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Bishop C. Hunt

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“Auditor Independence”

BY BISHOP C. HUNT

As an economist who has pursued some interest in the development of English company organization and control, I venture to comment on several matters discussed in a recent article in *THE JOURNAL OF ACCOUNTANCY* by A. C. Littleton entitled “Auditor Independence.” In the first place, I think his views of English practice are mistaken. Secondly, while I have no doubt that he has the best interests of the profession at heart, I am convinced that his proposals for the organization of audit practice and practitioners are unsound, not only from the point of view of the progressive development of accountancy in this country, but as well, from that of the security of shareholders for which we are all solicitous. If adopted, they would, in my judgment, bind accountancy in the fetters of an inevitably mediocre bureaucracy.

It will be worth while to take a brief glance at the evolution of the English law in the matter. “Periodical accounts,” Gladstone declared in 1844, “if honestly made and fairly audited can not fail to excite attention to the real state of [a] concern.” In accordance with this view, all joint-stock companies formed under the registration and regulation act of that year, were required, as a prerequisite of legal sanction to do business, to appoint auditors “to receive and examine the accounts.” Directors were to cause “A full and fair balance-sheet to be made up” and to approve it before delivery to auditors. Similar provisions were included in the act of 1845 to govern companies established by special act of parliament. Auditors, it is interesting to note in passing, were empowered to employ the assistance of professional accountants. The compulsory requirement of audit was dropped in the effective general statutes for the incorporation of companies with limited liability, those of 1856 and 1862. However, the provision was retained in the model (and optional) constitution for such companies, set up in table A of the act of 1862 and probably adopted by a majority of concerns. Compulsory and independent audit for banks was legislated in 1879. Under the combined influence of a growing complexity of accounts and fear of penalties, practice gradually substituted the professional for the lay auditor so that by the act of 1900, under which the ap-

pointment of auditors became compulsory for all companies, the accounts of most of them were not only audited but were in fact audited by chartered accountants (cf. *The Accountant*, Vol. XXVI [1900], p. 475). Indeed, practice has generally outrun legal minima. The stiffening of requirements over the years has, in fact, merely translated into statute the best of the current professional practice.

Undoubtedly, the most important characteristic of English company law and practice today is the position of the auditor. With relation both to shareholders and to directors, he occupies an independent status. Appointed by the annual general meeting of shareholders, he may be neither an officer nor a director of the company nor an employee of any director or officer. He may not be indemnified by the articles of a company for negligence or breach of trust. He is liable to proceedings for misfeasance, in the same fashion as directors. He is entitled to attend and to address any general meeting of shareholders before which accounts are to be laid. It is also to be mentioned that the board of trade may appoint inspectors to investigate the affairs of any company upon the application of members holding 10 per cent. of the shares issued, if it is supported by evidence showing good reason and the absence of "malicious motives."

The lack of auditor independence in England which Mr. Littleton alleges, and in which he seems to find an important argument for the nationalization of the profession in our own country, will be found on adequate acquaintance with the facts of English business life to be insignificant. In the first place, an auditor is obliged by law to state in his certificate whether directors have satisfied his requirements as to information. If they had not, it is fair to say, I think, that in the great majority of cases he would refuse to certify. At least seven days in advance of the general meeting before which they are to be laid, a copy of the balance-sheet and auditors' report must be sent to all shareholders entitled to attend. To put it mildly, directors would be under some embarrassment if they had to confront such a meeting of English shareholders without their auditor's certificate, to say nothing of the effect upon the company's credit. As already pointed out, auditors may, as of right, attend and address the general meeting before which accounts are laid. In other words, they have a right to be heard before being dropped. Furthermore, in view of the exacting standards of professional ethics among members of the

great societies of accountants, it would be difficult, to say the least, to fill the places of auditors who had retired on the score of pressure from directors to slight their duties, and such pressure would in the vast majority of cases lead to resignation. No firm of any reputation would consider appointment in the room of others without consultation first on the circumstances of withdrawal or dismissal with those who had retired. The existence of a high degree of professional comity in such matters is not to be overlooked. Moreover, it does not embroider the facts to say that the accounts of the great majority of the large public companies—those which appeal to the market for capital and whose incidents of ownership are widely diffused—are audited by accountants of high calibre. Despite the circumstance, then, that directors in office may in some cases dominate a meeting of shareholders and so nominate auditors indirectly, the general standards of the profession are a sufficient realistic safeguard of auditor independence.

