The auditors’ dilemma:

To disclaim or not disclaim

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Introduction
The decision in the Hedley Byrne case in 1963 set a precedent for liability in tort for negligent misrepresentation causing economic loss. During the more than forty years since that decision the New Zealand accounting profession has adopted six strategies for limiting the exposure of auditors to the consequent risk of professional negligence litigation by third parties. Five of those strategies, adopted successively through the 1960s and 1970s, have been uncontroversial but ineffective. The sixth strategy, the inclusion of disclaimers of liability in audit reports, only recently adopted and, at the time of writing, only by some auditors, is likely to be effective but also controversial. This discussion focuses on the reason for the controversy surrounding the use of disclaimers, and how that controversy can be resolved so that disclaimers can be recognised as a legitimate and effective means for limiting auditors’ tortious liability.

For a party to be held liable in tort for damages for negligent misrepresentation it has to be established, at least, that the defendant had a duty of care to the plaintiff, the defendant’s act or omission breached that duty, and the breach caused reasonably foreseeable loss. For auditors, a disclaimer can be an effective means for limiting that liability by clarifying in advance the scope of the duty of care assumed, both with respect to the third parties to whom the duty is owed and with respect to the purposes to which the audit report may be put.

The delay in the adoption of disclaimers by New Zealand auditors is remarkable in light of both the ineffectiveness of their earlier strategies for limiting their tortious liability, and the increasingly urgent need for an effective strategy. Since the 1980s the increase in the size and frequency of suits for professional negligence brought against auditors by third parties in New Zealand, and in other countries with similar legal systems, has been such that in the professional and academic auditing literature the litigation is referred to as the auditors’ “liability crisis”.

The auditors’ dilemma
The controversy that has prevented disclaimers of liability from becoming a standard feature of audit reports on companies’ annual accounts stems from an unresolved dilemma for the audit profession. Competing notions of professional pragmatism and professional idealism - the horns of the dilemma - appear to support equally persuasive arguments for and against the use of disclaimers.

From an idealistic perspective the use of disclaimers (and, indeed, any attempt to limit liability for professional negligence) is inappropriate because unlimited liability of practitioners is an essential element of their professional status - a necessary part of what it means to be a professional. On this view, if the theoretical and practical knowledge that may be expected of professionals is reflected in their standards of performance then limitations of liability are unnecessary. Consequently, the use of disclaimers by professional auditors signals, at best, a lack of confidence in the reliability of their work and, at worst, an admission that it is not reliable.

From a pragmatic perspective idealistic exhortations to standards of performance that make limitations of liability unnecessary are unrealistic counsels of perfection. Moreover, acceptance of unlimited liability for professional negligence would impose on auditors a duty of care greater in scope than any imposed by the law. In the evolution of the common law on negligence the incremental extensions to the scope of the duty of care...
presupposed for liability have never been made with the aim, or the effect, of establishing unlimited liability. On this view, it is not the scope of the auditors’ duty of care that generates the “liability crisis” but the uncertainty of that scope; an uncertainty created by the judicial decisions in successive cases unpredictably extending (and, on occasion, retracting) the scope of the tortious duty of care. For a pragmatist, then, disclaimers provide a solution to a systemic problem in the process by which common law is made, and a practical means for reducing costly uncertainty in the work of professional auditors.

The auditors’ dilemma in Britain
From a logical point of view a dilemma can be resolved either by refuting one of its alternatives - taking it by the horns - or by showing that its alternatives do not exhaust the possibilities - escaping between its horns. In Britain in recent years an attempt has been made to resolve the dilemma by the former means. In early 2003 PricewaterhouseCoopers began to include a disclaimer in its standard audit reports and within weeks the practice had been emulated by the other Big Four audit firms. In the meantime, a Technical Release issued by the Institute of Chartered Accountants in England and Wales (ICAEW) contained the draft of a disclaimer considered appropriate for inclusion in audit reports.

This report is made solely to the company’s members, 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 which 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.

However, within days of the ICAEW’s advice being made public its general approval of disclaimers in audit reports was strongly criticised by another British accounting organization, the Association of Chartered Certified Accountants (ACCA).

...accountants are saying this devalues the whole purpose of the audit process. If an auditor issues an audit report which carries a very prominent disclaimer, it gives the impression to any reader of the accounts that the auditors are not sufficiently confident about their work and that this audit report may not be as reliable as you'd like to think it was.

