

**LIABILITY OF ACCOUNTANTS AND
PROVIDERS OF FINANCIAL SERVICES
AND THE EFFECT OF QUALIFICATIONS
AND DISCLAIMERS**

by Dr Robert Chambers

Commentary by Mr A.N. Frankham

Chartered Accountant, Partner of Lawrence Anderson Buddle, Vice-President of New
Zealand Society of Accountants

1. INTRODUCTION

- 1.1 I congratulate Dr Chambers on his erudite paper and his excellent analysis of the legal principles of the current law. Whilst the subject is wide and there is much that can be added to Dr Chambers' argument I shall endeavour to perform in the manner I have been requested - that is as a commentator on the learned paper and not as author of an alternative treatise.
- 1.2 Dr Chambers' paper does not deal in depth with 'the effect of qualifications and disclaimers'. I am neither concerned nor critical about that. He has devoted his attention, quite properly, to the major issue which is clearly of considerable concern to the professions and a matter of high public interest. It is indeed timely that a learned gathering under the auspices of the Legal Research Foundation should consider and debate this important issue.
- 1.3 Dr Chambers states that the purpose of his paper is to investigate whether the existing law is imposing too onerous responsibilities on accountants and if it is what the most appropriate response is. With the greatest of respect, I do

not agree with his conclusions. My commentary endeavours to put an alternative viewpoint.

1.4 My viewpoint is signalled by the following quotations:

- (a) "(the ever increasing exposure of the professions to civil liability) militates against society because there is a temptation for the professional to drop the level of his responsibility ... Professionals are being driven into giving defensive advice ... Some are even starting to abandon their practices because of the civil liability risks involved."

Lord Hacking

(House of Lords debate - March 1987)

- (b) "We have extended the liability for negligence to an altogether excessive degree ... It has come to the situation where, even if there has been an error of judgment or any little mistake or mischance the law holds the professional man negligent."

Lord Denning

(House of Lords debate - March 1987)

- (c) "What the judgment demonstrates, if sustained on appeal, is that the financial consequences of auditors' negligence may not emerge for some years, and that when

they do they may far exceed any amount contemplated at the time of the negligent act. This makes the task of insuring against loss one of immense difficulty for the auditor and the underwriter ... How can the accountant adequately insure when the amount of possible liability is so speculative."

Rogers J

(the Judge in the Cambridge Credit case
commenting on the case in an ex curial
publication)

- (d) "In modern times the damages that may be awarded when an auditor's breach of duty may be so high as to financially destroy the auditor and the firm without there being any realistic insurance cover. This trend, if not addressed may make insurance practically unattainable, engender unwillingness by some people to serve as auditors, fearful of crushing personal liability and ultimately undermine sufficiently the integrity of the audit system envisaged by the legislation. There needs to be a redressing of the seeming imbalance between the extraordinary extent of liability and the auditors ability to pay."

(The Report of the Australian Companies and
Securities Law Review Committee to the
Ministerial Council - September 1986)

2. DR CHAMBERS' CONCLUSIONS

2.1 Duty of care to too many?

Dr Chambers says -

"(Many accountants) complain that they owe a duty of care to too many people ... It is difficult to accept that (this complaint) has any validity in the auditing sphere."

"I believe most accountants would have no objection in principle to their being liable to the company and its members ... the principle behind S204 of the Companies Act seems not merely reasonable but absolutely vital for the protection of shareholders."

"So far as liability to others is concerned the position is more complicated ... they may be able to claim millions of dollars ... should they rely upon accounts which turn out to have been negligently prepared ... I do not believe that this aspect of the law requires any change ... all that is required is that (the auditor) be careful in carrying out the audit ... "

Dr Chambers' conclusions are quite clear under this head and I support them in principle.

2.2 Damages too high?

"The award of large sums of damages ... is not really the result of any recent change in the law ... all that has happened is that people ... have become more litigation conscious"

Dr Chambers does not reach a clear conclusion under this head.

2.3 The remedies

Dr Chambers dismisses, on both philosophical and practical grounds, the solution of statutory capping and mandatory insurance. This approach is the one most favoured by the accounting professions in the United Kingdom, Australia and New Zealand and is the system in operation in Western Germany.

Dr Chambers sees the remedy as being in the hands of the profession and suggests incorporation of practices and the right to practice accountancy as a limited liability company as sufficient to deal with the problem in that it would "remove one's personal prospective liability for the actions of one's colleagues and employees".

