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Auditor Independence

By A. C. Littleton

The nineteenth century statutes by which the British sought to control joint-stock companies for the better protection of investors plainly show that Englishmen of that time had a very clear idea of the nature of a corporation and of the proper relation of directors to stockholders. The company was merely a mechanism for drawing scattered capital together and putting it to work; the stockholders were investors who pooled their savings for a common objective; the directors were elected representatives ("stewards") of the stockholders and were charged with the direct responsibility of managing the investment for the investors' benefit. But a knowledge of human nature and the existence of an historical background, which included the stock-jobbing period immediately preceding 1720, combined to lead the British to frame their corporation statutes in such a manner as to provide the stockholders with other representatives who were to "test the stewardship," as it were, of the managing representatives. At first the critic was an auditing committee of stockholders, later an independent professional auditor.

The developments of the past few years in our own country have raised questions similar to those which must have agitated Englishmen several generations ago. Can elected directors and hired managers of corporations that are touched with a public interest, because of the extent of the company's operations, the number of employees or investors or the character of the service rendered—can such men, chosen by one group of investors, be depended upon to manage the corporation with a balanced consideration for the best interests of all concerned? Can a way be provided for independent third parties to review the acts and proposals of the managing representatives in a critical manner and with the interests of both present and prospective investors in mind?

British and American experiences dictate a negative answer to the first question in enough cases to show that the problem of securing a responsible management is not a negligible one. The British precedent of the auditor-critic suggests an affirmative answer to the second problem and thereby raises the additional

question of whether the English plan of electing auditors in the stockholders' meeting should be adopted in this country or some other plan should be devised to improve investor protection.

The first reply to the last question probably would be that Englishmen are not altogether satisfied with their own system. In spite of election of the auditor by the stockholders, we are led to believe that the goodwill of the directors is important, that the selection of the auditor practically always rests with the directors in the final analysis, that the courts have so circumscribed the auditors' duties as to make the stockholders' protection rather formal and that "until auditors are insured a much greater degree of independence than they at present possess, it is hardly to be expected that they can be an effective safeguard against waste of shareholders' funds in company administration." (See *Financial Democracy*, Miller and Campbell, chapter 4.)

The second reply to the question of transplanting the British system is that conditions peculiar to the United States would seem to make election of the auditor by the stockholders even less satisfactory here. Getting stockholders out to meetings is a problem everywhere, but the impression persists that it is particularly difficult in this country.

Most of our security holders act alike in spite of differences in the terms of their contracts: bondholders by agreement have no vote for directors and policies; stockholders neglect to exercise their prerogative and thus voluntarily place themselves in the same category as bondholders as far as management control is concerned. Stockholders do not seem to feel ownership responsibilities; and they are quite apt to look to the market for the clue to the value of their holdings rather than to financial statements. This has a tendency to make many directors more market-conscious than good management would dictate.

In addition to the other things, we have devised a very extended array of securities contracts with numerous and complex diversities. This vast expansion in the types of credit instruments has greatly diluted the sense of ownership. The situation is no longer one of the simple pooling of capital in a joint-stock by individual investors receiving very similar interests in the enterprise. The diversity of securities makes for diversity of interests; and diversity, abetted by complexity of the contract, opens the way to a possible subtle undermining of the prior rights of senior

securities by new issues. (See Berle and Means, *The Modern Corporation and Private Property;* also Graham and Dodd, *Security Analysis.*)

The situation therefore calls for an American plan to fit American conditions.

The only American plan so far developed aims at investor protection through the application of the provisions of the federal securities act and the securities exchange act, supplemented by regulations issued by the securities and exchange commission. It is not proposed here to discuss the probable success or failure of this method of attack upon the broad problem. The statutes have been charged with blocking the flow of private capital into industry, but recent regulations of the commission seem to promise relief for corporations with an established record. The very large budget proposed for the commission has raised the fear in some quarters of an extensive bureaucracy which may sometime attempt to regiment business into too much uniformity, but anticipatory fears of this sort usually outrun eventual actualities. Yet it must be acknowledged that the British experience with decentralized administration of income-tax laws has been more satisfactory than ours has been with a high degree of centralization, which would seem to be an argument against too great centralization of control over securities.

However, it is desirable to raise the question whether the possibilities have been fully canvassed for investor protection by a more effective use of experienced public accountants. The work of our public accountants has now been given a statutory recognition it never had before. But that is only a tardy recognition of just a part of the service which they are competent to perform. Here is a body of men, estimated to be approximately 14,000 in number, who by education, experience and ideals of service are unusually well qualified to fulfill in America the spirit of the early British theory of the corporation auditor: an independent and expert critic, in the interest of all investors, of the stewardship of the directors.