This controversy in the British accounting profession may be a precursor to developments in New Zealand. In 2007 disclaimers of liability which copied the wording of the ICAEW’s draft disclaimer (except for references to New Zealand legislation) were included in audit reports on companies’ annual accounts issued by Ernst & Young New Zealand. Irrespective of how many New Zealand auditors follow that example, and irrespective of any official positions on it that may be adopted by national regulatory authorities, controversy surrounding the use of disclaimers by auditors will persist while the dilemma between professional idealism and pragmatism remains unresolved. In the light of the British experience, an attempt to resolve that dilemma in New Zealand may be more successful if it aims for some middle ground between the two positions - to escape between the horns of the dilemma, rather than taking it by the horns.

Accountants’ attitudes
Such an attempt is best made against the background of the New Zealand accounting profession’s change of attitude on limited liability, the ineffectiveness of its earlier strategies for addressing the auditors’ “liability crisis”, and its continual rejection of authoritative legal opinion and advice on the use of disclaimers.

Since the Hedley Byrne decision the official attitude on limited professional liability has changed from resistance to acceptance. In the aftermath of that decision, and while its implications for auditors were still being considered, the New Zealand accounting profession was content to take its lead from the British profession. In 1965, and again in 1972, the Council of the New Zealand Society of Accountants (NZSA) endorsed statements on members’ professional liability to third parties which had been issued by the Council of the ICAEW.

[Legal] counsel has advised that where an accountant specifically restricts the scope of his report...this can constitute a disclaimer which will be effective against any action for negligence brought against him by third parties...However, such a disclaimer should be introduced only where the circumstances warrant it, as, in the [ICAEW] Council’s view, an indiscriminate use of disclaimers would tend to impair the status of practising accountants by indicating a lack of confidence in the professional work they carry out. It would not, for example, be proper to endorse copies of accounts filed in accordance with section 127 of the Companies Act 1948 with a disclaimer by the auditor of responsibility to persons other than shareholders.

The Councils of the two organizations were as one in their view that unlimited liability was essential for
Professional status. In the late 1960s the New Zealand accounting profession was still struggling to accept the incorporation of accounting service firms (not practice firms) with limited liability. An editorial on the subject in The Accountants' Journal opened with an assertion.

The concept of practice under the guise of a company has carried with it an implication of self interest and limitation of liability which has been considered incompatible with professional status. 8

How things change. Two decades on, in the early 1990s, several reasons for the reverse attitude were advanced in an editorial article in The Accountants’ Journal written by the then president of the NZSA under the title “The Equity of Limited Liability”.

...the NZSA must continue to look for further ways to limit liability arising from negligence in order to preserve [the] economics of insurance, to guard against the opportunism which seems to be a motivating factor for joining our members in legal fights, and to avoid the likelihood of defensive practices which would operate against the public interest. 9

This change of attitude was reflected in the successive strategies adopted for addressing auditors’ liability after the Hedley Byrne case. The initial strategy of encouraging the maintenance of professional standards of performance was followed, in the late 1960s, by the adoption of a group scheme providing professional indemnity insurance. These strategies were aimed not so much at limiting liability as at limiting adverse and costly consequences of liability.

Subsequently, from the early 1970s, the aim of the strategies did shift to limiting liability per se as the profession began to lobby for various regulatory changes: a statutory upper limit, or “cap”, on the amount of damages that could be awarded in any suit for professional negligence, a change in the basis of civil liability from joint and several (solidary) liability to proportionate liability, and permission to incorporate accounting practice firms with limited liability.

However, none of these strategies has been successful. Evidence that professional standards of performance had been maintained in the conduct of an audit would provide the auditor with a defence against an action for professional negligence. But the repeated success of such actions, in tort and in contract, shows that exhortation to maintain professional standards has not been sufficient for their maintenance.

The strategy of contracting for professional indemnity insurance cover may have been counter-productive, insofar as it contributed to the perception of auditors as “deep pockets” and exposed them to the risk of larger and more speculative legal actions.

None of the desired regulatory changes has been achieved. No statutory “cap” on awards of damages for professional negligence has been legislated in New Zealand. The recommendation made by the New Zealand Law Commission in 1998 against any change to the solidary basis of civil liability continues to be accepted. 10 And while incorporation of accounting practice firms with limited liability has been permitted by the rules of the New Zealand accounting profession since 1997, the statutory disqualification of a body corporate from appointment as an auditor of a company’s accounts remains in place. 11

The use of disclaimers in audit reports in New Zealand has been delayed for longer than the use of disclaimers in other types of accounting report. Since the 1990s accountants have been issuing disclaimers of liability for the outputs of non-routine consulting services, and for the outputs of routine accounting services such as financial statements and income tax returns. Those practices have become pervasive. Nor has the delay in the inclusion of disclaimers in audit reports - the outputs of routine auditing services - been the result of legal advice. The profession has tended to reject authoritative legal opinion and advice on the matter.