3. THE ACCOUNTING PROFESSION'S POSITION

3.1 In summary the views of the accounting profession (in the United Kingdom, Australia and New Zealand at least - if not worldwide) include the following:

- (a) people who rely on the work of accountants and subsequently suffer loss, should continue to have the right to compensation
- (b) the current exposure of accountants for unlimited liability gives an exposure where penalties are not commensurate with fault
- (c) accountants who carry out the audit function are increasingly being asked to insure against corporate failure. With unlimited liability and the lack of available insurance cover auditors face the very real and serious risk of bankruptcy
- (d) permitting incorporation alone will not deal with the problem
- (e) some form of statutory capping with mandatory insurance is the preferred and fairest form of protection

- 3.2 The New Zealand Society of Accountants will shortly be making a case to Government for legislation to alter the present unlimited liability of chartered accountancy firms for damages arising from their audit responsibilities.
- 3.3 There is a public interest to be protected and some change in the present law is required

"There is a primary and anterior consideration of public policy which should be the starting point. That is that where there is a breach of duty causing damage to the other person, public policy in general demands that such damage should be made good to the party to whom the duty is owed by the person owing the duty. There may be a supervening and secondary public policy which demands nevertheless immunity from suit in the particular circumstances. (emphasis added)

Simon, L J

Arenson v Arenson [1977] AC 405

4. THE PROBLEM

The following summarises the problem in general. Each of the issues can be argued in depth.

- 4.1 Aggrieved parties in commercial failures should have the right and will seek recompense.

- 4.2 With dramatic growth in the size of corporate enterprises the potential for loss by creditors and investors is very significant (and is becoming more so).
- 4.3 Although directors have primary responsibility, aggrieved parties look increasingly to auditors for recompense. No doubt this is because auditors are perceived to have financial resources (and insurance cover).
- 4.4 Although auditors may be held to be responsible for a small percentage of loss suffered they can be liable for the full quantum of loss. Opportunities for recovery from directors are often minimal. Although the law may recognise culpability the effect of joint and several liability means the party with assets faces full liability.
- 4.5 The dramatic increase in potential liability has coincided with an equally dramatic reduction in the availability of insurance and an adverse judgment may well result in the personal bankruptcy of all partners and the demise of the firm.
- 4.6 In all areas where chartered accountants compete with other entities (services other than audit) liability may be limited by contract. Auditors are prohibited by statute from contracting out of liability.

- 4.7 Auditors may be liable both in contract and in tort for failure to exercise reasonable care and skill. It is the right of action under tort and the inability to contract out of liability that exposes the accountant most.
- 4.8 An auditor, in reporting adversely on financial statements runs the risk of an action for defamation and consequent potential liability for financial damage flowing from the effects of such a report. An adverse report may become a self fulfilling prophesy. In this regard the auditor cannot limit exposure to liability by an abundance of caution.
- 4.9 In the event of a corporate failure every decision made by an auditor during the conduct of his work will be scrutinised using the great benefit of hindsight. The auditor will be conscious of the need for a high degree of professionalism to discharge his public interest obligation but he must have regard for the commercial reality of his role. Business and the community cannot afford the cost of an audit of a scope sufficient to provide absolute assurance. Furthermore the time delays inherent in a report providing such assurance would be of questionable value to end users.

4.10 The auditor has a statutory duty to report without limitation of liability

"given the nature of the auditing task, the amount of money, considered as a multiple of the fees received, for which auditors may be held liable greatly exceeds that of other professions. Auditors appear to carry an excessively high monetary risk"

Australian Companies & Securities Law
Review Committee (para 1.4(d) supra)

4.11 Whilst available insurance cover has provided reasonably adequate protection to the auditor in the past, this is no longer the case. The accountants' professional indemnity insurance market world wide is facing severe difficulties and there has been a drastic reduction in the capacity of the market to provide cover and very substantial premium increases are being sought for the cover that can be obtained.

5. THE CONSEQUENCES - EFFECT ON THE PUBLIC INTEREST

5.1 It is apparent that a continuation of the current exposure of accounting firms to unquantified potential liabilities and an inability to obtain adequate professional indemnity cover will have particularly adverse effects on the public interest. It is essential for the protection of the

investing public and the maintenance of commercial credibility that auditing firms attract and retain highly competent independent professionals. However, it is evident that failure to provide some effective limitation on the liability of professional firms will result in some or all of the following consequences:

- (a) partners in accounting firms undertaking auditing work will run high risks of bankruptcy
- (b) skilled partners are already and will continue to retire prematurely to protect themselves from intolerable potential liabilities
- (c) talented professionals are being deterred from entering a profession where the personal risks are perceived to be unreasonable
- (d) active steps will be taken by professionals to protect themselves from the consequences of exposure by divestment of personal assets
- (e) the possibility of increased use of audit qualifications to protect the auditing firms from exposure to liability. As the consequences of an audit qualification can be extremely serious for the company being reported on, the use of qualifications to protect against liability should be of extreme concern to the

commercial community and the profession

- (f) the breaking up of professional partnerships and the signing of audit reports in individual names of practitioners
- (g) the withdrawal from providing audit services by many accounting firms
- (h) very significant increases in audit fees to recoup the insurance premium costs of available professional liability insurance

6. INCORPORATION

6.1 Dr Chambers concludes that the solution is to permit accountants and other professionals to incorporate and assume the cloak of limited liability. "While it would not reduce one's liability for one's own negligence - and that is no bad thing - it would remove one's personal prospective liability for the actions of one's colleagues and employees". Although I support limitation of liability through incorporation as far as it goes I cannot accept Dr Chambers' thesis that it is the full answer to the present problem.

