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Bernard Rose

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Responsibility of Auditors

By BERNARD ROSE

Responsibility may be defined as the state of being answerable or liable for one's actions or failure to act under certain conditions. It may be divided into two parts, namely, "respond" and "ability," which when connected by the preposition "with" would read: "Respond with ability." From the lowest to the highest forms of animal life, responsibility is apparent and is exercised to a degree proportionate to the conditions affecting each level of existence. In our present complex society, each one of us has an important and closely correlated function and the progress of civilization is predicated on the degree of individual and collective responsibility with which we perform our duties. The economic structure of the world has been slowly strengthened and enlarged through centuries of strife and oppression, and today provides for us the many comforts and luxuries that science and invention—subsidized by capital—have created.

Education, the most vital factor of all, has taught us the inter-dependence of individuals and nations. A close harmony of civilized peoples tends to eliminate useless destruction of life and property and will ultimately be the only means of perpetual peace. And yet, behind all this industrial and social progress, responsibility—that sub-conscious and absolutely essential state of mind—has ever been present. The railroads, steamboats, electric light and gas plants, telephone and telegraph lines—in fact, every form of commercial endeavor has succeeded because the pioneers of those industries have ever been ready to recognize their responsibility to the world; and faith in them and their enterprises has quickly responded and remains unyielding.

The national and international trade of the world, extending into billions of dollars annually, is transacted by contracts. And why? Because the contracting parties have faith in each other's responsibility to fulfill obligations. As business increased through the centuries, nations had to establish national and international codes of ethics whereby trade could be conducted. Laws were passed regulating the individual's rights and obligations and the

law-making bodies, handicapped as they were by lack of foresight and misunderstanding, have tried to accomplish the tremendous task of establishing a system of justice to all.

The phraseology of statutes passed and the decisions of cases arising thereunder created a large demand for attorneys, and the legal profession of today is considered one of the foremost. It has had hundreds of years in which to develop into its present responsible state. The medical profession is as old as the world and diseases that were incurable years ago are now cured quickly and permanently.

Using these two professions as examples, we naturally want to analyze the reason for their growth and recognition. The cause is the fact that sincere and ethical practitioners, having the love of their profession at heart, realized that they had an important mission to perform for society, accepted the responsibility for their actions and therefore laid the foundation for the people's faith in their work.

Today, a comparatively new profession is endeavoring to secure the people's faith in the work it has to perform. Compared to the other professions, it is still an infant and is struggling to grow into healthy manhood. That new profession is accountancy. Handicapped as it is by lack of knowledge by the business world as to its functions and obligations, it is reënföring the foundation laid for its world work and shows creditable promise for its future mission in the economic and social development of society.

We, as members of this new profession, have a two-fold duty to perform. First, we must be ready to accept full responsibility for the work we do, so that our clients and all others interested will have faith in our profession. Second, we must educate the world as to the purpose of our work and its beneficial results to society in general. Perhaps the second duty will be made comparatively easy for the accountant if he will conscientiously adhere to the first. The good-will of every business—and a profession can be classed as a business—is absolutely dependent upon the faith placed in that business by others, and faith depends upon the individual's degree of responsibility.

In former years the public accountant was engaged usually to balance the books of account or to assist the bookkeeping

force in finding errors accumulated during the fiscal period. Then, as the several states adopted laws creating the certified public accountant and prescribing the more or less rigid qualifications necessary to practise as such, business began to engage accountants for organization and dissolution, auditing and cost-analysis, systematizing and improvements in the general run of industry. Many accountants were called to conduct special investigations, especially those necessitated by misappropriation of funds and other assets. Meanwhile, universities throughout the country began to realize that an entirely new field of professional endeavor had been created, and added accounting courses to their curriculum. The federal and state income and capital-stock tax laws have educated and induced business men to engage expert accountants to assist in the preparation and filing of returns and claims.

Because of this increasing recognition of the profession of public accountancy and the reliance placed upon practitioners by business, the accountant has had to adopt a code of rigid laws governing his responsibility, duties and ethics. If accountancy is to remain on a plane with other professions, such as law and medicine, the accountant must be prepared to fulfill his duties and obligations, not only to his clients, but also to the public and to his chosen profession. In his engagements to audit books and report thereon he can no longer accept the oral statements of his client as to the assets and liabilities, but must secure such verifications as may be necessary from outside sources, conducting his audit "not as a bloodhound, but as a watch-dog." His conclusions must be of impartial fairness, stating conditions as he finds them and not as he is told of them without any confirming evidence.

