



**Audit and
Assurance Faculty**

The Audit Report and Auditors' Duty of Care to Third Parties

AUDIT 01/03

This guidance is issued by the Audit and Assurance Faculty of the Institute of Chartered Accountants in England and Wales in January 2003 to assist auditors in managing the risk of inadvertently assuming a duty of care to third parties in relation to their audit reports. The guidance does not constitute an auditing standard. Professional judgement should be used in its application.

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Preface

In recent years auditors have become increasingly aware of the risk of taking on responsibilities to third parties with regard to their audit reports. Sometimes a duty of care to a third party might be assumed inadvertently as a result of action or inaction by the auditors. The Institute has already issued a number of guidance documents to cover these risks and the guidance in these documents, for example in Audit 4/00 and Audit 1/01, remains relevant – see paragraph 1 below.

As the result of a legal judgment in the Scottish Court of Session auditors have considered whether they should include additional wording in their audit reports to protect against exposure to third party claims. The Institute believes that it is important to issue guidance that provides practical guidance for appropriate action which members may take.

The various options which firms may take in response to this judgment have been considered and the Institute has also taken the advice of Leading Counsel in this respect. The guidance in this Technical Release is based on the advice the Institute has received.

It should be noted that the court decision in the Scottish case in question was a preliminary order only on a legal point and is the subject of an appeal. Whilst the judgment might be overturned on appeal, the Institute recommends that members act now in accordance with this guidance. Even if this judgment is overturned on the basis of the particular facts of the case, the legal principle is not new and the initial finding may represent a trend in judicial thinking that may be followed by English courts and may encourage third parties to pursue claims.

It should also be emphasised that the best risk management policy is for firms to take the steps that are necessary to carry out quality audits. The Audit and Assurance Faculty has recently provided guidance on this in its publication *'Audit Quality'* – this makes it clear that the Institute actively promotes audit quality with a view to the production of audit reports that are independent, reliable and supported by adequate audit evidence. Nothing in this Technical Release in any way diminishes the messages provided in that publication.

The Questions and Answers in Appendix 4 have been included to assist members in dealing with possible misunderstandings that they might encounter.

Background

1. A recent Scottish judgment in *Royal Bank of Scotland v Bannerman Johnstone Maclay and others* ("*Bannerman*") has highlighted the potential exposure of auditors to parties, other than the members of a company as a body, who assert that they rely on audit reports, in circumstances where the auditors have failed expressly to disclaim responsibility to those third parties. The Institute is issuing this guidance to assist members in managing the risk of inadvertently assuming a duty of care in relation to their audit reports to third parties and to remind members of the guidance on these matters already given in the Institute Statements 919 (Audit 4/00 *'Firms' reports and duties to lenders in connection with loans and other facilities to clients and related covenants'*) and 920 (Audit 1/01 *'Reporting to third parties'*). Paragraphs 1-22 of Audit 4/00 are highly relevant to the matters considered in this Technical Release and so are reproduced in Appendix 3 to this guidance.
2. The facts of the *Bannerman* case were summarised in an article in the Audit and Assurance Faculty's newsletter *True & Fair* – an extract from this is reproduced in Appendix 1 to this Technical Release. The full text of the judgment can be found at www.scotcourts.gov.uk/opinionsv/mcf1807c.html.

Responsibilities of auditors

3. Auditors have a responsibility to carry out their audits in accordance with auditing standards. These responsibilities are unchanged as a result of the guidance in this Technical Release. The guidance is instead concerned with the question of to whom responsibilities are owed.

Wording to include in the audit report

4. It is clear that an auditor assumes responsibility for the audit report to the shareholders as a body. The decision in *Bannerman* indicates that the absence of a disclaimer may (depending on the other circumstances in the particular case) enable an inference to be drawn that the auditor has assumed responsibility for the audit report to a third party. Having taken advice from Leading Counsel, the Institute recommends that auditors who wish to manage the risk of liability to third parties use a disclaimer. The Institute would regard the following wording as appropriate (although other wording may also be appropriate, and auditors will have regard to any legal advice they may take), and as suitably placed in the first or second paragraph of the audit report:

"This report is made solely to the company's members, as a body, in accordance with Section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed."

