

Auditing Guidance Statement

AGS 1014
(July 2002)

Privity Letter Requests

Prepared by the **Auditing & Assurance Standards Board** of the
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AUDITING GUIDANCE STATEMENT
AGS 1014 “PRIVITY LETTER REQUESTS”

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Introduction

- .01 This auditing guidance statement relates to circumstances where third parties such as investors, lenders or providers of goods or services seek reliance on a general purpose financial report.
- .02 The English decision in *Caparo Industries PLC v Dickman & Others* [1990] established that an auditor’s statutory duty to audit and report an opinion on a company’s financial report is owed to the body of shareholders as a whole and not to shareholders or potential shareholders acting as individuals or as groups of individuals. Furthermore, no duty of care is owed to a third party unless, at the time the audit report is prepared, the auditor had knowledge of the third party and knew, or should reasonably have known, that the audited financial report would be shown to and relied upon by the third party and the particular purpose for which the third party intended to place reliance on the audited financial report. The Australian High Court judgment in *Esanda Finance Corporation Limited v Peat Marwick Hungerford* [1997] 142 ALR 750 is consistent with the *Caparo* decision in its approach to the circumstances in which an auditor may be found liable to a third party.
- .03 In Australia the common law concerning the nature and extent of an auditor’s duty of care to third parties remains complex as judgments contain differences of judicial opinion and interpretation. However, the judgment in *Esanda* was a positive development for auditors because the court rejected the contention that liability could be based on foreseeability of reliance alone. The High Court found that there had to be circumstances establishing a relationship of proximity between the auditor and the third party before a duty of care could be said to exist. This indicates that the auditor has to come into a real relationship with the third party for liability to arise rather than just knowledge of the third party’s existence as a theoretical possibility.
- .04 However, even after *Esanda*, it remains difficult to predict exactly what conduct or circumstance will expose auditors to this risk of undue reliance. The High Court did not establish a single definitive test since the individual judgments described various possibilities. The position is also complicated because third party liability is part of the law of negligence, which is still evolving. The applicability of the *Esanda* judgment may also be affected by the legislation under which the audit is performed, the terms of the audit engagement and the audit report itself.

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- .05 Situations may arise where a third party seeks a letter from the auditor in which the auditor is requested to acknowledge that the third party intends to rely on an audited financial report. In this way the third party is seeking to establish a relationship with the auditor, with the required foreseeability and proximity, which would give rise to a duty of care by the auditor to the third party. These letters are commonly referred to as “privity”, “reliance” or “comfort” letters. The term “privity letters” is used in this Guidance Statement.
- .06 The purpose of this Guidance Statement is to alert auditors to the risks associated with a privity letter request and to provide guidance to reduce the risk of undue reliance on the auditor’s report in specific circumstances. The Auditing and Assurance Standards Board is not advising on the application of the *Esanda* judgment, and any decision by an auditor as to how to respond to a privity letter request is to be made by that auditor after consideration of the risks involved in giving such acknowledgment. An auditor will exercise judgment whether an acknowledgment of facts giving rise to a duty of care is appropriate in the circumstances or whether a separate engagement would be necessary to meet the needs of the third party making the request.

Request from Third Party

- .07 Requests for a privity letter may arise in various circumstances seeking comfort for different purposes. For example:
- (a) the auditor is requested to acknowledge and accept in writing the third party’s intention to rely on a general purpose financial report and the auditor’s report thereon;
 - (b) the request relates to a transaction(s) planned either prior to or subsequent to the issue of the general purpose financial report and auditor’s report thereon, about which the auditor has not had any knowledge in planning and performing the audit;
 - (c) in respect of debt transactions, the period of intended reliance may extend to the period over which the debt is repaid, and reference may be made to the lender’s concern regarding compliance with the terms and conditions of the planned agreement.
- .08 Requests from a third party are of concern to the auditor because:
- (a) there are inherent limitations in any financial report. A financial report presents an entity’s state of affairs only at

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balance sheet date. A financial report presents an historical view of the entity’s results for the period and must be interpreted having careful regard to the underlying accounting policies. Furthermore, a financial report may not reflect items considered to be immaterial and certain revenues, expenses, assets and liabilities, for which no precise means of measurement exist, may be included on the basis of the directors’/managements’ best estimates. The only events occurring after balance date taken into account are those which impact on the financial report in accordance with AAS 8 and AASB 1002 “Events Occurring After Reporting Date”. While a financial report is normally prepared on a going concern basis, it does not give any indication of the level of future profitability or cash flows of the business;

