

## *Managing the Professional Liability of Accountants*

*This Section has not been updated, save for cross references, since it was first issued in October 1994. In particular, the Section does not incorporate guidance on the implications of the introduction of corporate practice, limited liability partnerships and other developments. Members in practice may find the information provided by the Audit and Assurance Faculty, Technical Strategy Directorate technical releases and the Members Services Directorate helpful. Please refer to the Institute's website to access helpsheets, technical releases and other publications and to access details of the various helplines which may assist members seeking information in this area.*

### **Text of Section**

(Issued October 1994)

*The Council of the Institute of Chartered Accountants in England and Wales draws the attention of members to the principal areas in which actions for negligence may be brought against them by clients or third parties and suggests steps which they may properly be able to take to reduce the risk of such claims. A discussion of the legal considerations applicable to this subject is included in the Appendix. The expressions of law included in this Section and its Appendix have the approval of Counsel and are stated as at 1 September 1994. This Section does not deal with the position under the law of the Republic of Ireland.*

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### **Introduction**

**1** In recent years, the incidence of cases where substantial sums have been claimed as damages for negligence against members has increased significantly. Members therefore need to ensure that they manage the extent of their liability when providing professional services. Sometimes claims arise not because of any inherent defect in the professional work performed but due to misunderstandings regarding the scope of or responsibility for that work or parts of it. The purpose of this Section is therefore in part to advise members on ways to reduce misunderstandings as to the extent of the liability which they assume in giving advice or expressing an opinion. It is also aimed at assisting them to identify the nature of their liability in respect of professional work and to give guidance on managing this liability.

**2** This Section is concerned only with the potential liability for professional negligence which a member may incur because of an alleged act or default by him or by one of his employees or associates which results in financial loss to a person to whom a duty of care is owed. It does not deal with liability arising from other causes (for example criminal acts, breaches of trust, breaches of statutory duty or breaches of contract other than the negligent performance of its terms).

**3** Negligence in this Section therefore means some act or omission which occurs because the member concerned has failed to exercise that degree of reasonable skill and care which is reasonably to be expected in circumstances of the case. The defences to an action for negligence are set out in paragraph 1 of the Appendix.

**4** There is a contractual relationship between a member and his client even if the contract is not in writing or is evidenced in writing but has not been signed. The standard of work required by that contract is set out in paragraphs 2 to 3 of the Appendix.

**5** A member may and usually will be liable to his client for negligence not only in contract, but also in tort. He will also be liable for negligence to a third party to whom he owed a duty of care and who has suffered loss as a result of the member's negligence. Liability to third parties is dealt with in more detail in paragraphs 4 to 9 of the Appendix.

### **Summary**

**6** It is not possible either in law or in fact to guard against every circumstance in which a member may risk incurring liability for professional negligence. However, as discussed below, there are a number of opportunities available to members to assist them in managing their liability.

**7** This Section recommends that members should consider adopting the following measures:

- (a) **defining the scope and responsibilities of the engagement:**
- (i) **to the client**, by agreeing an engagement letter:
    - identifying the terms of the engagement (paragraph 8);
    - **defining the specific tasks to be undertaken** and excluding those which are not to be undertaken (paragraphs 9 and 10);
    - **defining the responsibilities to be undertaken by the client** and making clear the extent to which reliance is to be placed on the client or others (paragraphs 11 and 12);
    - **specifying any limitations on the work to be undertaken** (paragraphs 13 to 16);
  - (ii) **to third parties**, by setting out in any report the precise work which has been carried out and, as far as possible, the work which has not been carried out, together with any limitations on the work undertaken (paragraph 17);
- (b) **defining the purpose of reports:**
- (i) by stating in the engagement letter the purpose for which the report has been prepared and that the client may not use it for any other purpose (paragraph 18);
  - (ii) by stating in any report which may be seen by a third party the purpose for which it has been prepared and that it may not be relied on for any other purpose (paragraphs 19 and 20);
- (c) **restricting the use of the member's name:**
- (i) by advising clients in the engagement letter of the need to obtain permission to use his name (paragraph 21);
  - (ii) by withholding permission to use his name, where appropriate (paragraph 22);
- (d) **identifying the authorised recipients of reports:**
- (i) by a term in the engagement letter; and
  - (ii) by a caveat in the report (paragraphs 23 to 25);
- (e) **limiting or excluding liability:**
- (i) **to the client**, by a term in the engagement letter (paragraphs 26 to 28);
  - (ii) **to a third party**, by a disclaimer in a report (paragraphs 29 to 34);
- (f) **obtaining an indemnity:**
- (i) **from the client or a third party** (paragraphs 25 to 37);
  - (ii) in connection with **receiverships, trust and secretarial work** (paragraphs 38 and 39);
- (g) **defining scope of professional competence** to include only matters within the member's competence (paragraphs 40 and 41).

