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The Accountant's Certificate in Connection with the Accountant's Responsibility*

(Concluded)

By Sir William Plender

Legal proceedings brought against auditors of limited companies by way of misfeasance summons or otherwise have been comparatively few in number. In the majority of reported cases relating to misfeasance it has been sought to make the auditor liable, on the ground of breach of duty, to refund jointly with directors dividends alleged to have been wrongfully paid out of capital owing to failure on the part of the auditor to detect and report either the non-existence, misdescription or overvaluation of assets or the omission of liabilities, disclosure of which would have shown that profits were not available for distribution. Having regard to the fundamental basis of limited liability it would seem equitable that the auditor ought not to be called upon solely on the ground of payment of a dividend to implement assets in the hands of a liquidator except to the extent required to meet claims of creditors (and possibly to indemnify holders of after acquired shares), bearing in mind the fact that the then existing shareholders themselves received the dividend in question. Such a limitation of the auditor's liability does not, however, appear to be regarded by the court as a defense available to the auditor; when, however, the shareholders who received the dividends knew at the time that they were improperly paid, the auditor, apparently, has a right of recovery from them. The extent of the auditor's liability in the circumstances mentioned is not, however, necessarily limited by the amount disbursed in dividends. He may be held accountable for loss or damage suffered by the company resulting from the cumulative effect or repetition of initial wrongs or errors for which he was originally in no way responsible, but which he failed to bring to the notice of the shareholders.

Having regard to the decisions of the courts which I have attempted to summarize, the auditor can not, I think, complain

* A paper read before the International Accountants' Congress, Amsterdam, 1926.

that they place too heavy a burden upon him. The legal standard of duty expected is high, but not too exacting having regard to the professional status which practising accountants have attained. It is true to say that the reputation enjoyed by the professional accountant does not rest upon his adherence to legal principles, however important; it is mainly by reason of the accountant's regard for his much wider moral duty and responsibility that he enjoys the confidence of the business community and the public generally. The mere observance of legal requirements may develop into a formality and render easy the evasion of responsibility upon technical grounds. No such limitation of our responsibilities should be permitted to influence the conduct of our professional business.

Although the auditor is responsible primarily to the shareholders, yet in the light of modern company development a somewhat wider view should, I think, be taken by the auditor himself. He should remember that balance-sheets of public companies are, for practical purposes, public documents: they are studied by the stock exchange and the prospective investor when forming an opinion as to the value of the share and debenture capital; they are made available to traders as an indication of financial stability and they are used by the companies themselves when raising bank loans and making other financial arrangements. Bearing in mind the variety of purposes for which an audited balance-sheet may be used, the auditor should refrain from taking too narrow a view of his responsibilities, and his object should be not merely to shield himself from legal consequences, but to realize and accept as the basis of his duty the more important moral responsibilities which the position involves.

It is not the duty of the auditor to prepare the balance-sheet; that is the responsibility of the directors assisted by the officials of the company. The auditor is concerned to see that the shareholders are given a true and correct view of the state of the company's affairs and the sole medium of his communication with the shareholders is his report. He is not accountable to individual shareholders or groups or classes of shareholders, but to the shareholders as a body. Primarily, the shareholders look to the directors for information as to the financial position of the company, and rely upon the auditor to point out in what way the balance-sheet may fail to reflect a true and correct view of the state of the company's affairs. Hence qualifications in the audi-

tor's report are apt to be regarded with disfavor by directors and with suspicion by shareholders. In practice, therefore, the auditor may be able to exercise considerable influence—by advice or persuasion—over directors in regard to the form in which accounts are presented to the shareholders.

Every balance-sheet is a summation of facts and opinions. It should represent what, in the judgment of the directors, is a fair statement of the financial position of the company, having regard to the object for which it was formed and to the existing circumstances and future maintenance of its business. It should be drawn up in such a manner as to afford shareholders an adequate means of ascertaining by perusal and inquiry the value of their interests without disclosing information likely to cause loss or injury to the business. It is the province of the auditor to apply his trained mind to a critical examination of the balance-sheet with a view to seeing whether, in his opinion, it substantially fulfills these conditions. He is not required to certify to an exact state of affairs, but he must be satisfied in the light of the evidence available to him that the balance-sheet is properly drawn up in accordance with customary usage.

