

PROFESSIONAL RISK MANAGEMENT BULLETIN No. 2



HONG KONG
SOCIETY OF
ACCOUNTANTS

Technical Bulletin “Auditors’ Duty of Care to Third Parties and The Audit Report”

Jointly issued by Auditing and Assurance Standards Committee and Professional Risk Management Committee

This guidance is issued to assist practising members in managing the risk of inadvertently assuming a duty of care to third parties in relation to their audit reports. Practising members may choose to adopt alternative approaches to managing such risks, provided that such approaches comply with the relevant governing statutory provisions and Statements of Auditing Standards issued by the Hong Kong Society of Accountants (Society). The intended effect of the recommended clarification wording in the statement of auditors' responsibility of the audit report is to disclaim liability to parties other than those provided for in the Companies Ordinance. The use of such wording is not mandatory. This guidance does not constitute a Statement of Auditing Standards. Professional judgement should be used in its application.

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This Technical Bulletin is based on the Technical Release (Audit 01/03) “The Audit Report and Auditors’ Duty of Care to Third Parties” issued by the Audit and Assurance Faculty of the Institute of Chartered Accountants in England and Wales (ICAEW), adapted by the Society to the Hong Kong context. The Society gratefully acknowledges the permission given for the use of the material by the ICAEW which is the copyright owner.

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Preface

In recent years practising members have become increasingly aware of the risk of inadvertently assuming a duty of care 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 practising members. In 1999, the Hong Kong Society of Accountants (Society) provided guidance to practising members in Professional Risk Management Bulletin “Managing the professional liability of accountants” (PRMB1) on the subject of limiting or excluding liability to a third party by a disclaimer in any written advice or report. This guidance is contained in paragraphs 53 to 60 of PRMB1 and paragraphs 7 to 10 of Appendix I of PRMB1.

This Technical Bulletin draws practising members’ attention to the recent developments in the United Kingdom (UK) in relation to an auditors’ duty of care to third parties. A recent judicial decision arising in connection with the case *Royal Bank of Scotland v Bannerman Johnstone Maclay and Others (Bannerman case)* in Scotland has highlighted the risk 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 financial statements and they did not disclaim liability. It should be noted that the court decision in the *Bannerman case* in question was a preliminary order on a legal point and is the subject of an appeal.

As a result of the *Bannerman case* guidance was issued in January 2003 by the Audit and Assurance Faculty of the Institute of Chartered Accountants in England and Wales (ICAEW) to assist auditors in managing the risk of inadvertently assuming a duty of care to third parties in relation to their audit reports.

While the judgement in the *Bannerman case* might be overturned on appeal, the legal principle is not new and the initial finding may represent a trend in judicial thinking that may be followed by UK courts and may encourage third parties to pursue claims. Given that the establishment of liability under Hong Kong law has so far tended to follow the same route in law as the UK and certain other common law jurisdictions, the Auditing and Assurance Standards Committee (AASC) and Professional Risk Management Committee (PRMC) of the Society consider that it is important to provide further guidance to practising members on appropriate action which they may wish to take to help protect themselves against exposure to third party claims.

It should be emphasized that the best risk management policy is for practising members to take the necessary steps to carry out quality audits, and the Society 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 Bulletin in any way diminishes the need for practicing members to undertake their audits with appropriate level of quality and care.

Purpose of this Bulletin

1. The guidance below is to assist practising members in managing the risk of inadvertently assuming a duty of care in relation to their audit reports to third parties. The guidance clarifies a point of law as to the auditors’ responsibilities under the Companies Ordinance. It is based on advice received from Counsel.

Clarification wording in the statement of auditors’ responsibility of the audit report

2. It is clear that an auditor assumes responsibility for the audit report to the shareholders as a body. Having taken advice from Counsel, it is recommended that practising members who seek to manage the risk of liability to third parties adopt the following clarification wording in the statement of auditors’ responsibility of the audit report (although other wording may also be appropriate, and practising members should have regard to any legal advice they may take):

“It is our responsibility to form an independent opinion, based on our audit, on those financial statements and to report our opinion solely to you, as a body, in accordance with [section 141/section 141D] of the Companies Ordinance, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.”

Based on the advice from Counsel, the above wording which clarifies the responsibilities of the auditors under the Companies Ordinance will serve to disclaim liability to parties other than the shareholders as a body.

3. Examples of unqualified audit reports with this clarification language in the statement of auditors’ responsibility are attached as [Appendix 1](#) to this Technical Bulletin.

