

# RMS1 Risk Management Statement RMS1

## **Miscellaneous Professional Statements**

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### **Background**

1. Risk Management is defined as processes and structures that are directed towards the effective management of potential opportunities and adverse effects. Risk management is recognized as an integral part of good management practice. To be most effective, risk management should become part of an organisation's culture. It should be integrated into the organisation's philosophy, practices and business plans rather than be viewed or practised as a separate program. When this is achieved, risk management becomes the responsibility of everyone in the organisation.

2. Risk management is a process consisting of well-defined steps which, taken in sequence, support better decision-making by contributing a greater insight into risks and their impacts. Irrespective of the size, nature and culture of the practice, the process involves the following elements:

- establish the context
- identify risks
- analyse risks and evaluate risks
- treat risks
- monitor and review
- communication and consultation

3. The basic objectives of a risk management program within an organisation are to:

- provide appropriate protection of assets, financial/commercial position and business operations in order to maintain the business and its net worth;
  - contribute to satisfactory legal compliance, corporate governance and due diligence;
  - assist with quality improvement of services;
  - protect the reputation, credibility and status of the organisation;
  - enhance public and client confidence in the organisation.
4. Members in public practice face many risks in the course of carrying on their businesses. The purpose of this Statement is to set out minimum Standards of risk management for members in public practice and to provide guidance on certain matters relating to minimising risks to the practice.

### Application

5. This Statement has mandatory application upon all members and practices, no matter how that practice is configured or controlled, that provide accounting and/or other professional services to the public, whether such services are assurance or non assurance and of whatever technical nature.

### Effective date

6. This Statement is operative from 1<sup>st</sup> January 2004.

### Definitions

7. For the purposes of this Statement:

**practice** means the form of practice referred to in CPA Australia's By-Law 702.

**member** means member of CPA Australia and any entity referred to in By-Law 702.

**personnel** means employees, officers, directors, contractors or agents.

**policies** means a practice's objectives and goals for effecting risk management.

**procedures** means the steps taken by the practice to accomplish the practice's stated policies.

**risk** means the chance of a negative impact upon the objectives, outputs or outcomes of the business.

**risk management** means the systematic application of policies, procedures and practices aimed at avoiding, reducing or controlling risks.

### Standard

8. The Standard is set out in **bold** type which is mandatory and is followed by discussion or amplification.

**The Risk Management Statement applies to members and practices providing accounting and other professional services to the public, whether such services are assurance or non assurance and of whatever technical nature.**

Risk Management is identified as one of the elements of the Quality Control Standard APS 4/5 whereby a practice must develop, implement and maintain a process to ensure that management of risk becomes an integral part of the planning management process and culture of the practice.

The Risk Management process is identified as follows:



### Establish the context

9. The member should first consider:

- the outcomes the practice wants to achieve;
- the environment in which the practice operates, (for example, cultural, legal, operational); and
- identify internal and external stakeholders. (for example, clients, personnel, consultants, agents, internal systems, third parties, suppliers, etc.)

### Identify risks

**10 Once the context has been established, the potential risk factors or threats, and the practice's existing risk controls need to be identified.**

The following checklist has been compiled as a guide only, to provide ready reference by members relative to identifying the risks of a practice.

(a) Services performed

- How do you evaluate knowledge/experience requirements for both new and ongoing work?
- How do you assess client expectations/intended use of reports?
- Is the service provided high risk? eg. assurance engagements undertaken or provided.
- Can you deliver an objective report or does the client require subjective judgment?

(b) Contract Risk

- How do you formally agree on the terms of engagement and any variation?
- Do you utilise "standard terms and conditions" for all engagements?
- Can your liability be capped?
- How do you manage "contingency fees" or performance based remuneration?