While auditor independence is not, therefore, an issue in English company regulation, the requirements as to disclosure of accounting results are admittedly inadequate, and practice in this matter both as to form and content suffers by comparison with the best which prevails in the United States. Although the reforms of 1928 were a considerable advance, they left serious lacunæ. Much information, the publication of which the law might reasonably require, remains cloaked in “Victorian garments of secrecy.” Published accounts are indeed often “a model of obscurity” (see my article in *Harvard Business Review*, January, 1930). Forward-looking accountants (and others) are convinced that the requirements as to publicity should be broadened, for unfortunately the irreducible minima prescribed by law become maxima in practice. However, as far as the prerogatives of the auditor are concerned, it must be remembered that “the responsibility for public accounts lies with the directors . . . and so long as the accounts comply with the minimum legal standard of disclosure the auditor has no official power whatever to interfere with the discretion of the board” (cf. *The Accountant*, April 16, 1932).

Mr. Littleton, further, argues from circumscription of auditors’ duties by the English courts. In view of the fact that legislative prescription of those duties, beyond a generalization that they shall report whether or not the balance-sheet “is properly drawn

up so as to exhibit a true and correct view of the state of the company's affairs," whatever that may be, is conspicuously absent from the statute book, it is fair to inquire what guide-posts have emerged from litigation. A classic dictum reads: "It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable care, skill and caution must depend upon the particular circumstances of each case. An auditor is not bound to be a detective, . . . to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch dog, but not a blood-hound" (*Re Kingston Cotton Mill Co.*). This, it would seem, is broad enough to catch within its net a multitude of sins and yet not place impossible burdens upon the profession. (For a recent case of misfeasance which cost an auditor upwards of £8,000, see *in re Fulton & Co.*, [1932]). But perhaps the decision *in re London General Bank* is in the minds of the authors whom Mr. Littleton cites. From that case we have it that "it is no part of an auditor's duty to give advice either to directors or shareholders as to what they ought to do"; he has nothing to do with the way in which the business is carried on. While I would not like to express agreement with all the implications involved, I do think that this decision points to the essential, if sometimes forgotten, fact that the accounts of a company are the accounts of directors and that the primary responsibility for them is theirs, a responsibility, moreover, that should in no circumstances be weakened or shifted to auditors. Let us be reminded of the original meaning of the word audit: "the hearing of explanations from the person rendering the account."

The legislature has in fact always refused a detailed or "cast-iron statutory" definition of auditors' powers and duties. Despite urging from various quarters, the most recent committee on company law reform (1925-26) again declined to recommend such, holding it better that "the law should retain its elasticity in this respect than that an attempt should be made to confine it within the bounds of a rigid formula." Wisdom and experience are embodied in this view. As it was argued before the committee, "a list of duties always leaves something in the air . . . the auditor might say, 'That is not in the statute, therefore I do not propose to do it.' . . . The cases vary so enormously that what is applicable in one is not applicable in another." Or, as a presi-

dent of the Institute of Chartered Accountants (H. L. H. Hill) has since observed: "I believe that the time will never come when legislation can be so definite and comprehensive that auditors will be reduced to mere automata, to obey audit programmes laid down by statute. The whole value of our work is dependent upon our proper exercise of judgment" (*The Accountant*, January 9, 1932). "In our professional life proper conduct has not been brought about and can not be brought about by legislation" (*The Accountant*, May 7, 1932). It is also of interest to mention that a committee of the board of trade on the registration of accountants refused, in 1930, to recommend such registration, in spite of the fact that the companies' acts do not require auditors of public companies to have any special qualifications. The committee found no evidence to show that any useful purpose would be served.