The references above identify the paragraphs where each of these measures is discussed in more detail in the rest of this Section.

## Defining the scope and responsibilities of the engagement

### (i) To the client

#### *Identifying the terms of the engagement*

**8** A member should ensure that at the time he agrees to perform work for the client the terms of his contract with his client are properly defined, preferably in writing. An engagement letter should be prepared setting out in sufficient

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detail the terms of the engagement, including the actual services to be performed, the sources and nature of any information to be provided and to whom any report should be addressed and supplied. These terms should be accepted by the client by signing and returning a copy of the engagement letter, so as to minimise the risk of disputes regarding the duties assumed (see Auditing Guideline 406 Engagement Letters). Where the appointment has been the result of a successful proposal, unless a separate contract is agreed with the client, the proposal will normally form the contract. Where a separate engagement letter is prepared, it should address any specific services or other contractual terms which have been agreed at the proposal stage. If the client subsequently asks a member to carry out any additional duties, or in any other way varies the terms of the engagement, the changes should also be defined and recorded in writing and ideally agreed in writing by the member and the client.

### *Defining the specific tasks to be undertaken*

**9** Besides reporting under the Companies Act 1985 and other statutes, members are called upon to give opinion and advice, including financial advice, in connection with many other matters, for example, profit forecasts, investigation or consultancy assignments, the preparation or audit of the accounts of sole traders, partnerships and charities and in the field of taxation. A member undertaking to carry out work of this nature should make clear in his engagement letter the extent of the responsibilities he agrees to undertake, making particular reference to any information supplied to him and relied on as a basis for his work for which the client or others are responsible, setting out in detail the specific tasks to be undertaken and, where appropriate, excluding those tasks which are not to be undertaken.

**10** Members should guard against the situation where they undertake to perform particular tasks, then during the course of the work find that it is impossible or unnecessary to perform all the tasks originally envisaged but do not agree with the client the change in scope of the work. If a member undertakes to perform tasks which he does not then perform, he is prima facie in breach of contract and to be safe from action he should obtain a variation of the contract (evidenced in writing) to cover the change in scope before submitting his report. In any event, he should make clear in his report precisely which tasks have and have not been undertaken. Members should also ensure that the description of work done in any bills sent to clients is consistent with the terms of the engagement letter, any subsequent variation of those terms and the report.

### *Defining the responsibilities to be undertaken by the client*

**11** A member should make it clear in the engagement letter where responsibilities are to be undertaken by the client. For example, a report or statement may be prepared by a member for issue by his client in circumstances where he can reasonably expect his client to check it for completeness or accuracy before any use is made of it involving third parties. Accounts prepared for the purpose of being submitted to Inland Revenue for the assessment of taxation will frequently, although not invariably, fall within this category. Ensuring that

the client is aware of his responsibilities should help protect the member from any subsequent dispute with the client. In such cases, the effective cause of any loss suffered by a third party may be reliance on a document which is the responsibility of the person in whose name it was issued and who ought to have checked the document, and not that of the member. If, however, the member considers that some matter particularly requires to be checked by the client he should make this clear.

