on difficult and complicated matters (for example in the field of taxation) members should bear in mind the magnitude of the financial consequences for their client should the advice tendered be incorrect or misconceived and the implications for them of a possible resulting financial loss. An accountant in general practice is deemed by the law to undertake to bring only a fair and reasonable degree of skill and competence to the problem on which he/she is required to advise, and in appropriate circumstances he/she may wish to obtain the approval of his/her client for consulting another person with specialist experience of the matter in question. Occasions may also arise when a member may wish to consider declining a particular assignment because, for example, he/she is of the opinion that the matter on which his/her advice is sought does not fall within the normal scope of a professional accountancy practice and the client would therefore receive better assistance from a member of another profession.

Members should be aware of the decision of the court in *Sayers v Clarke Walker* (2002) EWCA Civ 910, concerning a practitioner who had failed to advise a client on how to maximise his tax advantages when purchasing shares in a company. The practitioner had suggested to the client that specialist tax advice be sought, but that was not enough to absolve him from his obligation to give the client competent advice. Advice on how to maximise the client's tax advantages should have been within the practitioner's general competence as an accountant and the practitioner's failure to give such advice amounted to a breach of his retainer and/or negligence.

Members can never absolve themselves of the obligation to give competent general advice, as this case illustrates.

Receiverships, trusts and secretarial work

A member acting as a receiver incurs personal liability for his/her acts and may, in particular, incur liability under commercial contracts, irrespective of negligence on his/her part. Accordingly if a member appointed by a debenture holder to act in this capacity has to manage a business he/she should endeavour to ensure that he/she is fully indemnified by the person who appoints him/her against all loss and damage arising out of his/her management. If such an indemnity cannot be obtained, he/she should endeavour to ensure that contracts into which he/she enters on behalf of that business include a clause to the effect that he/she assumes no personal liability thereunder (see Section 44 of the Insolvency Act 1986).

It is often prudent for a member who is appointed to act as a trustee or asked to carry out certain secretarial work such as cheque signing to obtain an appropriate indemnity. In the former case an instrument creating a trust can give a wide form of indemnity if the settlor is willing to approve its inclusion in the deed; in the latter, the member should arrange for an indemnity to be obtained from his/her client.

### **Conclusions**

Although it is not possible to guard against every circumstance in which an accountant or auditor may run the danger of incurring liability for professional negligence, the following matters should be borne in mind:

(a) before carrying out any work for a client a member should ensure that the exact duties to be performed and in particular any significant matters to be excluded have been agreed with the client in writing by a letter of engagement or otherwise. If the accountant is asked to perform any additional duties at a later date, these should also be defined in writing;

- (b) in giving "snap" advice at the request of a client or advice which must necessarily be based on incomplete information, a member should make it clear that such advice is subject to limitations and that consideration in depth may lead him/her to revise the advice given;
- (c) when publishing documents generally a member may find it advantageous to include in the document a clause disclaiming liability;
- (d) when submitting unaudited accounts or other unaudited financial statements or reports to the client, a member should ensure that any special purpose for which the statements or reports have been prepared is recorded on their face, and in appropriate cases should introduce a clause recording that the report or statement is confidential and has been prepared solely for the private use of the client;
- (e) it should be recognised that there are areas of professional work (for example when acting as an auditor under the Companies Acts) where it is not possible for liability to be limited or excluded, and that there are other areas of professional work (for example when preparing reports on a business for the purpose of being submitted to a potential purchaser) where although such a limitation or exclusion may be included, its effectiveness will depend on the view which a court may subsequently form of its reasonableness;
- (f) when giving references to a third party with regard to future transactions (e.g. payment of rent) a member should state that his/her opinion is given without financial responsibility on his/her part;
- (g) where the circumstances appear to warrant it because of the complexity of an assignment or otherwise a member should advise his/her client that he/she considers it desirable to take specialist advice. In certain circumstances it may be appropriate for a member either to consult another accountant or to suggest to his/her client that the advice of a member of another profession should be sought;
- (h) where a member acts as receiver he/she should endeavour to ensure that the person appointing him/her

executes an appropriate letter of indemnity in his/her favour or should include appropriate exclusions of his/her personal liability in contracts with third parties. A member should also arrange for additional professional indemnity insurance cover of a realistic amount and should ascertain from his/her brokers whether or not cover is provided for the special risks involved.

NOTE: Responsibility for obtaining adequate cover lies with individual members. In the United Kingdom a scheme has been negotiated by ACCA on behalf of members.

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