- (b) there are inherent limitations in the audit of a financial report. An audit provides reasonable, but not absolute assurance that the financial report is free of material misstatement. The auditor exercises a significant level of professional judgment on such issues as materiality and audit risk, the application of procedures on a test basis, the evaluation of management’s accounting estimates and the ability to rely on management’s internal control structure. The auditor’s consideration of subsequent events and going concern assumptions are in accordance with AUS 706 “Subsequent Events” and AUS 708 “Going Concern”. The audit of a general purpose financial report does not extend to confirmation of future profitability or cash flows – matters which may be significant to a third party seeking to place reliance on the financial report;
- (c) the auditor may lack knowledge of the third party’s specific needs. The audit of a financial report may not be planned or performed for the benefit of, or to take into account the special needs of the third party who may wish to rely on the audited financial report for a specific decision(s). At the time of the audit, the auditor is often not aware of a third party’s decision to enter into a transaction or their specific needs. The auditor may not, therefore, give consideration to procedures which might otherwise be considered necessary and appropriate;
- (d) a third party may be substituting reliance on the audited financial report for assurance which should be obtained from the third party carrying out its own due diligence and monitoring procedures. It would be a reasonable

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expectation to assume that an experienced third party would have a degree of business experience and sophistication to properly assess the risks of entering into a particular transaction using information from various sources. Furthermore, once that transaction has occurred, the third party should carry out procedures to monitor the position of the investee/borrower; and

- (e) in certain circumstances, the period of intended reliance by a lender, for example, may extend to the entire period during which the debt is outstanding. While the auditor may be aware of this transaction during subsequent audits, special procedures over and above those necessary for the audit of the borrower’s financial reports may be necessary to address all the lender’s concerns, for example in relation to debt covenants. This may require a separate engagement to address the lender’s specific requirements.

The Auditor’s Position

- .09 Before responding to a request, the auditor makes appropriate inquiries of management, for example, to ascertain whether the third party is seeking to rely on the audited financial report in relation to an unspecified or specified transaction(s), and considers carefully all the circumstances relating to the request, for example, whether the request is received before or after signing the audit report. The auditor also considers taking legal advice before responding to the request.
- .10 The effectiveness of any form of response containing a disclaimer in restricting responsibility or liability with respect to a statutory duty is uncertain. It is likely that disclaimers of responsibility to third parties will only be upheld by a court where they are reasonable in all circumstances. Therefore, the auditor’s response to the third party clearly states the reasons why the auditor is not assuming responsibility to the third party. The auditor continues to behave consistently with that disclaimer. If a third party has evidence to support an allegation that an auditor’s conduct was misleading and deceptive, in breach of Section 52 of the Trade Practices Act or its equivalent section in the various State Fair Trading Acts, then the existence of a disclaimer will not of itself, protect the auditor.

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The Auditor’s Response

- .11 In view of the circumstances associated with a request for a privity letter and the audit concerns noted, unless an auditor intends to accept responsibility to a third party, an auditor responds unequivocally to a request for a privity letter stating that the body of shareholders is the only group entitled to rely on the audit report. Additional reasons are given to state why it is unreasonable for the third party to rely on the audit report as appropriate. Failure to decline responsibility to a third party presents a risk of responsibility being established if silence is taken as agreement. A copy of the response is sent to the auditee to ensure that the auditor, third party and auditee have a common understanding of the context in which the auditor’s report on the financial statements is issued.
- .12 The form of the auditor’s response should reflect the circumstances of the request. The following guidance indicates the form of response possible for the circumstances indicated:
- (a) where the proposed reliance by the third party is not for a specific purpose, the auditor responds by declining to accept responsibility to the third party (refer Appendix 1);
 - (b) where the proposed reliance by the third party is in relation to a specific transaction, the auditor responds by declining to accept responsibility (refer Appendix 2), unless the auditor intends to extend the duty of care to the third party, or the relationship between the auditor and the third party is such that a duty of care may already exist. If the auditor intends to extend the duty of care, or where the duty of care may already exist in the particular circumstances, the auditor responds by acknowledging a responsibility to the third party, but emphasising that such acknowledgment is confined to the context and scope of the financial report audit (refer Appendix 3).
- .13 Irrespective of the effectiveness of any disclaimer of responsibility that an auditor may issue, a duty of care may result from the auditor’s knowledge of the specific purpose for which the financial report is to be used. For example, the auditor would be expected to be aware a lender is placing reliance on the audited financial report where an unqualified audit report and a new loan facility agreement are signed contemporaneously, and the auditor has been informed that the former is a condition precedent of the latter.
- .14 Where the auditor acknowledges a responsibility to a specific third party, the nature and scope of the duty of care will depend on the