**12** Where the client has directly or indirectly determined the nature and scope of the member's procedures to be undertaken in an engagement ('agreed-upon procedures') the engagement letter should include a statement that the client is assuming responsibility for the sufficiency of the procedures for the client's purposes. If, however, the member considers that the procedures are or are likely to be insufficient for the client's purposes he should make this clear.

*Specifying any limitations on the work to be undertaken*

**13** It may be appropriate to alert the client to limitations in or restrictions on the scope of the member's work in response to risks unique to a particular engagement. The most common example is where the client requires an immediate answer to a complicated problem. In such circumstances, the member should consider whether it is appropriate to accept the engagement at the outset, having regard to the value to the client of the work which it is feasible for the member to carry out. If he does accept the engagement, the member would be well advised to make it clear in the engagement letter (or at the very least in his report) that the problem is a complex one, that he has been given a very limited time in which to study it, that further time is required in order to consider it in depth and that the opinion or advice tendered might well be revised if further time were available to him. He should also state that the client is responsible for the accuracy and completeness of the information supplied to him. In all cases, the client should be warned about the risk of acting on the advice tendered before further investigation has been carried out.

**14** Members are sometimes requested to report on information relating not to past (and therefore ascertainable) results but to the expected results of future periods. The specific considerations which arise in one such type of engagement are set out in Handbook Section 3.908 Accountants' Reports on Profit Forecasts<sup>1</sup> to which reference should be made. However, there are many other forms of forecast and projection on which a member may be requested to report. Because of the significant risk inherent in reporting on any prospective financial information, members should exercise particular care in determining whether, and under what terms, to accept such engagements. The following are examples of warnings which might be included in engagement letters and reports as appropriate:

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<sup>1</sup>3.908 is still available from the Institute Library. Members are also referred to SIR 3000 Investment Reporting Standards Applicable to Public Reporting Engagements on Profit Forecasts (available from [www.frc.org.uk/apb/publications](http://www.frc.org.uk/apb/publications)).

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- *'The directors of [the company] are solely responsible for the projections and assumptions on which they are based. The projections have been prepared to illustrate the consequences of [the project]. Since the projections relate to an extended future period, actual results could be different because events and circumstances frequently do not occur as expected and do not therefore match the assumptions. The financial projections are by their nature not susceptible to audit and we are unable to express an opinion as to the possibility that they will be achieved.'*
- *'The directors of [the company] are solely responsible for the projections and assumptions on which they are based. The financial projections cover an extended future period for a company with no previous history and are based upon the directors' assumptions and estimates. The financial projections do not constitute a forecast and they could be materially affected by changes in economic and other circumstances. For this reason the actual [profits and cash flows] may vary considerably from those shown. The financial projections are by their nature not susceptible to audit and we are unable to express an opinion as to the possibility that they will be achieved.'*

**15** The following are further examples of situations in which it may be appropriate to alert the client to limitations or restrictions:

- an engagement undertaken in connection with a financing transaction where additional procedures may be necessary to enable the report user to reach a conclusion;
- a report based on the performance of agreed-upon procedures, not governed by professional standards, particularly when the parties who are acknowledging their responsibility for the sufficiency of the procedures for the purposes may not fully comprehend the limited nature of the work which they have requested;
- a report on financial information in which there are significant uncertainties likely to be resolved in the near future, where it would be appropriate to point out that the member has no responsibility to update his report for subsequent events;
- an engagement to report on a presentation prepared in conformity with the requirements of a contractual agreement or a regulatory provision, particularly when there are indications that third parties may have differing views, where it would be appropriate to state that no representations are being provided with regard to legal interpretation.

