COMPANY AUDIT

WITH SPECIAL REFERENCE TO PROTECTION OF THE PUBLIC INTEREST

"Some companies use accounts like some people use lamp-posts — for support, rather than illumination." [1]

If the controllers of a company were allowed to maintain complete secrecy about the financial affairs of the company, several different groups might have cause to complain. The cloak of obscurity enables the fraudulent controller to hide his activities from the investor, who will only discover the insubstantiality of his equity of investment when the controller's defalcations finally bring the company to its knees. To a lesser extent, the creditor too may wish to know more about the current state of the affairs of the company to whom he has extended his credit in good faith on the representations of its controller. His interest does not seem to be as widely recognised. Even less so, is the interest of the public generally in publicity of accounts and audit. Yet the public is just as concerned to know something of the affairs of companies, particularly large groups, as it is to know about the affairs of the large state corporations which are becoming a more and more common commercial phenomenon in industrialised societies. It is obviously a matter of very considerable public concern that the financial affairs of the company shall be fully and accurately stated so far as is relevant for purposes of taxation.[2] But even leaving this aside the public comes into contact with modern commercial organisations in two important capacities, The public generally are the consumers of their products. And many members of the public are more closely associated as employees. The consumer is worried about prices — the employee concerns himself with wages. Without full information as to the company's financial affairs no informed opinion on either topic can be formed.[3] The controllers of companies are fully aware of this as was clearly evidenced in the course of the recent I.C.I. — Courtaulds affair where, pressed by

1. With apologies to Andrew Lang.
2. See *Chantry Martin* v. *Martin* [1953] 2 A.C. 286, for an example of the problems raised and the judicial attitude towards their solution.
3. See Report of the Committee on Company Law Amendment, 1945, Cmd. 6659 (hereinafter referred to as the Cohen Report), para. 50.

the necessity of painting a more glowing prospect for his company than, in different circumstances, he had sketched in the previous year's accounts, Sir Alan Wilson explained that year's reduced dividend as an attempt to impress the workers and stifle wage demands.[4] There was no question, on this view, of any reduced capacity to pay. There was only an attempt, by juggling dividends and reserves, to give the misleading impression of a reduced capacity to pay without, let it be said, in any way prejudicing payment of future dividends or issue of bonus shares, by capitalisation of the undeclared profits.

There are, of course, two sides to this story:

> Those who are engaged in commerce are familiar with the fact that undue publicity as regards the details of their trade, or as to their financial arrangements, may often be very injurious to traders, having regard to the rivalry of competitors in trade, to complications sometimes arising from strained relations between capital and labour and the like. There are legitimate reasons for ensuring secrecy to a proper extent.[5]

The question is, what is a proper extent? It is a question falling clearly within the public domain but it may, indeed, be unanswerable in the present social system, for it involves, in direct conflict, the values of an old-established commercial morality and those of a socialist philosophy which becomes increasingly more popular as this century progresses. What is necessary to the public may be incompatible with existing commercial procedures, and *vice versa.* If this is so, then either one of the two positions must be abandoned, or muddling through on an empirical basis must be considered acceptable by both sides. In this connection, the most the law can do is to achieve the highest degree of reconciliation possible, and, in those areas where reconciliation cannot be achieved, the best working compromise. This may at least serve to make muddling through easier.

One preliminary point must be dealt with. Why single out registered companies for public scrutiny of accounts etc.? Why not subject all commercial undertakings to the same control? And would it not be a severe, and perhaps objectionable imposition, to treat every individuals' bank account as public property? There is a facile appeal in this objection. But it must be remembered first of all that large registered companies are not easily embarrassed by a disclosure of the state of their personal affairs, as are individuals; and secondly, that individual traders do not, generally, have the same concentrated power that some large commercial organisations do, and hence present an insignificant threat to the general public. The private company (in the United Kingdom,

4. *Financial Times,* January 25th, 1962, p. 14, col. 3.

5. *Newton* v. *Birmingham Small Arms Co. Ltd.* [1906] 2 Ch. 378, *per* Buckley J.

the exempt private company) is not at present subjected to the same scrutiny as is the public company,[6] and no-one suggests that this privilege should be withdrawn.

There are various ways of attempting to secure the true and accurate statement of the company's affairs in its accounts. The creation of a right of public inspection by officers of the state is one way which promises good results, but at the price of an alleged invasion of privacy which not all commercial concerns would wish to pay. This price apparently has to be paid in some countries which lack an accounting profession of sufficient integrity to guarantee the efficient functioning of the alternative.[7] Here, however, it has not so far been deemed necessary to make provisions for regular public inspection by public officers appointed for that purpose. Such inspection as is possible is available only if requested, or if it is warranted by suspicious circumstances.[8] There is no guarantee of the discovery of suspicious circumstances by public inspection. The common law attitude has rather been to pin its faith on the philosophy of disclosure, the creed that those concerned can and should be trusted to look after their own interests provided that they are given the means of doing so, *i.e.*, all the relevant information about the company's affairs. This philosophy bears all the hall-marks of the era of laissez-faire in which it has its origins, and which is now behind us. The basic tenets of laissez-faire are no longer generally acceptable. It may be doubted whether all can be trusted to look after their own interests. There is no reason why some should, for concern with the company's affairs is often virtually thrust upon them by the exigencies of the labour and commodity markets. In any case, it is surely more efficient to have one competent inspector doing the work, rather than having it done by perhaps millions, most of whom are inadequately fitted for the task. The efficient deployment of its labour is itself a matter of national concern!

6. Companies Ordinance (The Laws of the Colony of Singapore, 1955 Edition, c.174), ss.111(3), 112; (extended to and applicable in the Federation of Malaya by F.M. Companies Ordinance, 1946, (No. 13) s.3(1)). The single statute (hereinafter referred to simply as "the Ordinance") is thus applicable throughout Malaya. In this paper, references will also be given to the parallel legislation in the U.K. (the Companies Act, 1929, hereinafter called "the 1929 Act"), now repealed, and the latest legislation, (the Companies Act, 1948, hereinafter referred to as "the 1948 Act"), in order to examine the cause of change in that jurisdiction which, heretofore, has set the pattern for Malaya. The exemption of private companies was stated in the 1929 Act, ss.110(3) and 111 and is preserved in some cases only in the 1948 Act, (ss.124(1)(d), 128 and 129, and the Seventh Schedule).

7. See Anderson, "Concepts for Export," (1962) 106 *Sol. Jo.* 84, 85.

8. Ordinance, ss.138-141; 1929 Act, ss.135-138; the 1948 Act witnessed a significant extension of the scope of inspection, see ss.164-175.

Leaving these considerations aside, it is obvious that the philosophy of disclosure will be no more adequate than are the guarantees that the information supplied will be complete and accurate. Unless companies are effectively deterred from publication of false or misleading accounts, the persons relying on them are the worse for the philosophy of disclosure in that they are lulled into a false sense of security. It is therefore vitally important that everything possible should be done to ensure that a company's statement of its affairs is full and accurate. In most common law jurisdictions, it is sought to achieve this end in two ways. The first of these is increasingly elaborate statutory provision as to what must be included in the statement.[9] The second way is by supervision by auditors. The main purpose of this article is to examine the law relating to auditors with a view especially to ascertaining the extent to which they guarantee protection of the public interest. Statutory requirements with regard to accounts are dealt with only insofar as they are relevant to the auditor's function, or indicate the general trend in protection.

THE HISTORY OF PROTECTION SO FAR[10]

Only gradually have concessions been granted even to investors. The 1948 Act, in the United Kingdom, marks the greatest triumph of the public interest to date, and, it is to be hoped, the path for the future.

The first Act providing for general registration, that of 1862,[11] imposed no duty whatever on any company even to keep accounts or submit to audit. Optional provisions were contained in Table A, but that was all. Banking companies were the first to fall, in 1879,[12] when audit of their accounts was provided for. This requirement was extended to companies generally in 1900,[13] thus effecting a considerable improvement in the position of the investor. The first public protection came with the 1907[14] Act (in force July 1st, 1908) providing that all companies (except private companies) must include a statement in the form of a balance sheet in the annual return to the Registrar. That was to remain the total public protection until 1948. Meanwhile, the position of the investor had been further improved by the 1929 Act which added to his right to a balance sheet a right to a profit and loss account. This was

9. Ordinance, ss.109-112; 123-131; 1929 Act, ss.108-111; 122-131. *Cf.* 1948 Act, ss. 124-129; 147-158 and Sixth to Eighth Schedules.