5. An example unqualified audit report (based on the example in Appendix 3 of Bulletin 2001/2 'Revisions to the wording of auditors' reports'), with this wording included, is attached as Appendix 2 to this guidance. In the event that the text of the audit report differs from the example attached, a check should be made (with the assistance of legal advice where appropriate) to ensure that the language suggested above remains suitable without amendment.

Purpose of the recommended wording

6. Auditors' responsibilities to their clients remain unaltered and as stated in paragraph 3 above, they are still required to carry out the audit in accordance with auditing standards¹. The purpose of this clarification language is to reduce the scope for the assumption of responsibilities to third parties.

Wording for the engagement letter

7. The form of an audit report is a matter for the discretion of the auditors (see SAS 600 'Auditors' reports on financial statements'), provided that the opinion meets Companies Act requirements and is in accordance with auditing standards. It is not necessary to amend engagement letters to make provision for the clarification wording in the audit report outlined in paragraph 4. However, if auditors wish to inform their clients in this way, it might be helpful to include the following language in the engagement letter:

"As noted above, our report will be made solely to the company's members, as a body, in accordance with Section 235 of the Companies Act 1985. Our audit work will be undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. In those circumstances, to the fullest extent permitted by law, we will not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for the audit report, or for the opinions we form."

Other points to communicate to clients

8. When auditors include the recommended wording, it may be helpful to explain the following important points to their clients:
 - a) The inclusion of the new wording does not affect the auditors' obligations to their clients. In fact it clarifies that the audit is for the benefit of the company's members in accordance with section 235 of the Companies Act 1985. Auditors will have the same duties and liabilities to their clients as they have always had.
 - b) The new wording does not mean that auditors will never agree to take on responsibilities to third parties such as lenders. All it does is make clear that auditors will only accept duties that are expressly agreed. Auditors maintain that if parties want to rely on their work then they should approach the auditors to agree expressly the scope and nature of work auditors can do for them that meets their purposes².

Alternative and/or additional actions

9. Auditors may take alternative or additional steps to communicate with third parties which are intended to have the same effect as the words in the audit report recommended above. However, if auditors consider taking these alternative or additional measures, they judge them on their practicality and efficiency, as well as their effectiveness. In doing this they consider both the completeness and the timing of the measures they propose to take.
10. If the wording recommended in paragraph 4 above is included in audit reports, auditors nevertheless remain vigilant to avoid the words being overridden by actions (contemporaneous or subsequent) which are inconsistent. In particular, auditors are aware of circumstances that might give rise to a duty of care to a third party³. Where auditors wish to disclaim responsibility to the third party in these circumstances, as would normally be the case, they state this expressly in writing through the issue of a letter to the particular third party. Appendix 1 of Audit 4/00, tailored to the specific circumstances, can be used for this purpose.

Legal considerations

11. This guidance provides a summary of what the Institute believes to be the most relevant considerations, based on the law at the time of issue and advice from Leading Counsel, but should not be regarded as a substitute for the specific legal and professional advice which firms may need to take on particular matters or engagements.

Scope

12. This guidance applies to all Section 235 audit reports issued by firms. Auditors may also consider the application of the guidance to other public reporting engagements, such as interim reviews, regulatory reports and reports issued under other statutes.

¹ See paragraph 16 of Audit 4/00 reproduced in Appendix 3.

² See paragraphs 20-22 of Audit 4/00 reproduced in Appendix 3.

³ See paragraphs 8-9 of Audit 4/00 reproduced in Appendix 3.

