



THE AUDIT REPORT AND AUDITORS' DUTY OF CARE TO THIRD PARTIES

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This guidance was 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. It was updated in May 2018.

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PREFACE

Auditors have been aware of the risk of taking on responsibilities to third parties with regard to their audit reports for a number of years. Sometimes a duty of care to a third party might be assumed inadvertently as a result of action or inaction by the auditors.

As the result of a judgment in the Scottish Court of Session, ICAEW took the advice of Leading Counsel and issued guidance which recommended that auditors who wish to manage the risk of liability to third parties use wording expressing clearly to whom they owe a duty of care (a 'disclaimer').

The disclaimer recommended by ICAEW has subsequently been widely used by the profession in the statutory and non-statutory audit and other assurance reports of a range of entities.

Following a more recent judgment, as well as a number of changes to audit reports, ICAEW has again taken the advice of Leading Counsel and updated this guidance.

ICAEW continues to emphasise that the best risk management policy is for firms to take the steps that are necessary to carry out high quality audits. ICAEW's Audit and Assurance Faculty has provided guidance on this in its publications *Quality Control in the Audit Environment* on the International Standard on Quality Control 1 and *Improving Audit Quality Using Root Cause Analysis*, which actively promote audit quality. ICAEW's Audit and Assurance Faculty has also provided thought leadership on extended audit reports and the revolution in auditor communications in its publication *The Start of a Conversation*. Nothing in this guidance in any way detracts from what is said in those publications.

The Questions and Answers in Appendix 2 have been included to assist members in dealing with possible issues and misunderstandings that they might encounter.

BACKGROUND

1. A Scottish judgment in *Royal Bank of Scotland plc v Bannerman Johnstone Maclay and others* ('*Bannerman*') 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. ICAEW issued guidance in 2003 to assist members in managing the risk of inadvertently assuming a duty of care in relation to their audit reports to third parties.
2. A more recent judgment of the High Court in England has provided helpful guidance: *Barclays Bank plc v Grant Thornton* ('*Barclays*'). The case concerned non-statutory audit reports prepared by the defendant auditor, which were passed to the claimant bank. There was no contract between the bank and the auditor. The bank alleged that the reports had been prepared negligently; that the auditor must have known that they would be passed to it; and that it had suffered loss as a result of relying on the misleading reports. It further alleged that the auditor owed it a duty of care in tort. The auditor made a summary application for the claim to be struck out on the ground that the presence of a *Bannerman*-type disclaimer in the reports made it impossible for the bank to prove that it was owed a duty of care. The judge, Cooke J., accepted this argument and struck out the claim. His judgment recognised that such disclaimers are commonly incorporated in audit reports. In effect, he held that users of audit reports can be expected to be commercially sophisticated parties, and that there is no good reason not to give effect to the terms of a clearly expressed disclaimer.
3. ICAEW believes that the *Barclays* decision provides strong support for the approach which it has been recommending to members since 2003.

CHANGES TO AUDIT REPORTS

4. In June 2013, the Financial Reporting Council (FRC) issued a revised International Standard on Auditing (ISA) (UK and Ireland) 700 *The Independent Auditor's Report on Financial statements* which required auditors reporting on companies which complied with the UK Corporate Governance Code to provide significantly increased disclosure around risks, materiality and scope of the audit. The revisions were designed to complement changes to the UK Corporate Governance Code in October 2012 and were effective for the audits of financial statements for periods commencing on or after 1 October 2012.
5. In June 2016, the FRC issued new and revised ISAs (UK) which include the following:
 - 5.1 Impacting all audit reports - ISA (UK) 700 (Revised June 2016) *Forming an Opinion and Reporting on Financial Statements*; and
 - 5.2 Impacting the audit reports of listed, public interest and certain other entities - ISA (UK) 701 *Communicating Key Audit Matters in the Independent Auditor's Report*.

The changes are effective for the audits of financial statements for periods commencing on or after 17 June 2016.

6. Some of the key changes to audit reports for all entities are as follows:
 - 6.1 Changes to the order of the reports, for example the 'Opinion' section is the first section of the report; and
 - 6.2 New requirements to report on going concern and other information, together with more detailed descriptions of the responsibilities of the directors and auditor, which increase the length of the reports.
7. There are further new requirements for audit reports of listed entities, public interest entities and other entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code. These include the requirement to communicate key audit matters, which may increase the length of the reports considerably depending on the number of such matters identified and reported.
8. ICAEW has now updated this guidance to reflect these changes to audit reports.