**16** Properly worded statements and warnings of the kind considered in paragraphs 13 to 15 above are not exclusions or restrictions of liability but definitions of the work undertaken and statements as to the extent to which the client can rely on it. They will help to protect a member from a claim from his client for negligence based on the contention that his enquiries should have been different from or more extensive than those so defined, provided that they are clearly included in the report and, preferably, incorporated into the contract with the client by being set out in the engagement letter or otherwise agreed (ideally in writing) by the client.

**(ii) To third parties**

**17** Definitions of scope of work or limitations on that work contained in an engagement letter will not be binding on any third party unless he has sight of the engagement letter or they are repeated in any report. Members should therefore ensure that they set out in their report, possibly by including a copy of the engagement letter, details of the precise work which has been carried out and its purpose and, as far as possible, the work which has not been carried out, together with any limitations on the work undertaken. If such matters are clearly set out in any report to which a third party might have access, members will be afforded some protection in relation to both the existence and scope of any duty of care owed to third parties who claim to have relied on the report. Where members are aware that specific third parties will have access to their report, they should also consider requesting them to sign a copy of the engagement letter to indicate acceptance of the terms, or if this is not possible, members should make it clear that they make no representations to third parties as to the sufficiency of the procedures adopted.

**Defining the purpose of reports**

**18** A member may be able to restrict his liability to his client by clearly restricting the use to which a report may be put. The restriction should be included in the engagement letter and should identify the purpose for which the work has been requested. Appropriate wording and its efficacy will depend on the circumstances of each individual case. The following is an example only:

*'This report/statement is intended solely for the information and use of the boards and managements of X Limited and Y Limited in connection with the proposed sale of Y Limited to A Limited and should not be used for any other purpose.'*

**19** 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 making clear that the document is only a draft. But if it is in fact intended to be relied upon or no final form is prepared, little or no protection will be afforded. A member should introduce a term into the engagement letter and restate it in the transmittal letter to make it clear to the client that he cannot rely on any document so marked, except with the member's consent. Similarly, where oral reports are likely to be provided prior to delivery of a final written report, members should make it clear in the engagement letter, and at the time of making the oral report, that such an oral report does not constitute the member's definitive opinions and conclusions and that these will be contained solely in the final written report.

**20** Where financial material is prepared or reported on by a member for some particular purpose, he will not usually be liable to an unknown third

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party who relies on it for any other purpose for which it is or may be unsuitable. In such cases, the member would usually have no reason to suppose that such reliance would be placed on it. Members would, however, be well-advised to make the position clear by including in the document itself a statement of the purpose for which it was prepared, along the lines of the example in paragraph 18 above.

### **Restricting the use of the member's name**

**21** Members should endeavour to ensure that no statement or document issued by their client (other than financial statements in the form in which they have been reported on by the member as auditor) bears their name unless their prior consent has been obtained. It is often desirable for a suitable paragraph to be included in the engagement letter.

**22** There have been occasions when the use of a member's name in a document 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 is aware that a client proposes to cite his name, he should inform the client that his permission must first be obtained and in appropriate cases he should withhold his permission.

### **Identifying the authorised recipients of reports**

**23** The implications of the duty of care to third parties are important for all members who produce or report upon financial statements or provide reports of various other kinds (whether for a fee or not) which may be relied upon by persons other than those for whom they were originally prepared. Some documents which by their nature will inevitably be subject to general publication, such as auditors' reports under the Companies Act or accountants' reports for listing particulars, may not by their nature be capable of being restricted as to their use. In other cases, however, it may be possible for a member to reduce his exposure to the claims of third parties by restricting the use of the report to named parties.

**24** It can be made a term of the contract between the member and his client that the member's report or statement may not be circulated to third parties without the member's prior written consent. If the client does then circulate the document he will be in breach of contract.

**25** In addition the reports or statements may appropriately contain a rubric specifically restricting circulation. For example:

*'Confidential: This report (statement) has been prepared for private use of X (the client) only.'*

When a document is so marked but is nevertheless relied upon by a third party without the member's consent, the member may still be able to resist liability on the basis that the third party was not a person whom he should have had in mind as being likely to suffer loss by his 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.