10. See *Newton* v. *B.S.A.*, [1906] 2 Ch. 378; Cohen Report, paras. 49, 96-105.

11. Companies Act, 1862.

12. Companies Act, 1879.

13. Companies Act, 1900.

14. Companies Act, 1907.

the position as it stood when the Cohen Committee came to consider the question of reform and as it still stands in Malaya today where the law is the same, subject to a minor exception.[15] The main lack, so far as actual publicity is concerned, is the absence of any duty to submit a copy of the profit and loss account to the Registrar, with the annual return.

The Cohen Committee, in dealing with the annual return[16] did not contemplate any change in the statutory requirements[17] as to inclusion of the balance sheet, together with all documents required to be annexed thereto, in the annual return. The documents required to be annexed to the balance sheet were "a report by the directors with respect to the state of the companies affairs, the amount, if any, which they recommend should be paid by way of dividend, and the amount, if any, which they propose to carry to the reserve fund ..."[18] and also the auditors' report.[19] The Cohen Committee, in dealing with accounts,[20] recommended[21] that section 129, dealing with annexation of the auditors' report to the balance sheet, should be extended to require annexation of the profit and loss account. This recommendation has been adopted and the profit and loss account has thus, in a somewhat involved manner, become a public document.[22]

Merely to require the publication of a balance sheet and profit and loss account, without any specification of the type of information required, offers no protection against the unscrupulous. The trend towards protection of the public interest, discerned above in connection with publicity of accounts, can also be seen in the parallel instance of required contents of accounts. From little, if any, control in the early days, the position has now become as follows. Proper books of accounts with respect to income and expenditure, sales and purchases and assets and liabilities, must be kept.[23] Certain information which must be supplied in the balance sheet is specified by sections 124-127, sections 126 - 7 seeking to expose details of groups structure. Section 129 requires revelation of loans to and total remuneration of the directors as a body.

15. The only difference is that in Malaya a banking company is treated no differently from any other company in respect of authorisation of accounts (Ordinance, s.130, *cf.* 1929 Act, s.129).

16. Cohen Report, paras. 72-76.

17. 1929 Act, s.110(3) —same, as Ordinance, s.111(3).

18. 1929 Act, s.123(2); same as Ordinance, s.124(2).

19. 1929 Act, s.129(1); same as Ordinance, s.130(1).

20. Cohen Report, paras. 96-109.

21. *Ibid.*, p. 63.

22. 1948 Act, s.156(1).

23. Ordinance, s.123.

Beyond the general requirements of section 124, no particulars were laid down with respect to the profit and loss account; nor were the auditors required to direct their attention specifically to it.

The Cohen Committee was alive to the shortcomings of the parallel scheme in the United Kingdom and recommended[24] more detailed requirements which have now been laid down in the 1948 Act.[25] The most significant gaps in the law, so far as the 1948 Act in England is concerned, are those created by para. 12(2) of Part I of the 8th Schedule, allowing the Board of Trade to consent to non-publication of details of secret reserves,[26] and the total failure to require any details of the trading account in the profit and loss account.[27]

The course of reform in connection with company accounts, here briefly reviewed, reflects the increased recognition which has been accorded to the right of the public generally to access to the details of a company's financial position. Since 1906 when Buckley, J., so categorically excluded the public's from the catalogue of interests entitled to protection, opinion has changed. Among others, the Law Society now appreciates that the functioning of large registered commercial organisations is a matter of public concern.[28]

Merely to require, by statute, that certain information be stated in accounts which must be published does not guarantee disclosure. Without more, all that the investigator can do is to check the internal consistency of the accounts made public. If the protection is to be made at all realistic, investors, creditors and the public must be provided with the means of checking that the published accounts represent the actual state of the organisation in question, and not merely the optimism, or even the brain-child, of its controllers. That means is the auditor. Buckley, J., would certainly not have admitted that the auditor's is a semi-public function. Yet nowadays it is said that "his position is that

24. Cohen Report, pp. 58-63.

25. Ss.149, 152 and particularly the Eighth Schedule.

26. The suggested danger is an inchoate one and lies in the fact that the grounds upon which the Board's discretion may be exercised are stated no more narrowly than that the Board must be "satisfied that 'disclosure' is not required in the public interest and would prejudice the company." No information seems to be available as to the policy pursued by the Board under the provision.

27. A criticism voiced by Gower: *Modern Company Law,* 2nd ed., pp. 417-418.

28. See "Company Law — A Memorandum by the Council" (1960-1), *Annual Report of the Council of the Law Society,* pp. 59-80 (hereinafter referred to as the "Law Society Memorandum"), para. 8.

of a statutory safeguard both to the members and to the public."[29] The next task will be to consider the effectiveness of such a safeguard under the present law.

This effectiveness depends upon the observance of four principles :—

1. Appointment must be guaranteed. Without it, there is no safeguard at all. Imprisonment of defaulting controllers puts no money in the bank.

2. The auditors must be qualified. A partial, incompetent or dishonest auditor is no safeguard at all.

3. Appropriate functions must be discharged — no safeguard is provided by an auditor who does nothing.

4. The auditor must be responsible to those whose interests he protects. A safeguard without a remedy is like a hole without a doughnut.

1. THE SECURING OF APPOINTMENT

The auditors are usually appointed by the company. The initial appointment may be made by the directors.[30] Auditors so appointed may hold office until the first annual general meeting or until removed by the company in general meeting, whichever occurs first. If directors fail to make the initial appointment, the general meeting may do so. All appointments other than the first are initially in the hands of the company in annual general meeting;[31] although the directors may fill casual vacancies.[32] It will be observed that thus far, the public has no say whatever in the appointment of auditors and indeed, these provisions do empower a company to make auditing a purely domestic affair. Only in default of an appointment by the company in general meeting does the public interest receive recognition. In these circumstances, the Minister (in the United Kingdom the Board of Trade) may appoint for the current year. This is one respect in which the increasing recognition of the public interest is manifested in the United Kingdom. Under the 1929 Act[33] the Board of Trade could only appoint on application to it by a member of the company. The motive here is clearly investor protection,

29. Arnold, "The Neutrality of an Auditor". (1958) 26, *The Solicitor* 37-38 (a comment on *Re Transplanters* [1958] 2 All E.R. 711, considered below, p. 103).

30. Ordinance, s.132(4); 1929 Act, s.132(4); 1948 Act retains the power — s.159(5).

31. Ordinance, s.132(l); 1929 Act, s.132(l); 1948 Act, s.159(l).

32. Ordinance, s.132(5); 1929 Act, s.132(5); 1948 Act, s.159(6).

33. S.132(2).

and that remains the position in Malaya today. Under the 1948 Act, however, appointment can be made by the Board of Trade on its own motion.[34] Exercise of this power would, of course, be defeated if the Board of Trade failed to hear of a failure to appoint, and keeping tabs on some thousands of public companies would be a very expensive charge on the Exchequer. An attempt is made to avoid both evils by subjecting the company and its officers to a fine in the event of failing to inform the Board of Trade of the non-appointment.[35] Short of abandoning the philosophy of disclosure in favour of public inspection, this is really all that can be done.

An informal appointment not complying with the statutory provisions is not, for that reason, completely ineffective. It was argued in *R.* v. *Shacter*[36] that it was not possible to appoint otherwise than in accordance with the provisions, but Lord Parker, C.J., in declining to accept this view, surmised that informal appointment for a limited purpose might be possible. That this is so would seem indicated by *Re Western Counties Steam Bakeries Ltd.*[37] The question in that case was whether auditors, informally appointed for a single audit, were officers of the company so as to be liable for misfeasance under section 10 of the Companies (Winding Up) Act, 1890. The decision, that they were not "officers", rendered consideration of their actual status obiter. Nevertheless, the court thought "it might well be that (the accountants) having acted as they did, could not be heard to say that they were not auditors." This sounds in estoppel, and the better view may well be that acceptance of informal appointment imposes upon the appointee the obligations of auditorship without entitling him to the benefits. It seems that merely acting as an auditor will suffice. The duty, it seems, arises out of the calling, not the contract.[38] Nothing in these cases suggests that a company is released from all duties by such an informal appointment.