Robert H. Montgomery, in his book *Auditing Theory and Practice*, clearly states the accountant's obligations in the following quoted paragraph:

Anyone who holds himself out as skilled in a profession is charged with a higher degree of responsibility than one who is inexperienced and who does not seek professional work. Acting in a professional capacity, an auditor must do more than ascertain the mere arithmetical accuracy of the accounts. If the accounts do not represent the true financial position of the undertaking under examination, and if the fact is apparent or can reasonably be deduced from the face of the accounts themselves, then the auditor is under a legal obligation to discover and disclose the true state of affairs.

Of course, the accountant is often limited by the client as to the extent of his investigation and audit, and in such cases he should always direct attention thereto in his report. But in no event should he certify to the amount of cash on hand or in bank unless he has absolute proof that such balance exists. It may sometimes be impossible to get other verifications (in that case it would be advisable for the accountant to consider withdrawing from the engagement); but the first commandment should be: "Verify cash."

There are cases on record in which auditors have been held liable for their neglect to make cash verifications, despite the accountant's defense that he was not engaged to examine the cash. Since it is the most accessible asset and offers the most alluring temptations, anyone inclined to follow the lines of least resistance would direct his energy towards appropriating cash. Accountants have been held liable for professional negligence in many cases, particularly in England. The laws of Great Britain are prolific in decisions and enactments prescribing the liabilities and responsibilities of auditors. Following is a summary of a few of the more important:

In re Leeds Estate Building & Investment Society, Lim. v. Sheperd, L. R. 36, Ch. Div. 787 (August 9, 1887).

Dividends had been paid out of capital and the auditor had passed the account. It was held that it was the duty of the auditor in verifying the accounts of the company not to confine himself to verifying the arithmetical accuracy of the balance-sheet, but to inquire into its special accuracy and to ascertain if it contained the particulars specified in the articles of association and was properly drawn up to contain a true and accurate representation of the company's affairs.

In each of these years, L (the auditor) certified that the accounts were a true copy of those shown in the books of the company. That certificate would naturally be understood to mean that the books of the company showed (taking, for example, the certificate for the year 1879) that, on April 30, 1879, the company was entitled to "moneys lent" to the amount of approximately £150,000. This was not in accordance with the fact; the accounts, in this respect, did not truly represent the state of the company's affairs, and it was a breach of duty upon L's part to certify as he did with reference to them. The payment of the dividends, directors' fees and bonuses to the manager actually paid in those years appears to be the natural and immediate consequence of such breach of duty; and I hold L liable for damages to the amount of the money so paid.

In re London & General Bank, 2 Ch. Div. 673 (1895).

The auditor presented to the stockholders a certified balance-sheet as of February, 1892, without any reference to the report which he had laid before the directors. The assets of the bank audited were put down on the balance-sheet at far too high a figure, and this entry, though not misleading if explained (as it was to the directors), was seriously misleading in the absence of explanation.

The court said:

It is not part of an auditor's duty to give advice either to directors or shareholders as to what they ought to do. An auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably. It is nothing to him whether dividends are properly or improperly declared, provided he discharged his own duty to the shareholder. His business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that. But then comes the question: How is he to ascertain such position? The answer is: By examining the books of the company. But he does not discharge his duty by doing this without inquiry and without taking any trouble to see that the books of the company themselves show the company's true position. He must take reasonable care to ascertain that they do. Unless he does this, his duty will be worse than a farce. Assuming the books to be so kept as to show the true position of the company, the auditor has to frame a balance-sheet showing that position according to the books, and to certify that the balance-sheet presented is correct in that sense. But his first duty is to examine the books, not merely for the purpose of ascertaining what they do show, but also for the purpose of satisfying himself that they show the true financial position of the company. * * * Such I take to be the duty of the auditor; he must be honest—that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true.

What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion, very little inquiry will be reasonable and sufficient; and in practice, I believe, business men select a few cases haphazard, see that they are right and assume that others like them are correct also. Where suspicion is aroused more care is obviously necessary, but still an auditor is not bound to exercise more than reasonable care and skill even in a case of suspicion, and he is perfectly justified in acting on the opinion of an expert where special knowledge is required.

In re Smith v. Shard, Liverpool assizes, May 11, 1906 (Accountant, L. R. 1906 P. 65).

