THE AUDITOR’S LIABILITY TO A THIRD PARTY

The House of Lords’ decision in Caparo Industries PLC -v- Dickman (1990) has put the liability of the auditor to a third party into issue.

In the Caparo case it was concluded that a third party could not rely on the auditor’s report on statutory annual financial statements as grounds for a claim against the auditor based upon the alleged reliance on those financial statements. The basis for the decision was that the auditor’s statutory report is prepared for the specific purpose of enabling the members of a company to exercise their rights as members of the company, and it is not intended for and cannot be relied upon by a third party as grounds for a cause of action. There is a perception that the South African courts may well follow the Caparo decision in the event of a similar case arising in South Africa.

The auditor’s liability to a third party in South Africa is limited by statute in Section 20(9) of the Public Accountants’ and Auditors’ Act (the Act). This section can be summarised as follows:

- No liability to a client or to a third party shall arise unless the report was given maliciously or negligently.

- The auditor must know or, in the particular circumstances must reasonably be expected to know, at the time when the negligence occurred, that the client would use the report to persuade a third party to act or refrain from acting in some way, or that the third party would itself rely on such report.

- If, after the date of the original report, the auditor represents to the third party that the report was correct, while at such time the auditor knew or could in the particular circumstances reasonably have been expected to know that the third party would rely on such representation, then liability may exist.

It has become common for auditors to receive letters from creditors, prospective investors or bankers of their clients seeking to create a
duty of care between such third parties and the auditor. Some auditors advisedly are replying to the third parties disclaiming liability. Section 20(11)(b) of the Act specifically recognises the right of an auditor to disclaim liability to the person alleging reliance. A legal opinion has been obtained to establish whether or not a letter to a third party disclaiming liability, does in fact prevent this duty of care from being established.

05 The opinion makes it clear that there is a significant difference between a letter received before the conclusion of the audit and one received after an audit opinion has been expressed. A letter received before the audit might create a duty of care in view of the intimation of reliance. A letter received after an audit opinion has been expressed cannot create a duty of care if no duty of care existed at the date of the performance of the audit. It is therefore necessary to distinguish between the two instances.

**Letter received before an audit opinion is expressed**

06 The mere fact that a third party writes to the auditor expressing an intention to rely on the audited annual financial statements would not necessarily give rise to an actionable duty of care. However, when being made aware of a third party’s intention to rely on audited annual financial statements, it is of great importance to respond to this type of letter, as silence could easily be interpreted as confirmation that the audited annual financial statements can be relied upon for the purposes as stated in the letter from the third party.

**Letter received after an audit opinion has been expressed**

07 As mentioned above, a letter received after an audit opinion has been expressed cannot create a duty of care where none previously existed. This principle is reinforced by Section 20(9)(b)(i) of the Act which indicates that foreseeability “at the time when the negligence occurred” (see .03 above) is the determining factor.

08 The general expectation is that a South African court would not recognise the existence that a duty of care on the part of an auditor to the wider investing public but that special circumstances may alter the position. The legal opinion states that it is appropriate to respond to letters from investors in order to record the disclaiming of any liability
and to avoid any suggestion that silence may constitute a confirmation of the report referred to by the third party.

**Wording of the letters to be issued by auditors**
Suggested wording of the letters to be issued by auditors is included in Appendix 1 for instances where the notification is received before or during the audit and in Appendix 2 for instances where the notification of intention to rely on the auditor’s report is received on or after the date of the report.

**Johannesburg**
November 1994

**K G Mockler**
Chief Executive

Issued November 1994
APPENDIX 1

NOTIFICATION OF INTENTION TO RELY ON AN AUDITOR'S REPORT RECEIVED BEFORE OR DURING THE AUDIT

Dear Sirs,

We acknowledge receipt of your letter dated ......................... in which you state your intention to rely on the 199X audited financial statements of ......................... (client) and our report thereon, in connection with ......................... (indicate circumstances of involvement).

Our firm has been appointed to audit the financial statements of the company/close corporation* for the year ended ......................... in accordance with generally accepted auditing standards. The objective of an audit is to form an opinion as to whether or not the financial statements, the preparation and content of which are the responsibility of the directors/members* of the company/close corporation*, fairly present the state of the company/close corporation*'s affairs and of its results and cash flow information for the year then ended and whether or not they have been properly prepared in accordance with the relevant legislation.

Our audit will be/is being* performed in fulfilment of our function as auditors and will not be/has not been* planned in contemplation of the circumstances involving yourselves referred to above. The financial statements prepared in accordance with statutory requirements will not necessarily address your requirement as part of our duties as auditors to the company/close corporation*. Therefore, we do not accept any liability to you in relation to the circumstances involved.

However, we could suggest that you put your proposal to our client, ................ (name). If our client is agreeable we shall be willing to discuss the matter further with you. Any additional special work you require

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that we are able to perform would need to be the subject of a separate engagement.

Yours faithfully
Auditor CA(SA)
Address
Date

cc Client
* Delete whichever is not appropriate
APPENDIX 2

NOTIFICATION OF INTENTION TO RELY ON AN AUDITOR’S REPORT RECEIVED ON OR AFTER THE DATE OF THE REPORT

Dear Sirs,

We acknowledge receipt of your letter dated ......................... in which you state your intention to rely on the 199X audited financial statements of ....................... (client) and our report thereon dated ..........., in connection with ........... (indicate circumstances of involvement).

The firm was appointed to audit the financial statements of the company/close corporation* for the year ended ....................... in accordance with generally accepted auditing standards. The objective of an audit is to express an opinion as to whether or not the financial statements, the preparation and content of which are the responsibility of the directors/members* of the company/close corporation*, fairly present the state of the company/close corporation*’s affairs and of its results and cash flow information for the year then ended and whether or not they have been properly prepared in accordance with the relevant legislation.

Our audit was performed in fulfilment of our function as auditors and was neither planned nor conducted in contemplation of the circumstances involving yourselves referred to above. Neither our audit, nor the financial statements that have been prepared in accordance with statutory requirements, necessarily address or reflect matters in which you may be primarily interested. Therefore, we are not prepared to accept any responsibility to you in relation to our audit opinion and disclaim all liability to you in relation to the circumstances involved.

Yours faithfully

Auditor CA(SA)

Address

Date

cc Client
* Delete whichever is not appropriate