Lawyers’ opinions

The effectiveness of disclaimers for limiting liability in tort for negligent misrepresentation was established at the outset, in the ratio decidendi of the Hedley Byrne case heard in the House of Lords. The appellant in that case had suffered economic loss because of its reliance on the respondent’s negligent mis-statement. But the appellant was not awarded damages because the respondent had, at the time of issuing the statement, disclaimed responsibility for its accuracy. The five Law Lords hearing the case were unanimous in holding that the disclaimer effectively negated any duty of care that otherwise may have arisen from the relationship between the parties. The most concise statement on point was made by Lord Morris.

...the bank in the present case [the respondent], by the words they employed, effectively disclaimed an assumption of a duty of care...If the inquirers [the appellant] chose to receive and act upon the reply they cannot disregard the definite terms upon which it was given. They cannot accept a reply given with a stipulation and then reject the stipulation...I would therefore dismiss the appeal. 12

Some of the advice offered to the accounting professions in Australia and New Zealand in the wake of the Hedley Byrne decision was even more forthrightly positive on
the use of disclaimers than the advice of legal counsel to the ICAEW. An Australian Queen’s Counsel suggested that the Institute of Chartered Accountants of Australia should take the initiative on limiting auditors’ liability and set an example for the profession to follow.

There is, of course, no easy solution to this problem. One possible way of meeting it would be for the Institute to lay down a standard form of disclaimer to be adopted in appropriate cases.13

In New Zealand a law lecturer commenting on a non-auditing case, which was claimed to be the first to test the principles of the Hedley Byrne decision in the New Zealand Court of Appeal, might have made the mistake of being too light-hearted for his advice to be taken seriously.

My view is that accountants and auditors must now be doubly on guard and shield themselves where appropriate by disclaimers of liability...and such other devices as will play legal gooseberry for their innocent professional frolics.14

More sober remarks on the potential use of disclaimers by auditors were made by two of the three judges of the New Zealand Court of Appeal hearing the Scott Group case.15 The diversity of judicial opinion informing the majority decision in that case extended to the judges’ obiter dicta on the use of disclaimers. Richmond P was less encouraging of their use, believing or, perhaps, hoping that the law would not make them necessary. However, while clearly not anticipating the audit profession’s future “liability crisis”, the possibility of the use of disclaimers, if that became necessary, was left open.

...it is not in the public interest that the courts should bring about a situation in which accountants and auditors will feel obliged to resort to the device of a general disclaimer as negating an assumption of responsibility...I would prefer that this branch of the law be left in a state where professional men of integrity can feel confident that they will not be held liable except in situations where they were indeed aware of a specific purpose for which their advice and assistance was required.16

Cooke J, on the other hand, was more encouraging of the use of disclaimers, and went to some length to distinguish their legitimate use from attempts by auditors to exempt themselves from contractual liability to their client companies (the latter being rendered void by section 204 of the Companies Act 1955). In this judicial opinion, the grounds for auditors’ reluctance to use disclaimers lay in professional pride rather than the law.

In relation to members of the public proposing to rely on the published accounts...a disclaimer would operate, not as an exemption from liability...but as negating any assumption of a duty of care...I do not think that [section 204] is aimed at such a case. Nor would there be any difficulty in appending a disclaimer of general liability.
to the auditor’s certificate...Perhaps some auditors, naturally jealous of their professional reputation, would hesitate to announce such a disclaimer...17

Resolving the auditors’ dilemma in New Zealand
An escape between the horns of this dilemma, across middle ground between the positions of professional idealism and pragmatism, can be made with a rights-based argument that enables distinctions to be drawn between justified and unjustified disclaimers of liability. Idealists and pragmatists who vacate their preferred positions for this middle ground can thus be reassured that the move is to a principled position, one that can be supported on the basis of the rights of the various parties involved.

The following argument establishes that an auditor conducting a statutory audit of a company’s annual accounts would be justified in disclaiming liability for negligent misrepresentation in the audit report to all third parties except the company’s shareholders, and for all purposes of the audit report except the expression of an opinion on the reliability of the company’s financial statements.

The argument is rights-based inasmuch as justified and unjustified disclaimers are distinguished on the basis of whether the denial of a duty of care implied by an auditor’s disclaimer is an abridgement of a third party’s existing right to care arising from the purpose of the audit process and the relationships between the parties to it.

