INSTITUTE OF CHARTERED ACCOUNTANTS OF BARBADOS
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LIMITATION CLAUSES IN THE AUDITOR'S REPORT

(Issued April 2016)

RESPONSIBILITIES OF AUDITORS

Auditors have a responsibility to carry out their audits in accordance with International Standards on Auditing, or other generally accepted auditing standards. These responsibilities are unchanged as a result of the proposed disclaimer discussed in this document. This document is instead concerned with the question of to whom responsibilities are owed.

SUMMARY

In 2003 - as a result of a ruling by a Scottish Court that allowed a third party to bring an action against an accounting firm – the UK accounting profession modified its standard form of audit report to confirm/clarify those to whom a duty of care is owed by the auditor.

BACKGROUND

The auditor's duty of care under the UK Companies Act is to the shareholders as a group, being those who appoint and pay for them. Consequently, they can bring an action against the auditors to recover losses suffered by the company that were caused by the auditors' negligence.

An extension of a duty of care to third parties can arise through the law of tort under which third parties may bring a claim on the basis that a duty is owed to them by the auditor as a result of particular circumstances. Case law in the UK has historically required some act of contact with the third party in order for sufficient proximity to arise for a claim in tort to be successful. This proximity would require the auditor to have knowledge that a particular third party would be relying on the audited financial statements for a particular purpose.

In a case in Scotland, – Royal Bank of Scotland v Bannerman Johnstone Maclay and others *("Bannerman")* the Court re-interpreted the tests of proximity such that no contact between the third party and the auditors is required. Instead, the auditor merely has to come across information in the ordinary course of their audit that indicates that a third party is likely to rely on the audited financial statements for a particular purpose and for the auditor not to disclaim any duty or liability to that third party.

In this case, Royal Bank of Scotland (RBS) lent money to APC Limited (APC) that was audited by Bannerman – Chartered Accountants. The terms of the loan required the Company to provide RBS a copy of their annual audited financial statements. APC went

into receivership owing RBS over 13 million pounds. RBS claimed that there were errors in the financial statements as a result of a fraud, and Bannerman was negligent for not finding the fraud. Bannerman argued that the case should be dismissed since it owed no duty of care to RBS. The Court ruled that Bannerman should have known that RBS was relying on its opinion on the financial statements because they would have reviewed the loan agreements that contained the provision about providing the audited financial statements to RBS. The court further ruled that, based on this knowledge, Bannerman has a duty of care to RBS unless they (Bannerman) expressly disclaim such responsibility in the auditor's opinion.

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.

RESPONSE OF THE UK PROFESSION

The UK accounting profession does not believe that it has a duty of care to third parties in situations such as Bannerman. As the Court ruled that, absent a disclaimer of responsibility, the auditor has a responsibility to third parties, the UK profession considered it appropriate to include such a disclaimer of responsibility to those third parties in the auditor's report i.e., eliminate the unintended duty of care to third parties that is not part of the auditor's duties under the terms of their appointment.

The Institute of Chartered Accountants in England and Wales issued a technical release in January 2003 entitled *The Audit Report and Auditors' Duty of Care to Third Parties* to specifically address the implications of this case. It recommended that auditors provide specific language regarding a disclaimer of responsibility in their report and suggested the following wording:

> ***This report is made solely to the company's members [shareholders], 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.***

OTHER COUNTRIES

The accounting profession in the Republic of Ireland has adopted similar guidance, as has the profession in Malaysia and in the Cayman Islands. The accounting profession in Hong Kong, China, South Africa and New Zealand are all using similar language in their reports on a selective basis pending formal guidance.

It is likely that many other countries that follow legal developments in the UK will also give consideration to making similar changes in their standard auditor's report.

ICAB'S RECOMMENDED ACTION

Professional accountants engaged in the audit of financial statements should continue to exercise appropriate professional judgment in determining to whom they owe a duty of care. Where based on the nature of the work performed by the practitioner it becomes apparent that a duty of care may be reasonably expected to exist, the practitioner should consider the appropriate course of action to be taken. This may include reviewing the terms of the engagement or modifying the report issued to ensure it is appropriate in the circumstances.