Continuity of tenure is ensured by the extension of privileges of re-appointment to existing auditors. Under the 1929 Act and the Malayan legislation, this takes the form of requiring special notice of an intention to replace the existing auditor.[39] This leaves a gap. The old auditors can be removed without special notice thus leaving the office vacant. The 1948 Act has filled this gap, in the United Kingdom, by providing

34. S.159(3).

35. 1948 Act, s.159(4).

36. [1960] 1 All E.R. 61.

37. [1897] W.N. 6; [1897] 1 Ch. 617, C.A.

38. See *per* Bacon V.C. in *Re The Matlock Old Bath Hydropathic Co. Ltd. (Wheatcroft's Case)* (1873) 42 L.J. Ch. 853.

39. Ordinance, s.132(3); 1929 Act, s.132(3).

for the automatic re-election of retiring auditors, unless other wheels are set into motion.[40] The most important of these is a motion to replace which, under the recent legislation, requires special notice.[41]

The Act is silent on the question of removal. On general principles, it would seem to follow that he only can take away who can give, and even then, subject to contractual restraint.[42] Were it otherwise, the statutory powers vested in the company in general meeting and the Board of Trade could be made quite illusory by immediate removal of their appointees by the directors. In some circumstances, however, the auditors may be suspended by directors. This is obviously a dangerous power to vest in controllers and hence is subject to strict limitations. Its existence is established by *Cuff* v. *London and County Land Co. Ltd.*[43] Here, the defalcations of a company secretary had allegedly been facilitated by the negligence of the auditors. The circumstances (failure to inspect the counterfoils of a rent receipt book) raised a *prima facie* case against the auditors, and the company instituted proceedings against them. At this point, for purposes best known to themselves but open to inference by the court, the auditors proposed to carry out an audit. The directors refused them access to the company's books and the auditors claimed an injunction to restrain this obstruction. The decision of Eve, J., to grant the injunction was reversed by the Court of Appeal, on the understanding that there would be early consultation with shareholders so as to give them an opportunity to comment on their directors' actions. The case is not one of dismissal, but, concerning as it does the suspension of the functions of the auditors, it amounts to the same thing in effect and may be taken to indicate the direction of the courts in cases of near necessity. The difficulty arises from the fact that in these circumstances, the directors fill two roles. They are the organs and managers of the company; and they are potential rogues. This is very relevant to the consideration of the remaining question which is the effect, if any, of dismissal by the directors, on the auditors' *locus standi* before the general meeting. The meeting can, if it so wishes, decline to ratify the directors' acts until it has heard the auditors. But can the auditors, without any help from the meeting, insist on a hearing? The answer is conceived to be that they can. The acts of the directors do not effectively terminate the auditor's appointment. Rather, it is *de facto* suspended until such time as the dismissal is authorised.

Yet there can be no doubt of the power of the company itself to take away what it can give. Here again, the public interest is quite unprotected.

40. S.159(2).

41. S.160.

42. *Cuff* v. *London & County Land Co. Ltd.* [1912] 1 Ch. 440.

43. *Ibid.*

2. QUALIFICATIONS

In order to ensure, so far as may be, that the auditors' functions are adequately discharged, men with the right qualifications must be appointed. Briefly, they must be independent, competent and honest.

(*a*) INDEPENDENCE

It is easy to understand the reason for the requirement of independence. "If an auditor allows himself to be so influenced by the prestige of one of the directors as not to perform his duties as auditor, disaster will be likely to result ...".[44] This is why, since 1879, some statutory provision has been made in order to "secure to the shareholders independent and reliable information respecting the true financial position of the company at the time of the audit."[45]

The crucial question here however is — independence of whom? The statutory provisions[46] disqualify the following from holding office as auditor:

1. directors or officers of the company;
2. their partners or servants (except in the case of private companies);[47]
3. bodies corporate.

The purport of these disqualifications is clearly to secure independence of the controllers and those subject to their influence. This aim is further secured by the provisions as to appointment above outlined, which, in vesting power in the hands of the company in general meeting, obviate the likelihood of appointment of the stooge of the controllers. The special notice provisions in turn bolster this up by making the rigging of meetings more difficult.

The auditor's independence of the company's controllers is thus adequately secured. In two other important respects, however, no independence whatsoever is guaranteed. It is assumed to be unobjectionable that the auditors should be subject to the patronage of the members, so far as appointments are concerned. This is doubly important when

44. *Per* Finlay R.C. and E.S. Food, *arguendo,* in *Re The London & General Bank Co. Ltd.* [1896] 1 Ch. 6.

45. *Per* Lindley L.J., in the above case, speaking of s.7 of the Companies Act, 1879.

46. Ordinance, s.133; 1929 Act, s.133; 1948 Act, s.161.

47. The Cohen Committee (Report, para. 56) favoured the withdrawal of this privilege.

it is remembered that remuneration is fixed by the general meeting and paid by the company.[48] Furthermore, membership of the company is no disqualification whatsoever. It is true that in the majority of cases, it will add self-interest to the other spurs to diligence on the part of the auditor. But in a minority of cases, it might work great harm. It is anomalous that whilst there are safeguards against the director's nominee being appointed auditor, there are no safeguards against the auditor's nominee being appointed director! Such a situation, whilst unlikely, is clearly possible where a substantial shareholder is appointed auditor. In the United Kingdom, the Cohen Committee's terms of reference included the "review of the safeguards afforded for investors and for the *public interest*".[49] Despite this, the Committee seemed to work on the commonly made assumption that the only function of auditors is investor protection and apparently did not consider lack of independence in the above respect to warrant consideration, let alone action by Parliament. Consequently, the 1948 Act did not alter the provisions ensuring independence of the auditors in any striking or novel way. The work was mainly that of refitting the 1929 model. Nor is any account of this point taken in the memorandum of the Council of the Law Society to the Departmental Committee at present considering company law reform. If the company's right to nominate its own auditor must be retained, some risk at least may be obviated by the disqualification of substantial shareholders and by the establishment of fixed scales of charges, avoiding, to some extent, the purchase of a good report in consideration of handsome remuneration. Such a scale would, of course, have to take into account the differences in complexity between various tasks. Gearing to issued share capital might be an adequate means of doing this.

The second respect in which the present law fails to secure independence is in connection with mergers, particularly take-overs. Here, the bidding company, if successful, will acquire control of the company and, in general meeting will be able to dismiss the auditor. This may involve breach of contract, but this will not destroy the effectiveness of the dismissal for the courts will not by injunction foist off on to a company an auditor whom it does not want.[50] There may be a perfectly good reason for dismissal of an auditor in these circumstances, for it may be much more convenient to have the accounts of the whole group of companies in the hands of a single firm of auditors. At the same time, it cannot be ignored that appointment as auditor to a large group is an attractive plum to most accountants and that they may be less keen than the dismissed auditors might have been to criticise the picture of the

48. Ordinance, s.132(6); 1929 Act, s.132(6); 1948 Act, s.159(7).

49. Cohen Committee Minute of Appointment; (Cohen Report, p. 2), italics supplied.

50. *Per* Wynn-Parry J. in *Re Transplanters* [1958] 2 All E.R. 711, citing *Cuff* v. *London & County Land Co. Ltd.* [1912] 1 Ch. 440.

merger as it appears in the accounts. On this matter, the Cohen Committee was again silent. The matter has now been raised by the Law Society, but only for the purpose of removing so-conceived doubts as to the removability of auditors in these circumstances. They recommend that it be made clear that there is no obstacle to removal in the case of merger. Unless this be coupled with a provision that removal cannot be effected before the annual general meeting next ensuing after the take-over, such a recommendation cannot be accepted without considerable misgiving. Entrenchment until the following annual general meeting would at least ensure that the details of the merger as revealed in the company's files were closely inspected by persons who would be more likely to be independent.

