Technical Bulletin
Managing the professional liability of accountants [N1]
(Issued July 1999)

PART III - Detailed Discussion

Does one have the professional competence to undertake the work?

21. Members are reminded that one of the fundamental principles established in Explanatory Foreword to Professional Ethics (Handbook Section 1.200) is that a member should not undertake or continue professional work which he is not himself competent to perform unless he obtains such advice and assistance as will enable him competently to carry out his task.

22. In expressing an opinion or giving advice on difficult and complicated matters (for example in the field of taxation) and on matters where there are no clear precedents, members should bear in mind the magnitude of the financial and other consequences should the advice tendered be incorrect or misconceived.

23. 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.

24. 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.

25. Where the engagement arises as a result of an agreement between other parties, the terms of the engagement may depend upon the terms of the agreement and the member may not be able to vary the terms of his engagement without a similar variation being made to the terms of the agreement by the parties to it. The member should therefore ensure that he is able to fulfil the engagement which the agreement requiries. A discussion of the considerations which parties should bear in mind in relation to such agreements is set out in Appendix V.

26. A member may need to consider whether he should decline to accept an engagement where he considers that the risks of the engagement are too high. Problems which 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 compilation only engagement without any limitation clauses.

Have the scope of the engagement been clearly defined?

IN THE ENGAGEMENT LETTER :

Identifying the terms of the engagement

27. A member is well advised to ensure that, before he begins the engagement, the terms of his contract with his client are properly defined in writing.

28. An engagement letter should be prepared setting out in sufficient detail the terms of the engagement including the purpose for which the engagement has been undertaken, 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 also Statement of Auditing Standards SAS 140 Engagement Letters).

29. Where the appointment has been the result of a successful proposal, unless a separate contract is agreed with the client, the proposal will normally, once accepted, form the contract. The acceptance should be in writing. Where a separate engagement letter is prepared, it would supersede the proposal. Care should be taken to ensure that any specific services or other contractual terms which have been agreed at the proposal stage are addressed in the subsequent engagement letter.

30. 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 recorded in writing and agreed in writing by the member and the client.

Defining the specific tasks to be undertaken

31. No matter what kind of work a member is undertaking to carry out he should make clear in his engagement letter 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 (see paragraphs Nos. 34-36 below), setting out in detail the specific tasks to be undertaken and, where appropriate, excluding those tasks which are not to be undertaken.

32. 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. If a member undertakes to perform tasks which he does not then perform, he is prima facie in breach of contract. To be safe from action he should obtain a variation of the contract (evidenced 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. Different considerations will of course apply where the engagement is a statutory audit. However, this paragraph will apply to non-statutory audit engagements and to situations where a member performing a statutory audit has agreed to carry out work beyond the normal scope of an audit engagement.

33. Members should also ensure that the description of work done in any bills sent to clients is consistent with the terms of the engagement letter, any subsequent variation of those terms and the report.

Defining the responsibilities to be undertaken by the client

34. 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 may be 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. Tax and accounting schedules prepared for the purpose of being submitted to the Inland Revenue Department for the assessment of taxation will frequently, although not invariably, fall within this category. The engagement letter should make clear that the client is responsible for the accuracy and completeness of any information or documentation provided by him, and if the member considers that some matter particularly needs to be checked by the client he should make this clear. Ensuring that the client is aware of his responsibilities should help to protect the member from any subsequent dispute with the client.

35. The letter of engagement should also set out the responsibilities not only of the client but also of any other parties who might be involved. An example would be where a "multi disciplinary" team of professional advisors is involved and there is a need to ensure a clear distinction between the work undertaken by the member and that to be undertaken by other professionals.

36. Where the client has directly or indirectly determined the nature and scope of the member's procedures to be undertaken in an engagement ("agreed-upon procedures") 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

37. It may be appropriate to alert the client to limitations in or restrictions on the scope of the member's work in response to risks unique to a particular engagement.

38. The most common example is where the client requires an immediate answer to a complicated problem. In such circumstances the member should be particularly careful in considering whether it is appropriate for him to accept the engagement at the outset, having regard to the extent of work which it is feasible for the member to carry out under those circumstances. 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.

39. 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 which arise in one such type of engagement are set out in Auditing Guideline 3.341 Accountants- Report on Profit Forecasts to which reference should be made. However there are many other forms of forecast and projection on which a member may be requested to report. Because of the significant risk inherent in reporting on any prospective financial information, members should exercise particular care in determining whether, and under what terms, to accept such engagements. The following are examples of warnings which might be included in engagement letters and reports as appropriate:

- "The directors of [the company] are solely responsible for the projections and the assumptions on which they are based. The projections have been prepared to illustrate the consequences of [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 directors of [the company] are solely responsible for the projections and the assumptions on which they are based. The financial projections cover an extended future period for a company with no previous history adirectors- assumptions and estimates. The financial projections do not constitute a forecast and nd are based upon the they could be materially affected by changes in economic and other circumstances. For this reason the actual [profits and cash flows] may vary considerably from those shown. 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."