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circumstances of the particular case, and may impose on the auditor a continuing obligation to advise the third party of events occurring after the date of the audit report. For example, having assumed a duty of care to a lender, the auditor may be under an obligation to advise the lender of a change in circumstances arising after the audit report is signed where the auditor is aware the lender intends taking further action, such as extending the loan facility, in reliance on the audit report.

- .15 If a specific third party requires assurance from the auditor on matters outside the normal audit scope, for example, on the adequacy of the entity’s internal control structure, the efficiency of management, or on other matters in which the third party may be primarily interested for its own specific needs, this should be the subject of a separate engagement between the auditee and the auditor.
- .16 Before entering into a separate engagement to meet the specific needs of a third party, an auditor carefully considers the position in light of any potential conflict of interest with respect to the auditor’s duties and responsibilities under the original audit engagement. The auditor obtains the consent of the management of the auditee to undertake the engagement. Such an engagement is separate from, for example, the audit of a financial report under the *Corporations Act 2001*, and is the subject of a separate engagement letter and separate fee arrangements with the parties for which the engagement is carried out.

Representations from the Third Party

- .17 In situations where the auditor intends to acknowledge a responsibility, the auditor obtains a written representation from the third party stating that:
 - (a) the third party is aware of the nature and scope of the audit as explained in the audit engagement letter;
 - (b) the third party acknowledges that the audit will not be specifically planned for the specific benefit of the third party and will not necessarily address the third party’s needs;
 - (c) the third party is a sophisticated investor/lender/provider of goods/services and will diligently perform their own inquiries, with due care, in connection with the transaction; and

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- (d) if the third party enters into the transaction, it will subsequently perform its own on-going monitoring activities.

This representation is obtained prior to issuing a privity letter and, once obtained, a copy should be forwarded to the auditee. Appendix 4 provides an example third party representation letter.

- .18 If the third party refuses to provide the required representation, the auditor refuses to issue a privity letter and declines responsibility (refer Appendix 2).

Operative Date

- .19 This AGS, which incorporates amendments made by AUS/AGS Omnibus 3 “Miscellaneous Amendments to AUSs and AGSs”, is operative from July 2002. This version of AGS 1014 supersedes AGS 1014 “Privity Letter Requests”, as revised in February 1999.

Compatibility with International Standards and Statements on Auditing

- .20 There is no corresponding International Standard or Statement on Auditing.

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APPENDIX 1

EXAMPLE LETTER FOR DECLINING RESPONSIBILITY TO A THIRD PARTY SEEKING GENERAL RELIANCE ON AN AUDITED GENERAL PURPOSE FINANCIAL REPORT AND AUDITOR’S REPORT THEREON

The letter contained in this appendix is for an auditor engaged to report on a company financial report and is for the purpose of illustration only. It should be amended as appropriate to suit individual circumstances.

ABC Limited
(Third Party)

Dear ...

XYZ Limited (Auditee)

We acknowledge receipt of your letter of [date].

As the statutory auditor of [Company], we were appointed by the shareholders to perform an audit and report to them. The objective of our audit is to form an opinion whether the financial report, the preparation and presentation of which is the responsibility of the directors of the company, is in accordance with the *Corporations Act 2001*, including: giving a true and fair view of the company’s [and consolidated entity’s] financial position as at [date] and of its [their] performance for the period ended on that date; and complying with Accounting Standards and the Corporations Regulations; and other mandatory professional reporting requirements. Our audit was planned and performed for this purpose only and should not be relied upon for any other purpose.

