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In what circumstances can an auditor or a reporting accountant be found legally liable for negligence? This is a question that has exercised the minds of accountants in professional practice for decades.[1]

The law of tort imposes certain conditions that must be fulfilled if a claim in negligence is to succeed. In general, liability will only arise if a plaintiff can satisfy a court that:

- the accountant owed a duty of care to the plaintiff,
- the accountant was negligent in carrying out his professional responsibilities,
- the plaintiff suffered loss or damage, and
- the loss or damage suffered by the plaintiff was caused by the accountant's negligence.

This article discusses briefly the standards of care required of accountants, and goes on to describe developments in the duty of care owed by accountants and auditors and new proposals in the U.K. to allow auditors to limit their liability to client companies and third parties.

Standards of Care

The question of whether an accountant has been negligent is determined by a comparison of his actual performance with the standard of care required of him in the particular circumstances. It is clear, therefore, that a crucial element of the process by which liability is decided will be the determination of what constitutes the necessary standard and whether the accountant met that standard. A court will need to be assisted in making this assessment and usually both sides to the dispute will engage experts in this capacity.[2]

When assessing whether a professional person has been guilty of negligence in the performance of his profession, courts pay great regard to what is described as "customary practice". In preference to making an assessment against a notional standard of care that may be too high (if derived from ideal standards) or too low (*i.e.* the lowest common denominator), the courts attempt to arrive at a standard that reflects the reality of how things are generally done in practice. However, the courts reserve the right to decide whether current practice is acceptable.

[1] Further information on accountants and professional negligence is to be found in Lemar, C. J. and Mainz, A. J. (eds), *Litigation Support* (4th ed., Butterworths, London, 1999), Chapter 8; MacGregor, G. and Hobbs, I., *Expert Accounting Evidence: A Guide for Litigation Support* (Accountancy Books, London, 1998), Chapter 26; and Taub, M., Rapazzini, A., Bond, C., Solon, M., Brown, A., Murrie, A., Linnell, K. and Burn, S. *Tolley's Accountancy Litigation Support* (Butterworths, London, looseleaf), Part VI, Para 95.

[2] Further discussion of the role played by accountants in giving expert evidence in relation to accountants' liability cases can be found in Brennan, N. and Hennessy, J. *Forensic Accounting* (Round Hall Sweet & Maxwell, Dublin, 2001).

Standards of care applying to auditors

Auditors are expected to exercise reasonable skill and care in carrying out their responsibilities. These are not clearly defined in law. In the oft-quoted case *Kingston Cotton Mill Company (No. 2)*, Lopes J. said:

> "It is the duty of an auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be detective or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is watchdog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful."[3]

There is no simple formula or set of rules establishing the standard of care required of an auditor or accountant. However, certain materials are regarded as authoritative and courts would attach significant weight to them. These materials include:

1. statutory duties (imposed by legislation),

2. professional standards developed and published by the accountancy profession, including Auditing Standards, Accounting Standards, Ethical Standards and Rules of Professional Conduct,

3. textbooks by reputable experts in the relevant field,

4. manuals, particularly those adopted by the accountant or auditor in question or by his firm, and

5. best practice as described in journals, other publications and exposure drafts of proposed future professional standards.

Duty of Care

Liability for a loss suffered due to negligence is based on a duty of care owed to the complaining party by the accountant. Such a duty of care can be established relatively easily where there is a contract between the accountant and the other party, in which case an action lies in breach of contract as well as in tort. The existence of a duty of care is also relatively easily established between an accountant and the addressee of his report.

A duty of care can also exist between the accountant and another party who, although not the addressee of the report, is relying on it with the knowledge and agreement of the accountant. Whether an accountant owes a duty of care to a third party who relies on his report without the accountant's express knowledge or agreement is a much more difficult area.

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[3] [1896] Ch. 279 at 288-289.

From Hedley Byrne to Caparo

For many years, accountants and other professionals believed, with justification, that, whilst they clearly owed a duty of care to the parties to whom their reports were addressed (usually the shareholders of a company), no duty of care to any other party arose other than in very specific and restricted circumstances, such as fraud or through the existence of some other clearly defined contractual or fiduciary duty. However, this comfortable position became a thing of the past with the landmark decision in *Hedley Byrne & Co v. Heller and Partners Ltd*,[4] which effectively became Irish law through the judgment of Davitt P. in *Securities Trust Ltd v. Hugh Moore and Alexander Ltd*.[5] Those decisions had the effect of extending the duty of care beyond actual contractual relationships to where there was a 'special relationship' equivalent to a contract between the parties. The learned judge in the latter case summarised the extended duty of care as follows:

> "The proposition that circumstances may create a relationship between two parties in which, if one seeks information from the other and is given it, that other is under a duty to take reasonable care to ensure that the information given is correct, has been accepted and applied in the case of *Hedley Byrne & Co. Ltd.* v. *Heller and Partners Ltd.*, recently decided by the House of Lords."[6]

The decision in *Hedley Byrne* has since been considered in a number of cases in the U.K. and Ireland as the Courts have attempted to interpret the general principle and apply it to specific circumstances. These attempts have led to a pendulum effect, as successive decisions appeared to alternately widen and narrow the extent of the accountant's potential exposure.

