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CFACG(91)10

COMMITTEE ON THE FINANCIAL ASPECTS
OF CORPORATE GOVERNANCE

THE STATUTORY DEFINITION OF AUDITORS'S RESPONSIBILITIES: THE CAPARO CASE

Note by the Secretary

The submission on 'The Statutory Definition of Auditors Responsibilities' by the Financial Reporting and Auditing Group of the Institute of Chartered Accountants in England and Wales (paper CFACG(91)11 FRAG) deals inter alia with the implications of the Caparo decision. The purpose of this note is to provide the Committee with some factual background about the case and to report representations made by Mr James Leek, a Director of Caparo, to Sir Adrian Cadbury at a meeting on 1 October 1991 and in correspondence.

2 The background is that Caparo Industries plc purchased shares in Fidelity plc after the latter's statutory accounts for 1984 had been published, and subsequently launched a take-over bid. A little over a year later Caparo commenced an action against the auditors and directors of Fidelity, alleging that the published pre-tax profit of £1.3m should have been a loss of £400k. Caparo claimed that it had been the victim of fraud by the directors and negligence by the auditors, and that if the true position had been known it would not have made the bid.

3 The auditors argued that they did not owe a duty of care to Caparo. In the Court of Appeal a majority decided that the auditors' duty did extend to shareholders of the company who might buy and sell its shares (including Caparo as an existing shareholder), but not to other potential investors. The House of Lords however overturned this decision, ruling that a company's auditors did not owe a duty of care to potential investors in the company or to individual shareholders who purchased further shares; and that an investor or shareholder who relied on the company's statutory accounts when deciding to purchase shares in the company had no claim against the auditors if the accounts were negligently prepared. Their Lordships distinguished between two situations: first, the duty of care owed by a professional man to his client, or to a third party if the professional man was aware that the third party was contemplating a transaction and would rely on his advice in deciding whether

to complete the transaction; and secondly, the entirely different situation where a statement was effectively put into general circulation and might be relied on by strangers for many different purposes. There had to be a 'special relationship' between the professional and the third party for a duty of care to be owed.

4 Fidelity (Caparo's subsidiary) has now itself issued a writ against the auditors alleging that they were negligent in failing to detect significant fraud (now established by the High Court) and that Fidelity itself suffered significant losses as a result of its auditors' negligence.

5 Mr Leek's representations are in summary as follows:

i) auditors should be made liable for their negligence to accounts users who suffer loss. It is anomalous that under the Companies Acts and the Financial Services Act auditors should be liable for their reports appearing in a prospectus (for example on a rights issue or a new issue of shares) but not for their reports appearing in annual accounts. It is unethical in Mr Leek's view for the profession to shelter behind such a fine legal distinction. He argues that many more people buy and sell shares based on accounts than do so as a result of subscribing under a prospectus.

ii) auditors should have a better form of defence against their increased liability exposure. Mr Leek suggests that they might have a valid defence if they made more frequent use of qualified audit reports, where there is reasonable ground for discomfort on either the accuracy or presentation of the figures or of the accounting system.

iii) there should be an independent review body to hear cases of auditors' negligence, once it had been established by the court in each relevant case that the auditor owed a duty of care to the plaintiff.

iv) there should be a better mechanism for shareholders' involvement in the selection and appointment of auditors.

6 Mr Leek was not prepared to divulge details of how Fidelity would seek to demonstrate that it had itself suffered significant losses when the case was

heard. He did however suggest that it was more difficult for a company to prove losses than for shareholders, and that any damages were likely to be inadequate because the losses demonstrated for the company would be less than the amount by which Caparo had overvalued the company's shares when it acquired them.

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