Such statutory provisions as there are for independence would be considerably weakened in their effect if, notwithstanding that his appointment was guaranteed free from favour, the auditor's fortunes inevitably became involved with those of the company, once appointed. Some degree of involvement would seem to flow inevitably from the mere fact of appointment by the company. The authorities are not, however, by any means clear as to whether, and for what purposes if at all, an auditor is an officer or an agent of the company.

Statute does not make it clear whether an auditor is an officer or not. The interpretation sections[51] are silent on the point. Various provisions speak of the auditor's holding "office"[52] whilst others seem to imply that the auditor is not an officer, for example, the disqualifications of, *inter alia,* "officers" from holding office as auditor.[53] The position so far as statute is concerned is little improved by the 1948 Act in the United Kingdom, which, on the one hand, provides that: "'officer', in relation to a body corporate, includes a director, manager or secretary",[54] and, on the other hand, expressly provides that references in the disqualification subsection[55] to an officer or servant shall be construed as not including references to an auditor. Apart from the comforting news that an auditor is not disqualified from being an auditor, the position is quite unclear from the statutory provisions.

Prior to the great cases of the 1890's, discussed below, such expressions of Opinion as there were, on this point, conflicted. In *Wheatcroft's* case[56] Bacon, V.C., in declining to remove an auditor's name from the

51. Ordinance, s.2; 1929 Act, s.380.

52. Ordinance, s.132(l) and (3); 1929 Act, s.132(l) and (3); 1948 Act, s.159(l) and (5).

53. Ordinance, s.133; 1929 Act, s.133.

54. S.455.

55. S.161(2).

56. *Re The Matlock Old Bath Hydropathic Co. Ltd.* (1873), 42 L.J. Ch. 853.

list of contributories, attached some significance to the fact that he had assumed office, that he was "an office-bearer". This, however, was not essential to his decision, which turned on information which the auditor must have known, *qua* auditor, regardless as to whether he was an officer or not. Even more casual was the *dictum* of Cave, J., in *Re Liberator Permanent Building Society*,[57] where, in considering the status of the solicitor to the building society, he expressed the view that "he does not become an officer of the society any more than ... the auditor if he is appointed auditor to the society." In *Re London and General Bank Co. Ltd. (No. 1)*,[58] the Court of Appeal had to decide whether an auditor was an "officer" of the company so as to be liable for misfeasance under section 1 of the Companies (Winding-up) Act, 1890, empowering the liquidator to order summary restitution. Little attention was paid to either of the above cases. Lopes, L.J., was content to dismiss the *Liberator* case as an authority only on the position of solicitors, and *Wheatcroft's* case was not mentioned. The statutory provisions and articles of the company in question left as much room for unhindered judicial choice as do their counterparts today. The court decided that the auditors were officers. They did so on two grounds. The first of these was the description of the auditor's position as an "office" in the statutory provisions (which involved ignoring or discounting those provisions which suggested otherwise). The second is more important. It concerns the mischief of the prohibition. "I know nothing about the charges against this auditor", says Lindley, L.J., "as the facts have not been gone into before us, but suppose that an auditor whose business it is to audit accounts and sign balance-sheets knows perfectly well that the balance sheet so signed by him will be acted upon, and that if it shews profits properly divisible as dividends a dividend will be declared, and suppose that he purposely and fraudulently prepares and signs a balance-sheet shewing profits divisible when there are none . . . that is a misfeasance within ... the Act.". This does not make him an officer. But such a potential for causing the harm guarded against by the section makes it very easy to infer that the position of the auditor is an "office". The other members of the court, in concurring with Lindley, L.J., take the two grounds even more distinctly.

In *Re Kingston Cotton Mill (No. 1)*[59] the Court of Appeal faced a question identical except in that the statutory provisions were inapplicable, the company in question not being a banking company, to which alone the 1879 Act applied. Here, the Court of Appeal[60] followed the decision in the *London (No. 1)* case and held that the

57. 71 L.T. 406, 407.

58. [1895] 2 Ch. 166.

59. [1896] 1 Ch. 6.

60. Lord Herschell and Rigby and A. L. Smith L.JJ.

auditor was an officer. This decision has been criticised[61] on the ground that the *London (No. 1)* case turned on the statutory provisions and was hence no authority in the situation in the *Kingston (No. 1)* case. This, it is thought, overlooks the double *ratio decidendi* of the former case.[62]

The gloss put upon this doctrine by *Re Western Counties Steam Bakeries Ltd.*[63] (*i.e.*, the distinction between permanent appointments, where the appointee is an officer, and *ad hoc* appointments, where he is not) settled the law as found in the recent case of *R.* v. *Shacter*.[64] Here, an auditor was charged with publishing fraudulent statements and falsifying books of account contrary to sections 83 and 84 of the (English) Larceny Act 1861, with frauds and defaults by officers of a company contrary to sections 331 and 333 (a) of the Companies Act, 1948; and with making a false entry contrary to section 328(1) (j) of the same Act. The Larceny Act charges required that he be a "public officer of a public company"; the others simply that he be an "officer". The Court of Criminal Appeal in a judgment delivered by Lord Parker, C.J., affirmed his conviction on all counts, notwithstanding that the company in question was a private one.

The characterisation of the auditor as an "officer" of the company is a mixed blessing. On the one hand, it exposes him to the threat of sanctions which would not otherwise be brought to bear and hence, will tend to make him seek to avoid their application to him. In most cases, this will be all to the good. On the other hand, it links his interests too closely to those of the controllers for comfort. A small act of carelessness on the part of the auditors may snowball into fraud and expose them to the risk of proceedings designed to catch fraudulent controllers The tendency here may well be to hide a defalcation. Much better, surely, to put the auditor on the side of the liquidator, rather than the rogue, and encourage disclosure of any impropriety.

The history of the auditor as agent of the company is less disquieting. In the days before compulsory registration, let alone before compulsory appointment of auditors, the view seems to have been taken that "within the scope of their duty [auditors] were at least as much the agents of the shareholders as the directors were".[65] This is understandable. Where there is no obligation whatever to appoint an auditor, and hence no obligation whatever to submit to any scrutiny, public or otherwise, it would be invidious to discriminate against such companies as did

61. Gabbay, "Auditor's Position in a Company" (1961) 111 *L.J.* 6.

62. See *Jacobs* v. *L.C.C.* [1950] 1 All E.R. 737.

63. [1897] 1 Ch. 617 (c.1).

64. [1960] 1 All E.R. 61.

65. *Re The Royal British Bank (Nicol's Case)* (1858), 3 De G. & J. 387, 441, *per* Turner L.J.

demonstrate sufficient business efficiency as to appoint auditors. In this light, the decision in *Spackman* v. *Evans*[66] appears somewhat unsatisfactory. That case concerned an unauthorised acceptance of forfeiture by directors and involved the question whether the shareholders could be said to have ratified the directors' act. An affirmative answer to this question presupposed knowledge, actual or constructive, in the shareholders of the irregularity. One source of constructive knowledge was the agency, if any, of the auditors. On this point, Lord Chelmsford expressed dissatisfaction with the *dicta* of Turner, L.J., quoted above, but failed to state any convincing reason for his dissatisfaction. The decision of Lord Chelmsford, that the auditors were not agents of the company, is all very well. With limited liability comes public risk and, with it, the first glimmerings of a case for public inspection. To this extent one welcomes the independence of the auditor. But one would have preferred better grounds. In fact, the *ratio decidendi* of *Spackman* v. *Evans* seems to be that knowledge of the fact in question would be outside the scope of the duties of auditors, and hence, the question of agency was strictly unanswered.

Not until 1958 was the position of the auditor as agent made more clear. In *Re Transplanters*,[67] decided in that year, Wynn-Parry, J., came down in favour of complete independence in this respect. The applicant in that case sought to prove, in a winding up, for money lent to the company more than six years previously, relying on a balance sheet signed by auditors as acknowledgement for the purposes of the Limitation Act, 1939. In *Jones* v. *Bellgrove Properties Ltd.*,[68] nine years previously, the Court of Appeal had held that the signature of accountants on a balance-sheet prepared by them was an acknowledgement for the purposes of the Limitation Act, 1939. Wynn-Parry, J., declined to follow this apparently strong authority, on the ground that whilst accountants may be agents of the company, auditors usually are not. This is a very important distinction. The accountant's function is a private and internal one. He is in charge of the firm's accounting system. His only duty is to his employers whose agent he in consequence is. The auditors position is wholly different. "Once a man takes upon himself the position of an auditor ... he must stand aloof and divorced from the aims, objects and activities of the company".[69] He should no more be an agent of the company than is the judge an agent of the plaintiff. Independence is essential to both.

