No Free Riding: The Scope of Auditors' Negligence in *Barclays*[1]

I. Introduction to auditors' liability in negligence

1. The extent of auditors' liability in negligence has, on the whole, been a settled area of law, stemming from the important English case of *Caparo Industries Inc v Dickman*[2] ("***Caparo***"). There, the plaintiff purchased a controlling stake in another company, having relied on the information contained in the audited financial statements. After the takeover, it was discovered that the purchased company was in a worse financial position than expected and the plaintiff claimed that this led to the shares of the company being overvalued.[3] The plaintiff commenced a claim in negligence against the auditors for the negligently audited and certified statements in an attempt to recover the amount it overpaid for the shares.[4] However, the Court held that the auditors did not owe the plaintiff a duty of care as the auditors had had no actual knowledge of the purposes to which the plaintiff put the audited financial statements, and could not have assumed any responsibility for the plaintiff's use of the audited financial information.[5]

2. The decision in *Caparo* with respect to negligent audit work has been followed in Singapore[6] and other Commonwealth countries such as Australia[7] and Canada[8]. Nonetheless, with the benefit of legal advice, disclaimers of liability limiting auditor liability to the audit clients have crept into auditors' reports. In *Royal Bank of Scotland Plc v Bannerman Johnstone Maclay,*[9] although a duty of care was found to exist between a company's auditor and the bank which had loaned money to the company, Lord Macfayden stated, *obiter*, that if not for the absence for a disclaimer of liability he

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[1] Gan Ee Kiat, 2nd Year J.D. Student, Singapore Management University's School of Law
[2] *Caparo Industries plc v Dickman* (1990) 2 AC 605 ("***Caparo***").
[3] *Id*, at 614.
[4] *Id*, at 615.
[5] *Id*, at 629.
[6] See *Ikumene Singapore v Leong Chee Leng (trading as Elizabeth Leong & Co)* [1993] 2 SLR(R) 480 and *Standard Chartered Bank v Coopers & Lybrand* [1993] 3 SLR(R) 29. Both cases concerned the liability of negligent auditors to aggrieved creditors who had extended loans to companies on the faith of materially misstated audited financial statements.
[7] See *Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* (1997) 188 CLR 241.
[8] See *Hercules Management Ltd v Ernst & Young* [1997] 2 SCR 165.
[9] *Royal Bank of Scotland Plc v Bannerman Johnstone Maclay* [2003] SLT 181.

would not have found a duty of care—giving rise to the term: "*Bannerman* disclaimers"[10].

3. The validity of such disclaimers was formally recognized by the English Courts in the recent case of *Barclays Bank plc v Grant Thornton (UK) LLP*[11] ("*Barclays*"). In that case, Barclays Bank required audited financial information from a potential borrower ("**VEH**") prior to agreeing to a loan agreement. In response, VEH engaged the defendant auditors ("**GT**") to audit and certify the financial information provided to Barclays. Unlike the defendant auditors in *Caparo*, GT was aware that the audited financials would be used by Barclays[12]. After the loan agreement was signed and the funds provided,[13] VEH went into administration.[14] Barclays Bank sought to sue GT on the grounds that by having failed to detect material and fraudulent misstatements in VEH's financial information, GT acted negligently.[15] However, the report prepared by GT contained a standard-form disclaimer:[16] that GT would not accept or assume responsibility to anyone (other than VEH) in relation to the reports or its audit work.[17]

II. The decision in *Barclays Bank plc v Grant Thornton (UK) LLP*

4. The Court relied on *Caparo*, *Al-Saudi Banque v Clark Pixley*[18] and *Man Nutzfahrzeuge AG v Freightliner Ltd* as authorities for the proposition that the extent of auditors' liability in negligence to a third-party user of audited financial information would depend on an objective determination of whether the user would have understood that the purpose of the provision of the audited financial information included protecting him from a type of loss suffered in reliance on that information.[19] The Court accepted that GT was aware that the audited report would be used by Barclays and that "[in] the *absence of any disclaimer…a duty of care would exist* as between Grant Thornton and