- Are you precluded from holding financial interests in the client or receiving commissions?
- (c) Acceptance/Continuance Risk
- How are you formally assessing potential clients for acceptance?
  - Why is the client changing accountants?
  - Have any other professionals rejected the potential client?
  - Are there early signs of disputes on the fees that are proposed to service the client?
  - Has the client allowed sufficient time for the acceptance process to be completed?
  - How do you evaluate retention of clients from time to time?
  - How do you address any conflict of interest?
  - How are you maintaining independence?
  - Are there any concerns about a client's viability, reputation, or management?
- (d) Performance Risk
- Do you seek the opinion of a second partner or an external "mentor"?
  - How are you maintaining confidentiality?
  - Are fees too low for quality work?
  - Are you investing enough in CPD for yourself and personnel and have you complied with minimum CPD requirements?
  - What is the level of your Professional Indemnity insurance? Is it adequate in terms of level and policy conditions? (*Refer* Schedule A.)
  - Have you declared all services offered to the underwriter?
  - Are you aware of the potential of a claim and have you given notice to the underwriter during the period of insurance or on your proposal for insurance? (*Refer* Schedule A.)
  - Have you a claim for fees that could result in a client counter claiming for negligence?
  - What are the risks of the performance of different professionals from within the practice? (if applicable)
  - How are you engaging sub-contractors/agents/consultants and how are they indemnified in respect to their work?
  - Have you considered skill levels, levels of insurance cover and is there an indemnity in place?
  - Are you or is your advertising/promotional material deceptive or misleading as to your skill, qualification, etc?
  - Are there any other Trade Practices or Fair Trading issues to consider?

Information is available from the ACCC and Fair Trading Offices in each State. (*Refer to the "Additional Information"*)

- How have you given appropriate guidance and assistance to personnel?
- How have you given appropriate supervision to personnel?
- How have you appraised ongoing performance of personnel?
- Do you have appropriate inspection and review processes in place?
- Have the roles and responsibilities of personnel relative to risk management been defined and communicated?

## Analyse and evaluate risks

### 11. A member should analyse and evaluate the practice's risks on a continuing basis.

Risk evaluation takes into account the following:

- importance of the activity that is being risk managed and its outcomes;
- degree of control over the risk;
- potential or actual losses which may arise from the risk;
- benefits and opportunities presented by the risk.

There are a number of ways in which it may be analysed and evaluated, the simplest model is to consider the likelihood of occurrence of an event and the consequences of that event, for example Risk = Likelihood X Consequence. Consult with others and use your experience to calculate the level of risk. It may be categorized as extreme, high, moderate or low.

The assessment process needs to canvass amongst other matters:

- the practice's existing and anticipated areas of practice;
- its composition, experience and expertise;
- its management and internal control procedures;
- the likelihood of being sued and the potential ambit of any claim;
- assessment of new and existing clients.

*[Refer to APS 4/5 Quality Control Standard].*

## Treat risks

### 12. Strategies need to be developed to manage the identified risks.

Examples of strategies to manage risk are as follows:

*A contingency strategy* applies to risks of higher consequence but lower likelihood of occurrence and aims at bringing the potential consequence of the risk within acceptable confines. Simple examples of such a risk control strategy are insurance and contractual indemnities, business continuity plans, contracting some or all of the activity to another organisation or person

*A preventive strategy* applies where potential impacts are not very large but the likelihood of occurrence is high, for example client complaints. In this case, quality control assurance procedures, supervision and training would be examples of this strategy.

*A monitoring strategy* is suited to exposures where the likelihood and consequence of risk are deemed to be relatively small. This strategy aims to ensure all "standard safeguards" are in place and working. It also requires the risk to be periodically reviewed. For example, quality checks, regular reporting, audit and performance reviews.

*A mixed strategy* corresponds to managing a risk environment that is managing potentially likely negative outcomes and outcomes of high impact or consequence which would involve a combination of strategies outlined above.

*[Refer to paragraph 13 below for more examples].*

### 13. Where an area of the practice is identified as posing high risk, the practice should:

- evaluate its ability to reduce the risk in terms of existing procedures;
- adjust or reconsider that area of practice and its development;
- retrain or employ personnel to meet any staffing weaknesses;
- review the engagement with clients in that area of the practice; and
- apply risk management procedures.

The following are important risk management procedures that need to be considered:

- Terms of Engagement

Documentation and agreed Terms of engagement are essential in any practice and benefit both the member and the client.