66. (1868) L.R. 3 H.L. 236.

67. [1958] 2 All E.R. 711.

68. [1949] 2 K.B. 700.

69. Arnold, "The Neutrality of an Auditor" (1959) 26 *The Solicitor,* 37-38.

(*b*) COMPETENCE

An independent nincompoop is no good to anybody. If the auditor is to provide an effective safeguard, he must be competent. Statutory provisions go a long way towards guaranteeing competence by prohibiting the appointment as auditor of any person who has not obtained the written authority of the Minister.[70] Authorisation is in the discretion of the Minister and may be granted generally, or for a particular appointment.

It has recently been suggested that "only the United Kingdom has an accountants' profession of such a high standard of training and integrity as to offer a ready supply of efficient auditors. Other countries have no body of men easily available to act as such and they therefore have to have complicated rules about the company books to be kept and elaborate provisions for supervisory boards to act in the general role of auditors and to keep an eye on the directors and their accounts".[71] From the comparatively efficient way in which the Companies Acts have discharged their functions when transplanted into foreign soil, it would seem that this claim of exclusive competence on behalf of the English profession is ill-founded. Nevertheless, there can be little doubt that the existence of a reputable profession increases the efficiency of the audit system, and Ministerial authorisation in general terms has usually been conferred on members of recognised professional organisations.[72] It may be noted that whereas the 1948 Act allows the Board of Trade to delegate the question of authorisation to recognised bodies, the Malayan Ordinances do not. Whether the time is yet ripe for handing over this power to the professional bodies in Malaya depends entirely upon whether it is considered that they can be trusted to ensure an acceptable standard of competence

There is, however, no question of ministerial authorisation being conclusive of competence. Authority to act is granted on the basis of a presumed competence which events may prove not to exist. Hence the main standard of competence remains that set by the common law.[73]

70. Ordinance, s.134; the 1929 Act in England contained no such provision, but the 1948 Act, adopting the recommendation of the Cohen Committee (Report, para. 110), followed the example of the Malayan Legislation and required authorisation (see s.161 (1)) by the Board of Trade.

71. Anderson, "Concepts for Export", (1962) 106 *Sol. Jo.* 84-85.

72. In the U.K., the Board of Trade have recognised the following bodies under s.161 — The Institute of Chartered Accountants in England and Wales; The Society of Incorporated Accountants and Auditors; The Association of Certified and Corporate Accountants; The Institute of Chartered Accountants of Scotland; The Institute of Chartered Accountants in Ireland. See Charlesworth, *Company Law,* 6th. ed., p. 201.

73. There are no statutory safeguards beyond those outlined above.

The best statement of the standard which the statutory provisions assume is that of Wynn-Parry, J., in *Re Transplanters*:[74]

> That scheme seems to me designed to produce the result that a skilled professional man or a firm of skilled professional men is or are appointed in order that there shall be before the company all the requisite information indicated .... and by his certificate the auditor pledges himself that he has properly performed his statutory duty.

The standard is a professional one, beyond the capabilities of the Clapham Omnibus passenger. The auditor's competence embraces the capacity to discharge the complicated and onerous duties laid down by the statutes and the common law.[75] It bears all the hall-marks of the old "common calling" standards, responsibility being altogether independent of contract or payment.[76] It is an unvarying standard which yields not to reputation but requires always personal discharge.[77] This means very little more than that the best is not necessarily good enough. What is required is the expert best. Judicial flexibility is retained by *dicta* assuring auditors that perfection is neither sought nor expected.[78] In *Re City Equitable Fire Insurance Co. Ltd.*,[79] for example, failure to detect "window-dressing" which would involve remembering accounts from past years, was considered not to breach the standard.

One can usefully particularise in certain respects. The general professional competence required is that of accountancy, although even here, the courts will not always assume that accountants know best.[80] Proficiency in other skills is also, apparently, required. Valuation of assets is often essential if a true picture of the company's affairs is to be obtained. The auditor cannot decline the task as falling outside the usual scope of accountancy,[81] but he may derive comfort from the fact that slight over- or under-valuation is unlikely to be considered a cause of damage in the legal sense and hence is unlikely to lead to an action for damages.[82] The final say on valuation again rests with the court, which

74. [1958] 2 All E.R. 711, 714.

75. See below, pp. 107-118.

76. *Wheatcroft's Case* (1873) 42 L.J. Ch. 853.

77. *Re City Equitable Fire Insurance Co. Ltd.* [1925] Ch. 407, *per* Sarjant LJ.

78. See, *e.g.*, *per* Lindley L.J., in *Re London & General Banking Co. Ltd. (No. 2)* [1895] 2 Ch. 673.

79. [1925] Ch. 407.

80. As in *Johnston* v. *Chestergate Hat Manufacturing Co. Ltd.* [1915] 2 Ch. 338, where auditors had settled the balance sheet and profit and loss account on the basis (rejected by the Court) that "net profits" was the amount left after deduction of tax.

81. *Leeds Estate, Building & Investment Co. Ltd.* v. *Shepherd* (1887) 36 Ch. D. 787.

82. *Mead* v. *Ball, Baker & Co.* (1911) 28 T.L.R. 81.

will impeach a valuation not only for fraud but also on other grounds, *e.g.* mistake, gross discrepancy.[83]

The auditor must also, it seems, be something of a lawyer:

> The check, to be effective, may require some legal knowledge, or some knowledge of patents or other speciality. What is he then to do? Take, for instance, a point of law arising in the course of auditing a company's accounts. He may come on a payment which, it appears to him, may be unlawful, in that it may not be within the powers of the corporation, or improper in that it may have no warrant or justification. He is, then, not only entitled but bound to enquire into it and, if need be, to disallow it. It may be, of course, that he has sufficient legal knowledge to deal with it himself, as many accountants have.[84]

The extent of his required legal knowledge is not, however, accurately indicated by this latest statement. The following propositions set out the position as established by the authorities at the present time:

1. Auditors are bound to know or make themselves acquainted with their duties under the articles of the company whose accounts they are appointed to audit, and under the Companies Acts for the time being in force.[85]

2. Whether he must go beyond this and have knowledge of legal matters other than in connection with his own function is not clear. In the early days of auditors, there are suggestions both ways. By contrast, in *Leeds Estate, Building and Investment Co. Ltd.* v. *Shepherd*[86] it is suggested that the auditor failed in his duty in not verifying the authority for certain payments to a manager. This same tendency is apparent in *Re City Equitable Fire Insurance Co. Ltd.*,[87] where it is assumed that the auditor should ascertain the authorised limits for loans to officers. The latest statement, that of Lord Denning quoted above, takes the same view. But *dicta* in the two latter cases, whilst carrying the prestige of the Court of Appeal and House of Lords respectively, are strictly *obiter.* Against them, and against the *Leeds Estate* decision which was made at a time when standards may not have been so high, must be set the decision in *Re Republic of Bolivia.*[88] In this case,

83. *Dean* v. *Prince* [1954] 1 All E.R. 741, C.A.

84. *Fomento Ltd.* v. *Selsden* [1958] 1 All E.R. 11, 23, *per* Lord Denning.

85. *Re Republic of Bolivia Exploration Syndicate* [1914] 1 Ch. 139, 171, *per* Astbury J., *Leeds Estate Building and Investment Co. Ltd.* v. *Shepherd* (1887) 36 Ch. D. 787.

86. *Ibid.*

87. [1925] Ch. 407.

88. [1914] 1 Ch. 139.

Astbury, J., after first recognising the lack of clarity in the authorities, held that auditors were not liable for not knowing or ascertaining that sums paid as commissions for procuring subscriptions were *ultra vires* and illegal; that they were not supposed to know that sums paid under contracts by directors with the company were illegal; and that they were under no duty to enquire as to the authority for payments.