Mr. Littleton finds a necessity for an "American plan to fit American conditions." It strikes an American as peculiarly odd that he should overlook the admirably poised, if not altogether infallible, system of checks and balances which inheres in English audit practice, not to mention its happy characteristics of elasticity and freedom for the exercise of that judgment so necessary in the practice of public accounting. Strangely, he offers in alternative a proposal for the regimentation of the profession and practice from which, so far as I can see, anything in the nature of check and balance is conspicuously absent—a scheme fraught with danger from several points of view, not the least of which is that it would be apt to create in the minds of directors and investors "the feeling that the state is the chief mentor of the one and the guardian of the other." Under his plan, all statements submitted to the securities commission are to be certified only by licensed auditors whose tenure is subject only to a governmental board of review charged with the responsibility of their appointment and discipline, of defining their duties, and, as well, empowered to adjudicate and officially to pronounce upon controverted questions of accounting theory and practice. Such a board, it is argued, would under the afflatus of high position, plus a not inconsiderable lure of fat pensions, draw to its membership personnel of the highest calibre professionally and of utter devotion to the common weal.

In the first place, is it presumptuous to inquire what there is in the past experience of our country, or in the visible future, which

would guaranty that appointments to (or under) such a commission would be free from political interference (what, then, of that independence so desirable in an auditor?), or that it would attract the best of our accounting intelligence? It would seem that there is only one answer: an emphatic "No." Next, in the case of controversy between a corporation and licensed auditors (and what possibilities thereof!), the dice seem to be loaded in favor of the latter and of the particular views of the board. In common matters of accounting policy, there is more often than not room for a legitimate and, indeed, wide diversity of opinions—any one of which could perhaps be reasonably supported. A company might be forced to accept a decision from Washington against its own best judgment and that of its accounting advisors. Can it be maintained seriously that holy writ in a matter such as obsolescence, for example, sanctified as administrative law by such a body, would necessarily be the part of wisdom? There is in accounting, peculiarly, a broad area of "scientific guesswork." It is preposterous to suppose either that the responsibility therefor can be shifted to the shoulders of civil servants or that by so doing that area can be narrowed. Nor by attempting to do so should investors be misled into thinking that it either can be or is being done. And, even in routine matters of audit, I venture to doubt whether an auditor labelled with the magic word "licensed" could attain superior results from their point of view.

No doubt under English practice when differences arise between directors and auditors, the directors may in some cases exercise considerable pressure to bring about acceptance of their views by the auditors (see, for example, *Minutes of evidence*, company law amendment committee [1926], QQ. 520; 3617-19). And, if the directors are forceful, and not wholly wrong, and the auditors are somewhat compliant, the results may be—indeed in some cases clearly have been—prejudicial to the interests of the stockholders. But this is merely to say that the system does not function perfectly; and admitting this to be a fact, it is reasonably certain that discussion between two parties, each possessing special experience and each vested with definite powers and responsibilities, will, by and large, produce better results than a bureaucratic control which in actual practice is apt to be exercised by persons of less competence, acting with less sense of personal responsibility.

May I quote in conclusion, and in illustration of what I believe to be the sound point of view in this whole matter a remark made

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a decade ago by Sir Josiah Stamp? It is well known that his distinction is by no means confined to his own profession. "I think," he said, "accountancy will grow more by modifying conventions than by force of law." As a recent example of this line of advance, one may mention the form of auditors' report, etc., developed as a result of coöperation between the American Institute of Accountants and the authorities of the stock exchange. It called forth the following comment from the other side of the Atlantic:

"It is interesting to reflect that this result has been achieved by coöperation between the expert interests affected, and that it has not been necessary to invoke legislative sanction. It seems natural to expect that the parties who have contributed to this happy agreement will do their utmost to secure that American business units and the American investing public shall understand the general nature of an audit and its inevitable limitations. We rather envy our American cousins, too, on the score that the coöperation which has resulted in the agreement can be used advantageously if it should later appear that some amendment is required. In that event, no such cumbersome machinery as parliamentary action need to be invoked; the parties will again confer, and if they again display the qualities of wise statesmanship which their present action has revealed, they are likely to have no difficulty in amending the result of their present labours" (*The Accountant*, May 19, 1934).

The profession in this country is under challenge to resist any attempt to have its freedom of development arrested, or its hands shackled, in the course of the overemphasis on the prerogatives of government which characterizes the hour.