APPENDIX 1

Extract from the article in the November 2002 issue of *True & Fair*

The Scottish Court of Session held that a company's auditors could owe a duty of care to a lending bank if they knew (or ought to have known) that the bank would rely on their client's audited accounts and they did not disclaim liability.

The background

Royal Bank of Scotland ("RBS") provided overdraft facilities to APC Limited and Bannerman Johnstone Maclay ("Bannerman") were APC's auditors. The relevant facility letters between RBS and APC contained a clause requiring APC to send to RBS, each year, a copy of the annual audited financial statements.

In 1998 APC was put into receivership with approximately £13,250,000 owing to RBS. RBS claimed that, due to a fraud, APC's financial statements for the previous years had misstated the financial position of APC and Bannerman had been negligent in not detecting the fraud. RBS contended that it had continued to provide the overdraft facilities in reliance on Bannerman's unqualified opinions.

Bannerman applied to the court for an order striking out the claim on the grounds that, even if all the facts alleged by RBS were true, the claim could not succeed in law because Bannerman owed no duty of care to RBS.

The decision

The judge held that the facts pleaded by RBS were sufficient in law to give rise to a duty of care and so the case can now proceed to trial.

This article does not deal in detail with the reasons behind the judgement or contrast it with previous cases such as the House of Lords' decision in *Caparo v Dickman*. This area of law is highly fact-dependent with situations examined on a case by case basis. However, one of the key reasons behind the decision highlights a significant potential exposure for auditors to third parties. The judge held that, although there was no direct contact between Bannerman and RBS, knowledge gained by Bannerman in the course of their ordinary audit work was sufficient, in the absence of any disclaimer, to create a duty of care owed by Bannerman to RBS. In order to consider APC's ability to continue as a going concern, Bannerman would have reviewed the facility letters and so would have become aware that the audited financial statements would be provided to RBS for the purpose of RBS making lending decisions. Having acquired this knowledge, Bannerman could have disclaimed liability to RBS but did not do so. The absence of such a disclaimer was an important circumstance supporting the finding of a duty of care.

Risk management lessons

It has long been and remains a risk that in dealing with third parties a duty of care may be inadvertently assumed by auditors in relation to their opinions. A key feature of this case is that there were no direct dealings between the auditors and the third party. In spite of this, the auditors were found to owe a duty to a third party based on knowledge of the use to which the bank could be expected to put the accounts acquired as part of their ordinary audit work (required by Auditing Standards), and without having done anything else to suggest a relationship of proximity with, or assumption of responsibility to, the third party. It was then the omission to send a disclaimer to the third party, rather than any positive action by the auditors, that supported the existence of the duty of care.

In the current economic environment, the consideration of the going concern basis in financial statements in accordance with SAS 130 is a key part of the audit process. This is likely to involve the review of loan agreements or facility letters. Given that many such agreements will contain a requirement that the borrower provide a copy of its accounts to the lender, auditors should consider what steps they should take to protect themselves by disclaiming liability to their clients' lenders.

APPENDIX 2

Example audit report with an unqualified opinion (based on the example in Appendix 3 of Bulletin 2001/2 'Revisions to the wording of auditors' reports')⁴

Independent Auditors' Report to the Shareholders of XYZ Ltd

We have audited the financial statements of (name of entity) for the year ended ... which comprise [state the primary financial statements such as the Profit and Loss Account, the Balance Sheet, the Cash Flow Statement, the Statement of Total Recognised Gains and Losses] and the related notes. These financial statements have been prepared under the historical cost convention [as modified by the revaluation of certain fixed assets] and the accounting policies set out therein.

This report is made solely to the company's members, as a body, in accordance with Section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditors

As described in the Statement of Directors' Responsibilities the company's directors are responsible for the preparation of financial statements in accordance with applicable law and United Kingdom Accounting Standards.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and United Kingdom Auditing Standards.

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the Directors' Report is not consistent with the financial statements, if the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and transactions with the company is not disclosed.