The present system of audit makes it unreasonable to require an appropriate degree of legal knowledge from auditors. In the present scheme of things, the *Republic of Bolivia* case[89] probably represents a more realistic approach to the question of standards. The gap thus created in the safety net must, however, remain a cause for concern, and it is perhaps not surprising, if somewhat demanding, to find the suggestion of a re-assertion of the old standard of legal knowledge in Lord Denning's latest contribution.

The accountancy professions may take consolation from the fact that it has been repeatedly stated that auditors need not question the wisdom of a particular policy. They are not expected to show, in addition to accountancy, valuation and legal learning a high degree of business and investment acumen.[90] Only one case ventures near to suggesting that auditors might properly question the prudence of a particular investment and even that is done *obiter.*[91]

This survey of the question of competence raises questions so far as the public interest is concerned. If questions of competence cannot be safely left to the profession, it is a moot point whether some statutory provision as to suspension or disqualification on grounds of proved incompetence should be made, or whether such matters are better left, as at present, to the discretion of a Minister. More important, however, is the problem posed by the growing complexity of modern accounting and the increasing burden imposed upon it by recognition of the public interest. Adequate safeguards require knowledge not only of accounting, but also of valuation, law and other professional skills. The law frankly recognises that too much can be asked of one man and requires but a limited competence in these fields. A possible solution might lie in recognising the auditor's power to call in experts in these fields wherever necessary. It has recently been suggested by Lord Denning[92] that such a power of delegation already exists by virtue of the principle in *Bevan* v. *Webb.*[93] That case, however, decides not that where *A* employs *B*

89. *Ibid.*

90. *Re London & General Bank Co. Ltd. (No. 2)* [1895] 2 Ch. 673, *per* Lindley L.J.

91. *Newton* v. *B.S.A.* [1906] 2 Ch. 378.

92. *Fomento* v. *Selsden* [1958] 1 All E.R. 11, 23.

93. [1901] 2 Ch. 59.

as auditor, *B* may delegate expert functions to *C* (presumably at *A*'s expense), but that where *A's* books are subject to a liability to inspection by *B*, *A* may not object to inspection by a reasonable expert agent of *B*. This is a wholly different proposition, and will not bear the burden which Lord Denning seeks to impose upon it.[94]

The obvious solution is that which is already adopted by the large firms of accountants. Auditing is no longer a one-man function but calls for the activities of an expert team. Failing the establishment of a public inspection organisation by means of which specialist services could be arranged on the most efficient basis, the smaller company must continue to make do with the unspecialised services which it can reasonably afford.

(*c*) HONESTY

"Such I take to be the duty of the auditor: he must be honest — *i.e.* 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."[95]

Honesty, like loyalty, is a simple virtue. There is little, if any, risk of a company knowingly appointing a dishonest auditor. What must be guarded against is inadvertent appointment. It is to be regretted that the Ordinances do so little to ensure the presence of honesty in the auditors, as opposed to taking retributive measures against its absence. Sections 261 - 4 render the dishonest auditor liable to up to five years imprisonment, if he has not exchanged Tanglin for Tahiti in the meantime. What the Ordinances do do, that the 1929 Act in England did not, is (as is above stated) to require the authorisation of the Minister, before an appointment can be taken up. No doubt, a reputation for dishonesty will be one of the factors taken into consideration in considering authorisation. It would be more satisfying to see such consideration expressly required.

A further measure which might be considered, with a view to ensuring the presence of honesty, is disqualification of the proved dishonest. One has here to steer a course between the public interest in honest auditing and the auditor's own interest in being allowed to mend his ways. As long, however, as loss of livelihood is regarded as a suitable penalty

94. This does not mean that no agent can be appointed but merely that Lord Denning's alleged warrant does not authorise such a course. A better warrant is that of Lindley L.J. in *Re London & General (No. 2)* [1895] 2 Ch. 673.

95. *Ibid.* See also *Re London & General (No. 1)* [1895] 2 Ch. 166, *per* Lindley L.J.

for the careless truck-driver, the dishonest accountant can expect no better. As yet, no Committee in the United Kingdom has seen fit to adopt any of these measures, which, it seems, can be safely left to the professional bodies.[96]

It may perhaps be mentioned, in conclusion, that if complete independence is not guaranteed (and it is not guaranteed at the present moment) the temptation to dishonesty is greater than it otherwise would be. An auditor who is also an investor may find that public duty and self interest conflict.

Once the appointment of qualified auditors has been secured, the next thing is to see that their services are properly used. What, then, are the auditors' duties?

3. Duties

The statutory duties are contained in section 135:[97]

> (1) The auditors shall make a report to the members on the accounts examined by them, and on every balance sheet laid before the company in general meeting during their tenure of office and the report shall state—
>
> (a) Whether or not they have obtained all the information and explanations they have required; and
>
> (b) Whether, in their opinion, the balance sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them, and as shown by the books of the company.

The protection sought in these duties is fortified by sub-sections (2) and (3)[98] providing for the auditor's right of access to all accounts and records, and his right of audience at general meetings.

The only express duty contained in the above section is the duty to report. Implicit in it, however, if absurdity is to be avoided, is the preliminary duty to obtain information and thus assess the truth of the picture presented by the balance sheet. There are thus, two duties. "Their duty is not merely a duty to use care in their reports. They have also a duty to use care in their work which results in their reports."[99]

96. The functioning of professional monopolies is itself a subject which requires investigation in the light of the public interest in cheap and efficient legal, medical and (in these days of complex taxation) accounting services.

97. 1929 Act, s.134; 1948 Act, s.162; and Ninth Schedule.

98. 1948 Act, s.162(3) and (4).

99. *Candler* v. *Crane, Christmas* [1951] 2 K.B. 168, 179, *per* Denning L.J.

These two duties, the duty to inquire and the duty to report, are the two most important of the auditor's duties. Indeed, it has been stated that "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",[1] but this is too exclusive. There is one primary duty which must always be discharged, for without it, the extent of the subsequent duties remains uncertain. The auditor must always be familiar with what is required of him by the statutes and by the articles.[2] This is so whether the duties are usual or extraordinary.[3] The duty in this respect seems strict and "ignorance would not afford any legal justification for not observing it."[4] So far as the main duties of inquiry and report are concerned, the standard is not strict:

> An auditor however, is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs; he does not even guarantee that his balance sheet is accurate according to the books of the company. If he did, he would be responsible for error on his part even if he were himself deceived without any want of reasonable care on his part, say, by the fraudulent concealment of a book from him. His obligation is not so onerous as this.[5]

Beyond such general statements as these, it is not easy to indicate what the standard is. It is, however, possible to particularise in some respects what is entailed in discharging the two main duties of inquiry and report.

1. THE DUTY TO INQUIRE

An accountant called in by a company for the purposes of carrying out work of a purely internal nature may well, depending upon the terms of his appointment, be perfectly entitled to take the books of the company as true and accurate and proceed from there.[6] Similarly, it was suggested in *Fomento Ltd.* v. *Selsden*[7] that the auditor "is bound only to verify the sum, the arithmetical conclusion, by reference to the books and all necessary vouching material and oral explanations; and that it is no part of his function to inquire [further]". In the view of Lord Denning, this was not so. "An auditor is not to be confined to the mechanics of

1. *Re London & General Banking Co. Ltd. (No. 2)* [1895] 2 Ch. 673, *per* Lindley L.J.
2. *Re Republic of Bolivia, etc.* [1914] 1 Ch. 139.
3. *Re Kingston Cotton Mill Ltd. (No. 2)* [1896] 2 Ch. 279.
4. *Ibid., per* Lindley L.J. So held in *Leeds Estate, etc.* v. *Shepherd* (1887), 36 Ch. D. 787.
5. *Per* Lindley L.J. in *Re London & General, etc. (No. 2)* [1895] 2 Ch. 673.
6. *Fox & Son* v. *Morrish, Grant* (1918) 35 T.L.R. 126.
7. [1955] 1 All E.R. 11.