### **Limiting or excluding liability**

#### **To the client**

**26** In many cases a member may limit or occasionally even exclude liability in an agreement with a client, but this will not always be effective at law. The main relevant considerations are set out in paragraph 10 of the Appendix. Appropriate reference should be made in the letter of engagement to any exclusion or restriction of liability. 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 agreement to submit to the exemption provisions.

**27** It may be appropriate to exclude liability in respect of certain claims by the client where there has been fraud, misrepresentation or wilful default by the client or his employees. Such clauses cannot be introduced into engagement letters for certain statutory audits because of the general prohibition on any limitation of liability in section 310 of the Companies Act 1985 and corresponding provisions in some other statutes. They may, however, be appropriate in non-statutory audit work and in non-audit engagements. Members who are undertaking statutory audits which are not governed by the Companies Act 1985 should familiarise themselves with the relevant statutory provisions relating to liability to determine whether it is possible to limit their liability in respect of their audit work.

**28** For all engagements (other than certain statutory audits as discussed above) and particularly where the risks associated with a non-audit engagement are unacceptably high, members should consider the need to negotiate a limitation on the monetary amount of any liability to the client. The purpose of such a clause in the engagement letter is to put a monetary limit on the claims that a client can make for breach of the member's contractual obligations or negligence. The efficacy of such a clause will depend on whether it is reasonable, judged under the Unfair Contract Terms Act 1977, and some of the factors to be taken into account are set out in paragraph 10(b) of the Appendix. Members should ensure that any monetary limitation imposed under a contract is reasonable in amount and is agreed by means of a genuine negotiation with the client.

#### **To a third party**

**29** An exclusion or restriction of a member's liability will not generally avail him against a third party unless that third party has notice of the exclusion or restriction. Section 2 of the Unfair Contract Terms Act 1977 also applies to an attempt to exclude or restrict liability to third parties for negligence. It provides that where a person is in principle liable for negligence, he cannot exclude or restrict that liability by reference to a notice, except where the notice is reasonable. The same criteria for reasonableness are applied as to

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contractual terms (see paragraph 10(b) of the Appendix), but reasonableness is considered as at the time when the liability arose rather than at the time when the contract was made. In each case it will be for the member to prove the reasonableness of the term or notice on which he relies.

**30** Where a member prepares for his client a report which may be seen and relied upon by third parties, the member is recommended to include in his report a definition of the responsibilities of the engagement, the purpose of the report and its use, as discussed in paragraph 18 above. In addition to this, the member may also wish to exclude liability to third parties. Where the identity of the third party is known to the member, in view of the terms of the Unfair Contract Terms Act 1977, the member may well be in a better position if he were to enter into a separate contract with the third party, incorporating a fully negotiated exclusion or limitation of liability clause. This will prevent the third party from arguing that he had no notice of the exclusions. Alternatively, and in any case, the member may include a disclaimer in the report to the effect that he accepts no responsibility to any third party who may rely on the report. This may be effective, subject to the reasonableness test in the Unfair Contract Terms Act 1977. Care should be taken to ensure that third parties do not attempt to establish contractual status, for example by paying the member an unsolicited nominal sum, without obtaining the member's express agreement to the change in status or becoming party to the engagement letter.

**31** Where a member (necessarily with the authority of his client) passes information directly to a third party, the effectiveness of a disclaimer will depend upon the nature of the information. For example, when giving references or making statements regarding creditworthiness or similar matters, the normal commercial practice is to state that, although the reference or statement is given or made in good faith, the member accepts no financial responsibility for the opinion he expresses. Such disclaimers will generally be effective where the references or statements can be seen not to be information of a kind which is expected to be the result of extensive knowledge or research by the member.