The auditor will naturally be largely guided in the opinions he forms by the proved ability and character of the directors and officials entrusted with the management and conduct of the company's affairs; more particularly must he rely upon them in connection with matters involving expert and specialized knowledge of the industry concerned which he himself can not reasonably be expected to possess. In the main, however, the financial problems of every business are much the same and differ only in degree, and in considering such questions the auditor is able to bring to bear a mind capable of impartial and expert judgment and discrimination.

The duties of the auditor, as laid down by statute, may conveniently be summarized in two words—verification and report. He has first to examine the books and obtain information and explanations; thereafter he has to submit a report setting forth the conclusions at which he has arrived as the result of his investigation and inquiries. The first stage of his duty concerns the ascertainment of facts; the second stage necessitates the expression of an opinion based upon the exercise of independent judgment.

Now, in regard to the former, it may be said, subject always to exceptional circumstances, that there are certain facts which an auditor is bound to verify independently, viz.:

(1) The existence of such of the physical assets as are capable of verification by inspection or trustworthy confirmation from sources other than the company's officials. Such assets would include cash in hand, investments bills receivable, freehold and leasehold property, security held against advances and the like.

(2) The amounts of balances owing by or to the company's bankers and other debts and liabilities of exceptional character, not arising from normal trading operations.

The auditor must, generally speaking, satisfy himself as to the existence of other assets, if any, and the extent of the liabilities by the evidence of the books and records verified as far as necessary or practicable, having regard to the volume of the business and its internal organization, and supplemented by information and explanations obtained from the company's officials. And in this connection it may be noted that the practical application of scientific accountancy to all classes of business has largely minimized the risks of fraud by means of defalcation and embezzlement.

Any inability on the part of the auditor so to verify the existence of assets or any doubts he may entertain as to the omission of liabilities and commitments should be clearly stated in his report. Instances are common of companies whose operations abroad render it impossible for the auditor himself to examine accounts kept locally, and in such cases reliance must to a considerable extent be placed upon returns either audited locally or certified by the officials in charge. The fact that the balance-sheet incorporates accounts not under the immediate purview of the auditor should be specifically referred to by the auditor in his report. I do not propose to enlarge upon these basic principles except to say that responsibility can not be evaded by self-imposed limitation of duty which the circumstances do not warrant even if the auditor reports the extent to which he has restricted his examination. His duties are statutory.

Having satisfied himself as to the correctness of the transactions recorded in the books and the existence of the assets, the auditor has to consider whether the balance-sheet submitted to him by

the directors is presented in such a form as will justify him in reporting thereon in the words of the statute without qualification or supplemental observations. The legislature has rightly considered the conduct of private enterprise to be the concern of business men, and has refrained from undue interference in matters of domestic policy affecting shareholders as a body. The form and contents of the annual balance-sheet and accounts presented to the shareholders by the directors are not prescribed by law except in certain cases (e.g. life-assurance companies, building societies, railways and other public-utility undertakings governed by special acts of parliament) where the nature of the business and privileges enjoyed are such that special financial information is necessary in the public interest. Apart from these exceptional instances, the question of the information to be disclosed by the balance-sheet and the form in which it is submitted to the shareholders are, except to the extent that the directors may be bound to comply with any directions duly given by the company in general meeting, matters within the sole discretion of the directors subject to any regulations contained in the articles of association. In the words of Lord Justice Lindley, "it has been very judiciously and properly left to the commercial world to settle how the accounts were to be kept." The directors alone are responsible for the administration of the company's affairs and are accountable to the shareholders for their acts.

Undoubtedly, there has been a growing tendency during the past few years to curtail—in some cases unreasonably—the information afforded to shareholders. The remedy is in the hands of the shareholders themselves. The auditor has no power to insist upon a fuller disclosure of details by directors, and yet, unless the balance-sheet be in his opinion actually misleading, he can not well report that it is not properly drawn up so as to exhibit a true and correct view of the state of the company's affairs. So to do would be to confuse his duties and responsibilities with those of the directors; the auditor should be careful to distinguish between what may appear to him to be desirable as opposed to what is essential, remembering that a mistaken view of his duties might be the cause of embarrassment and loss to the shareholders, whose interest he is appointed to protect. When, however, the auditor is not satisfied that the balance-sheet discloses a true and correct view of the state of the company's affairs, and considers that it is incorrect or misleading, he should

convey his views in clear and unambiguous terms to the shareholders.