checking vouchers and making arithmetical computations. He is not to be written off as a professional 'adder-upper and subtractor'. His vital task is to see that errors are not made, be they errors of computation or errors of omission or commission, or downright untruths." As was emphasised some sixty years earlier, "he does not discharge his duty . . . without inquiry and without taking any trouble to see that the books themselves show the company's true position. He must take reasonable care to ascertain that they do so. Unless he does this his audit would be worse than an idle farce."[8] The reason for this is obvious. Were the auditor allowed to take the company's books as accurate and proceed from there, the only inconvenience caused to a fraudulent controller would be the necessity of falsifying the books. The auditor would be no safeguard. This has been repeatedly recognised.[9] There is authority for the proposition that failure to inquire into the accounts, with the result that loss is incurred, will involve the auditors, *ipso facto,* in liability[10] or at least raise a *prima facie* case against them.[11] In *Leeds Estate, Building and Investment Co. Ltd.* v. *Shepherd*[12] the auditor was found liable where he had contented himself with checking that the balance-sheet complied with the various accounts of the company, but had failed to ascertain the accuracy of any of the accounts. His reports, at least after the first two years of the company's functioning, could hardly be described as misleading, for all that he had certified was that he had "examined the above accounts and (found) them to be a true copy of those shown in the books of the company." This decision must, however, be read in the light of the articles. The auditor was charged specifically with the duty of examining the accounts and vouchers and ascertaining the correctness of the balance-sheet. It appears, furthermore, that the auditor actually knew of the deficiency. Nevertheless, support is lent to this view by *dicta* of the Court of Appeal in *Cuff* v. *London and County Land Co. Ltd.*[13] Here, the auditors must have known of the defalcations of a company secretary, who had been embezzling rents for which he had issued receipts, if they had checked the stubs of the receipt book. In these circumstances, the Court of Appeal was of opinion that they had a *prima facie* case to answer. This decision also suffers from the effect of special provisions in the articles requiring auditors to examine accounts and vouchers. The *dicta* in question were, furthermore *obiter,* the court preferring to decide on the wider ground that it would never force auditors on a company against

8. *Re London & General, etc. (No. 2)* [1895] 2 Ch. 673.

9. *E.g., Leeds Estate, etc.* v. *Shepherd* (1887) 36 Ch. D. 787.

10. *Ibid.*

11. *Cuff* v. *London & County Land, etc.*

12. (1887) 36 Ch. D. 787.

13. [1912] 1 Ch. 440

its wishes, even if the purported dismissal was unjustified and so remediable by damages.

Against these authorities must be set a number of cases in which the view has been expressed that the auditor is under no duty to probe until spurred into action by suspicious circumstances. This trend seems to have been set by the Court of Appeal in *Re London & General Bank (No. 2)*[14] where Lindley, L.J., expressed the opinion that "where there is nothing to excite suspicion very little enquiry will be reasonably sufficient." The auditor in that case had, however, made fairly detailed enquiries and it was not until the following year, in *Re Kingston Cotton Mill (No. 2)*[15] that the point was actually decided. Here, the auditors had been content to accept as accurate a statement by the manager as to the stock position. It would have been simple to take a sample check, but this was not done. Nevertheless, the auditors were not liable. "Although it is no doubt true that such a process might have been gone through, and that, if gone through, the fraud would have been discovered ... I cannot bring myself to think that they were wanting in reasonable care."[16] Subsequent cases have re-affirmed the right of auditors to take the word of trusted servants[17] and in the absence of special provisions in the articles, and suspicious circumstances, this was the better view prior to the *dicta* of Lord Denning in *Fomento* v. *Selsden.*[18] This case may well mark the return to a higher standard on the part of company auditors. The orthodox view of their function was reiterated by Viscount Simonds,[19] who could not forbear to recall that the auditor's duty "is not detection but verification", recalling the pithy summary of Lopes, L.J., in *Re Kingston (No. 2).*[20] Lord Denning thought otherwise. "To perform [his] task properly, he must come to it with an inquiring mind — not suspicious of dishonesty, I agree — but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none. I would not have thought that *Re Kingston Cotton Mill (No. 2)* relieved an auditor of his responsibility for making a proper check."[21]

14. [1895] 2 Ch. 673.

15. [1896] 2 Ch. 279.

16. *Ibid.*, *per* Lindley L.J. See also the judgments of Lopes L.J., and especially of Kay L.J. at pp. 292-4.

17. *Mead* v. *Ball, Baker* (1911) 28 T.L.R. 81, C.A.; *Pendlebury's Ltd.* v. *Ellis, Green & Co.* (1936) noted in 181 *L.T. Journal,* 410.

18. [1958] 1 All E.R. 11, 23.

19. *Ibid.*, at p. 15.

20. [1896] 2 Ch. 279, 290.

21. [1958] 1 All E.R. 11, 23.

If this branch of the law does develop along the path indicated by Lord Denning, then the significance of the effect of suspicious circumstances on the auditor's duty will diminish, at least to becoming a matter of degree. At present, it involves a matter of substance. Where there are suspicious circumstances, the auditor must trust no-one. This is very likely the true explanation of *Leeds Estate, Building and Investment Co.* v *Shepherd*[22] where the auditor was fully aware of the fact that the accounts were being arranged so as to cloak the fact that dividends were being paid, in effect, out of capital. At all events, the significance of suspicious circumstances is made unambiguously clear in *Re London & General Bank (No. 2)*.[23]

What will amount to "suspicious circumstances" cannot readily be stated. A good example is an unusual or abnormal entry which reveals no useful information.[24] On the other hand, the mere fact that there appears to be "window-dressing", from the fact that large sales of stock have occurred at the start, and large purchases at the end of the accounting year, need not arouse suspicion.

Nor, even, it seems, need actual discrepancies in the accounts themselves.[25] This last case must be regarded as describing the very limit to which the auditor's protection can be pushed. It seems, indeed, very probable that since then the boundaries have been more narrowly defined. Whereas *Re Kingston Cotton Mill (No. 2)*[26] might seem to suggest that the auditor is perfectly entitled to take the word of a servant, agent or other representative of the company, provided that there is no reason to suspect his honesty, the Court of Appeal in *Re City Equitable Fire Insurance Co. Ltd.*[27] has certainly qualified this. In that case, it fell to the court to pass upon the duty of auditors with regard to accepting the word of trusted associates with unblotched escutcheons, doing unusual jobs. The books revealed that certain securities were supposed to be in the hands of the company's stockbrokers, apparently for safe-keeping. The court expressed the view that the auditors should have taken steps over and above obtaining a certificate from the stockbrokers, such as inspection of a sample of the securities. In the event, the auditors were excused under a "wilful default" clause, but a strong court seemed quite clear on the above point, even if their views were, strictly, *obiter.* In this connection, it is to be borne in mind that even

22. (1887) 36 Ch. D. 787.

23. [1895] 2 Ch. 673.

24. *Mead* v. *Ball, Baker & Co.* (1911) 28 T.L.R. 81.

25. *Re Kingston Cotton Mill (No. 2)* [1896] 2 Ch. 279, especially *per* Kay L.J. at pp. 292-294.

26. [1896] 2 Ch. 279.

27. [1925] Ch. 407.

before 1925, the "suspicious circumstances" exception was well established, and that in a sense, one's suspicions perhaps ought to be aroused by the news that a stockbroker is acting as a repositor, or that a banker is acting as, for example, a house agent. To that extent, the effect of *Re City Equitable*[28] is not as extensive as might be thought. Again, this whole doctrine is now to be considered in the light of the more stringent standards demanded by the professions themselves; and by the most recent statutes[29] introducing the requirement of public authorisation for the first time. These factors tend towards an increased stringency, at least as regards the accountancy practices of auditors.

So far as the duty to inquire is concerned, it remains to note inquiries which the auditor need never make. The authorities seem to be agreed upon the proposition that "it is no part of the 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".[30]

2. THE DUTY TO REPORT

Three aspects of the duty to report require consideration. These are (a) the question of the destination of the report — to *whom* must it be made? (b) *When* must the report be made? and (c) *What* must be reported?