**32** Sometimes, however, a member may supply directly to a third party information of a kind which the third party (unless he is told otherwise) can reasonably expect to be the result of research of a more or less extensive kind. An example of this is provided in technical release AUDIT 4/00 (TECH 29/00)<sup>2</sup> *Firms' reports and duties to lenders in connection with loans and other facilities to clients and related covenants*, which incorporates proposed disclaimers of responsibility for auditors who receive requests from banks to rely on audited accounts, either before or after the audit opinion has been signed.

**33** Where potential acquirers, investors or lenders request access to the working papers of the auditors of a target company or group, the auditors should only permit access on the basis of an agreed disclaimer of any duty or

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<sup>2</sup>See also AUDIT 1/01, Reporting for Third Parties.

liability as a result of providing access or information. This disclaimer should be obtained both from those to whom the access is granted (usually another firm of auditors) and from the potential acquirers, investors or lenders who make the request.

**34** A disclaimer may be appropriate in 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, substantial reliance upon it for a particular purpose would usually not be reasonable. A member can reinforce his 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 is appropriate:

*'No responsibility for loss to any person acting or refraining from acting as a result of any material in this publication can be accepted by Y [the member, the author or publisher]. Professional advice should be taken before applying the contents of this publication to your particular circumstances.'*

### **Obtaining an indemnity**

#### **From the client or a third party**

**35** It may be appropriate to obtain indemnities from clients in respect of claims from third parties arising from the contents of a report or directly from third parties. These indemnities, known as 'hold harmless' clauses, obligate the client or third party to indemnify the member from third-party claims but do not limit the third parties' ability to assert their claims.

**36** Indemnities may not be practical in situations where a report can be expected to receive wide circulation, such as in the case of accountants' reports in listing particulars or in an acquisition circular. Where use of the report is restricted, however, or where (as in the case of preliminary announcements of results by listed companies) there is no requirement for a public statement about the auditor's involvement to be made, it may be reasonable to include an indemnity against any claims or other losses which the auditor may suffer from actions by third parties, including the costs of defending any such action.

**37** It must be remembered that an indemnity does not prevent a claim from being brought against the indemnified party, it merely gives him a right to pass on his liability to the indemnifier. It follows therefore that if the indemnity is in some way ineffective or the indemnifier does not have adequate resources to meet the liability, the indemnified party will be left unprotected.

#### **Receiverships, trust and secretarial work**

**38** A member acting as a receiver incurs personal liability for his acts and may, in particular, incur liability under commercial contracts irrespective of negligence on his part. Accordingly, if a member appointed by a debenture holder to act in this capacity has to manage a business, he should endeavour to

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ensure that he is fully indemnified by the person who appoints him against all loss and damage arising from his management. If such an indemnity cannot be obtained, he should endeavour to ensure that contracts into which he enters on behalf of that business include a clause to the effect that he assumes no personal liability thereunder.

**39** 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 client.

### **Defining scope of professional competence**

**40** 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 and other consequences should the advice tendered be incorrect or misconceived. Although a member in general practice is deemed by the law only to undertake to bring a fair and reasonable degree of skill and competence to the problem on which he is required to advise, in appropriate circumstances this may include recognising the need to obtain the approval of his client to consult 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 is of the opinion that the matter on which his advice is sought does not fall within the normal scope of his accountancy practice. Members are reminded that one of the fundamental principles established in Section 3, Code of Ethics, 3.2, General Application (Part A), is that a member should not accept or perform work which he is not competent to undertake unless he obtains such advice and assistance as will enable him competently to carry out the work.

**41** Where the engagement arises as a result of a commercial agreement between other parties, the member will not be able to vary the terms of his engagement without a variation of the terms of the agreement by the parties to it. The member should therefore ensure that the terms of the engagement, as defined in the agreement, are acceptable and he should decline to accept any engagement where he is unable to fulfil the terms of the agreement or where he considers that the risks of the engagement are too high. Problems which a member may wish to avoid include: owing a duty of care to a party known to be litigious; owing a duty of care to both sides of a transaction; and being required to perform limited procedures or merely a preparation only engagement without any limitation clauses.