[10] *Barclays Bank plc v Grant Thornton (UK) LLP* [2015] 1 CLC 180 ("***Barclays***") at [8].
[11] *Id*.
[12] *Id*, at [53].
[13] *Id*, at [34].
[14] *Id*, at [31].
[15] *Id*, at [34].
[16] *Id*, at 71; published in sample form by the Institute of Chartered Accountants of England and Wales (ICAEW).
[17] *Barclays, supra* n 10, at [5].
[18] *Al-Saudi Banque v Clark Pixley* [1990] Ch 313.
[19] *Barclays, supra* n 10, at [52].

Barclays, with the necessary foreseeability and proximity, if the threefold approach is adopted (i.e. *Caparo*)."[20] (emphasis added.)

5. Therefore, the Court held that the existence of a duty of care between GT and Barclays turned on the validity of the *Bannerman* disclaimer in the auditors' report as a limitation of liability[21] which, in turn, was determined by the finding of reasonableness under the Unfair Contract Terms Act 1977[22], Cooke J stating that "the issue still ultimately depends on the reasonableness or otherwise of the disclaimer in all the circumstances of the case. If reasonable, it will have the effect of negating liability. If not, it will not."[23]

6. Cooke J also held that the reasonableness of *Bannerman* disclaimers could be determined by reference to whether such disclaimers had found broad commercial acceptance. With reference to auditors' liability, such disclaimers were generally reasonable as an "expected part of auditors' business":

> It is true to say that it is not unusual in the world of finance for commercial parties to rely upon the work of others for which they have not paid without having any enforceable rights in respect of that work. Reliance on such statements is then placed at their own risk. … An expectation of reliance, whilst disclaiming any responsibility should the person choose to so rely, cannot create a duty ... if a disclaimer is an expected part of auditors' business, why should it not be effective?[24]

7. The Court ultimately concluded that the disclaimer was reasonable and therefore valid, further holding that the lack of a contractual relationship between GT and Barclays would mean that Barclays would have gotten "a free ride" if its claims succeeded.[25]

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[20] *Barclays, supra* n 10, at [54].
[21] *Barclays, supra* n 10, at [58].
[22] Unfair Contract Terms Act 1977 (c 50) (UK). In Singapore, a materially similar statute was enacted under the Unfair Contract Terms Act (Cap 396, 1994 Rev Ed).
[23] *Barclays, supra* n 10, at [61].
[24] *Barclays, supra* n 10, at [62].
[25] *Barclays, supra* n 10, at [67].

III. Commentary on the decision

A. Increased reliance on the auditors' reputation may lead to lower competition

8. With the decision in *Barclays* upholding the validity of a broad exclusion of auditors' liabilities to third parties by way of a *Bannerman* disclaimer, third-party investors may accord even more weight to the reputation of the audit firms as an indicator of audit quality. Larger accounting firms have more substantial reputations of quality to protect, and may thus be perceived by potential investors to be more reliable[26], particularly where *Bannerman* disclaimers are *de rigeur*. Businesses may then engage these larger accounting firms in a bid to secure higher levels of investor funding at lower costs of capital, due to the higher level of investor confidence that a certificate from a larger accounting firm provides. This "flight to quality" may potentially reduce the client base of smaller audit firms and result in lower levels of competition in the audit industry which, past a certain level, may then paradoxically lead to a reduction of audit quality in the industry[27], though this phenomenon has not yet been conclusively proved.

B. Not taking responsibility may diminish the credibility of an auditors' certificate

9. In light of the fact that disclaimers such as the one upheld in *Barclays* are industry-standard clauses[28], this would mean that auditors would—in most cases—only owe a duty to their client. The pernicious impact of such a situation was described by Denning LJ in his dissenting judgement in *Candler v Crane, Christmas & Co*[29] ("***Candler***"):

> I think that the law would fail to serve the best interests of the community if it should hold that accountants and auditors owe a duty to no one but their client. It would encourage accountants to accept [information] … without verifying it … there will be no reason why

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[26] Carlos Corona & Ramandeep S. Randhawa, "The Auditor's Slippery Slope: An Analysis of Reputational Incentives", Management Science 2010; 56(6): 924-937 at 926.