RESPONSIBILITIES OF AUDITORS

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

WORDING TO INCLUDE IN THE AUDIT REPORT

10. It is clear that an auditor assumes responsibility for the audit report to the members as a body. The *Bannerman* decision, read with earlier case law, 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, ICAEW continues to recommend that auditors who wish to manage the risk of liability to third parties use a disclaimer. ICAEW would regard the following wording as appropriate, and as suitably placed as the final section of the audit report, directly preceding the auditor's signature:

'Use of our report

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. 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.'

11. An example of an unqualified audit report for a non-publicly traded company (based on the examples in Appendices 1 and 2 of the FRC's Bulletin: *Compendium of illustrative auditor's reports on United Kingdom private sector financial statements for periods commencing on or after 17 June 2016*), with this wording included, is attached as Appendix 1 to this guidance. The wording may also be included in this place in any of the example audit reports for general purpose financial statements, including those with the requirement to communicate key audit matters, in the FRC's Bulletin.
12. In the event that the text of the audit report differs from these examples, a check should be made (with the assistance of legal advice where appropriate) to ensure that this wording remains suitable without amendment. For entities other than companies, the reference to the Companies Act will need to be replaced with reference to the relevant legislation or, for non-statutory audits, the purpose of the report. ICAEW's Helpsheets *Preparing an audit report* include appropriate wording for entities other than companies, for non-statutory audits and for a range of specific situations.
13. Based on advice from Leading Counsel, ICAEW believes that it is desirable that the same wording should appear in the same position in audit reports generally. Consistency in these respects will promote clarity and certainty as to the scope of the auditor's responsibility.
14. A possible exception to the location suggested above is in the example audit reports for special purpose financial statements, single financial statements and specific elements, accounts or items in ISA (UK) 800 (Revised) *Special Considerations – Audits of Financial Statements prepared in accordance with Special Purpose Frameworks* and ISA (UK) 805 (Revised) *Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*. ISA (UK) 800 requires that for special purpose financial statements the auditor's report include an Emphasis of Matter paragraph alerting users to the fact that the financial statements are for a special purpose and further suggests that, where there is restriction on distribution or use, this is included as part of that paragraph. It would seem reasonable to treat this wording in the same manner.

PURPOSE OF THE RECOMMENDED WORDING

15. Auditors' responsibilities to their clients remain unaltered and as stated in paragraph 9 above, they are still required to carry out the audit in accordance with auditing standards. The purpose of the wording outlined in paragraph 10 above is to reduce the scope for the assumption of responsibilities to third parties.

WORDING FOR THE ENGAGEMENT LETTER

16. The form of an audit report is a matter for the discretion of the auditors (see ISA (UK) 700 (Revised June 2016) *Forming an Opinion and Reporting on Financial Statements*), provided that the opinion meets Companies Act requirements and is in accordance with auditing standards. It is not mandatory to amend engagement letters to make provision for the wording outlined in paragraph 10 above. However, having regard to the desirability of providing full information to the client, members may wish to include the following in the engagement letter:

'As noted above, our report will be made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. 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

17. When auditors include the wording outlined in paragraph 10 above, it may be helpful to explain the following important points to their clients:
- a) The inclusion of this 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 Chapter 3 of Part 16 of the Companies Act 2006. Auditors will have the same duties and liabilities to their clients as they have always had.
 - b) This 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. It must be clear that if third parties want to rely on the audit work then they should approach the auditors to agree expressly the scope and nature of work auditors can do for them that meets their purposes.

ALTERNATIVE AND/OR ADDITIONAL ACTIONS

18. Auditors may take alternative or additional steps to communicate with third parties which are intended to have the same effect as the recommended wording. However, ICAEW strongly recommends that the auditor's report should include a disclaimer in the terms set out above.
19. If the wording outlined in paragraph 10 above is included in the audit report, auditors should nevertheless remain vigilant to avoid the words being overridden by actions (contemporaneous or subsequent) which might be regarded as being inconsistent with the disclaimer. In particular, where auditors are aware of circumstances that might give rise to a duty of care to a third party. 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.

LEGAL CONSIDERATIONS

20. This guidance provides a summary of what ICAEW 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. The need for specific legal advice is particularly acute where auditors find that they are being asked to, or expected to, communicate directly with third parties in connection with the contents of the audit report.