6.2 Limited liability does not address at least two major problems.

(a) While limited liability may protect some partners from personal bankruptcy, a director of an auditing corporation who participates in the auditing activities of the corporation may be personally liable in tort concurrently with the corporation in the event of a breach of duty by the audit corporation (C Evans & Sons v Spritebrand Ltd, [1985], 1 WLR 317).

(b) There is a strong argument that in terms of Sections 320 and 321 of the Companies Act an officer of an audit corporation could be personally liable for the debts of the corporation in the event of the audit corporation becoming insolvent as a result of a successful action for negligence.

6.3 The enormous potential liability from a successful claim against the firm, where adequate insurance cover is not available, may well result in the demise of the firm even though many of the partners avoid personal bankruptcy.

6.4 Further, notwithstanding Dr Chambers' comments, this alternative does not lie solely within the profession's own hands. For the accounting profession a significant change in the Companies Act would be required to permit corporations to undertake auditor, liquidator and receiver

positions.

6.5 If the individual is to remain liable, the problem of insurance cover availability and cost is not likely to be ameliorated. The most dangerous of all consequences however is that unless all of the shareholders of an incorporated accounting firm were prepared to indemnify the directors providing the auditing function (thereby sharing exposure to potential personal liability) only the foolhardy or ignorant would be prepared to specialise in that field. This would in effect destroy the very foundation of a successful professional entity which provides a wide range of financial services of the highest standards to the business community. Such an indemnity would negate all of the benefits Dr Chambers perceives as all that are necessary.

7. THE OPTIONS

7.1 To address the problems there are a number of options. These are fully documented in the Australian Companies and Securities Law Review Committee report to the Ministerial Council on the Civil Liability of Company Auditors, September 1986.

7.2 In summary these options include:

Option 1 Require that a plaintiff exhaust all remedies available against the defaulting directors or

other parties before having recourse to the auditors.

Option 2 Enable the amount of loss for which an auditor is liable to be ascertained in a manner different from that by which any loss attributable to directors or other relevant persons is determined.

Option 3 Courts be given the discretion to apportion liability between directors, other relevant parties and the auditors, having regard to their differing degrees of culpability.

Option 4 Legislate to limit the life of an audit so that losses arising subsequently could not be attributed to it.

Option 5 Legislate to limit the potential amount of an auditor's liability (the statutory cap).

7.3 The first four options were rejected for the following reasons:

- Option 1, assessing awards to reflect the degree of responsibility represents a fundamental philosophical move away from the principle of joint and several liability. Such a move was not felt to be in the public interest.

Options 2, 3 and 4 were rejected for public policy considerations set out in the Australian Companies and Securities Law Review Committee pages 15 to 19.

7.4 The Committee supported the fifth option of a statutory cap as being "the most direct and suitable means of translating into practice the principle of limited liability for company auditors."

7.5 The New Zealand Society of Accountants supports the contention that a statutory cap on auditors liability is the most appropriate means of dealing with the problem.

8. CONCLUSIONS

8.1 By reason of the fact that this paper is only a commentary on a major paper and the time for preparation has been only a few days I have not fully developed all of the arguments in favour of my profession's case. Neither have I endeavoured to answer all of Dr Chambers' detailed objections. For those who have a serious interest in developing the very much needed solution to a serious problem I do urge a close study of the September 1986 Report of the Australian Companies and Securities Law Review Committee to the Ministerial Council on the Civil Liability of Company Auditors.

8.2 Again I compliment Dr Chambers on his well prepared and logically argued case which is admirably supported by legal precedent. With respect I do not believe Dr Chambers adequately addresses the seriousness of the problem and its effect on the public interest.

8.3 I conclude my commentary with a summary of the best way I believe the public interest can reasonably be protected.

(a) That there be a specified limit on the amount of damages that can be awarded against an auditor, once negligence is established.

This "statutory cap" could, for example, be based on a multiple of the audit fees for assignment to which the loss relates.

(b) That auditors be required to carry a minimum prescribed level of professional indemnity cover, being at least the amount of the statutory cap.

(c) That auditors be permitted, at their option, to incorporate through limited liability companies.