Terms of engagement can be embodied in an engagement letter as follows:

- confirms acceptance of the appointment;
- outlines the objective, scope and extent of the engagement
- highlights the extent of the member's responsibilities to the client;
- defines the client's responsibilities
- manages the "client expectation gap" i.e. ensuring that the services delivered are the services expected by the client;
- confines the extent of exposure by:
  - specifying limitations on the work to be undertaken;
  - confining the advice to the client only;
  - restricting use of member's name on documentation supplied to the client;
  - obtaining an indemnity from the client, any third party or in connection with receiverships, trust and secretarial work;
- reviews on a continuing basis the scope of the engagement during the engagement period;
- The form and nature of the engagement could change in the following circumstances:
  - where the breadth and scope of the agreed services alter or where they become more complex or detailed;
  - where additional services may be required by the client;
  - where the status or structure of the client could have changed from a partnership to a company or a trust mid-term, reviews of engagement letters should be conducted on a formalised basis and in agreement with the client.
- sets the fees applicable to the engagement.

*[Refer to APS 2 Terms of Engagement for guidance]*

- Advise Clients on Risks

To avoid undertaking the client's risks, advise the client in writing of relevant dates and consequences in the event of failure by the client to act. This will transfer the risk of non-compliance back to the client to action and/or follow up.

- Obtain adequate insurance and the control of claims once they have occurred.

*[These measures are discussed in more detail at Schedule A].*

- Accurate and contemporaneous documentation.

It is recommended that all advice a member or personnel provide is noted in a file/diary system or by confirmation letter or report to the client. The information that should be included is:

- date;
- time;
- content of conversation/advice;
- notation to whom it was made; and
- signature (if applicable).

- Timeliness of action and diary systems.

File notes will have the dual effect of:

- assisting with the recollection of events if there is litigation many years down the track;
- being tendered in court as evidence that a conversation actually occurred (subject to authenticity of documentation being established)

- Practice in areas where there is sufficient expertise.

Every member is required to recognise their own limitations. Where the member forms the view that there is insufficient time, or he/she does not have the skill required to perform the service requested, then the matter should be referred on to a specialist.

- Consultants/agents selection

Consultants/agents are required to:

- have adequate qualifications and resources;
- have adequate indemnity insurance; and
- be independent of the member.

- Client selection.

A review of the practice's client mix is recommended with a view to considering:

- increasing the proportion of clients requiring lower risk advice;
- the type of business conducted by the client, for example
  - ongoing work or one-off engagement;
  - the effect of economic climate on the client's business.

It is important to note that the application of such measures does not protect the member from his/her duty to exercise the level of skill, care and judgement appropriate to the service provided and therefore application of the highest standard at all levels is essential.

*[Refer to Code of Professional Code of Conduct]*

Generally, the practice should consider its quality control and assurance procedures, the problems that have arisen, and how they have been dealt with in the past.

## Communication and consultation

**14. The risk management process requires continuous communication and consultation with all parts of the business as well as outside parties to ensure that all personnel are informed of all stages of the process.**

## Monitoring and review

**15. A member needs to continuously monitor and review the strategies used to manage risk.**

Over time, new risks are created, existing risks are increased or decreased, risks no longer exist, the priority of risk may change or the risk treatment strategies may no longer be effective.

Monitoring should comprise of:

- monitoring existing risks;
- identifying new risks;
- identify any trouble spots;
- evaluate the effectiveness of current risk treatment strategies and adjust where necessary.

Monitoring ensures that, as risks change, new measures are introduced to control these risks. On-going review is required to ensure that strategies remain relevant.

## Recordkeeping

**16. All policies and procedures should be in writing. Records should be maintained documenting the assessment process carried out, the major risks identified and the measures identified to reduce the impact of these major risks.**

Failure to document policies can lead to breaches in performance because of misunderstanding or misinterpretation. A written set of policy statements supported by documented procedures provides a constant reference, a guide to action and a framework for checking that the operations are conducted in the manner intended by the member.

## Conclusion

17. Where a practice has in place:

- a set of documented policies and procedures that reflect what the practice does; and
- those policies and procedures adequately address the various elements of APS 4/5 Quality Control Standards and the mandatory requirements of other Professional Statements relevant to the practice's area of professional practice; and
- has a built in system of controls and checks; and
- has a mechanism to ensure they are kept current; and
- are driven by the principals of the practice who are committed to risk management and quality control,

then the following benefits are achieved:

- all personnel know what is required from them and how to perform;
- the principal/s can determine the control and standard of service that the practice provides;
- quality and consistency is promoted to clients;
- communication is enhanced;
- risk can be effectively managed; and
- there is a level of insurance that the practice is adequately managing risk.