SCOPE

21. This guidance applies to all audit reports issued by firms. Auditors should also consider the application of the guidance to other public reporting engagements, such as interim reviews, regulatory reports and reports issued under other statutes, as well as to private reporting engagements.

APPENDIX 1

Example audit report with an unqualified opinion for a non-publicly traded company (based on the examples in Appendices 1 and 2 of the FRC's Bulletin: *Compendium of illustrative auditor's reports on United Kingdom private sector financial statements for periods commencing on or after 17 June 2016*)¹

Independent auditor's report to the members of [XYZ Limited]

Opinion

We have audited the financial statements of [XYZ Limited] (the 'company') for the year ended [date] which comprise [specify the titles of the primary statements] and notes to the financial statements, including a summary of significant accounting policies. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards, including Financial Reporting Standard 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland (United Kingdom Generally Accepted Accounting Practice)*.

In our opinion, the financial statements:

- give a true and fair view of the state of the company's affairs as at [date] and of its [profit/loss] for the year then ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the Auditor's responsibilities for the audit of the financial statements section of our report. We are independent of the company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Conclusions relating to going concern

We have nothing to report in respect of the following matters in relation to which the ISAs (UK) require us to report to you where:

- the directors' use of the going concern basis of accounting in the preparation of the financial statements is not appropriate; or
- the directors have not disclosed in the financial statements any identified material uncertainties that may cast significant doubt about the company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the financial statements are authorised for issue.

Other information

The directors are responsible for the other information. The other information comprises the information included in the annual report, other than the financial statements and our auditor's report thereon. Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in our report, we do not express any form of assurance conclusion thereon.

¹ This example is for a non-publicly traded company. For listed entities, public interest entities and other entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code additional wording will be required, for example on key audit matters.

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In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact.

We have nothing to report in this regard.

Opinions on other matters prescribed by the Companies Act 2006

In our opinion, based on the work undertaken in the course of the audit:

- the information given in the strategic report and the directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the strategic report and the directors' report have been prepared in accordance with applicable legal requirements.

Matters on which we are required to report by exception

In the light of the knowledge and understanding of the company and its environment obtained in the course of the audit, we have not identified material misstatements in the strategic report or the directors' report.

We have nothing to report in respect of the following matters in relation to which the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Responsibilities of directors

As explained more fully in the directors' responsibilities statement [set out on page ...], the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the company or to cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

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[As part of an audit in accordance with ISAs (UK), we exercise professional judgment and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.
- Conclude on the appropriateness of the directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.]

OR

[A further description of our responsibilities for the audit of the financial statements is located on the Financial Reporting Council's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditor's report.]

Use of our report

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. 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.

[Signature]

John Smith (Senior Statutory Auditor)
For and on behalf of ABC LLP, Statutory Auditor
[Address]
[Date]

APPENDIX 2

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

Q1: Does the inclusion of the recommended wording 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 wording 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 Chapter 3 of Part 16 of the Companies Act 2006.

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

A3: No, the recommended wording simply clarifies to whom auditors owe duties as established by the case *Caparo Industries plc v Dickman*. Auditors are not restricting their liability to the entity which has retained them to carry out the audit. Subject to certain limited exceptions, the Companies Act 2006 makes ineffective any attempt to exclude or limit liability in that respect.

Q4: If my firm includes the recommended wording 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 19 of this guidance.

Q5: 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.

A5: 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 1. 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 may discuss the possibility of separate engagements to provide specific assurances to them.

The ICAEW Audit and Assurance Faculty is the professional and public interest voice of audit and assurance matters for ICAEW and is a leading authority in its field. Internationally recognised as a source of expertise, the Faculty is responsible for submissions to regulators and standard setters and provides a range of resources to professionals, providing practical assistance in dealing with common audit and assurance problems.

ICAEW connects over 150,000 chartered accountants and students worldwide, providing this community of professionals with the power to build and sustain strong economies.

Training, developing and supporting accountants throughout their career, we ensure that they have the expertise and values to meet the needs of tomorrow's businesses.

Our profession is right at the heart of the decisions that will define the future, and we contribute by sharing our knowledge, insight and capabilities with others. That way, we can be sure that we are building robust, accountable and fair economies across the globe.

ICAEW is a member of Chartered Accountants Worldwide (CAW), which brings together 11 chartered accountancy bodies, representing over 1.6m members and students globally.

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