The auditor should have a clear conception of the attitude he should take up in regard to the values placed upon the various assets. Whilst he is not a valuer in the ordinary sense of the word and can not be expected to place values upon fixed assets, such as land, buildings and plant—indeed, such assets are not, in the ordinary way, revalued for balance-sheet purposes—yet he can generally obtain sufficient information to enable him to form an opinion as to the adequacy of the provisions for the amortization of the book values of wasting assets. If he is not satisfied on this point it might be his duty, but only after reviewing the whole circumstances, to make a qualification in his report. In regard to many liquid assets, however, he should be able to form, and if necessary express, a view as to the values adopted in the balance-sheet. Otherwise the opinion he is required to give as to whether the balance-sheet exhibits a true and correct view of the state of the company's affairs will be of little or no value to the shareholders. Qualifications in auditors' reports largely arise in connection with values placed upon the assets by the directors, and in this connection it is of the utmost importance to appreciate the bearing which such valuations have upon the financial position of the company as disclosed and the profits shown as available for dividend.

In Great Britain, the auditor is confronted with a series of somewhat involved legal decisions given as a result of applications to the courts to determine to what extent it is necessary for the share capital of companies to be preserved intact as an essential condition to be fulfilled before a dividend can be paid. Each case necessarily has reference to the specific facts and circumstances before the court and in particular to the company's own domestic regulations so far as such regulations are not inconsistent with the statute; the decisions, therefore, can not be regarded as laying down any unalterable or fixed rules which should be slavishly followed. In the words of the lord chancellor (Lord Halsbury) in the case of *Dovey* v. *Cory:*

> "The mode and manner in which a business is carried on, and what is usual or the reverse, may have considerable influence in determining the question what may be treated as profits and what as capital. . . . It is easy to lay down as an abstract proposition that you must not pay dividends out of capital, but the application of that very plain proposition may raise questions of the utmost difficulty in their solution. I desire, as I have said, not to express any opinion, but as an illustration of what

difficulties may arise the example given by the learned counsel of one ship being lost out of a considerable number, and the question whether all dividends must be stopped until the value of that lost ship is made good out of the further earnings of the company or partnership, is one which one would have to deal with. On the one hand, people put their money into a trading concern to give them an income, and the sudden stoppage of all dividends would send down the value of their shares to zero and possibly involve its ruin. On the other hand companies can not at their will and without the precautions enforced by the statute reduce their capital; but what are profits and what is capital may be a difficult and sometimes an almost impossible problem to solve. When the time comes that these questions come before us in a concrete case we must deal with them, but until they do, I, for one, decline to express an opinion not called for by the particular facts before us, and I am the more averse to doing so because I foresee that many matters will have to be considered by men of business which are not altogether familiar to a court of law."

In the same case, Lord Macnaghten said:

"I do not think it desirable for any tribunal to do that which parliament has abstained from doing—that is, to formulate precise rules for the guidance or embarrassment of business men in the conduct of business affairs. There never has been, and I think there never will be, much difficulty in dealing with any particular case on its own facts and circumstances and speaking for myself, I rather doubt the wisdom of attempting to do more."

Nevertheless, observations made by judges in summing up evidence and facts before them in specific cases are useful and instructive and enable us to contrast what may be held to be legally sufficient with what is regarded as financially sound and commercially prudent. I have extracted from the judgments the following passages as illustrative of the way in which the courts approach these questions:

"But if the court sees that the directors and the company have acted fairly and reasonably . . . the court is very unwilling to interfere with the discretion exercised by directors who have the management of the company. . . . The act does not say what expenses are to be charged to capital and what to revenue. Such matters are left to the shareholders; they may or may not have a sinking fund or a deterioration fund, and the articles of association may or may not contain regulations on those matters; if they do, the regulations must be observed; if they do not, the shareholders can do as they like so long as they do not misapply their capital. . . . The companies acts do not require the capital to be made up if lost . . . I can not find anything in them which precludes payment of dividends so long as the assets are of less value than the original capital. . . . The act says nothing to make the loss of the capital a ground for winding-up. . . .