We read the Directors' Report and consider the implications for our report if we become aware of any apparent misstatement within it.

Basis of audit opinion

We conducted our audit in accordance with United Kingdom Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In our opinion the financial statements give a true and fair view of the state of the company's affairs as at ... and of its profit [loss] for the year then ended and have been properly prepared in accordance with the Companies Act 1985.

Registered auditors
Address
Date

⁴ This example is for an unlisted company. For a listed company additional wording will be required on directors' remuneration disclosures to reflect APB Bulletin 2002/2.

APPENDIX 3

Extract from Institute Statement 919 'Firms' reports and duties to lenders in connection with loans and other facilities to clients and related covenants' (Audit 4/00)

Introduction

- 1 The responsibilities of auditors to third parties in respect of the statutory audit report are established in case law. The House of Lords in its judgment in *Caparo Industries Plc v Dickman* (1990) 2 WLR 353 set out the essential ingredients by which the existence of a duty of care is to be recognised.
- 2 In his judgment, Lord Bridge described the salient features of earlier cases, stating that for a duty of care to a third party 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 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.
- 3 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 specifically to anticipate that the third party would rely on the advice or information given in deciding whether or not to engage in the transaction in contemplation.
- 4 Since the issue of the *Caparo* judgment, banks and other lenders have sought ways to document a direct and sufficient relationship between themselves and their customers' auditors so as to be able to rely on audit reports contained in financial statements prepared for statutory purposes.
- 5 This Statement gives guidance on the implications of such practices by lenders and the matters that should be taken into consideration by firms regarding the extent of their duty of care in respect of audit, review and other reports on financial statements which they may provide.
- 6 It also provides guidance on reports which firms may be requested to provide to lenders in connection with their clients' compliance with covenants and other conditions included in agreements for loans and other facilities.

Duties of Care for the Statutory Audit Report

- 7 Auditors would not normally expect to owe duties of care in respect of their audit report to anyone other than their audit client. However, the general trend of authorities since *Caparo* makes it clear that, unless there is an effective disclaimer, an auditor may owe a duty of care to a lender or other third party. The test is whether the auditor, in making the statements in the audit report, assumed a responsibility to a lender who may have been provided with those statements. This test is an objective one: it is not whether the particular auditor intended to assume such a responsibility, but whether a reasonable auditor in those circumstances would have assumed such a responsibility.
- 8 Whether a duty of care to a lender exists will depend upon all the circumstances. The following factors will, however, be relevant:
 - the precise relationship between the auditor and the lender;
 - the precise circumstances in which the audit report came into existence;
 - the precise circumstances in which the audit report was communicated to the lender, and for what purpose(s), and whether the communication was made by the auditor or a third party (such as the client);
 - the presence or absence of other advisers on whom the lender would or could rely;
 - the opportunity, if any, given to the auditor to issue a disclaimer.