40. The following are further examples of situations in which it may be appropriate to alert the client to limitations or restrictions:

- an engagement undertaken in connection with a transaction where additional procedures may be necessary to enable the report user to reach a conclusion;
- a report based on the performance of agreed-upon procedures, not governed by professional standards, particularly when the parties who are acknowledging their responsibility for the sufficiency of the procedures for the purposes may not fully comprehend the limited nature of the work which they have requested;
- a 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 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 when there are indications that third parties may have differing views on how the agreement or provision should be interpreted, where it would be appropriate to state that no representations are being provided with regard to the interpretation of the terms of the agreement or provision.

IN THE REPORT :

41. Members should ensure that they set out in their report, possibly by including a copy of the engagement letter, details of the precise work which has been carried out and its purpose and, as far as possible, the work which has not been carried out, together with any limitations on the work undertaken.

42. Draft and oral reports - Where a document is prepared in draft for discussion with, 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 upon it. The point should be made in the engagement letter that no reliance should be placed on a draft or oral report. This point should also be made at the time of making the oral report or the draft report, that such report does not constitute the member's definitive opinions and conclusions and that these will be contained solely in the final written report.

Have the purpose and authorised recipients of reports been clearly defined?

43. A member may be able to restrict his liability by clearly restricting the intended recipients of his advice and the use to which a report may be put. The restriction should be included in the engagement letter and in any advice or report. The appropriate wording and its efficacy will depend on the circumstances of each individual case. The following is an example only:

    "This report/statement is for the sole use of X for the purpose of/in connection with Y. It should not be used or relied upon by any other person or for any other purpose."

    When a document is so marked but is nevertheless relied upon by a third party without the member's knowledge or consent, the member should normally not incur a liability to the third party.

44. Some documents which by their nature will inevitably be subject to general publication, such as auditors- reports of public companies under the Companies Ordinance or accountants- reports for listing particulars, may not 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.

45. 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 he will be in breach of contract.

46. The implications of the duty of care to third parties are important for all members who produce or report upon financial statements or provide advice or reports of various other kinds (whether for a fee or not) which may be relied upon by persons other than those for whom they were originally prepared.

Has an appropriate restriction been imposed on the use of the member's name?

47. Members should endeavour to ensure that no statement or document issued by their client (other than financial statements in the form in which they have been reported on by the member as auditor) bears their name unless their prior consent has been obtained. It is often desirable for a suitable paragraph to be included in the engagement letter.

48. There have been occasions when the use of a member's name in a document has been interpreted by third parties as implying that the company is financially sound and well conducted, whether or not this is in fact the case. If a member is aware that a client proposes to cite his name, he should inform the client that his permission must first be obtained and in appropriate cases he should withhold his permission.

Have appropriate steps been taken to limit or exclude liability?

TO THE CLIENT:

49. In many cases a member may limit or occasionally even exclude liability in an agreement with a client, but this may not always be effective at law. The main relevant considerations are set out in paragraph No. 11 of Appendix I. Any term or provision seeking to restrict or exclude liability to the client must be expressly agreed by the client and included in the engagement letter or other contract documents.

50. It will be appropriate to exclude liability in respect of certain claims by the client where there has been fraud, misrepresentation or wilful default by the client or his employees.

51. For all engagements (other than statutory audits as discussed [below]) members may wish to 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, normally by way of a multiple of fees. The effectiveness of such a clause will depend on whether it is judged reasonable under the Control of Exemption Clauses Ordinance Cap 71 and, where the client is classified as a 'consumer', the provisions of the Unconscionable Contracts Ordinance Cap 458. Some of the factors to be taken into account are set out in paragraph No. 11(b) of Appendix I.

52. Clauses seeking to limit or exclude liability cannot be introduced into engagement letters for statutory audit appointments under the Companies Ordinance Cap 32 because of the general prohibition on any limitation of liability in section 165 of the Companies Ordinance (see paragraph No. 11 of Appendix I). They may, however, be appropriate in non-statutory audit work and in non-audit engagements. Members who are undertaking statutory audits which are not governed by the Companies Ordinance (for example audits of foreign corporations) should familiarise themselves with the relevant statutory provisions to determine whether it is possible to limit their liability in respect of their audit work.

TO A THIRD PARTY:

53. It will in most cases also be necessary to consider and exclude or limit potential liabilities to third parties. Paragraphs Nos. 7 to 10 of Appendix I discuss the circumstances in which a member may become liable to someone other than his client. Since an increasing number of claims against accountants are made by third parties, it is essential that steps are taken to avoid this risk.