"The proposition that it is ultra vires to pay dividend out of capital is very apt to mislead, and must not be understood in such a way as to prohibit honest trading. If you treat it as an abstract proposition, that no dividend can be properly paid out of moneys arising from the sale of property bought by capital you find yourself landed in consequences which the common sense of mankind would shrink from accepting. On the other hand if the working expenses exceed the current gains, you can not divide your capital under the head of profits when there are no profits in any sense of the term. . . .

"It is said . . . that a company is not to be at liberty to pay a dividend unless they can show that their available property at the time of declaring the dividend is equivalent to their nominal or share capital. In my opinion, such a contention is untenable." (*Lee* v. *Neuchatel Asphalte Co., Ltd.*)

"The broad question . . . is whether a limited company which has lost part of its capital can lawfully declare or pay a dividend without first making good the capital which has been lost. I have no doubt it can—that is to say, there is no law which prevents it in all cases and under all circumstances. Such a proceeding may sometimes be very imprudent, but a proceeding may be perfectly legal and may yet be opposed to sound commercial principles . . . there is a vast difference between paying dividends out of capital and paying dividends out of other money belonging to the company, and which is not part of the capital mentioned in the company's memorandum of association. The capital of a company is intended for use in some trade or business, and is necessarily exposed to risk of loss . . . if the capital is lost the company is under no legal obligation either to make it good, or, on that ground only, to wind up its affairs. If, therefore, the company has any assets which are not its capital within the meaning of the companies acts, there is no law which prohibits the division of such assets amongst the shareholders. . . . There is no law which prevents a company from sinking its capital in the purchases or production of a money-making property or undertaking, and in dividing the money annually yielded by it without preserving the capital sunk so as to be able to reproduce it intact. . . . It would, in my judgment, be most inexpedient to lay down a hard and fast rule which would prevent a flourishing company either not in debt or well able to pay its debts from paying dividends so long as its capital sunk in creating the business was not represented by assets which would, if sold, reproduce in money the capital sunk. . . . Moreover, when it is said, and said truly, that dividends are not to be paid out of capital, the word 'capital' means the money subscribed pursuant to the memorandum of association or what is represented by that money. . . . But, although there is nothing in the statutes requiring even a limited company to keep up its capital, and there is no prohibition against payment of dividends out of any other of the company's assets, it does not follow that dividends may be lawfully paid out of other assets regardless of the debts and liabilities of the company. A dividend presupposes a profit in some shape . . . if the income of any year arises from a consumption in that year of what may be called circulating capital, the division of such income as dividend without replacing the capital consumed in producing it will be a payment of a dividend out of capital within the meaning of the prohibition which I have endeavored to explain . . . the word 'profits' is by no means free from ambiguity. The law is much more accurately expressed by saying that dividends can not be paid out of capital than by saying that they can only be paid out of profits. . . . Perhaps the shortest way of expressing the distinction which I am endeavoring to explain is to say that fixed capital may be sunk and lost, and yet that the excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess, in which case to divide such excess without deducting the capital which forms part of it will be contrary to law. . . . Capital lost must not appear in the accounts as still existing intact; the accounts must show the truth and not be misleading or fraudulent." (*Verner* v. *The General and Commercial Investment Trust, Ltd.*)

" . . . Where a company has made losses in past years and then makes a profit out of which it pays a dividend, the question is a different one. Such a dividend is not paid out of paid-up capital. If it were, the paid-up capital would be still further reduced by the payment. In fact, the assets representing the paid-up capital remain the same or of the same value as before the payment of the dividend. It may be that the balance to the credit of profit-and-loss account ought to be applied in making up lost capital, and it may be that the directors are liable for neglecting to apply it in this way. But such a payment does not involve a reduction of capital, it involves a failure to make good capital which has already been lost. . . . If payment of dividends out of the balance to the credit of profit and loss is open to attack, it is, I think, on the ground (omitting any question of

dishonesty) that the course adopted is one which is contrary to the practice which governs all competent business men in the keeping of their accounts. This is possibly another aspect of the distinction, on which stress has sometimes been laid, between the two propositions that dividends must not be paid out of capital and that dividends can only be paid out of profits. . . .