The general purpose of independent, professional audits of company accounts is to resolve an inherent conflict of interest between company shareholders and company directors; a conflict created by the separation of the ownership and control of the equity investment in the company. Shareholders’ funds are under the directors’ control and at risk of being employed in ways that are in the directors’ best interests rather than the shareholders’ best interests.

This agency problem in corporate contexts is aggravated by asymmetric information and moral hazard. Not only are the directors in a position to know more about their stewardship of the shareholders’ funds than the shareholders themselves, but the preparation of the reports on the directors’ stewardship to be presented to the shareholders (i.e. the financial statements) is in the hands of the directors. These threats to the safe reliance that shareholders can place on the financial statements are addressed by the appointment of an independent and professionally competent auditor to form an opinion on the reliability of the statements, and to report that opinion to the shareholders.18

Reaching an informed opinion on the reliability of a set of financial statements is not something that can be done casually; the exercise of care is an essential element in the proper conduct of an audit for that purpose. Shareholders have a right to such care because of their relationship with the auditor. Shareholders formally approve the appointment of the auditor, they bear the cost of the audit fee, and they are the addressees of the audit report. The auditor’s corresponding duty of care to the shareholders is assumed, or may be deemed to be assumed, when the auditor accepts appointment. Consequently, an auditor’s disclaimer of liability to shareholders for the opinion expressed in the audit report would not be justified because it would abridge shareholders’ existing rights.

Third parties other than shareholders may come into receipt of copies of the audited financial statements, and may claim that the same or a similar duty of care that the auditor owes to shareholders is owed to them. However, unless there is some separate representation by the auditor to such other third parties in which the auditor assumes responsibility for the reliability of the audited financial statements, their claim to both the auditor’s duty of care and their own corresponding right to care is unfounded.

Their circumstances are different from those in which the shareholders’ right to care is established: non-shareholder third parties do not participate in the appointment of the auditor, they bear none of the cost of the audit, and they are not addressed in the audit report. Nor does the mere circumstance of them being in receipt of a copy of the audited financial statements establish, ipso facto, that the auditor owes them a duty of care. To suppose otherwise is tantamount to supposing that the host of a party owes a duty of hospitality to all those who come into receipt of an invitation, not just those to whom the invitation is addressed, and that the same right to hospitality is held by invited guests and gatecrashers alike. In the absence of any separate right to care from the auditor that a non-shareholder third party may establish an auditor is justified in disclaiming liability to such parties for the opinion expressed in the audit report.

Shareholders have a right to such care because of their relationship with the auditor

Effects of disclaimers
A disclaimer of liability is pre-emptive in its effect, clarifying in advance (and, thereby, limiting) the scope of the duty of care assumed. For auditors, such clarification is necessary because of the indeterminacy of the principle of reasonably foreseeable reliance which has been used in the Courts to determine the otherwise ill-defined scope of their duty. The indeterminacy of the principle, driven by the vagueness of the phrase “reasonably foreseeable” and the range of its possible interpretations, was thrown
into sharp relief in the Scott Group case by conflicting judgments of the scope of an auditor’s duty of care, both with respect to the third parties who may come into receipt of the audit report and the purposes to which it may be put.

Quilliam J, in the Court of first instance,19 and Richmond P, in the Court of Appeal,20 limited the class of third parties whose reliance on audited financial statements could be reasonably foreseen by an auditor to those who had been shown the statements either by the auditor, or by the auditor’s client if the auditor knew that the client was thereby inducing the third party to act upon the statements. As neither condition was satisfied by the facts of the case it was held that the auditor did not owe a duty of care to, respectively, the plaintiff and the appellant. On the other hand, Woodhouse and Cooke JJ, in the Court of Appeal, applying the same principle to the third parties who may come into receipt of the audit report and the purposes to which it may be put.

Remarks by Quilliam and Cooke JJ reveal diametrically opposed views on the purpose of the audit report

The uncertainty created by these remarks about the scope of an auditor’s duty of care with respect to the purpose of the audit report is compounded by the judicial confusions between the purposes of audit reports and audited financial statements, and between the rights of shareholders and non-shareholders to the use of information in those documents.21 The danger for auditors in this uncertainty is that their exposure to the risk of negligence in the conduct of an audit increases as the purpose of the audit report for which they may be held to have a duty of care is extended. Clearly, their exposure is significantly greater if the purpose of the audit report is investment decision support for everyman (as seems to have been held by Cooke J) rather than the expression of an opinion on the reliability of the financial statements.

It would be unrealistic to expect judicial decisions to provide a lasting resolution of this uncertainty. As Siliciano observes, “...tort law is organic and evolutionary in nature... [Extension and retraction of liability] is simply part of the normal ebb and flow of the tort system.”22 Resolution of the uncertainty requires a more proactive response and it may be that Cooke J, while contributing to the uncertainty, also indicated a means of controlling it.