## Additional information

For more information on risk management, refer to the Australian Standards AS/NZ 4360 or CPA Australia's website <http://www.cpaustralia.com.au>

For more information on Trade Practices / Fair Trading issues refer to the ACCC website at <http://www.accc.gov.au> or the Fair Trading Office in each:

<http://www.fairtrading.act.gov.au>

<http://www.fairtrading.nsw.gov.au>

<http://www.kakadu.nt.gov.au>

<http://www.consumer.qld.gov.au>

<http://www.ocba.sa.gov.au>

<http://www.justice.tas.gov.au>

<http://www.justice.vic.gov.au>

<http://www.docep.wa.gov.au>

## Schedule A — Managing risk — professional indemnity Introduction

This information will assist members when assessing the adequacy of the practice's level of professional indemnity insurance.

Members providing public accounting services are required to have a public practice certificate which imposes amongst other things, a requirement on the member who is a principal in public practice to hold and maintain professional indemnity insurance in accordance with CPA Australia's Bylaw 705. This Bylaw applies to members who reside in Australia and to member practices whether it be as a sole trader, partnership, incorporated practice as director/shareholder, trust or multi-disciplinary practice.

### Minimum professional indemnity insurance requirements

It is a mandatory requirement to hold professional indemnity insurance under the contract of membership with CPA Australia.

Such professional indemnity insurance must:

- insure the member against loss arising from claims in respect of any civil liability incurred by the member;
- the sum insured shall be at least \$250,000 of any claims in the aggregate arising out of any class of service; (\$500,000 in NSW and Western Australia due to limitation of liability schemes in operation);
- maximum excess for each and every claim shall be no more than 3% of gross fee income of the practice or 1% of the aggregate of the policy;
- "run off" cover is required for retired practitioners;
- provide for claims arising out of dishonesty of partner, directors and employees;
- be non cancellable for its specified period.

Members are required to review their insurance policies to ensure that the above minimum requirements are satisfied. A request to vary any of the above requirements can be made to the Board Insurance Committee in writing on a case by case basis. Such matters should be brought to the attention of the Manager Member Services at CPA Australia local offices.

### Understanding your professional indemnity policy

#### Key features

Professional indemnity insurance indemnified the practice from claims made alleging breach of professional duty.

Members are encouraged to read their policy and proposals thoroughly and be aware of the type of policies that they have taken out. When in doubt write back to the Broker/Insurer and seek confirmation/clarification.

#### Claims made/claims notified policies

Professional indemnity (and Directors and Officers) policies are usually written on a claims made/claims notified basis. When the claim is made against the insured during the period of the policy, the claim is activated. Therefore under a claims made policy, the event for which the claimant makes a claim may have occurred prior to the current policy in operation. The relevant policy is the policy which was current at the time the claim is made against the insured, not the policy which was current at the time the event occurred.

The insurer's obligation arises when the claim is made against the insured during a period of cover and the insured notifies the insurer of the event giving rise to the claim (Section 40 Insurance Contracts Act). Subject to any policy terms, the insured is required to notify the insurer where:

- (a) A third party has directly intimated or otherwise implied that the insured has caused loss and/or threatened to make a formal claim or has actually initiated litigation; or
- (b) Any circumstance in which the insured knows will likely lead to a claim against the insured at some time in the future. For example, the insured may realise that he has made an error handling a client's affairs, which may cause the client some loss in the future but the claim is not quantified.

If the policy is both "claims made" and "claims notified", the insured is further protected when he gives the insurer notice of facts which may lead/give rise to a claim. For example, if a claim is made against the

insured after the policy period has expired, but was caused by or arose from facts that occurred whilst covered, and which the insurer was notified during the policy period, then the relevant policy is the one that is current at the time when the insurer was notified.

