Lessons of auditors' responsibilities

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Introduction

Just over a century ago, in 1892, L. R. Dicksee in the first edition of his book, *Auditing*, indicated the lack of agreement among accountants as to the precise nature of their responsibilities for auditing company accounts due in part to the paucity of legal decisions in cases involving auditors. Within a short space of time, the question of auditors’ responsibilities appeared to have been answered in two decisions handed down by the Court of Appeal: *In re The London and General Bank* (Acct. L. R. 1895, 173; henceforth L&G) and *In re The Kingston Cotton Mill Co.* (Acct. L. R. 1896, 77; henceforth KCM). These two cases were quickly established in the professional literature and case law and today are frequently cited in arguments before the courts, e.g. in *Galoo v. Bright Grahame Murray*, (WLR 1994, 1360). Although the two Victorian cases share many similarities, they have opposite outcomes: in L&G the auditors were held liable for dividends improperly paid, whereas in KCM, the auditors escaped liability.

The similarities of the cases are:
- The actions were brought by the Official Receiver alleging misfeasance under the Companies (Winding Up) Act 1890.
- Both began with a substantial claim against the auditors—£400,000 in L&G and £80,000 in KCM, though these were reduced during the course of the litigation.
- The auditors were Chartered Accountants, professional men, not as in the earlier case of Leads Estate, Building and Investment Co. (1887 Ch. D., 36, 787) which involved an unskilled amateur.
- Both were heard in the first instance before Mr. Justice Vaughan Williams.
- Two of the appellate judges were the same in each case, Lindley, L. J. and Lopes, L. J., (with Rigby L. in L&G, and Kay, L. in KCM).
- Both auditors appeared to have placed too much reliance on management’s judgement regarding the values of assets, customer accounts in the case of L&G and stock and fixed assets in the case of KCM.

Brief reviews

L&G was closely connected with the Balfour group of companies—in fact it was established that the sole purpose of the bank was to support other group companies. The bank’s profits were inflated over the course of several years by the inclusion as income of interest on loans which was never received.

KCM was a cotton spinning company whose profits had been overstated through

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the deliberate manipulations of the stock figure by the Managing Director. The value of fixed assets had also been overstated since no allowance had been made for depreciation.

The reliance on management is evident in both cases. In the L&G case, the auditors including Theobald, a chartered accountant, had been alarmed at the condition of some of the bank’s debtors’ accounts. They had made a special report to the directors recommending that given the conditions no dividend should be paid. They also proposed to warn the shareholders of this report. They were persuaded mainly by Balfour to change this report on his assurance that he would report to the shareholders at the general meeting. They sought to cover themselves by inserting in their report to shareholders a rather cryptic comment that the “value of the assets was dependent on realisation.” Balfour did not honour his alleged promise to inform the shareholders during the general meeting, at which the auditors were present but did nothing.

The position of the KCM auditors, Peasegood and Pickering, is quite different. They knew nothing. They were not even remotely suspicious of the stock manipulations although the stock figure had increased substantially and the gross profit percentage had increased dramatically in a short space of time. The auditors simply accepted the values of stock as computed by the managing director. Although they claimed to have tested the “casts” of the stock sheets and summaries, they could provide no proof of this. In their defense, they argued that stock was a technical area beyond the expertise which could reasonably be expected of auditors, and therefore, they were entitled to rely on management’s certificate of the stock figure.

How then is one to reconcile these contradictory decisions? From a legal point of view, the only apparent explanation lies in the degree of honesty in reporting the audit findings. In L&G the auditors had performed what appears to be an adequate audit, at least in terms of discovering the true state of the bank’s customers’ accounts. But they failed to make a full report to the shareholders. In KCM, the auditors appeared to have performed a perfunctory audit, at least in regard to stock, but they reported honestly. Herein lies the anomaly of the two decisions: a thorough audit may produce results which should be communicated to shareholders, and the auditor will be liable if he does not give an honest report; an auditor who performs a mechanical audit is less likely to unearth conditions of which shareholders deserve to be made aware, and therefore, there is less chance of being subjected to management pressure. An auditor in these circumstances will find it easier to produce an “honest” report.

The nature of the accounting errors provides no plausible reason for the different judgements. The arguments before the court concerning the technical nature of stock in a manufacturing company could have been made in the context of the banking case where it is undoubtedly a skilled job to assess the credit risk of different types of business, the solvency of customers, and the value of securities provided (as acknowledged by a contemporary writer in The Juridical Review, 1901, p. 104). The auditors of L&G tackled these technicalities and ascertained the true position, whereas the auditors of KCM simply relied on management. Although other sources of evidence were available, for example, a Stock Journal which if analyzed would have shown the discrepancy in the physical volumes of book stock and reported stock. In addition it is clear from contributions to The Accountant that some of its readers thought that there were other warning signs which should have put the auditor upon enquiry. The significant change in gross profit percentage and the stock turnover ratio seemed to be matters which the auditor should have investigated.
Although valid reasons for these observed changes could have been advanced, there is no indication that the auditor called for any explanations.

An alternative explanation may be the question of public policy. Did the Balfour connection condemn the auditor in L&G? The collapse of the Balfour group sent ripples through the city and concern among investing classes. KCM was not nearly so large an enterprise, and there may have been less pressure on the judiciary to pander to public sentiment. However, it is difficult to prove or disprove this possibility.

Conclusion

These two cases did not really help the profession in its attempts to clarify its responsibilities. However, some of the dicta have withstood the test of time. The lesson from L&G is that auditors should report honestly—a point which was readily taken on board in the literature although doubt exists even now as to whether auditors have sufficient independence to go against management and to make an honest report.

In terms of the extent of audit fieldwork, the signals from the cases are less clear. In L&G it was said that the auditors should go beyond the books of account, which they did; they examined securities for the bank’s loans. But in KCM it seemed sufficient to rely on a certificate from management; no further checks were performed and no analytical procedures were employed in order to get audit evidence. It is hard to rationalize the different stances of the same court. Was it that the court sought to punish the auditor who knew more than he reported and to be lenient to the auditor who reported honestly albeit on an inadequate job or were there policy factors involved?

The reaction of practitioners to the cases, so far as may be judged from correspondence reproduced in The Accountant, was that the KCM auditor was deserving of less sympathy from his peers, though this was mingled with some relief for the protection which the decision appeared to give auditors. On the other hand the L&G decision was viewed by some as harsh. The uncertain outcome of litigation was to continue throughout the present century and is one factor in the reluctance of auditors and their insurers to pursue legal action preferring instead to settle out-of-court.

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