

MANAGING THE PROFESSIONAL LIABILITY OF ACCOUNTANTS

Introduction

There are many areas of a Chartered Accountant's work that expose .01 them to the risk of a claim for damages due to his alleged negligence in performing his work. This circular addresses the major areas in which actions for negligence may be brought against Chartered Accountants by clients or third parties and suggests steps that Chartered Accountants may properly be able to take to reduce the risk of such claims.

South Africa has not yet experienced the worldwide phenomenon of .02 large-scale litigation against accountants, which has seen claims for horrendous amounts in, for example, the United States of America and Australia and in the former, has even led to the collapse of a substantial firm of accountants. This does not mean that practising firms will not face such claims in the future, and as South Africans become more aware of their rights, particularly in light of the fundamental rights provisions in the Constitution and the workings of the Constitutional Court in interpreting those rights, it is highly probable that Chartered Accountants in South Africa will face the same litigation explosion that the rest of the world has seen. Members, therefore, need to ensure that they manage the extent of their liability when providing professional services. Claims sometimes 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 circular, therefore, is in part to advise members on .03 ways to reduce misunderstandings as to the extent of liability that 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.

This circular deals only with the potential liability for professional .04 negligence that a member may incur because of an alleged act or default by him or by one of his employees or associates that 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, such as criminal acts, breaches of a statutory duty, other breaches of contract, etc.

- .05 Negligence in this circular means some act or omission that occurs because the member concerned has failed to exercise the degree of reasonable care and skill that is reasonably expected of him in the circumstances of that case.
- .06 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. Notwithstanding the other terms in the contract, there is an implied term that the member will perform his tasks in terms of the contract with reasonable care and skill. The care and skill required will be judged primarily on the nature of the work undertaken. Where a member undertakes work of an unusually specialised nature, or work of a kind whose negligent performance is particularly liable to cause substantial loss, he will usually be taken to have assumed a duty to exercise a higher degree of care and skill reasonably to be expected of any accountant undertaking such demanding work, especially if he has held himself out as being experienced in the kind of work in question. Opinions expressed or advice given will generally 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 in judgement, provided they were arrived at using the care and skill that was reasonable for an accountant undertaking such work.
- .07 A member may and usually will be liable to his client for negligence, not only in contract, but also in delict (civil wrong). He will also be liable for negligence to a third party to whom he owed a duty of care and who has suffered a loss as a result of the member's negligence.
- .08 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 steps that members can take to assist them in managing their liability.

Defining the scope and responsibilities of the engagement**(i) To the client****Identifying the terms of the engagement**

A member should ensure that, at the time he agrees to perform work for the client, the terms of his contract with the client are properly defined, preferably in writing. An engagement letter should be prepared setting out in sufficient 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 ISA 210 *Terms of Audit Engagements* (paragraph 5-9 Audit engagement letters) in this regard.)

Where the appointment has been the result of a successful proposal, the proposal will normally form the basis of the contract. Where a separate engagement letter is prepared, it should address any specific services or other contractual terms that 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 agreed by the member and the client, once again preferably in writing.

Defining the specific tasks to be undertaken

Besides reporting in terms of the Companies Act (1973) and other statutes, members are called upon to give opinions and advice in connection with many matters, and undertake a great variety of assignments. A member should make clear in his letter of engagement 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 that are not to be undertaken.

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 the scope of the

work. If a member undertakes to perform tasks that he does not then perform, he is prima facie in breach of contract and to be safe from legal action, he should obtain a variation of the contract (preferably 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 the work done in any invoice sent to clients is consistent with the terms of the engagement letter, any subsequent variation thereof, and the report.

Defining the responsibilities to be undertaken by the client

- .13 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 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. Financial statements prepared for the purpose of being submitted to the Receiver of 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 to 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 that 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. Therefore, if the member considers that some matter needs to be checked by the client, he should make this clear.
- .14 Where the client has directly or indirectly determined the nature or scope of the member's procedures to be undertaken in an engagement, 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

- .15 It may be appropriate to alert the client to limitations 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 or not it is appropriate to accept the engagement at the outset, having regard to the value to the client of the work that 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.