Qualified to serve these men may be, but free to serve with a real independence they are not.

Public accounting is faced with certain weaknesses which are probably inherent in the present scheme of things.

1. Auditors are engaged by the officers or directors whose activities are to be examined.

2. Auditors may be dropped and others substituted at the pleasure of the officers or directors; and the deposed auditor has no recourse even though he may suspect that attempts to mislead investors are contemplated.
3. Auditors have no power effectively to criticize directors' valuations or financial proposals even though the equity of some prior stock is being weakened. When their powers of persuasion are exhausted, auditors have but little choice except acquiescing or resigning.
4. Auditors may be subjected to subtle pressure in many ways; the scope of their examination may be restricted more than is wise; the time allowed may be arbitrarily limited at the psychological moment; their reports may be suppressed and their recommendations disregarded.

These situations, even when they do not create definite open issues, can do much to undermine the auditors' feeling of independence and prevent his convictions from showing teeth. Unconsciously he may seek ways of meeting concrete situations without realizing that, while constituting technical "disclosure," his phrases may nevertheless fail to carry the necessary message to the reader. He is constrained, perhaps, to qualify his certificate. But that device may give the average reader the impression that the auditor was merely dodging responsibility, or it may fail utterly because of its cautious phrasing to accomplish its purpose of putting the investor "on notice."

This is no indictment of public accountants; no other equal group of men in contact with affairs will assay a higher average of disinterestedness and impartiality. Certified public accountants have made an enviable record of high-minded, expert service and many individual accountants have repeatedly demonstrated that they set their convictions above fees. Yet the fact remains that the conditions under which they perform their critical and quasi-judicial function constitute a definite culture-medium in which the germs of professional weakness can and sometimes do grow. The principal issue here raised is whether a practical way can be found to reduce these handicaps upon a real professional independence and to utilize an increase of auditor independence for the public good.

The principal feature of the ideas outlined below is the thought that the federal securities act and the securities exchange act might be amended by congress and developed by commission regu-

lations in a manner to confer a larger degree of real independence upon public accountants.

1. Corporations submitting statements under these acts could be required to use for that purpose only statements prepared and certified by auditors who shall have been licensed under the securities and exchange commission; they could be required in general to facilitate the auditor's work and specifically to keep him advised concerning proposed changes in financial structure or other major financial adjustments; they should be prevented from taking the initiative in terminating the professional services of their licensed auditor unless by authority of a board of financial review after a full hearing; they should be required to submit disputes with the auditor to arbitration by the board of financial review.

2. Auditors who desire to qualify for practice under these statutes could be required to register with the commission and receive a licence. The basic requirements for obtaining a licence should be:

a. The applicant must be professionally qualified for this type of engagement as indicated by his education, experience, state certificate and professional connections.

b. The applicant must have membership in a professional body having professional qualifications for admission and disciplinary powers over the members.

c. The applicant must make public acknowledgment, by oath or otherwise, of his acceptance of the responsibilities resting upon an auditor to disclose the full facts clearly and to express his professional opinion fearlessly in behalf of all parties at interest. The phrase "parties at interest" is to mean potential or present investors of every grade or contractual relationship.

Employees of auditing firms, if given substantial discretion in the conduct of professional engagements under these statutes, must be licensed auditors.

3. Licensed auditors' duties should be made broader than those of the usual audit and should be outlined in general terms by commission regulations under the statute. Briefly these duties would be to examine and disclose. Examination would call for the following:

a. Examination of the corporate records and accounts to see that the results of the transactions reflect the principles of good accounting.

b. Scrutiny of security contracts, of proposals to change the financial structure and of financial valuations or operations to see that the principles of sound finance were not being violated and that the interest of no class of security holder was (accidentally or by design) being undermined without the latter's knowledge of the real significance of the situation.
c. Follow up the accounting of new financing to see if the use made of the funds was as stated in the prospectus.

Disclosure would call for the following:

a. Presentation and certification of a full, clear statement of present financial condition, including a careful indication of the types of security contracts outstanding.
b. Presentation of full, clear statements of income for the current fiscal period, as well as an analysis of past surplus, and a certification of the earned income of the past three years.

These responsibilities laid upon the auditor would place his trained judgment and skill as an analyst at the disposal, as it were, of the whole investing public. The right of appeal by either party of unsettled issues between auditor and client to the board of financial review for arbitration would further assure the public of sound practices.