Therefore claims made against an insured and any circumstances that lead to a claim against the insured, must be notified to insurers immediately. Otherwise, the insured may be liable for the degree to which late notification has prejudiced the insurer's interests. Alternatively, failure to notify could deprive the insured of cover altogether.

There is exclusion for liability arising from circumstances that should have been notified under a previous period of insurance. In this case, exclusion is offered where a reasonable person could be expected to know the circumstances could lead to or cause liability. Therefore prior to the end of any period of insurance particularly when the insured is changing insurers, all matters which may result in a claim should be notified.

Accordingly:

- ensure complete disclosure in writing of any potential claim/circumstance prior to the end of each policy year to ensure cover;
- review and update proposal form at renewal times as accurately as possible;
- lodge proposals as early as possible to ensure there is enough time to "shop around";
- proposals should detail the risk management processes undertaken by the practice.

### **Type of policy**

Policy coverage is available at varying levels from the most restrictive, being "negligent acts, errors and omissions" to the more broader wording of "civil liability" cover. Essentially the latter covers negligent acts, error and omissions as well as any claims made pursuant to legislation for example the Trade Practices Act. Civil liability cover is the coverage required by CPA Australia's Bylaws and is the wording CPA Australia has negotiated with underwriters for its members.

### **The insured**

The policy should cover the following (where appropriate):

- the practitioner
- the practice definition in the policy needs to adequately cover the actual services provided by the practice
- any person, firm or company that previously carried on the practice
- partners
- directors
- consultants
- sub contractors
- employees
- the estate of any insured person in the event of death
- predecessors in practice, that is, any person, partnership or incorporated practice that previously carried on the accounting practice
- mergers and acquisitions
- joint appointments (if applicable)

### **The insurer**

#### **Extent of cover**

This relates to the maximum amount the insurer will pay on any claim under the policy.

There are varying degrees of coverage, with the highest being "each and every claim". Other forms of cover are "aggregate limits with reinstatements" through to the lowest level of cover being an "aggregate limit for multiple claims".

These limits should be reviewed annually and discussed with insurance brokers/ underwriters.

The policy should be cost exclusive, that is there is no excess for legal costs and associated expenses. It should cover all costs reasonably incurred after notification to insurers and in the proceedings for the recovery of fees, costs and expenses from the time the insurer appoints legal adviser to act on the insured's behalf.

### **Excess**

Excess is the first amount of any liability which must be paid for by the insured.

[Refer to "Minimum Professional Indemnity Insurance Requirements" relative to CPA Australia's By-Laws requirement for excess.]

### **Period of insurance**

Contracts of insurance are generally written for a term of one year.

### **"Run-off" cover**

A distinction should be drawn for run-off cover for sole practitioners and/or those practices that dissolve, from run-off for former partners of practices that continue to operate.

For a sole practitioner, the individual is on his or her own and will need to pro-actively, on an annual basis, secure run off cover for an adequate period. Seven years is not necessarily sufficient and legal advice should be taken as to the applicable run-off period.

If a partner leaves a practice that continues, however, it is then incumbent on that partner (and indeed the former practice) to keep in touch to ensure that the practice maintains a policy in place for a sufficient period to provide coverage for the former partner(s). A practice protocol should be developed to assist members to advise them how best to manage this monitoring process for a sufficient period.

### **Geographical area**

If a practice provides services overseas or is likely to be relied upon by people overseas, a member will need to ensure that no geographical limitations apply to the policy.

### **Retroactive date**

There is a need to ensure that the retroactive date captures the inception date of the business, as this will ensure any subsequent changes to the entity will then be covered.

Any circumstances that have occurred prior to the retroactive date will not be covered.

Alternatively, check to see whether the wording provides for "unlimited retroactive liability."

### **Endorsements**

There may be endorsements on the policy. Endorsements may:

- Specify an extra risk covered by the policy; or
- Delete/modify particular wording/classes according to the specific requirements of the insured.

Recent endorsements found in policies may include:

- Terrorism exclusion;
- Financial planners/investment advice endorsement;
- Finance/mortgage/lease brokers mortgage originator endorsement;
- Provision of some taxation advice;
- Audit;
- Information Technology.