Your proposed reliance on the financial report of [Company] is for the purpose of unspecified transactions and for an indefinite period of time. We do not know what factors you regard as being significant in relation to the transaction(s) which you envisage undertaking [and any future monitoring thereof]. Therefore our audit of the financial report prepared in accordance with statutory requirements has not necessarily addressed (will not necessarily address) such factors. We therefore cannot issue any letter which assumes responsibility to you in respect of our audit opinion on which you could reasonably rely, and disclaim any assumption of responsibility for any reliance by you on the report or the financial report to which the report relates.

If [the third party] require us to investigate the affairs of [Company] for their particular purposes, we could do so, but only with the express consent of the directors of [Company] and within the relevant regulatory parameters. We

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would naturally charge a fee for any such services provided. We would also have to be satisfied that conducting a special engagement for the purpose of [the third party] will not create a conflict between our resulting duty to [the third party] and our duty to [Company] and its shareholders.

We also note that any report issued to [the third party] as a result of additional services provided would be issued solely for use by [the specific third party] and would not be suitable for distribution to or use by any other party.

Yours faithfully,

(Auditor)

NOTE: Items in brackets are for completion as required.

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APPENDIX 2

EXAMPLE LETTER FOR DECLINING RESPONSIBILITY TO A THIRD PARTY SEEKING RELIANCE ON THE GENERAL PURPOSE FINANCIAL REPORT AND AUDITOR'S REPORT THEREON IN RELATION TO A SPECIFIC TRANSACTION

The letter contained in this appendix is for an auditor engaged to report on a company financial report and is for the purpose of illustration only. It should be amended as appropriate to suit individual circumstances.

ABC Limited
(Third Party)

Dear ...

XYZ Limited (Auditee)

We acknowledge receipt of your letter of [date] in which you state your intention to rely on the audited financial report of [Company] for the [period] ended [date] and our report thereon [date] in connection with [describe transaction].

As the statutory auditor of [Company], we were appointed by the shareholders to perform an audit and report to them. The objective of our audit is to form an opinion whether the financial report, the preparation and presentation of which is the responsibility of the directors of the company, is in accordance with the *Corporations Act 2001*, including: giving a true and fair view of the company's [and consolidated entity's] financial position as at [date] and of its [their] performance for the period ended on that date; and complying with Accounting Standards and the Corporations Regulations; and other mandatory professional reporting requirements. Our audit was planned and performed for this purpose only and should not be relied upon for any other purpose.

We do not know what factors you regard as being significant in the transaction(s) which you envisage undertaking [and any future monitoring thereof]. Therefore our audit of the financial report prepared in accordance with statutory requirements has not necessarily addressed such factors. We therefore cannot issue any letter which assumes responsibility to you in respect of our audit opinion on which you could reasonably rely, and disclaim any assumption of responsibility for any reliance by you on the report or the financial report to which the report relates.

If [the third party] require us to investigate the affairs of [Company] for their particular purposes, we could do so, but only with the express consent of the

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directors of [Company] and within the relevant regulatory parameters. We would naturally charge a fee for any such services provided. We would also have to be satisfied that conducting a special engagement for the purpose of [the third party] will not create a conflict between our resulting duty to [the third party] and our duty to [Company] and its shareholders.

We also note that any report issued to [the third party] as a result of additional services provided would be issued solely for use by [the specific third party] and would not be suitable for distribution to or use by any other party.

Yours faithfully,

(Auditor)

NOTE: Items in brackets are for completion as required.

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APPENDIX 3

EXAMPLE LETTER FOR ACKNOWLEDGING RESPONSIBILITY TO A THIRD PARTY IN RELATION TO A SPECIFIC TRANSACTION WITHIN THE CONTEXT OF THE SCOPE OF A GENERAL PURPOSE FINANCIAL REPORT AUDIT

The letter contained in this appendix is for an auditor engaged to report on a company financial report and is for the purpose of illustration only. It should be amended as appropriate to suit individual circumstances.

ABC Limited
(Third Party)

Dear ...

XYZ Limited (Auditee)

We acknowledge receipt of your letter of [date].

We understand that you intend to use the audited financial report of [Company] for the year ended [date] and our report thereon in connection with a proposed [transaction/event] with the company. We also understand that [third party] is a sophisticated [investor/lender/provider of goods/services] in [identify business/industry].