- 9 Accordingly, auditors need to be alert to the possibility that circumstances may be such that, unless steps are taken to limit their exposure, they may, however inadvertently, have assumed responsibility and, therefore, a duty of care, to a lender for the statements in their audit report. This may result from events contemporaneous with the audit, such as the client's discussions with the lender, or from events subsequent to the audit, such as a request for sight of the most recent audited accounts. For this reason, the auditors' relationship with lenders needs to be managed carefully, using established risk management techniques, and clear statements defining the auditors' duties, if any.
- 10 In seeking to document a sufficient relationship so as to enable them to rely on the audited financial statements of their customers, certain banks have included 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 bank that, in connection with the facilities offered, the bank may rely on the audited financial statements of the borrower. An example of such a clause is as follows:
- 'The bank shall have received written acknowledgement from the borrower's auditor that in connection with the facilities or any increase or extension thereof the bank may, with the auditor's knowledge and consent, rely on the audited financial statements of the borrower (and the group) from time to time made available to the bank, directly or indirectly, in connection with the bank's assessment and monitoring of the financial condition of the borrower (and the group) and compliance with the terms and conditions of the agreement.'*
- 11 Whether a duty of care to a bank arises in fact will depend upon whether the criteria set out in paragraph 2 above are met. Nevertheless, auditors in receipt or aware of a request to provide acknowledgement of their responsibility to their client's bankers or other lenders should not allow it to go unanswered.
- 12 In addition to, or as part of, a notification which seeks to establish an ongoing duty of care, a duty in respect of a lending decision might also be established if the lenders write to a firm expressing their intention to rely on audited or reviewed financial statements in connection with a proposed transaction. The presumption in such a situation would be that the firm had accepted that it had a duty of care to the lender unless it had robustly denied it. Should the firm wish to disclaim responsibility to the lender, as would normally be the case, it should state this expressly in writing. An example of a response which might be appropriate and can be customised to the circumstances of the lender's notification is provided in Appendix 1 of Audit 4/00.
- 13 Where a firm is contemplating signing a statement containing a specific undertaking or form of words provided by the lender (rather than responding along the lines of Appendix 1 of Audit 4/00), it should consider obtaining legal advice regarding the consequences for its legal responsibilities to the lender of complying with such a request and discuss its proposed response with its client.

Draft accounts

- 14 Care needs to be taken in relation to the provision and circulation of draft audited or reviewed accounts to lenders prior to the report being signed. Whilst the courts have held that reliance upon draft audited accounts was not actionable because a reasonable auditor would not intend such reliance, nevertheless there may be circumstances in which a duty of care could arise based on statements in draft accounts. Accordingly, the status of the accounts needs to be stressed, and representations and assurances as to the reliability of the accounts, or whether the final position is likely to differ materially from that shown in the draft accounts, should be avoided.

Disclaimer of responsibility

- 15 Disclaimers of responsibility will be subject to a test of reasonableness set out in section 2 of the Unfair Contract Terms Act 1977. It is for a person seeking to rely upon the disclaimer to show it is reasonable, failing which it will be void. Disclaimers of responsibility to lenders (and other third parties) who seek to claim reliance on a report, and disclaimers made for the avoidance of doubt to confirm that a firm does not accept a duty to a lender or other third party to whom a report is shown or reference to a report is otherwise made, should be capable of being worded so as to pass the reasonableness test. Consequently they are an effective method of excluding or limiting a firm's liability to a lender or other third party.
- 16 Issuing a disclaimer of responsibility does not remove a firm's obligation to carry out the audit or review of the financial statements in accordance with Auditing Standards (or other applicable standards) and it should therefore plan, control and record its work appropriately.

The Contracts (Rights of Third Parties) Act 1999

- 17 The Contracts (Rights of Third Parties) Act 1999 came into force on 11 November 1999 and applies to all contracts entered into after 10 May 2000. Under the Act, third parties have the right to enforce a term of a contract if that is the intention of the parties, which intention shall be determined from the contract. An intention will be found if, upon proper construction, the contract purports to confer a benefit or an express term grants the right.
- 18 Accordingly, if under the engagement between the firm and the client reference is made to the provision of the accounts to a lender, or to a lender requiring the accounts for specific purposes, it is conceivable that a benefit will have been conferred upon that lender. Furthermore, in considering the reasonableness of any exclusion of liability to that lender, any such provisions will be taken into account, which has the potential of defeating any such exclusion in its entirety. It is therefore important that the engagement letter between the firm and the client makes clear that it does not confer any rights on any third party and that, for the avoidance of doubt, any rights conferred on third parties pursuant to the Contracts (Rights of Third Parties) Act 1999 shall be excluded.