As to the duty of care, [to] the essential facts of this case...a take-over offer for the shares of a public company... may be added a third: there was no disclaimer of liability to members of the public who might rely on the published accounts.23 If the absence of a relevant disclaimer is a necessary condition for the imposition of a duty of care on the auditor then a relevant disclaimer would avoid such a duty.

Benefits of disclaimers

A range of economic and reputational benefits for the auditing profession may be expected to follow from the use of justified disclaimers of tortious liability. The limitation of liability would reduce the incidence of litigation and provide economic benefits in the form of cost savings from having fewer suits to defend, fewer suits to settle out of court, fewer awards of damages to pay and, consequently, lower premiums for professional indemnity insurance. The professional reputations of auditors would be improved by reduced rates of litigation, just as private reputations are improved by reduced rates of recidivism.

The use of disclaimers of liability would also be in the public interest, and would benefit the professional reputation of auditors in other ways. Clarification of the scope of auditors’ duty of care would help to forestall ill-founded public expectations of audit reports, and help to protect auditors’ professional reputations against the unjustified, but nevertheless real, critical reactions to the disappointment of those expectations. All of these economic and reputational benefits would help to address the profession’s alleged recruitment and retention problems that are attributed to its “liability crisis”.

Conclusion

More than forty years on from the Hedley Byrne case the New Zealand accounting profession still does not have in place an effective, generally accepted strategy for limiting auditors’ tortious liability. Legal commentators can still
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speak of “the spectre of indeterminate liability hanging over auditors in New Zealand”. A general adoption of the type of disclaimer advocated in this discussion would implement such a strategy.

It would be a mistake to regard the inclusion of disclaimers in audit reports as a lowering of auditors’ professional performance standards, either in the quality of their work or in their professional relations with third parties. Just as the quality of audit work is not improved simply by any increased liability for that work, so its quality is not diminished simply by any limitation of liability for it. And as the rights-based argument for justified disclaimers that is set out above demonstrates, the inclusion in an audit report of a disclaimer of liability to all third parties except for the auditor’s client company shareholders does not abridge the rights of any third parties.

Whether the wording of the ICAEW’s draft disclaimer of liability is the most appropriate for use in audit reports on New Zealand companies’ annual accounts is a matter for expert legal opinion. That draft (quoted above) does demonstrate, however, that such a device for limiting auditors’ tortious liability, and gaining some relief from their “liability crisis”, can be effected with brevity and in plain English.

References

1. *Hedley Byrne & Co v Heller and Partners Ltd* [1963] 2 All ER 575
4. *The Accountant*, December 2002, p.1; February 2003, p.1. PricewaterhouseCoopers’ disclaimer is quoted in the former note as “We do not in giving this opinion accept or assume responsibility for any other purpose or to any other person to whom the report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.”
7. *The Accountants’ Journal*, October 1972, p.83. Section 127 of the (English) Companies Act 1948 was copied in Section 133 of the (New Zealand) Companies Act 1955 and related to the auditor’s report on the accounts to be filed with a company’s annual return.
10. Apportionment of Civil Liability (New Zealand Law Commission 1988)
12. *Hedley Byrne & Co v Heller and Partners Ltd* [1963] 2 All ER 575, at p.595
15. Scott Group Ltd. v McFarlane and Others [1978]
1 NZLR 553
16. Ibid, p.569
17. Ibid, p.580
18. In this scenario, the auditor’s independence and professional competence are regarded as sufficient for the shareholders’ safe reliance on the auditor’s report for their safe reliance on the directors’ report. Thus an infinite regress of reports on the reliability of other reports is avoided.
19. Scott Group Ltd. v McFarlane and Others [1975]
1 NZLR 582
20. Scott Group Ltd. v McFarlane and Others [1978]
1 NZLR 553
21. Scott Group Ltd. v McFarlane and Others [1975]
1 NZLR 582, at p.587
22. Scott Group Ltd. v McFarlane and Others [1978]
1 NZLR 553, at p.581 (original italics)
23. A confusion between the purposes of a company’s annual accounts and a company’s prospectus could be added to these confusions. For a more detailed discussion of English judicial misunderstandings of the purpose of statutory audit reports see Arnul, C.J. (2002). Auditors’ reports, misconceptions and third party disclaimers. *Tolley’s Journal of Professional Negligence*, 18, pp.146-155.
25. Scott Group Ltd. v McFarlane and Others [1978]
1 NZLR 553, at p.580 (original italics)