[27] Jere R. Francis, Paul N. Michas, & Scott E. Seavey, "Does Audit Market Concentration Harm the Quality of Audited Earnings? Evidence from Audit Markets in 42 Countries", Contemporary Accounting Research 2013; 30(1): 325-355 at 350.

[28] *Barclays, supra* n 10, at [71].

[29] *Candler v Crane, Christmas & Co* [1951] 2 KB 164 ("***Candler***"). This dissenting opinion eventually formed the foundation for the development of the law of negligence extending claims in tort for negligent misstatements to non-contracting parties in *Hedley Byrne v Heller & Partners Ltd* [1964] AC 465 ("***Hedley Byrne***") and *Caparo, supra* n 2.

> accountants should ever verify the word of [management], because there will be no one to complain about it … *the persons who are [consequently] misled cannot complain because the accountants owe no duty to them*.[30] (emphasis added)

He then went on to say,

> If such be the law, I think it is to be regretted, for it means that the accountants' certificate, which should be a safeguard, becomes a snare for those who rely on it …[31]

10. As stated by Denning LJ, the auditor is an essential actor in ensuring the integrity of the capital and financial markets precisely because his certification of the accuracy of the audited financial information is perceived and relied on by other market actors as a "safeguard" against the possibility that materially inaccurate information is provided by the audit client to potential investors to "snare" them in a bad bargain. It must then follow that, where this perception is undermined, the degree of reliance placed by potential investors in the auditors' work is reduced, and the extent that clients are willing to pay for audit work accordingly decreases.

11. In a similar vein, accounting literature has noted that the value of an audit depends on the auditor's perceived ability to discover misstatements in a manner that is independent of external pressure.[32] The greater *perceived* incentive for the auditor to tell the truth, the greater the value of the audit opinion; further, "if the capital market expected the auditor never to deviate from management's position, then it would assess the value of the opinion as zero".[33] In other words, the value of audit services provided by an auditor ultimately depends on the *trust* that users place in the auditor.

12. The judgement in *Barclays* may undermine that trust by allowing the auditor to shelter behind disclaimers of liability to anyone other than their client. Even if the auditor has

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[30] *Candler*, *supra* n 30, at 184.
[31] *Candler*, *supra* n 30, at 185.
[32] Linda E. DeAngelo, "Auditor Independence, 'Low Balling', and Disclosure Regulation", Journal of Accounting & Economics 1981; 3(2): 113-127 at 115.
[33] *Id*, at 116.

not in fact been negligent, other market actors may, as a consequence of the disclaimer, and for the reasons stated by Denning LJ in *Candler*, "assume the worst". As a result, the value that market actors place on the auditors' certificate and work would be diminished, leading to a compression of profit margins for the audit industry as a whole.

IV. Analysis

A. The legal principles of Barclays are founded on the basis of preventing an over-expansion of liability.

13. The legal proposition in *Barclays* (that disclaimers of responsibility would *prima facie* serve to negate the existence of a duty of care between two non-contracting parties as long as they have been determined to be reasonable, in the sense of "broad commercial acceptance",[34] at both statutory and common law) is founded on the sound legal logic of preventing an over-expansion of liability, especially in the commercial context. As Lord Devlin said in *Hedley Byrne v Heller & Partners Ltd*[35] ("***Hedley Byrne***"), "[a] man cannot be said voluntarily to be undertaking a responsibility if at the very moment when he is said to be accepting it he declares that in fact he is not."[36]

14. The existence of a duty of care between parties in Singapore is governed by a two-stage framework premised on both proximity (at the 1st stage) and policy considerations (at the 2nd stage) with a threshold consideration of factual foreseeability.[37] This was enunciated in the landmark decision of *Spandeck Engineering (S) Pte Ltd v Defence Science & Technology Agency* ("***Spandeck***").[38] Based on this framework, the Singapore Court of Appeal ("**CA**") has stated in both *Man B&W Diesel S E Asia Pte v PT Bumi International Tankers*[39] as well as *Animal Concerns Research & Education Society v Tan Boon Kwee*[40] that where the extension of a duty of care would contradict express contractual terms, the courts would be reluctant to find a duty of care without