Members in practice in Scotland

- 19 Though the Contracts (Rights of Third Parties) Act 1999 does not apply to Scotland, Scots law has long recognised the principle at common law of *ius quaesitum tertio* (a right vested in and secured to a third party in and by a contract between two parties). Accordingly a third party has the right to enforce a contract between two parties if the intention to confer a benefit on that third party can be gathered from the terms of the document. Members must therefore consider whether there is an express or implied intention that the third party acquires a right to enforce the contract. However, it should be borne in mind that each case depends upon its own circumstances and a member who is in doubt should seek independent legal advice.

Separate engagements to provide specific assurances to lenders

- 20 If a firm decides that it is able and prepared to provide specific assurances to a lender regarding, for example:

- financial statements where the audit or review report has been signed or will be signed in the near future;
- the design and/or operation of the client's systems of internal control or the financial reporting procedures; or
- other matters of primary interest to a lender,

they should be the subject of an engagement between the firm, the client and the lender which is entirely separate from the work on the financial statements and is the subject of a separate engagement letter and separate fee arrangements as agreed between the parties for whom the engagement is carried out.

- 21 Before a firm enters into such an engagement to provide specific assurances to a lender to a client, it should consider its position carefully in the light of the Accountancy Bodies' ethical statements since its responsibilities to the client and the lender could, in certain circumstances, present it with a conflict of interest. The same consideration applies when a loan agreement purports to appoint the firm as agent for, or financial advisers to, the lenders for the purpose of providing services and reports in connection with a loan agreement, facility or drawdown.
- 22 The firm should also consider professional guidance (e.g. the ICAEW Statement on 'Managing the Professional Liability of Accountants') in deciding the scope and terms of business of any engagement to provide specific assurances to a client's lenders.

APPENDIX 4

Questions and Answers intended to be of practical help for members in applying the guidance and in countering possible misunderstandings about it

References are to this guidance unless stated otherwise.

Q1: Does the inclusion of the recommended language devalue the audit?

A1: No, the purpose and value of the audit remains the same. It is still carried out in accordance with auditing standards and firms should be doing all they can to achieve the highest audit quality (see comments about this in the fifth paragraph of the Preface). However, other than the addressees of the audit report, readers of the audit opinion rely on the report entirely at their own risk and the auditors do not accept any duty or responsibility to them. The recommended language does no more than clarify to whom the auditors owe duties.

Q2: Aren't auditors paid to take on these risks?

A2: No, auditors are paid to carry out an audit to provide a report for, and only for, the members of the company as a body in accordance with Section 235 of the Companies Act 1985.

Q3: Is the legal position of auditors altered as a result of this guidance?

A3: No, the recommended language in the audit report simply clarifies to whom auditors owe duties as established by the case *Caparo Industries plc v Dickman* – see paragraph 6. Auditors are not restricting their liability to the members of the company as a body.

Q4: If my firm includes the wording as recommended in the audit report, does this guarantee that we will not owe any duty of care to third parties?

A4: No. Auditors should remain vigilant and take or avoid any additional actions as appropriate to prevent such duties being created – see paragraph 10 of this guidance and paragraph 15 of Audit 4/00.

Q5: My firm is considering the alternative option of writing to all banks expressly disclaiming any responsibility to them. Isn't this a suitable alternative to the wording for the audit report provided in this Technical Release?

A5: There are serious practical shortcomings. Banks are not the only third parties who may claim that the absence of a disclaimer is a circumstance enabling the inference of an assumption of responsibility by the auditors. Even as regards banks, there would be a risk that not all banks reading the audit report would have received the letter.

Q6: What do we do when a third party seeks our agreement in writing that they can rely on the audited accounts? In these situations there might be some client pressure to comply with this request.

A6: In these situations auditors clarify the purpose of the audit and their responsibilities with regard to it as set out in the audit report – see Appendix 2. The audit is for a specific purpose and is not carried out with the interests of third parties in mind. If lenders or other third parties seek assurance on certain matters auditors discuss the possibility of separate engagements to provide specific assurances to them – see paragraphs 20-22 of Audit 4/00.