The House of Lords took the opportunity to clarify the position somewhat in the celebrated case *Caparo Industries v. Dickman*.[7] This decision was widely interpreted as being favourable to accountants in that it appeared to set restrictive boundaries around the circumstances in which a duty of care to third parties could arise. However, it can be seen from the judgments themselves, and from subsequent case law, that the issue cannot be resolved by a comprehensive set of rigid rules – judgment must still be exercised in each set of specific circumstances. This is clear from the conditions necessary for a duty of care to arise, as set out in the *Caparo* decision, which can be summarised as follows:

(i) the damage to the third party was reasonably foreseeable by the accountant;

(ii) there was sufficient 'proximity' between the third party and the accountant – this usually means that the accountant knew of the existence of the third party and knew that the third party would probably rely on the accountant's work for a particular transaction; and

(iii) it would be fair, just and reasonable to impose a duty of care in all the circumstances of the case.

[4] [1964] A.C. 465.
[5] [1964] I.R. 417.
[6] *ibid*. at page 421.
[7] [1990] 2 A.C. 605.

Clearly all three of these conditions, but especially the third, require the application of significant judgment. In addition, the words of Lord Bridge emphasise the lack of precision in the second condition:

> "The concepts of proximity and fairness … are not susceptible of any such precise definition as would be necessary to give them utility as practical tests, but amount in effect to little more than convenient labels to attach to the features of different specific situations which, on a detailed examination of all the circumstances, the law recognises pragmatically as giving rise to a duty of care of a given scope."[8]

The decision in *Caparo* is therefore regarded as having had less than the hoped-for effects on the appetite for litigation of putative plaintiffs, and on the related potential exposure of accountants to large awards of damages and prohibitive professional indemnity insurance costs.

Beyond Caparo

The accountancy profession has spent considerable time and effort addressing this issue and attempting to develop proposals that would place reasonable limits on exposure to the costs associated with claims for negligence without diluting significantly the value of the services provided by accountants. Proposals discussed and developed have included:

- requiring directors to carry professional indemnity insurance;
- allowing auditors to limit their liability through incorporation of their practices;
- overhauling the system of joint and several liability that permits a successful plaintiff to recover all of his loss and damage against any negligent party – this would replace the existing regime with a system of proportionate liability, whereby each negligent party would be liable only to the extent to which he was adjudged to have caused the loss and damage; and
- allowing auditors to limit their potential exposure by contract – i.e., permitting an agreement between auditors and shareholders that the auditors' liability would be capped at a predetermined amount.[9]

New U.K. Proposals

Until very recently, despite much discussion and debate on this topic, very little by way of concrete proposals for change had emerged. However, the recently published Final Report of the Company Law Review Steering Group in the U.K. contains some important recommendations that may at last provide some relief to auditors.[10] The report recognises that "… auditors' so-called 'deep pockets' have ensured that, of the possible targets of professional negligence claims for financial loss caused by

[8] *ibid*. at page 618.
[9] Such a contractual limitation is expressly prohibited by Section 200 of the Companies Act 1963.
[10] The full text of the report, *Modern Company Law for a Competitive Economy*, is available at www.dti.gov.uk/cld/final_report.

misstatement in accounts, they are the favourite."[11] It then rejects the 'proportionality solution' as contrary to principle, stating that:

> "The effect of the proportionality approach would be to impose on a plaintiff who is wholly innocent the risk that a party in the wrong may be unable to satisfy a claim, rather than imposing that burden on another party (the auditor) whose fault caused the loss."[12]

This conclusion would likely be supported by Irish lawyers, courts and legislators alike and reflects the philosophy of joint and several liability that underpins our legal system.[13]

However, the report goes on to make an important recommendation relating to the prohibition on the contractual limitation of his liability by an auditor. The report states:

> "In addition, we recommend that auditors should be able to limit their liability contractually with the company in tort (or delict) with third parties. Contractual limitation should be achieved by the repeal of the prohibition on auditors' and companies' so limiting the liability. Such limitation should be publicised in the auditors' report and such notice should bind those who rely on the report (i.e. thus achieving limitation of liability in tort). In both cases the limitation would not be effective without prior approval by shareholders."[14]

This proposal has been welcomed by accountants in the U.K. Its implementation is, of course, by no means certain, although the membership of the Steering Group, the fact that it was established by the DTI and the extent of consultation undertaken before final recommendations were made all suggest that the proposals will be given serious consideration.

Concluding Comment

The U.K. proposals to allow contractual limitation of liability are, at first blush, attractive to accountants, and do not threaten any of the core values underlying the legal system. For these reasons they may emerge unscathed from a process of public debate and find their way onto the Statue books in the U.K.

However, before proposing that this trend be followed in Ireland, it might well prove prudent for accountants on this side of the water to observe how the proposals develop following implementation. It is certainly possible that the amount of the liability limit proposed by an incumbent or potential new auditor could become yet another factor in competition for audit work. It is also quite possible that the widespread adoption of contractual liability limits by auditors would serve to make the audit appear even more like a commodity (in the nature of an insurance policy) than it already does, damaging the efforts of auditors to portray their services as value-added. Either or both of these possibilities, if realised, would inevitably lead to further downward pressure on audit fees. If these emerge as real risks, auditors in the U.K. may well prove reluctant to make use of their new-found contractual freedom.

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[11] Paragraph 8.136 of the report.
[12] Paragraph 8.138 of the report.
[13] See Part III of the Civil Liability Act 1961.
[14] Paragraph 8.143 of the report.

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Niamh Brennan and John Hennessy are the authors of *Forensic Accounting,* due for publication in October 2001 by Round Hall Sweet and Maxwell.