### **Conclusion**

**42** Members are reminded that, even if they use their best endeavours to ensure that they adopt all the relevant measures discussed above, they may still be exposed to legal claims from clients or third parties. Whether or not these claims have merit, members should ensure that they have established proper

procedures to deal with all claims promptly, to notify their insurers and to seek appropriate legal advice.

## **Appendix – Legal Considerations**

### **Defences to an action for negligence**

**1** It would be a defence to an action for negligence to show:

- a. that no duty of care had been owed to the plaintiff in the circumstances;  
or
- b. that there had been no negligence; or
- c. that the negligent act or omission had not been an effective cause of the plaintiff's loss; or
- d. in the case of actions in tort that no financial loss had been suffered by the plaintiff; or
- e. that the action was statute-barred.

The fourth 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.

### **Standard of work**

**2** Where there is a contractual relationship, unless an express agreement is made between the accountant and his client 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, whereby there is an implied term that the supplier (i.e., accountant) will carry out the service with reasonable skill and care. The same standard is applied by common law where there is a duty of care in tort.

**3** The skill and care required will be judged principally on the nature of the work agreed to be undertaken. An accountant who undertakes work of an unusually specialised nature, or work of a kind whose negligent performance is particularly liable to cause substantial loss, will usually be taken to have assumed a duty to exercise the higher degree of skill and care reasonably to be expected of any accountant undertaking such demanding work. This will, especially, be the case if he holds himself 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 liability merely because in the light of later events they prove to have been wrong, even if they amounted to an error of judgement, provided that they were arrived at using the skill and care which was reasonable for an accountant undertaking such work.

### **Liability to third parties**

**4** Liability to third parties may arise where there is a duty of care owed by the member in tort. Whilst an accountant will also almost always owe a duty of care to his own client, that duty is likely to be coextensive with his contractual duty.

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5 Following *Caparo Industries plc v. Dickman* (1990) 2 AC 605 HL, (see in particular the speeches of Lord Bridge at pages 620H to 621A and Lord Oliver at page 638 C to E), a duty of care to a particular third party may be owed by accountants where there are all of the following ingredients: foreseeability of damage to the third party, a relationship of proximity or neighbourhood with that third party, and a situation where it would be fair, just and reasonable to impose a duty of a given scope on the accountants. Although the courts have attempted to limit the circumstances in which a duty will be held to exist, it would be prudent to assume that it will exist in a situation where the accountant knows of the existence of a third party whom he reasonably expects to receive and rely on the accountant's work for a particular transaction or purpose and to whom damage will be caused if the work has been done negligently. The danger of a duty being imposed will be increased where that third party has no other source of advice and where the purpose of the accountant's work is to induce the third party to take the particular action that he has taken.

6 While it must be emphasised that each case will depend on its particular circumstances the courts have recognised a number of circumstances in which a liability to third parties in tort will not generally arise and indicated some of the material factors in addressing that issue:

Liability to shareholders/investors:

- a. The House of Lords decided in *Caparo Industries plc v. Dickman* (supra) that the auditors did not owe a duty of care to individual shareholders, whether or not they were existing shareholders, who purchased shares in the company in reliance on the audited accounts.
- b. In *Al-Nakib Investments v. Longcroft* (The Times, 4 May 1990) it was decided that a duty of care was owed to subscribers who relied on a prospectus but not to anyone else who bought shares in the market in reliance on the prospectus. However, there may be liability under section 152 of the Financial Services Act 1986 to investors where advisers' opinions or reports are contained in listing particulars.
- c. The Court of Appeal decided in *James McNaughton Group v. Hicks Anderson and Co* (1991) 1 All ER 135 that the auditors of a target company did not owe a duty of care to an identified takeover bidder who relied on draft accounts. The accounts were produced for the target and not for the bidder, they were in draft and not final and it was not foreseeable that the bidder would not take independent advice. On the other hand, the same court held in *Morgan Crucible v. Hill Samuel* (1991) Ch. 295 that it was plainly arguable that a duty of care was owed to an identified bidder by auditors where extracts from financial statements were included in the defence document which were intended to lead to an increased bid.