4. As a judicial adjunct to the security and exchange commission a board of financial review should be formed to serve as a court of arbitration of such disagreements as may arise between licensed auditors and their clients. Disputes may arise over questions of

a. Good accounting theory or sound financial principles.
b. Neglect by the auditor of professional duty.
c. Need for a change of auditors.
d. Adequacy of service or fee.

The members of such a court should be appointed for a long term of service by the president of the United States from a list of men whom the accountants' national organizations (American Institute of Accountants, American Society of Certified Public Accountants, National Association of Cost Accountants, American Association of University Instructors in Accounting) would nominate as particularly well qualified for this type of governmental service. Obviously such a list should be made up of the best that the accountancy profession could produce of broad education, varied experience and judicial temperament.

A group of interested, earnest specialists in accounting, such as would be chosen for this court, would build up in a relatively short time a most useful body of sound and authoritative precedents related to specific situations. This would afford an exceptional basis for shaping that body of doctrine called principles of good accounting and sound finance into a well coördinated form, so needed by practitioners in the field as guides in their current work and by students in the class room in preparation for their future work.

In order to assure wholly disinterested and fearless judgments, the members of the court should receive a generous salary during their term of service and every member not reappointed should get a substantial pension upon retirement. This would give every person entering this new responsibility the same economic and intellectual independence as a life appointment.

5. Auditors who are protected in their professional independence, when they are conscientious in their duties and correct in their principles, should willingly accept definite and positive liabilities to be applied when they become derelict as auditors.

a. Neglect of professional duty should, after a hearing before the board of financial review, result in suspension of licence of the individual accountants directly responsible and loss of the client if the fault be decided to be minor neglect, and permanent loss of licence if the decision was major neglect.
b. Anyone convicted before the board of financial review of neglect of the duties of auditors, which are customary in the circumstances of that case, who loses his licence as a result, may not practise for himself under these acts or serve as a responsible supervisor on the staff of an accountant who does so practise.
c. If a hearing before the board of financial review should disclose a presumption of connivance by the auditor in the issuance of a false financial statement or in concealing fraud in the accounts, the statute should make the auditor civilly and criminally liable to the client and to third parties who could prove they had relied upon the false statements.

The time is past when it is proper to divide those who supply the capital for modern corporations into two opposite categories: owners and lenders. All investors, not excluding open trade creditors, are contractual creditors of the corporation and differ one from the other only by the terms of their respective contracts.

Under a simpler financial structure, where practically all capital came from common stockholders, the directors in effect represented all sources of capital. The problem of finding a way to select directors who can truly be called representatives of all suppliers of capital is still unsolved, and until it is solved the early ideal of the British plan of two counter-poised representatives can not be fully achieved for our modern corporations. But the above outline suggests that a way could be found to bring the auditor-half of the plan into a close approximation of the ideal of a really independent critic "in the interest of all who supply capital." If that independence were made possible, surely it would be quite generally acknowledged a better method of increasing investor protection than either dependence upon auditors subject to dismissal by the persons under scrutiny or upon an inadequate number of auditors attached to a federal bureau as bank examiners now are.

The plan outlined is a middle course resting upon a foundation already available. And it is a plan which should not be difficult to put into operation. In essence it would provide first, a system of quasi-judicial scrutiny—by men trained under exacting professional standards—of corporate transactions and proposals, to the end that brakes may be applied to unsound practices still in the making, and, second, a method for a considered review of disputed questions and a suitable discipline for unprofessional or improper conduct.

This proposal would elevate public accountants to a larger responsibility. But it is not advanced for their sake. It is suggested in the conviction that public accountants would be able to make a real contribution to the problem of protecting investors from deceit. Even hedged about as they now are by subtle factors tending to undermine their full freedom of opinion, public accountants still are more unprejudiced in their views than the management which plans an issue of new securities, more unbiased than the underwriters who expect to sell the issue to others at a profit to themselves, and more public-minded than the attorney who draws a security contract with a keen sense of the best interests of the "insiders."

A real independence for the auditor is as necessary to the fulfillment of his function as an unofficial representative of the investing public as the recognition of privileged communications is to the fulfillment of the lawyers' function. Indeed it is the

public accountants' already well-developed sense of professional independence that qualifies them for an increased real independence as quasi-public representatives of the interests of inarticulate and scattered investors. They are in fact professional men who already are well suited to " . . . protect those whom they serve against spoliation." But they need better public support in their task.