" . . . What is circulating capital and what is fixed capital is a question which in many cases may well embarrass the business man and the accountant, as well as the lawyer. According to some of the definitions the same asset may be fixed capital in one company and circulating capital in another. . . . I am not satisfied that the proposition that it is contrary to all principles of commercial accountancy to utilize an increase in the value of a fixed asset for the purpose of getting rid of a debit which represents loss of paid-up capital is not too wide. It may be a precept of prudence and yet be far removed from the sphere of the categorical imperative. Assuming that a company ought to keep the value of its assets up to the amount of the liabilities and paid-up capital or, in other words, to see that its paid-up capital is intact, why should it be absolutely precluded from stating the true value of its assets? . . . If it is necessary or proper that a company shall maintain its assets at the amount of its paid-up capital liabilities, there would not appear to be anything illegitimate in showing that the assets are equal to the paid-up capital and liabilities. Nor for this purpose can it matter that the increased value is due to the fixed assets. The paid-up capital is represented by both fixed and circulating capital, and it seems somewhat arbitrary that circulating capital may be shown at its true value while fixed capital must not. Take the case of a depreciation fund. The effect is that the value of the assets as shown in the account is diminished by the amount of the depreciation fund. If the assets in fact increase in value to the extent of the depreciation fund, there is no rule which prohibits a company from wiping out the depreciation fund from the liabilities side of the account . . . directors would no doubt not be justified in ascribing to a fixed asset a value which is the result of purely temporary fluctuations. It is one thing to treat an unrealized increase in value of a fixed asset as profit and to pay dividends out of it as profits; but it appears to me to be a different question whether in considering whether there is a deficiency in paid-up capital owing to past losses, which ought to be made good out of future profits, the real value of the assets can be ascertained with the object of discovering if, in fact, there is a deficiency in the paid-up capital. . . .

"The directors, no doubt, would have been better advised if they had obtained a revaluation from some expert valuer, although, if one may judge by the evidence on the subject which I have heard, the margin of difference between the views of valuers on the subject is very great. But there is no rule of law which requires directors to obtain outside assistance in such matters or prevents them from valuing the property themselves, provided, of course, that they act honestly in doing so." (*The Ammonia Soda Co., Ltd.* v. *Arthur Chamberlain and others.*)

"I proceed on a principle as old as the beginning of company law—the principle, namely, that in matters of the kind here in question—matters necessarily of estimate and opinion—a company is presumably the best judge of its own affairs . . . a manufacturer requires or resolves to discard certain machinery and to replace it with other machinery more effective or more economical. Here again, the sacrifice in the case of the old machinery is simply an item in the cost of the change. . . . And although it may be a prudent and proper thing to provide for the recurrence of such expenditure, and to set up a renewal fund, that is a question which the trader considers for himself, and one as to which even in the case of limited companies, courts of law are not accustomed to interfere." (*Cox* v. *Edinburgh and District Tramways Co., Ltd.*)

"It is necessary, however, to consider whether the depreciation in goodwill and leases is to be treated as loss of 'fixed' capital or of 'floating or circulating' capital. . . . Depreciation of goodwill seems to me to be loss

of 'fixed' capital. It closely resembles the loss which a railway company might be said to sustain if it were found that a line, which had been made, say, ten years ago, at a certain cost, could now be made for a very much smaller amount and, consequently, would not yield if it were sold the price expended in making it." (*Wilmer* v. *McNamara & Co., Ltd.*)

". . . the periodical ascertainment of profits in a business is an operation of such practical importance as to be essential to the safe conduct of the business itself. To follow out the strict consequence of the legal conception in making out the accounts of the year would often be very difficult in practice. Hence the strict meaning of the word 'profits' is rarely observed in drawing up the accounts of firms or companies." (*The Spanish Prospecting Co., Ltd.*)

Although the courts confine themselves to the interpretation and administration of the law it will be seen that practical considerations are not unheeded. If legal requirements are complied with the judges are disinclined to interfere with or restrict the discretion of business men in a course of action, which, whilst exceeding legal requirements, may be sanctioned by custom and dictated by prudence. On the other hand, if directors prepare accounts solely on the basis of legal requirements, the court will not regard their action as blameable even if it be recognized that prudence should or might have dictated another policy.

