PROFESSIONAL RISK MANAGEMENT BULLETIN

Technical Bulletin
Managing the professional liability of accountants (N1)
(Issued July 1999)

Appendix V - The Involvement of Accountants in Commercial Agreements

1. Engagement

Those entering into commercial agreements will sometimes wish to provide that monetary amounts or other data shall be subject to "certification" by an independent third party. Such agreements may be in respect of a wide variety of transactions, e.g., agreements for the sale and purchase of companies or businesses where the consideration is based on net assets, results or other information derived from the accounts, financial agreements and agency and franchise agreements. Typically, the third party may be an accountant or auditor named or otherwise identified in the agreement.

As a general principle, the accountant can only "certify" where the certificate relates to matters of which he can be certain and do not involve professional judgement. An example of this would be a certificate that, according to the records of his client, a certain amount of money has been paid, or that the turnover figure shown in his client's accounting records is HK$X, because he can verify this by examining the accounting records. He cannot, however, certify the accuracy of his client's accounting records, financial statements or information extracted from them because he cannot be sure that he has access to all the facts behind them. To endeavour to ascertain those facts would be likely to necessitate investigations so extensive as to make the exercise not economically viable. If what is sought is an expression of the accountant's professional opinion, the word "certificate" is inappropriate.

2. Some detailed considerations

Set out below are certain detailed considerations which parties and their advisers may wish to bear in mind when negotiating commercial arrangements involving participation by professional accountants. The examples are illustrative only:

(i) Financial statements are the responsibility of management, not the auditors.

(ii) Because of the judgemental issues involved, figures in financial statements should not be referred to as "correct".

(iii) It should be recognised that a figure in financial statements represents a "carrying amount" which may not be the same as the current value of an item.

(iv) Many items in financial statements are based on accounting estimates made by existing management in the light of their financial and operating policies.

(v) The difference between a subsidiary and an associated entity should be borne in mind where an agreement is not confined to individual entities.

(vi) Where an accountant is asked to prepare financial statements, unless the parties agree otherwise, the accounting bases used will be those adopted in previous accounting periods. Areas where the parties might wish to agree otherwise may include, for example, provisions for corporation tax, deferred tax, pension contributions and holiday pay. The financial statements will be prepared on the basis of the information and explanations supplied to the accountant by the management of the entity concerned.

(vii) Where an accountant is to carry out an audit, it should be borne in mind that items are likely be examined on a selective basis and regard had to materiality considerations.

(viii) Where accounting standards are to be applied to financial statements other than annual accounts prepared under the Companies Ordinance, the additional costs involved should be borne in mind. Examples are those in relation to information about associated companies, property valuations and actuarial valuations of pension costs.

(ix) Requirements for the retrospective preparation of financial statements may present difficulties, for example, where no stocktaking has taken place in the relevant period.

(x) The possibility of changes in legislation or practice should be recognised when specifying that financial statements should be drawn up on an existing basis.

(xi) If figures are expressed to be subject to any necessary adjustments, the adjustments should be adequately defined.

(xii) Parties and their advisers should satisfy themselves before the event that any time limit they wish to agree on is capable of fulfilment.

(xiii) Conditions that involve time factors outside the control of the accountant should be avoided in setting his terms of reference. For instance, it would be inappropriate to require that liabilities with the Inland Revenue should be finalised by a certain date.

(xiv) If what is sought is an expression of the accountant's professional opinion, the word "certificate" is inappropriate.

(xv) An auditor's working papers are his own and if production is envisaged his consent will be required.

(xvi) Commercial agreements should include provision for the responsibility for payment of the charges of any third party involved.

(xvii) An engagement letter should be drawn up and agreed with the accountant recording his terms of reference with particular regard to the scope of the work to be done and the terms under which it is to be performed.

3. A Court of Appeal decision

Attention is also drawn to a 1991 Court of Appeal decision below which is also relevant.

In May 1991 the Court of Appeal had to consider a case (Shorrock Limited & Anor v Meggitt PLC) which turned on the construction of an agreement under which the consideration was to be determined by reference to a certificate to be given by joint auditors.

In essence, the facts were that, under an agreement for sale, a vendor company agreed with a purchaser company to sell to it the issued share capital of a third company for a nominal sum to be subsequently adjusted. The amount of the adjustment was to be determined by way of a certificate by the auditors as to the net deficit shown by the audited accounts of the company being sold. In their audit report on the accounts the joint auditors stated that they were unable to determine the adequacy or otherwise of a provision of some £730,000 in respect of potential legal claims. The certificate of net deficit prepared in accordance with the agreement confirmed in its first paragraph the amount of the deficit derived from the accounts and included a second paragraph drawing attention to the fact that in their audit report the joint auditors had been unable to determine the adequacy of the provision for potential legal claims. In including the second paragraph, the joint auditors were following the Auditing Standard "the Audit Report" which indicates that if the auditor is unable to express an audit opinion without reservation he should qualify his report by referring to all the matters which he considers to be material and about which he has reservations.

The question before the court was whether, as a matter of construction, the certificate as given was a valid certificate under the terms of the agreement. At the first hearing of the case before reaching the Court of Appeal, the court had held that "an otherwise clear certificate cannot be rendered invalid because by reference to an audit report the auditors are shown to have accepted the directors' assessment of the burden of the outstanding claim, without being themselves liable to check such assessment". The Court of Appeal held, however, that it was not a valid certificate, because the two paragraphs had to be taken as a whole and the second paragraph indicated that the auditors were unable to determine a significant part of the amount included in the figure of net deficit. The court indicated that it would have been open to the auditors to certify a certain figure as the net deficit or to refuse to certify, but not, in the context of the particular agreement, to state a sum "and then say, in effect, that they were not sure if that sum was correct".

The terms "certify" and "incorrect" were used in the case although they are not used in statute law in the context of an audit. The Companies Ordinance requires the auditor to express an opinion on the truth and fairness of financial statements, rather than to certify that they are correct. The Court of Appeal decision underlines the importance of discussions at an early stage with any professional accountants who may be involved in carrying out the terms of commercial agreements.

N1: This statement is based on similar guidance issued by The Institute of Chartered Accountants in England and Wales (ICAEW) appropriately adapted to the local context. The Society gratefully acknowledges the permission given by the ICAEW in this respect.