As the statutory auditor of [Company], we were appointed by the shareholders to perform an audit and report to them. The objective of our audit is to form an opinion whether the financial report, the preparation and presentation of which is the responsibility of the directors of the company, is in accordance with the *Corporations Act 2001*, including: giving a true and fair view of the company's [and consolidated entity's] financial position as at [date] and of its [their] performance for the period ended on that date; and complying with Accounting Standards and the Corporations Regulations; and other mandatory professional reporting requirements. Our audit was planned and performed for this purpose only and should not be relied upon for any other purpose.

The financial report is not designed for the specific purpose for which [third party] wish to rely on it, nor do we have such a purpose in mind when carrying out our audit. Accordingly this firm, its partners and employees do not assume any additional responsibility to [the third party] or any other third party for our audit report and, without affecting the generality, we deny that by writing your above-mentioned letter you have imposed any obligation to take any special steps in the interest of [the third party] or any other third party.

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Our audits are planned and performed in accordance with Australian Auditing Standards to provide reasonable assurance whether the financial report are free of material misstatement. The application of these professional standards requires judgment in the design, completion and evaluation of the results of our procedures. Those procedures include:

- (i) examining, on a test basis, evidence supporting the amounts and other disclosures in the financial report;
- (ii) the evaluation of the accounting policies and significant accounting estimates; and
- (iii) forming an opinion whether, in all material respects, the financial report presents a view of the company which is consistent with our understanding of its operations.

Our audit is not designed to provide absolute assurance that there are no misstatements in the financial report resulting from fraud, irregularities or error, and the audit report does not represent any form of guarantee or warranty in that regard, nor is it a guarantee or prediction of the present or future performance or sagacity of management.

If [the third party] requires us to investigate the affairs of [Company] for their particular purposes, we could do so, but only with the express consent of the directors of [Company] and within the relevant regulatory parameters. We would naturally charge a fee for any such services provided. We would also have to be satisfied that conducting a special engagement for the purpose of [the third party] will not create a conflict between our resulting duty to [the third party] and our duty to the company and its shareholders.

We also note that any report issued to [the third party] as a result of additional services provided would be issued solely for use by [the specific third party] and would not be suitable for distribution to or use by any other party.

We also understand that [third party] will exercise due care to diligently obtain whatever information it feels is necessary to determine whether to undertake the proposed [specify transaction/event], and will monitor the future activities of [Company] on an on-going basis to the extent it deems necessary.

Information obtained by us during our audit cannot be disclosed by us to third parties such as [the third party] except pursuant to our statutory obligations or with the express consent of the company. That being so, may we suggest that any questions that [the third party] may have regarding the

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affairs of the company be referred to the company which will, if it sees fit, request us to respond.

This letter applies only to the financial report of [Company] for the year ended [date] and to [specify transaction/event]. Reliance relates only to the financial report as indicated as at the date of the audit report and cannot extend to events occurring after the date of that report.

Yours faithfully,

(Auditor)

NOTE: Items in brackets are for completion as required.

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APPENDIX 4

*EXAMPLE REPRESENTATION LETTER FROM THIRD PARTY –
OBTAINED PRIOR TO ISSUE OF A PRIVITY LETTER*

The letter contained in this appendix is for an auditor engaged to report on a company financial report and is for the purpose of illustration only. It should be amended as appropriate to suit individual circumstances.

DEF
(Auditor)

Dear ...

XYZ Limited (Auditee)

In connection with [specify transaction/event] that we propose to enter into with [Company] you have agreed to provide us with a copy of the company’s financial report for the year ended [date] together with the audit report thereon as well as a privity letter and a copy of a letter from the company indicating that they are aware of, and consent to, this action.

In making this request, we acknowledge:

- (a) that we have read and understand the terms of the audit as explained in your engagement letter dated [date]; and
- (b) in view of the terms of the audit engagement letter, that the audit was neither planned for the specific benefit of [third party] nor does it necessarily address our needs.

We also confirm that:

- (a) [third party] is a sophisticated [investor/lender/provider of goods/services] and we will exercise due care to diligently obtain whatever information we believe is necessary to determine whether to undertake [specify transaction/event] and will not rely solely on your report on the financial report of [Company] for the year ended [date], and
- (b) [third party] will monitor future activities of [Company] on an ongoing basis to the extent we deem necessary.

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We also acknowledge that the letter which you will provide will apply only to the company’s financial report for the year ended [date] and to [specify transaction/event].

Yours faithfully,

(Third Party)

NOTE: Items in brackets are for completion as required.