Assets as a rule can not be specifically earmarked as representing the share capital, neither does the expenditure on fixed assets necessarily correspond to the share capital subscribed. The proposition that floating or circulating assets must be kept up or be shown at their true value is, generally speaking, not at variance with commercial practice. Instances arise which give great concern to an auditor—such as the value of securities owned or lodged as collateral against loans where the securities are not quoted or it is extremely difficult to ascertain their immediate or ultimate worth, where a loan is entirely unsecured and repayment is not made within the period of its currency as arranged with the borrower, where trade debts are overdue and bills receivable are repeatedly renewed. No exact rules for the treatment of such cases can be laid down. The auditor must reach his own conclusions, from the available facts, as to whether he is justified in giving an unqualified report if no adequate inner reserves exist to protect the institution in the event of the directors' and management's views as to values in the instances cited perhaps proving to be optimistic.

It is in regard to the treatment of fixed asset values that considerable divergence of opinion may arise between the legal aspect and the business conception of the balance-sheet. Neither

has nor should have regard to break-up values: the function of the balance-sheet is to show the position of an undertaking as a going concern and not to show the probable result of liquidation, a fact not always appreciated by those who are inclined to criticize published accounts. The value of fixed assets such as buildings, plant, machinery, etc., acquired for the purpose of producing profits should not be regarded for balance-sheet purposes as dependent upon their cost of replacement or upon earning capacity. The intrinsic value may, for various reasons, fluctuate widely from to time; the only stable and known factor so far as the company is concerned is their cost. Cost may therefore be said to be the correct initial basis of value; but the auditor must have regard to the maintenance of the fixed assets and provision for their ultimate renewal and in this connection temporary falls in value are not by themselves ground for adverse report. There is no obligation upon directors to have assets valued by independent experts. Indeed, unless a sale be contemplated, it is frequently a matter more of academic than practical interest to attempt to estimate any variation in value. Any depreciation so computed could hardly be regarded as lost capital or capital unrepresented by assets provided a systematic and adequate provision for depreciation had been set aside; the effect of such a provision should go far to rectify any probable shrinkage in value and should adjust to appreciably their correct relationship the value of the fixed assets with that part of the share capital sunk in the undertaking.

The expediency or otherwise of writing off goodwill out of profits and making provision against other capital expenditure not represented by tangible assets is a question of policy and as such does not concern the auditor; but the balance-sheet should show the facts in these respects. Practically the only fixed assets to which a market value can be attached consist of permanent investments as, for example, shares possessing stock-exchange quotations; but the size of the holdings and benefits derivable therefrom in addition to dividend income may have a material bearing upon their real worth apart from their purely investment value.

The extracts from judgments of the court to which I have already drawn attention show an appreciation by the judges of the difficult and delicate nature of our duties, and there is legal recognition of circumstances which may justify secrecy and the adoption of a course of action dictated by prudence. The latitude

allowed to directors is illustrated by the following definitions by judges of what a balance-sheet should convey:

> "A full and fair balance-sheet must be such a balance-sheet as to convey a truthful statement as to the company's position. It must not conceal any known cause of weakness in the financial position or suggest anything which can not be supported as fairly correct in a business point of view." (*Re London & General Bank, Ltd.*)
>
> "If the balance-sheet be so worded as to show there is an undisclosed asset, whose existence makes the financial position better than that shown, such a balance-sheet will not in my judgment be necessarily inconsistent with the act of parliament. Assets are often, by reason of prudence, estimated, and stated to be estimated, at less than their probable real value. The purpose of the balance-sheet is primarily to show that the financial position of the company is at least as good as there stated, not to show that it is not or may not be better." (*Newton* v. *Birmingham Small Arms Co., Ltd.*)

These judicial utterances are helpful as indicating that the legal perception of the balance-sheet is not wholly uninfluenced by practical considerations of business expediency. Not seldom is it the fact that there are undisclosed reserves whose existence is a necessity for the well-being and security of the institution. To publish those reserves might be not only inexpedient but damaging, and the dicta of the learned judge just quoted is a justification for reasonable reticence and business prudence honestly exercised. An auditor who issues a report whose terms are ill-judged and without a due sense of proportion by a confusion of his duties with those of the directors and management, against whose probity and business capacity there is no reflection of allegation, may do infinite and irreparable harm. And on the other hand by an easy compliance with the views of others and by subordinating his own judgment to that of men whose management of an institution has been indifferent and faulty, as disclosed by the books, he would injure those who look to him for protection. An auditor in such cases must not only exercise sound judgment, but display courage regardless of consequences if he believes himself to be in the right. If the auditor's judgment be attacked the onus rests upon him to show that the facts and circumstances of the particular case justified the report he has signed. And therein lies the responsibility; an opinion will not by itself afford protection to the auditor if the view he acts upon and expresses is subsequently held to have been formed carelessly or without sufficient inquiry.