### **Extensions**

Some standard extensions to the policy include the following:

- Loss of documents. The insured is protected for the cost of replacing or repairing the client's and insured's documents which are lost or damaged.
- Forgery — liability arising from the fraudulent execution, alteration or use of a title document (certificate of title, power of attorney), or forgery of such a document is covered.
- Fidelity — the fidelity extension is the only part of the policy that covers first party loss. For example, when a partner absconds with the funds, leaving the other partner out of pocket. Provided the remaining partner is innocent and not on notice of the theft, then the extension may react to indemnify him/her.

It should be noted that this does not form part of the coverage for a sole practitioner because he cannot rely on the extension to indemnify himself for amounts stolen.

### **Limitation of liability schemes**

The Professional Standards Act 1994 (NSW) and the Western Australian Professional Standards Act 1997 cover the limitation of liability of members in occupational associations in certain circumstances. A scheme limiting the liability of members of CPA Australia is in operation in NSW and has recently been approved in Western Australia.

Under the Accountants' Scheme, liability is limited to 10 times the fee for the service giving rise to the liability claim, but not exceeding a monetary ceiling on all claims of \$50 million.

If sued, a member must prove compliance with CPA regulatory matters in order to take advantage of the limitation of liability.

Recently the State Governments and Commonwealth Government have approved in principle, to create a national scheme which is expected to become operative in 2004.

### **Amount and extent of professional indemnity insurance**

Having carried out the above assessment, the practice will need to decide how much insurance it needs. In making this decision the practice should:

- consider and attempt to quantify the practice's exposure, taking into account the worst case scenario;
- include any minimum amount required by law in respect to providing a particular service;
- assess limits of insurance arranged by practices of a similar size and profile. The practice's broker should be consulted and information held jointly with other practices by mutual arrangement should be considered;
- secure from the practices' broker a number of quotes for varying limits so that the relative impact on cost can be assessed against the issue of adequate policy limits;
- set the excess payable under the policy;
- determine the sufficiency of the practice' own resources to meet claims, the availability of both personal and practice's assets and reserves set aside to meet known claims;
- take into consideration the long-tail nature of liability claims;
- recognise that the extent of losses can be substantially increased by interest, legal costs and inflation.

### **Other forms of insurance**

Other forms of insurance to consider include:

- Directors & Officers insurance. This insurance indemnifies the assured for liabilities arising from errors in the management of corporate entities. It also provides reimbursement to the company where the company has obligations to indemnify its corporate officers.
- Trustees liability insurance. Trustees of, for example, superannuation funds, can now arrange separate cover from the practice's professional indemnity insurance.

- Statutory liability insurance. This class of insurance provides indemnity for the legal costs of defences and for statutory penalties that might be imposed in certain circumstances. This insurance may be of particular interest to insolvency or voluntary administrator appointments.

### **Identifying and monitoring claims**

The practice should look for ways to limit the possible damage caused by any existing claims. The following steps would assist:

- the establishment of a formal review process to ascertain from all personnel and partners whether anyone is aware, after enquiries, of any claims or circumstances that could give rise to or may have led to a claim and ensure that they are notified. In the review process, it is important to ensure personnel and partners:
  - are warned not to inadvertently or directly admit liability when an enquiry is made;
  - understand what constitutes a claim and/or circumstances pursuant to the policy terms and conditions.
- monitoring of insurance arrangements to ensure that they remain effective (e.g. notifications to insurers, review of limits, etc);
- regular claims review; and
- regular use of independent advisers such as insurance brokers, legal advisers and risk manager, where appropriate.

### **Schedule B – Liability of accountants**

Accountants, auditors and other professionals have a legal liability to their clients and others who rely on their professional advice. ("accountants")

#### **Client liability**

Client liability can arise from:

- Breach of contract (eg. failure to exercise care and skill)
- Professional negligence (eg, negligent mis-statements)
- Breach of fiduciary duty
- Breach of statutory provisions
  - Trade Practices Act 1974 (Cth), eg, misleading and deceptive conduct
  - Corporations Act 2001 (Cth)

When undertaking professional services, the member is expected to exercise the appropriate level of skill and care. The skill and care required depends on the nature of the work to be performed. For example, a higher degree of care is required for specialist advice on taxation rulings.