The plaintiff's cashier had embezzled about £700, and the plaintiff thereupon sued the auditor on the ground that the auditor should have detected the embezzlement. The defendant alleged that he had not been retained to make a complete audit, but that the only work he undertook was the stating of accounts between the partners.

The case was tried before a special jury which found for the plaintiff.

In re Martin v. Isitt, decided before Lord Chief Justice Russell, in the queen's bench division, March 3 and 4, 1898 (Acct. L. R., 1898, p. 41).

James Martin & Sons sued Isitt & Co., chartered accountants, alleging that as auditors they were negligent in failing to check the cashbook and the bank pass book, and that thereby a clerk was able to embezzle £612.

The defendants had been retained to make monthly audits. They claimed, however, that they had been unable to conduct their work properly, owing to the tardiness of the plaintiff's book-keepers in giving them definite information on questioned items, whereby they were kept about six months behind in their audit. A trial of the case was begun, but the defendants settled during the course of the trial.

In re Astrachan Steamship Company and Others, v. Harwood-Banner and others. (See "The Accountant Law Reports" of March 17, 1900. Pages 49-50).

The Astrachan Company was one of a series of five single-ship companies standing on the court list as plaintiffs, each company managed without directors by one William Weston Tapscott, a man of no great means, but who had been well known in Liverpool for his success in obtaining capital from people who were willing to subscribe for the building of the various ships severally owned by this group of single-ship companies. The Astrachan Company was registered in February, 1892, and Tapscott was appointed as manager, at a salary of £200 a year plus two and one half per cent. on the gross earnings of the steamer. As there were no directors, the only safeguard of the shareholders was the audit by the firm of the defendants who audited the accounts of the company and of the other single-ship companies which Tapscott managed.

It appears that this company went into bankruptcy and Tapscott was imprisoned for embezzling funds of the company. The auditors did not detect the defalcation at their first audit in 1893. Briefly, what Tapscott did was to present the accounts of the various companies for audit at different times, and by keeping in hand a sum of money which went all around, he

Responsibility of Auditors

contrived to balance each company's cash account for a short period in turn. While the first audit of the defendants ought to have revealed this state of affairs to the shareholders, the second audit by the defendants exhibited a kindred state of affairs, but on a larger scale, the sum belonging to the Astrachan Company which Tapscott had on loan for his own use having increased. The interest on these loans was openly debited to Tapscott in the ledger of the company but the interest was never paid.

It was not, as his honour had remarked, the business of the auditor to act as a detective, but he ought to be a watch-dog. Supposing things were kept out of the books altogether, the auditor would not be held responsible for that. The way, however, in which Tapscott borrowed money from this company, even to the extent of overdrafts at the bank, keeping large sums belonging to the company in hand until the eve of the audit, merely replacing those sums for the audit and again withdrawing them, was most significant. By allowing the shareholders to remain ignorant of the fact that their manager was continuously borrowing their money in large sums, the defendants caused the shareholders in this single company to lose a sum more than they would have lost had the defendants put a stop to the practice of Tapscott at the first audit when he had borrowed only a small amount.

The evidence of well known chartered accountants of Liverpool, London and Manchester was then called. They all agreed that the state of things palpable on the face of the books of the Astrachan Company called on the defendants (1) to demand from Tapscott his special authority for borrowing the moneys of the company; (2) to report the position to the shareholders; (3) to have altered the item in the balance-sheet "cash in manager's hands" to "cash borrowed by manager at 4 per cent. interest." The defendants made a proposal to settle all the cases and paid the necessary sum of money.

Our profession will grow as soon as we appreciate the seriousness of our work and as rapidly as the world increases its faith in our responsibility. Two forms of the horror of responsibility are laziness and the fear of risk. The first must not and cannot be tolerated, and the second must be eliminated if we expect to

place our profession on the high level of esteem and honor to which it is entitled.

Emerson says:

A wise man will extend this lesson to all parts of life, and know that it is the part of prudence to face every claimant and pay every just demand on your time, your talents or your heart. Always pay; for first or last you must pay your entire debt. Persons and events may stand for a time between you and justice, but it is only a postponement. Life invests itself with inevitable conditions, which the unwise seek to dodge, which one and another brags that he does not know, that they do not touch him—but the brag is on his lips, the conditions are in his soul. If he escapes them in one part they attack him in another more vital part. If he has escaped them in form and in the appearance, it is because he has resisted his life and fled from himself, and the retribution is so much death.