Purpose of the recommended clarification wording

4. The purpose of the recommended clarification wording is to attempt to reduce the scope for the assumption of responsibilities to third parties. Practising members’ responsibilities to their clients remain unaltered and they are still required to carry out an audit of the financial statements in accordance with Statements of Auditing Standards (SASs).

Clarification wording for inclusion in the engagement letter

5. It is not necessary to amend engagement letters to make provision for the clarification wording in the statement of auditors’ responsibility of the audit report outlined in paragraph 2. However, if practising members wish to inform their clients of the clarification wording in this way, it might be helpful to include the following clarification language as paragraph 1.4 in the section “Responsibilities of directors and auditors” in the example audit engagement letter in SAS 140 “Engagement letters”:

“1.4 Our report will be made solely to your shareholders, as a body, in accordance with [section 141/section 141D] of the Companies Ordinance, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of our report.”

Other points to communicate to clients

6. When practising members adopt the recommended clarification wording in the statement of auditors’ responsibility of the audit report, it may be helpful to explain the following important points to their clients:
 - a) The clarification wording merely clarifies a legal point as to where does the responsibility of auditors lie under the Companies Ordinance and does not affect the auditors’ obligations to their clients. It clarifies that the audit is for the benefit of the company’s members in accordance with section 141 or section 141D of the Companies Ordinance. Auditors will have the same duties and liabilities to their clients as they have always had.
 - b) The clarification 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 meet their purposes.

Alternative and/or additional actions

7. Practising members may take alternative or additional steps to communicate with third parties which are intended to have the same effect as the clarification wording in the statement of auditors' responsibility of the audit report recommended above. However, if practising members 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.
8. If the clarification wording recommended in paragraph 2 above is adopted in audit reports, practising members nevertheless remain vigilant to avoid the words being overridden by actions (contemporaneous or subsequent) which are inconsistent. In particular, practising members are aware of circumstances that might give rise to a duty of care to a third party. Where practising members 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, an example of such a letter, to be tailored to the specific circumstances, is set out in [Appendix 2](#) to this Technical Bulletin.
9. Where practising members are contemplating signing a statement containing a specific undertaking or form of words provided by the lender (rather than responding along the line of Appendix 2), they need to consider obtaining legal advice regarding their legal responsibilities and duties to the lender as a consequence of complying with such a request and also consider discussing their proposed response with their client.

Reasonableness test

10. The recommended clarification language will be subject to a test of reasonableness. It is for the auditors to show that it is reasonable, failing which it will be void.

Obligation to carry out an audit in accordance with SASs

11. The recommended clarification language in the statement of auditors' responsibility does not remove practising members' obligation to carry out an audit of the financial statements in accordance with SASs and practising members should therefore plan, control and record their work appropriately. It is imperative for practising members to note that the best risk management practice continues to be carrying out quality audits.

Legal considerations

12. This guidance provides a summary of what the AASC and PRMC believe to be the most relevant considerations, based on the law at the time of issue and advice from Counsel, but should not be regarded as a substitute for specific legal and professional advice which practising members may need to take on particular matters or engagements.

Scope of this Bulletin

13. This guidance applies to all audit reports issued by practising members pursuant to section 141 and section 141D of the Companies Ordinance. Practising members may also consider the application of the guidance to audit engagements for companies incorporated overseas or other public reporting engagements.

Appendix 1

Examples of unqualified audit reports

Example 1 – Company incorporated in Hong Kong

**AUDITORS' REPORT
TO THE SHAREHOLDERS OF XYZ LIMITED**
(incorporated in Hong Kong with limited liability)

We have audited the financial statements on pages to..... which have been prepared in accordance with accounting principles generally accepted in Hong Kong.

Respective responsibilities of directors and auditors

The Companies Ordinance requires the directors to prepare financial statements which give a true and fair view. In preparing financial statements which give a true and fair view it is fundamental that appropriate accounting policies are selected and applied consistently.

It is our responsibility to form an independent opinion, based on our audit, on those financial statements and to report our opinion solely to you, as a body, in accordance with section 141 of the Companies Ordinance, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

Basis of opinion

We conducted our audit in accordance with Statements of Auditing Standards issued by the Hong Kong Society of Accountants. 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 as to whether the financial statements are free from material misstatement. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements. We believe that our audit provides a reasonable basis for our opinion.