INCLUSION OF THE DISCLAIMER

The Institute of Chartered Accountants of Barbados (ICAB) has considered the appropriateness of the disclaimer and now recommends that local auditors who wish to manage the risk of liability to third parties and having appropriately determined to whom a duty of care is owed; use the disclaimer language included in Appendix 2 in their reports to disclaim a duty of care to any unintended users. As mentioned earlier, the auditors' responsibilities to their clients (i.e., the company's members, as a body) will remain unchanged.

An example audit report is attached in **Appendix 2**. The appendix includes the recommended language to be used for regulated entities which has been agreed with the Central Bank of Barbados. This language should be used for regulated entities under other regulators such as the Financial Services Commission. Also included is the recommended language for those entities that are not regulated.

PROPOSED WORDING OF THE ENGAGEMENT LETTER

While it is not necessary to amend engagement letters to make provision for the clarification wording in the audit report, this may be advisable in most circumstances. If auditors wish to inform their client in this way, then it might be helpful to include the following paragraph in the engagement letter:

> *As noted above, our report will be addressed solely to the company's members, as a body, in accordance with Section 147 of the Companies Act of Barbados. 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.*

POINTS TO COMMUNICATE TO CLIENTS

It may also be helpful to explain the following points to clients:

The inclusion of the disclaimer does not affect the auditor's obligation to their clients. Instead it clarifies that the audit is for the benefit of the company's members in accordance with Section 147 of the Companies Act of Barbados. Auditors will have the same duties and liabilities to their clients as they have always had.

The new wording does not mean that auditor 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 that auditors can do for them that meets their purposes.

ALTERNATIVE AND / OR ADDITIONAL ACTIONS

Auditors may take alternative or additional steps to communicate to third parties which are intended to have the same effect as the words in the auditor's 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.

If the recommended wording is included in audit reports, auditors should nevertheless remain vigilant to avoid the words being overridden by actions (contemporaneous or subsequent) which are inconsistent. In particular auditors should be aware of circumstances that might give rise to a duty of care to a third party.

APPENDIX 1

Questions & Answers (Extracted from the ICAEW 2003 Technical Release)

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. 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 the Companies Act (of Barbados).

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

Q3 No, the recommended language in the audit report is intended to clarify to whom the auditor owes duties as established by the case Caparo Industries Plc v Dickman. 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.

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 working 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 read 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. 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.

APPENDIX 2

INDEPENDENT AUDITORS' REPORT

To the Shareholders of
ABC Co. Ltd.

We have audited the accompanying [consolidated] financial statements of **ABC Co. Ltd.** [and its subsidiaries], which comprise the [consolidated] [statement of financial position or balance sheet] as of **DATE** , and the [consolidated] statement of income, statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the* [Consolidated] *Financial Statements

Management is responsible for the preparation and fair presentation of these [consolidated] financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of [consolidated] financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these [consolidated] financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the [consolidated] financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the [consolidated] financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the [consolidated] financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the entity's preparation and fair presentation of the [consolidated] financial statements 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 entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the [consolidated] financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the [consolidated] financial statements present fairly, in all material respects, the financial position of **ABC Co. Ltd.** [and its subsidiaries] as of **DATE** , and its/[their] financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards.

Other Matter

[1] ***This report is made solely to the Company's members [shareholders], as a body, in accordance with Section 147 of the Companies Act of Barbados. Our audit work has been undertaken so that we might state to the Company's members [shareholders] 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 and subject to any enactment or rule of law to the contrary, 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 opinion we have formed.***

[2] ***This report is made solely to the Company's members [shareholders], as a body, in accordance with Section 147 of the Companies Act of Barbados. Our audit work has been undertaken so that we might state to the Company's members [shareholders] 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 opinion we have formed.***

Chartered Accountants
DATE
Bridgetown, Barbados

[1] For use with regulated entities

[2] For use with non-regulated entities