Auditors beware: the dangers of taking on duties to banks without realising

The HKSA issued a Technical Bulletin on 27 May 2003 entitled 'Auditors' Duty of Care to Third Parties and the Audit Report' to assist practising members in managing the risk of inadvertently assuming a duty of care to third parties in relation to their audit reports. The Bulletin recommends the addition of clarification wording in the statement of auditor's responsibility in the audit report.

The Technical Bulletin was prompted by a recent first instance decision of a Scottish Court in the case of *Royal Bank of Scotland v Bannerman Johnstone Maclay* [2003] PNLR 77 and subsequent guidance issued in the form of a Technical Release by the Audit and Assurance Faculty of the ICAEW.

The ICAEW Technical Release is aimed at assisting auditors in managing the risk of inadvertently assuming a duty of care to third parties in respect of audit reports. It recommends that auditors include additional wording in their reports to protect against such exposure. The Securities and Exchange Commission ('SEC') in the United States has written to the ICAEW to say that it will not accept for filing an audit opinion prepared in accordance with US generally accepted audit standards that contains the clarifying language recommended in the Technical Release.

Risks

It is worth reviewing the circumstances in which the Court's decision in *Bannerman* was made to highlight the risks that auditors can face without even realising it.

Royal Bank of Scotland ('RBS') had been principal lender to APC Limited. It was a requirement of their facility letters that APC provide audited accounts to RBS within six months of the financial year-end. Copies of the audited accounts of APC for the periods ended 30 November 1995 and 31 March 1997 with clean audit opinions provided by Bannerman Johnstone Maclay, APC's auditors, had been provided to RBS.

RBS asserted that it had relied on the audited accounts in extending further loans to APC and its wholly owned subsidiary and in taking an equity stake in the business. APC ran into financial difficulties and RBS failed to recover its loans and investment. RBS subsequently commenced proceedings against Bannerman alleging that the accounts had been wrong and had been negligently audited.

Duty of care

The basis for asserting a duty of care existed included:

- Bannerman's knowledge that RBS was providing working capital to APC, a cash hungry business;
- the knowledge which Bannerman would have had of the facility letters and the requirement that audited accounts be supplied together with monthly management accounts; and
- the knowledge which Bannerman had or ought to have had that RBS would rely on the audited accounts as a cross check on the management accounts and in deciding whether to maintain its financial support.

Application to strike out

Bannerman applied to strike out the claim on the basis that the facts alleged were not sufficient to found a duty of care. In particular, Bannerman argued that a duty of care would only arise if the auditor intended that the bank should act in reliance on the information supplied and there was no allegation to this effect in RBS's pleadings. Indeed, there was no suggestion of any direct contact between RBS and Bannerman.

The judge rejected Bannerman's application and, in particular, the requirement that auditors should intend reliance by the Plaintiff for a duty of care to arise. The judge held that a proper analysis of the authorities indicated that a Plaintiff would need to establish knowledge of relevant matters on the part of the auditors in order for the court to hold that a duty of care arises. The judge considered the cases which indicated that it was necessary to show that the auditor intended the Plaintiff should rely on the accounts for a duty to arise. He remarked they only did so because the pleaded allegations had not gone beyond the assertion that reliance was reasonably foreseeable which was not enough on its own for the necessary relationship of proximity to exist.

The judge relied on the decision of the House of Lords in *Caparo Industries plc v Dickman* [1990] 2 AC 605. He stated that for a relationship of proximity to be held to exist the adviser must at the time when the advice is given know: (1) the identity of the person to whom the advice or information is to be communicated, (2) the purpose for which that person is to be provided with the advice or information, and (3) that the person to whom the advice or information is

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communicated is likely to rely on it for the known purpose.

Bannerman had argued that once they had accepted office as auditors of APC, they were under an obligation to audit the annual accounts. They argued that knowledge they acquired as auditors that RBS was likely to place reliance on the audited accounts could not yield an inference that they had accepted responsibility to RBS to exercise reasonable care in their work. They remained under an obligation to APC to audit the accounts and had no freedom of choice as to whether to do so. The judge indicated that he could see force in the argument if Bannerman truly had had no alternative course of action available to them. That was not the case as he suggested that they could have issued a disclaimer to RBS. As they had not done so, the judge held that they could be taken to have assumed responsibility to RBS.

The judge had greater difficulty in considering other issues arising from the case. The first was whether a duty of care would arise in connection with the supply by APC to RBS of draft accounts for the year ended 31 March 1998. The second was whether RBS could recover as part of their loss amounts lent to APC's wholly-owned subsidiary allegedly in reliance on the audited accounts of APC especially in the absence of any specific allegation as to Bannerman's knowledge that APC's audited accounts would be used for this purpose. Whilst the judge had difficulty with RBS's case in respect of both matters, he did not feel it would be appropriate to strike out those aspects of the claim when the matter would be proceeding to trial in any event.

Bannerman were successful, however, in one aspect of their strike out application. At the end of 1995, one of Bannerman's employees had been seconded to APC as financial controller. RBS alleged that he had participated with members of APC's management during the course of his secondment in the financial irregularities and fraud that led to APC's collapse. RBS contended that Bannerman were vicariously liable for the secondee's fraudulent acts and sought compensation for its losses in this way also. The judge held that responsibility for the acts of an employee on secondment should be determined by

establishing who had the right to direct and control the employee's activities. The judge held that, although Bannerman continued to pay him, the employee had effectively become a member of APC's management team and only APC had the right to direct his activities. Accordingly it was his view that APC had direction and control of the employee during his secondment and that this aspect of RBS's claim should therefore be struck out.

The judge's decision is subject to an appeal by Bannerman which it is understood will be heard towards the end of this year. The outcome of the appeal is awaited with interest especially as one of the weakest elements of RBS's case does not appear from the judgment to have been argued. The judge reached his conclusion in relation to duty of care on the basis of Bannerman's constructive knowledge of RBS's proposed reliance rather than on Bannerman's actual knowledge. Whilst no doubt Bannerman did know that RBS was APC's main financier and that it would see the audited accounts, it is less clear whether the audit partner knew the use RBS proposed to make of the audited accounts when he signed the audit reports.

Conclusion

The decision represents a stark warning for auditors that they remain at risk of unwittingly taking on responsibility to third parties. The auditors had not been approached directly by the bank and had probably never considered that they might be at risk of a claim. Their confidence might have been inspired by the perception within the profession in the UK that the risk in such circumstances had all but been extinguished following the decision of the English Court in *Al Saudi Banque v Clark Pixley* [1990] 1 Ch 313, a decision specifically mentioned with approval by the House of Lords in *Caparo*. Following *Caparo*, if a bank contacted auditors to say that it proposed to rely on the audited accounts for a particular purpose, the standard response had been to issue a letter of disclaimer. Auditors may now need to consider a disclaimer or similar in every case.

The decision in *Bannerman* was reached on the basis of assumed facts on a point of law rather than after consideration of all the evidence at trial. It is hoped that this decision is not indicative of a new trend of judicial thinking which could be followed by the courts elsewhere, including Hong Kong. Whatever the outcome of the appeal, it is too early to assess the impact of disclaimers as suggested by the ICAEW Technical Release or the clarification wording recommended by the HKSA Technical Bulletin in seeking to protect against inadvertently taking on duties to third parties. Disclaimers will not be effective for all clients, as the SEC's response has made plain. The SEC has not, however, responded to the HKSA Technical Bulletin at the date of writing.

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