54. In most cases it will be appropriate to try and exclude liability to third parties by inserting a clause in any written advice or report such as the example given in paragraph No. 43 above.

55. Alternatively, if a member is requested by his client to produce a report or advice which will be shown to a third party (for example, the client's bank) and upon which the client wishes the third party to be able to rely, the member may consider whether he is prepared to accept that risk. If he chooses so to do then he should consider taking one or both of the following steps:-

(a) obtaining an indemnity from his client against claims by the third party (see paragraphs Nos. 61-63 below);

(b) entering into a separate engagement with the third party and negotiating a separate limitation of liability as discussed in paragraph No. 51 above.

Members should, however, consider carefully and, if appropriate, seek legal advice before accepting such third party risks.

56. Members should take particular care in situations where they are providing information or advice directly to a third party or which they know will be communicated to a third party. An example of such a situation is when the auditor of a target company is requested to provide information to a potential acquirer or its investigating accountant. In such situation, the member should provide a written disclaimer to the third party along the following lines:-

"The information/explanations provided to you at the request of [the client] should not be relied on by you or any other parties. We accept no responsibility and expressly disclaim any liability to you. Should you choose to rely on information/explanations provided by us, you do so entirely at your own risk."

Reference should also be made to Appendices III and IV.

57. Members should be particularly careful in situations where a third party attempts to establish a contract between it and the member, for example by sending an unsolicited cheque purportedly in payment for advice.

58. Where potential acquirers, investors or lenders request access to the working papers of the auditors of a target company or group, the auditors should only permit access on the basis of an agreed disclaimer of any duty or liability as a result of providing access or information. This disclaimer should be obtained both from those to whom the access is granted (usually another firm of auditors) and from the potential acquirers, investors or lenders who make the request. An example of a release letter to prospective purchaser / investor / lender and investigating accountants and an example of a client authorisation letter to allow access to client confidential information containing such "disclaimer" clauses are given in Appendices III and IV respectively.

59. A disclaimer may be appropriate in a document which is prepared neither in response to the instructions of a particular client nor for any statutory or public purpose: e.g. a text book or a newsletter. In such cases, reliance upon it for a particular purpose would usually not be reasonable. A member can reinforce his legal position in relation to documents of this kind by including a disclaimer of liability in the document itself. The form of the disclaimer will depend upon the nature of the document. In many cases a disclaimer along the following lines is appropriate:

"Nothing in this [article] should be taken as constituting any representation or advice. No responsibility for loss to any person acting or refraining from acting as a result of any material in this publication can be accepted by Y [the member, the author or publisher]. Professional advice should be taken before applying the contents of this publication to your particular circumstances."

60. The Control of Exemption Clauses Ordinance also applies to an attempt to exclude or restrict liability to third parties for negligence. It provides that where a person is in principle liable for negligence, he cannot exclude or restrict that liability by reference to a notice, except where the notice is reasonable. The same criteria for reasonableness are applied as to contractual terms (see paragraph No. 11(b) of Appendix I). In each case it will be for the member to prove the reasonableness of the term or notice on which he relies.

Have appropriate steps been taken to obtain an indemnity?

From the client or a third party

61. 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 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. See example in Appendix III.

62. Indemnities may not be forthcoming 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 (as in the case of preliminary announcement of results by listed companies) 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 which the auditor may suffer from actions by third parties, including the costs of defending any such action.

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

Receiverships, trust and secretarial work etc.

64. A member acting as a receiver incurs personal liability for his acts and may, in particular, incur liability under commercial contracts irrespective of negligence on his part. Accordingly, if a member appointed by a debenture holder to act in this capacity has to manage a business, he should endeavour to ensure that he is fully indemnified by the person who appoints him against all loss and damage arising out of his management. If such an indemnity cannot be obtained, he should endeavour to ensure that contracts into which he enters on behalf of that business include a clause to the effect that he assumes no personal liability thereunder.

65. It is often prudent for a member who is appointed to act as a trustee or asked to carry out certain secretarial work, such as cheque signing, to obtain an appropriate indemnity. In the former case, an instrument creating a trust can give a wide form of indemnity if the settlor is willing to approve its inclusion in the deed; in the latter, the member should arrange for an indemnity to be obtained from his client.

PART IV - Conclusion

66. 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.

N1: This statement is based on similar guidance issued by The Institute of Chartered Accountants in England and Wales (ICAEW) appropriately adapted to the local context. The Society gratefully acknowledges the permission given by the ICAEW in this respect.

| Part I | Part II | Part III & IV |

| Appendix I | Appendix II | Appendix III | Appendix IV | Appendix V |