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 that arise in such matters are set out in the Audit and Accounting Guide Profit forecasts to which reference should be made. Because of the significant risk inherent in reporting on any prospective financial information, members should exercise particular care in determining whether or not, and if so under what terms, to accept such engagements. The following is an example of a warning that might be included in an engagement letter or report, as appropriate: .16

“The directors of [the company] are solely responsible for the projections and assumptions on which our report will be or is based. The projections have been prepared to illustrate the consequences of an engagement letter or report [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 following are further examples of situations in which it may be appropriate to alert the client to limitations or restrictions: .17

- An engagement undertaken in connection with a financing transaction where additional procedures may be necessary to enable the report user to reach a conclusion.
 - An engagement to report based on the performance of agreed-upon procedures, particularly where the parties that are acknowledging their responsibility for the sufficiency of the procedures for the purposes may not fully comprehend the limited nature of the work that they have requested.
 - An engagement to 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 where 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.
- .18 Properly worded statements and warnings of the kind expressed 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 the report. They will help 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 in 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

- .19 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, precise details of the work that has been carried out and its purpose and, as far as possible, the work that 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 may 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 that 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. 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. Members are also referred to Circular 11/94 The auditor's liability to a third party for further guidance in this regard.

Defining the purpose of reports

A member may be able to restrict his liability to his client by clearly .20 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 X Limited and should not be used for any other purpose."

Where a document is prepared in the first instance for discussion with, .21 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 on 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 letter of engagement 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, a member 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.

Where financial material is prepared or reported on by a member for .22 some particular purpose, he will not usually be liable to an unknown

third 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 upon it. A member 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 .20 above.

Restricting the use of the member's name

- .23 A member should endeavour to ensure that no statement or document issued by his client (other than financial statements in the form in which they have been reported on by the member as auditor) bears his name unless his prior consent has been obtained. Members are referred to Section 495 Inclusion of the name of a member in public practice in a document issued by a client in the Code of Professional Conduct for guidance in this regard.

Identifying the authorised recipients of reports

- .24 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) that may be relied upon by persons other than those for whom they were originally prepared. Some documents that by their nature will inevitably be subject to general publication, such as auditors' reports under the Companies Act, 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.
- .25 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 without the member's prior written consent, then the client will be in breach of contract.
- .26 In addition, the reports or statements may appropriately contain a section specifically restricting circulation. For example:

“Confidential

This report (statement) has been prepared for the 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 will 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 possible negligence. Such a section should be introduced only where the circumstances warrant it, as it would tend to be devalued by indiscriminate use in connection with documents that, by their nature, must receive a wide distribution.

Limiting or excluding liability to the client

In many cases, a member may limit or occasionally even exclude .27 liability in an agreement with a client, but this will not always be effective at law. Section 247 of the Companies Act 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. However, section 46 (3) of the Auditing Profession Act, 26 of 2005 provides that a registered accountant and auditor shall not incur any liability towards his client in respect of any opinion expressed or certificate given or report or statement made or statement, account or document certified by him in the ordinary course of his duties unless it is proved that any of the above actions were performed maliciously or pursuant to a negligent performance of his duties.

Appropriate reference should be made in the letter of engagement to .28 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.

It may be appropriate to exclude liability in respect of certain claims by .29 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 247 of the Companies Act. They may, however, be appropriate in nonstatutory audit work and in non-audit engagements. Members undertaking audits that are not governed by the provisions of the Companies Act should familiarise themselves with the relevant provisions relating to liability to determine whether or not it is possible to limit their liability in respect of such audit work.

- .30 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 or not it is reasonable, bearing in mind the amount of the monetary limitation imposed in terms of the contract, and whether or not it was agreed upon by means of a genuine negotiation with the client.

Limiting or excluding liability to a third party

- .31 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. In this regard, members are referred to Circular 11/94-*The auditor's liability to a third party*, for further guidance.

Obtaining an indemnity from the client or a third party

- .32 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.
- .33 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 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 that the auditor may suffer from actions by third parties, including the costs of defending such action.

It must be remembered that an indemnity does not prevent a claim from .34 being brought against the indemnified party. It merely gives him the right to pass on his liability to his 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.

Defining scope of professional competence

In expressing an opinion or giving advice on difficult and complicated .35 matters, 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 the Code of Professional Conduct (Section 130 - Professional competence and due care) is that a member should not accept or perform work that he is not competent to undertake unless he obtains such advice and assistance as will enable him competently to carry out the work.

Where the engagement arises as a result of a commercial agreement .36 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, therefore, should 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 that 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

- .37 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.

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Chief Executive**