I now pass on to a brief review of the responsibility attaching to the accountant in connection with certificates issued for inclusion in prospectuses or offers for sale inviting the public to sub-

scribe for or purchase shares and debentures in industrial undertakings.

The development of joint-stock enterprise in Great Britain, great and beneficial as has been its effect, was not unattended by some disadvantages, as it afforded scope for the activities of dishonest persons seeking to enrich themselves at the expense of the unwary. Much has since been done by the legislature to protect the investing public by making compulsory the disclosure of material information and by rendering directors and promoters personally liable in respect of incorrect or erroneous statements appearing in prospectuses offering share and debenture capital for subscription. And apart from such legislation, the stock exchanges in Great Britain have greatly assisted in safeguarding investors by withholding quotations, and thus rendering securities largely unnegotiable, in cases where prospectuses do not comply with their requirements.

There is no statutory obligation upon companies to publish in prospectuses a record of trading profits for a series of years, or a statement of their financial position at a recent date. It has, however, become the almost regular practice for such information, when available, particularly as regards profits, to be given in the form of an accountant's certificate for two reasons: (1) the certificate generally speaking relieves directors and promoters from responsibility in regard to the facts it conveys, and (2) the certificate serves as an assurance to the public that the figures are reliable.

The vast amount of capital subscribed each year for the development of industrial undertakings is both an indication and a justification of the value attributed to such certificates. The accountant who furnishes such a certificate whether or not he thereby incurs any legal liability is at any rate morally responsible, first to promoters and directors who, relying upon the results of the accountant's investigation as embodied in the proposed prospectus certificate, proceed with the formation and flotation of an existing business as a public company, and, secondly, to investors who apply for and take up shares and debentures in established or in newly formed companies, and may have been influenced in doing so by the indication of earning capacity as reflected by the certified profits of past years.

It is, I think, true to say that no class of accountant's certificate has greater publicity than the prospectus certificate or is wider in

its influence and appeal. The auditor is not responsible for the preparation of accounts or the form in which they are presented to shareholders: his report thereon follows the wording of the act subject to necessary qualifications. In the case, however, of prospectus certificates he is solely responsible for the manner in which they are framed: they are his entire creation, and his sense of responsibility should prevent him from signing a certificate whose terms, whilst technically correct and sufficient, may nevertheless be presented in such a manner as to render the true results obscure and lend themselves open to wrong construction and inferences. A certificate liable to criticism on such grounds is none the less reprehensible because the impression it conveys was unintentional on the part of the certifying accountant. It is his duty to exercise all necessary care and caution to prevent possible misunderstanding, and whilst endeavoring to comply with the reasonable wishes of his client the accountant should remember that his first concern—which is not inconsistent with his client's true interests—must be for the public. The responsibility for the form of the certificate must, therefore, rest entirely with the accountant, and he should reject any suggested modification of the form of certificate which in his judgment the circumstances do not warrant.

It is a truism to say that the accountant in such a certificate must confine himself to facts: it is not within his province to make or certify estimates, neither should he express an opinion as to the probabilities or possibilities of the future. But the facts stated should be adequate and sufficient. The period in respect of which it is desired to quote the profits is a factor of considerable importance. A short period of exceptional prosperity clearly due to abnormal circumstances in the specific business or trade would by itself be an unfair criterion to adopt; whilst, on the other hand, unfavorable results attributable to price cutting and trade strikes or other depressing influences might also by themselves not do justice to the merits of the security offered. The detailed explanation which the bearing of such unfavorable conditions has had on profits is more a matter for the directors to deal with in the prospectus than the accountants in their certificate. In such circumstances, the period selected should be sufficiently long to enable the financial effects of abnormal prosperity or depression to be viewed in their true perspective. The manner of arriving at the profits should be suitably described to indicate the adjustments considered necessary and made in the figures as shown by