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[34] *Barclays*, *supra* n 10, at [55].
[35] *Hedley Byrne*, *supra* n 30.
[36] *Hedley Byrne*, *supra* n 30, at 533.
[37] *Spandeck Engineering (S) Pte Ltd v Defence Science & Technology Agency* [2007] 4 SLR(R) 100 ("***Spandeck***") at [73].
[38] *Spandeck*, *supra* n 38.
[39] *Man B&W Diesel S E Asia Pte v PT Bumi International Tankers* [2004] SGCA 8 at [50].
[40] *Animal Concerns Research & Education Society v Tan Boon Kwee* [2011] 2 SLR 146 at [58].

more. The decision in *Barclays*, which gives regard to express disclaimers of liability, is consistent with the decisions of the CA and would likely serve to negate a finding of proximity between an auditor and a third-party user of the audited financial information at the first stage of the *Spandeck* framework.

15. However, it is submitted that although *Barclays* can be considered the latest lineal descendant in a line of authority on negligent misstatements stemming from the dissenting opinion of Denning LJ in *Candler*, the law relating to auditor negligence as it stands after *Barclays* appears to have disregarded the "ancestral" warning of Lord Denning in *Candler* of the dangers of having accountants owe a duty to no one but their client. While Lord Denning's warnings were not expressly adopted by the House of Lords in *Hedley Byrne* and *Caparo*, they do embody the broader, commercial realities of the audit industry.

B. The short-term commercial impact of disclaimers are beneficial to neither the audit industry nor the audit clients

16. As has been noted above, the upholding of the legal validity of *Bannerman* disclaimers in *Hedley Byrne* and *Barclays* may potentially lead to two outcomes. Firstly, the widespread adoption of *Bannerman* disclaimers may trigger a "flight to quality" within the audit industry, leading to reduced competition.[41] This may be detrimental to audit clients, in that they would then need to incur higher audit costs to engage larger accounting firms in order to secure higher levels of investments at lower costs of capital.

17. Secondly, as noted by Denning LJ in *Candler*, the value of an auditors' certificate as a "safeguard" may be diminished, leading to a reduction in the value of audit services and in turn to downward pressures on audit fees,[42] as a result of which the audit industry may experience a compression of profit margins.

[41] See para 9 above.
[42] See paras 10 – 14 above.

V. Conclusion

18. The audit profession—like other professions—is subject to heavy competition. Certificates issued by audit firms unafraid to forgo the protection of broadly-worded disclaimers, may be perceived to be more reliable and therefore of higher value compared to those of audit firms sheltering behind such limitations of liability.[43] Companies seeking investments and lower costs of capital due to investors' higher confidence in their audited financial information would then seek out these audit firms, prompting their "timorous"[44] (to borrow a phrase from Lord Denning) competitors to follow suit or risk irrelevancy.

19. As such, even if upholding the validity of broadly-worded disclaimers is correct in law, the use of such disclaimers ultimately represents an abrogation of responsibility by the audit profession which is likely to be toxic to both the profession and the capital markets. This author is of the opinion that, in the long term, the operation of the economic and commercial realities of demand and supply may well prompt a return to a pre-disclaimer era. Should that come to pass, the test for the existence of a duty of care owed by the auditor to a third-party user of audited financial information would essentially be that enunciated in *Caparo*, and dependent on whether the auditors, in certifying the financial information, knew of the purposes to which the audited financial information would be put by that user of such information. This would also be consistent with the judgement of Cooke J in *Barclays* had the *Bannerman* disclaimer not existed.[45]

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[43] See paras 11 – 12 above.
[44] *Candler*, *supra* n 30, at 178.
[45] *Barclays*, *supra* n 10, at [54].