A member may limit or exclude liability but only to the extent permitted by law, for example, a member cannot contract out of a statutory liability such as the Trade Practices Act and corresponding Fair Trading Acts.

#### **Third party liability**

The potential for action by third parties such as shareholders, investors and lenders, lies in professional negligence and possibly breach of statutory provisions as mentioned above.

#### **When might an accountant be liable to third parties**

- The following elements need to be established before a third party is successful against an accountant;
  - the accountant could reasonably foresee damage to the third party;
  - there is a sufficient relationship of proximity between the accountant and the third party; and

- where it is fair, just and reasonable to impose a duty of a particular scope on the accountant.

### **Where might it be fair, just and reasonable to impose a duty**

- Where the accountant knows:
  - the third party exists;
  - the third party will reasonably expect to receive and rely on the accountant's work for a particular transaction or purpose;
  - the third party will suffer damage if the work is negligently done.
- More particularly where:
  - the third party has no other source of advice;
  - the purpose of the accountant's work was to induce the third party into a particular transaction.

*(Caparo Industries plc v Dickman [1990] 2 AC 605 HL)*

- Where it can be established that the accountant made a misrepresentation with the intention that it be acted upon by the third party.

*(R Lowe, Lippman Figdor & Franck v AGC (Advances) Ltd [1992] 2VR 671 (Full court of the Supreme Court)*

### **What are the recognised circumstances in which liability to third parties will not generally arise and why**

The following are summaries of recent court decisions:

- No duty of care to individual shareholders (current or otherwise) who bought shares in a company relying on audited accounts.

*(Caparo Industries plc v Dickman [1990] 2 AC 605 HL)*

- A duty of care was owed to subscribers who relied on the company prospectus but not anyone else who bought shares in the market in reliance on a company prospectus.

*(Al Nakib Investments v Longcroft)* (Mts WAS MENTIONED IN The Times on 4 May 1990 without citation).

- No duty of care owed to an identified takeover bidder who relied on draft accounts — because the accounts were not produced for the bidder and were in draft and not final form. It was not foreseeable that the bidder would not obtain independent advice.

*(James McNaughton Group v Hicks Anderson & Co [1991])*

- No duty of care where auditors did not know of Bank's existence or its reliance on accounts in order to lend money to a company

*(Al Saudi Banque v Clark Pixley [1989] 3 All ER 361)*

### **What are the recognised circumstances in which liability to third parties may generally arise and why**

The following are summaries of recent court decisions:

- A duty of care was owed to a company acquiring shares relying on audited accounts because the firm's audit manual recognised "interested parties who read and rely upon our reports"

*(Columbia Coffee & Tea Pty Ltd v Churchill (t/a Nelson Parkhill) [1992] 29 NSW LR 179 (Supreme Court of NSW).*

- A duty of care may be owed where the auditor in conjunction with other factors assumes responsibility for particular third parties who may access the reports. Other factors include, knowledge of the existence of such third parties and making a misrepresentation with the intention to induce such third parties into specific transactions.

(*Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* [1997] (unreported — 14 February 1994).

## Protection against claims

### What should accountants do to protect against claims

In any reports generated, the accountant should:

- Specify the extent of work carried out and more specifically the work not carried out, thereby limiting arguments of reliance on reports;
- Identify who is authorised to receive the report (ie: the client);
- Identify any limitations to the work sought by the client, so that problems are canvassed early and brought to the attention of anyone seeking to rely on the report;
- Utilise disclaimers which:
  - define the responsibilities owed to clients;
  - define the extent clients should rely upon that work;
  - limit or exclude liability of third parties;

As noted earlier, the *Trade Practices Act 1974* (Cth) and corresponding Fair Trading Acts limit the effect of disclaimers, and accountants should not rely too heavily on the success of disclaimers to protect them completely.

- If accountants know that a particular third party will or may gain access to the report, they should:
  - clearly state to that third party that they make no representations about the accuracy or adequacy of the processes or procedures undertaken in preparing the report; and
  - obtain a signed disclaimer from those third parties excluding duty or liability.

*[The above information is not intended as legal advice. Members should consult a suitably qualified legal adviser to obtain advice tailored to their particular circumstances.]*



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