the books and accounts in order to arrive at the desired result, namely, the balance of profit which remains (after providing for prior charges, if any) to meet appropriations to free reserves and interest or dividend upon the security offered. It is, of course, true that the results for a past series of years do not take into account the increased profits which the employment of additional capital is likely to yield. But the accountant should refrain from attempting to prophesy the annual benefit likely to be derived therefrom and should leave the directors responsible for the carrying on of the business to make their own estimate in this respect.

Many important questions of accounting arise in the adjustment, for the purpose of a prospectus certificate, of the profits shown by the books and the annual accounts. It is permissible to delete charges which can properly be regarded as capital outlays but which for reasons of prudence have been written off against profits, and reserves made by a company for contingencies which have not arisen may properly be eliminated. The re-allocation of expenditure charged in any one year over a series to which they properly apply is frequently necessary. On the other hand there may be expenditure of an exceptional and non-recurring nature which, whilst properly provided for out of profits, is not an annual charge, and the income itself may have been augmented by extraneous profits not arising from the normal trading activities of the company. The extent to which the accountant must qualify his certificate in all or any of these respects can only be determined by a review of individual circumstances. The trend of the profits is of great importance, and for this reason the figures for each year should be stated separately. Where the results reported upon include those of a broken period they should be stated separately: it may be misleading to compute the yearly profits by reference to those earned during a portion of a year.

The natural desire for brevity in certificates should not, of course, be allowed to curtail a statement of all necessary figures and explanations. Conciseness is very desirable, but it is sometimes found that both the interests of the company and the public will be served by figures giving additional information bearing on the amount of the profits, such as the gross turnover; dividends paid; the amount of share capital outstanding from time to time; the annual expenditure upon repairs and renewals, and the provisions for depreciation. One occasionally sees an accountant's certificate which does not state the profits of each year, but at-

tempts to convey what is the earning capacity by indirect means such as, for example, a statement that the average annual net profits over a given number of years are sufficient to pay the interest or dividends on the new capital several times over and that the net profits of the last year exceeded such average. In such cases the accountant accepts undesirable responsibilities and often constitutes himself a judge of circumstances upon which the investor himself should be placed in the position to form his own opinion by a full and frank disclosure in the prospectus.

Whilst it may be said that responsibility of the accountant in regard to prospectus certificates is largely a moral responsibility, he does incur the risk of having to justify before the courts the statements made by him in such a certificate. I can only recall one case (*Maynards, Ltd.* v. *Maynard and others*) in which action has been taken in respect of a prospectus certificate, and the certificate in that case was in the following terms:

> "We have examined the accounts of the forty-six retail businesses proposed to be acquired by your company, the majority of which have been established for several years. The accounts show that the businesses have been steadily increasing, the sales now being at the rate of £39,542 7s. 5d. per annum. We have also examined the accounts of the wholesale businesses carried on in connection with these retail shops, and find that the sales are at the rate of £17,795 11s. 7d. per annum, of which by far the greater portion is for goods supplied to customers other than the retail businesses, the total sales of the combined retail and wholesale businesses above referred to being at the rate of £57,337 19s. per annum. Owing to the absence of figures showing the expenses of some of the businesses we are unable to ascertain the exact net profit of the whole of them, but from our knowledge of the extremely profitable nature of the confectionery trade and from the facts disclosed during our investigation we are satisfied that the profits of the businesses are large, and that after payment of the interest on the preference shares there will remain a profit sufficient to pay a substantial dividend upon the ordinary shares."

The plaintiffs alleged that the accountants had knowingly made false statements as to the profits, but the court held that they had acted honestly and were honestly satisfied as to the correctness of their certificate, and the action against them was dismissed, but the mere fact that they were called upon to substantiate the opinions expressed indicates the danger in practice of constituting oneself an expert as to possibilities.

No one is free from the frailties which are the heritage of men and no one is infallible. But in the last half-century which has witnessed the rise and the development of accountancy as a profession there have been comparatively few reported cases in which it has been shown that practising accountants have failed in discharging adequately their onerous and responsible duties.