Liability to lenders:

- d. In *Al Saudi Banque v. Clark Pixley* (1989) 3 All ER 361 it was decided that auditors owed no duty of care to a bank lending money to a company in reliance on accounts, whether the bank was an existing creditor or not,

where the auditors were not aware of the bank's existence nor of the fact that lenders were relying on the accounts.

7 The implications of tortious liability are important for all accountants who produce reports or 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.

8 An accountant may sometimes be informed, before he 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 will be held to owe the same duty to the third party as to his client, unless he has taken steps to disclaim liability as discussed in paragraphs 27 to 32 of Section 9.1, Managing the professional liability of accountants, in which case his liability may be reduced.

9 It is, however, important that members should appreciate that the precise ambit of the test in *Caparo Industries plc v Dickman* (supra) remains uncertain and, for example, a duty of care to a third party may also arise when an accountant does not know that his work will in fact be relied upon by a particular third party, but only knows that it is work of a kind which is liable in the ordinary course of events to be relied upon by a third party, although it will be more difficult for an unidentified third party to show a sufficient degree of proximity to meet the test.

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

10 The following are the main relevant considerations.

Auditors under the Companies Acts and certain other statutes:

- a. Section 310 of the Companies Act 1985 makes void any provision in a company's articles or any contractual arrangement purporting to exempt the auditor from or to indemnify him against any liability for negligence, default, breach of duty or breach of trust. Whilst it is believed that this section only covers audit work as distinct from other work carried out by the auditor for the audit client, this question has not yet been decided by the court. 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 is very unlikely that an auditor would be relieved of liability. There are similar provisions in respect of audits under some other statutes.

The Unfair Contract Terms Act 1977:

- b. This Act introduces extensive restrictions upon the enforceability of exclusions and limitations of liability for negligence and breaches of contract (where a party contracts with an individual consumer or contracts on standard terms of business). Section 2 of the Act, which applies in

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England, Wales and Northern Ireland, makes void any exclusion or limitation of liability for negligence, even in a case where the other party has agreed to it unless the party seeking to rely on that exclusion or restriction can show that it was a fair and reasonable one in the circumstances which were or ought reasonably to have been known to or in the contemplation of the parties when the contract was made, or, where a non-contractual notice is relied on, in all the circumstances when the liability arose. Part II of the Act contains a somewhat similar provision applying as part of the law of Scotland. If a clause is held to be unreasonable, it is struck out in its entirety, leaving liability completely unlimited. Because the courts look at each individual case on its own facts, there is little general guidance as to what exclusions or restrictions of liability for negligence will be regarded as reasonable. There are, however, a number of specific factors which the courts may take into account when considering reasonableness.

These include:

- i. whether the client knew or ought to have known of the term – it must have been brought to the client’s attention before entering into the contract rather than buried in the small print on the back of a standard form;
- ii. the nature and bargaining powers of the parties – the more sophisticated the client and the greater his bargaining power, the more likely it is that the term will be held to be reasonable;
- iii. the resources of the accountant and the availability to him of insurance cover – the greater his resources, the higher any limit on the extent of liability should be;
- iv. the nature of the transaction and the size of the likely loss – the larger the transaction and any potential loss, the higher the limit should be;
- v. the availability of similar services from another provider without the client having to accept a similar exclusion or limitation – if there are other providers of similar services in the market who do not impose similar limitations then the client may not be able to argue that he was forced to accept the term;
- vi. the size of the fees payable – the higher the fees, the higher the limit should be;
- vii. whether any inducement was received by the client to agree to the term – an inducement to accept the term would make it easier to argue that the term was reasonable.

A total exclusion of liability is most unlikely to be considered reasonable other than in exceptional circumstances.