Opinion

In our opinion the financial statements give a true and fair view of the state of the company's affairs as at 31 December 20.. and of its profit [loss] and cash flows for the year then ended and have been properly prepared in accordance with the Companies Ordinance.

ABC & Co.
Certified Public Accountants
Hong Kong
Date

Example 2 - Company incorporated in Hong Kong submitting group accounts**AUDITORS' REPORT
TO THE SHAREHOLDERS OF XYZ LIMITED**
(incorporated in Hong Kong with limited liability)

We have audited the financial statements on pages to..... which have been prepared in accordance with accounting principles generally accepted in Hong Kong.

Respective responsibilities of directors and auditors

The Companies Ordinance requires the directors to prepare financial statements which give a true and fair view. In preparing financial statements which give a true and fair view it is fundamental that appropriate accounting policies are selected and applied consistently.

It is our responsibility to form an independent opinion, based on our audit, on those financial statements and to report our opinion solely to you, as a body, in accordance with section 141 of the Companies Ordinance, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

Basis of opinion

We conducted our audit in accordance with Statements of Auditing Standards issued by the Hong Kong Society of Accountants. 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 and the group'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 as to whether the financial statements are free from material misstatement. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements. We believe that our audit provides a reasonable basis for our opinion.

Opinion

In our opinion the financial statements give a true and fair view of the state of affairs of the company and of the group as at 31 December 20.. and of the group's profit [loss] and cash flows for the year then ended and have been properly prepared in accordance with the Companies Ordinance.

ABC & Co.
Certified Public Accountants
Hong Kong
Date

**Example 3 - Company incorporated in Hong Kong
applying section 141D of the Companies Ordinance**

**AUDITORS' REPORT
TO THE SHAREHOLDERS OF XYZ LIMITED**
(incorporated in Hong Kong with limited liability)

We have audited the balance sheet together with the notes thereon on pages to which has been prepared in accordance with accounting principles generally accepted in Hong Kong.

Respective responsibilities of directors and auditors

The Companies Ordinance requires the directors to prepare a profit and loss account and a balance sheet. Pursuant to section 141D of the Companies Ordinance, the balance sheet together with the notes thereon should be prepared in accordance with the requirements of the Eleventh Schedule to the Companies Ordinance. In preparing those statements it is fundamental that appropriate accounting policies are selected and applied consistently.

It is our responsibility to form an independent opinion, based on our audit, on the balance sheet together with the notes thereon and to report our opinion solely to you, as a body, in accordance with section 141D of the Companies Ordinance, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

Basis of opinion

We conducted our audit in accordance with Statements of Auditing Standards issued by the Hong Kong Society of Accountants. The audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the balance sheet and the notes thereon. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the balance sheet and the notes thereon, 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 as to whether the balance sheet together with the notes thereon is free from material misstatement. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the balance sheet together with the notes thereon. We believe that our audit provides a reasonable basis for our opinion.

Opinion

We report that we have obtained all the information and explanations which we have required.

In our opinion the balance sheet together with the notes thereon is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs as at 31 December 20.. according to the best of our information and explanations given to us, and as shown by the books of the company.

ABC & Co.
Certified Public Accountants
Hong Kong
Date

Appendix 2

Example disclaimer of responsibility to lenders for audit reports

[Lender Ltd]

Dear Sirs,

[Client Ltd] – [Loan Agreement/Transaction Reference]

We acknowledge receipt of your letter of [...date...] in which you state your intention to rely on the financial statements of Client Ltd for the year ended [...date...] and our audit report thereon [in connection with the above mentioned loan agreement].

Our audit of the financial statements [was/is] neither planned nor conducted for the purpose of (or in contemplation of) the loan agreement (and transaction) referred to above. In particular, the scope of our work [was/is] set and judgements made by reference to our assessment of materiality in the context of the financial statements taken as a whole, rather than in the context of your needs. For this reason, our work would not necessarily [have addressed/address] or reflect[ed] matters in which you may be primarily interested as lenders. Therefore, we cannot accept any responsibility to you in relation to our report and disclaim all liability to you in connection therewith (and your lending decision in relation to the proposed transaction and any other actions you may take).

Should you require any specific assurances from us regarding any matters in which you may be primarily interested as a lender, we should be happy to discuss them with you in the context of an engagement between ourselves, Lender Ltd and Client Ltd which would be entirely separate from our audit of Client Ltd's financial statements.

Yours faithfully,

ABC & Co.
Certified Public Accountants
Hong Kong
Date

cc Client Ltd