(a) *To whom?*

The statute is explicit and simple. Report must be made to "the members".[31] In so far as it is the function of auditors to act as watch-dogs for investors as against the controllers, a duty to report direct to members would seem to be essential. Such a view of the law is, indeed, taken by Lindley, L.J., in *Re London & General Bank (No. 2)*.[32] The auditor in that case had indubitably discharged his duty to inquire, but had made a full report only to the directors. The only report actually

28. *Ibid.*

29. Above, p. 102.

30. *Re London & General, etc. (No. 2)* [1895] 2 Ch. 673.

31. Ordinance, s.135; 1929 Act, s.134; 1948 Act, s.162. By s.131(l)(a) of the Ordinance (1929 Act, s.130(1)(a)) only persons entitled to receive notice of general meetings of the company are entitled to receive a copy of the auditor's report without making special request therefor. This is a right, the correlative of which is the company's, not the auditor's, duty to send a copy. Section 131(1)(6) entitles other members to a copy of the auditor's report, if demanded. The 1948 Act has waived these distinctions. By s.158, all members and debenture holders are *prima facie* entitled to have sent, without request, a copy of the auditor's reports.

32. (1895) 2 Ch. 673.

made to members was to append a statement that "the value of the assets as shown on the balance-sheet is dependent upon realisation," sufficient, perhaps, to put a suspicious investor on his guard, but no more. On the inadequacy of this, Lindley, L.J., was adamant:

> I am compelled to hold that [the auditor] failed to discharge his duty to the shareholders . . . Possibly he did not realise the extent of his duty to the shareholders as distinguished from the directors, and he unfortunately consented to leave the chairman to explain the true state of the Company to the shareholders instead of doing so himself.

This view, that the duty owed by the auditor is a direct one which cannot be discharged by delegation, *e.g.*, to a director, appears at first sight to have been departed from in subsequent cases. It was briefly resuscitated in *Pendlebury's Ltd.* v. *Ellis, Green &* Co.,[33] where counsel for the plaintiffs argued that auditors had failed to discharge their duties in communicating warnings only to directors, only to be met by the reply that they were the only members! In several other cases since 1896, however, report to directors has been regarded as adequate. The point is first admitted in *Mead* v. *Ball Baker &* Co.,[34] where an auditor who voiced irregularities only to a director could not, according to Lord Alverstone, C.J., have been expected to do more. Romer, J., at first instance in *Re City Equitable Fire Insurance Co. Ltd.*[35] held that the auditor had done all that was reasonably to be expected in sending his report to a director who was, unknown to the auditor, implicated in the irregularities, a situation which neatly illustrates the inadequacies of the new view.

The whole matter was reviewed by Bennett, J., in *Re Allen, Craig &* Co.[36] Here, the auditors had prepared a balance sheet and submitted it to the secretary of the company. It never got beyond that official, and no meeting was ever called to consider it. The question arose whether the auditors ought, in these circumstances, to have done more. It was argued that the statutory duty involved reporting to all the members. This was rejected by Bennett, J., who considered that such a liberal interpretation would impose far too great a burden on the auditors. The requirement to report to "members" meant "the members assembled in general meeting". The auditors were absolved from that duty if, having no power to convene a meeting themselves, they delivered the accounts etc. to the secretary, leaving it to him to take the matter further. Adverting to the possibility of abuse by the directors in refusing to call a general meeting, Bennett, J. could not see why the auditors should shoulder this risk. The shareholders, being entitled to an annual general meeting, must demand it for themselves.

33. (1936) 181 *L.T.* Journal 410.
34. (1911) 28 T.L.R. 81.
35. [1925] Ch. 407.
36. [1934] Ch. 483.

In considering the apparent conflict between the *dicta* of Lindley, L.J., in the Court of Appeal, in *Re London & General Bank*,[37] and the decision of Bennett, J., at first instance in *Re Allen, Craig & Co.*,[38] the force of the reasoning of the latter must be admitted. Some large public companies may have thousands of shareholders. Personal communication to all of them is too much to ask of the auditor. It seems little to ask of the shareholder that he look after his own interests to the extent of demanding the meeting. To allow report to the secretary or directors, as in *Re Allen, Craig & Co.* is, however, dangerous. True, the members may insist on an Annual General Meeting, at which the auditors' report must be presented, and at which the auditor may insist on speaking. But nothing here protects the members against the fraud of the controllers in circulating an altered or fabricated auditors' report. The auditor does not have to speak. At this point, *In re London & General (No. 2)*[39] can be reconciled with *Re Allen, Craig & Co.*[40] The auditor does not have to report direct to the members, but if, whether as a result of the importunings of the controllers or otherwise, he submits a false or inadequate report, he is in breach of his duty. That was what had happened in *Re London and General Bank.*[41]

Nevertheless, the gap in the investor's shield remains, in the absence of a duty on the auditor to attend the meeting and correct any errors. To this must be added a much more serious objection. The public are simply not protected at all. They cannot call an annual general meeting having no *locus standi.* They may view the annual return, which is a public document and with which must be enclosed the auditor's report,[42] always assuming it has been made. But it will have passed through the controllers' hands, and may reveal nothing of the true and perhaps alarming position. To this there is an obvious and simple remedy, even if resort to public inspection as a general rule is not favoured. This is to provide for direct report by auditors to the Registrar, short-circuiting the controllers and, to that extent, cutting out the possibility of abuse.

(*b*) WHEN ?

The first statute providing for compulsory audit, (the Act of 1879 relating only to banking companies) expressly required an annual audit. Since then, the successive statutes have all lacked such a provision.

37. *(No. 2)* [1895] 2 Ch. 673.
38. [1934] Ch. 483.
39. [1895] 2 Ch. 673.
40. [1934] Ch. 483.
41. *(No. 2),* [1895] 2 Ch. 673.
42. Ordinance, s.111(3); 1929 Act, s.110(3); 1948 Act, s.127(1)(*b*).

It was pointed out, however, apropos the first statute requiring audit for all companies (the Act of 1900) that requirement of annual audit was clearly implied.[43] To-day, the company is obliged to hold an annual general meeting[44] at which the accounts are presented[45] with the auditor's report attached.[46] A duty of annual audit therefore clearly exists. The important question, however, arises as to who is saddled with the duty of setting the wheels in motion. The duty to convene the annual general meeting is imposed upon "every director or manager" and, obviously, not upon an auditor *qua* auditor.[47] The duty to present the accounts falls upon the directors.[48] The auditor's duty seems in strict law to remain dormant until preliminary steps are taken. The balance sheet must first be prepared — his duty is simply to examine its veracity.

In practice, the good auditor does not await the call from the company secretary. Many companies rely upon their auditors to discharge the whole of the business from beginning to end and would be very surprised not to receive notification from the auditors of necessary steps as and when they fell due to be taken. In many cases, the auditors are also accountants and will be under a separate contractual duty to prepare balance sheet and profit and loss account.[49] Few firms would feel the necessity to await a separate call to audit.

(*c*) WHAT ?

The legislation is designed to guarantee that his audience shall hear two things from the auditor. "That scheme seems to me designed to produce the result that a skilled professional man or firm of skilled professional men is or are appointed in order that there shall be before the company all the requisite information indicated in the [legislation] and by his certificate, the auditor pledges himself that he has properly performed his statutory duty." [50] Strange as it may seem, the legislation does not expressly require either of these things. The literal demands

43. *Newton* v. *B.S.A.* [1906] 2 Ch. 378.

44. Ordinance, s.113; 1929 Act, s.112; 1948 Act, s.131.

45. Ordinance, s.124; 1929 Act, s.123; 1948 Act, s.148. Strictly speaking, accounts may be presented at any general meeting during the year. In the ordinary course of events, only one general meeting will be held — the Annual.

46. Ordinance, s.130(l); 1929 Act, s.129(l); 1948 Act, s.156(l).

47. Ordinance, s.113(2); 1929 Act, s.112 (2); 1948 Act, s.131. This latter provision creates an additional safeguard by empowering the Board of Trade to convene an A.G.M. in default.

48. Ordinance, s.124 (3); 1929 Act, s.123 (3); 1948 Act, s.148(3).

49. Internal audit staff would, of course, be disqualified — p. 96, above.

50. *Re Transplanters* [1958] 2 All E.E. 711, 714, *per* Wynn-Parry J.

of section 135[51] would be satisfied by a pair of negatives; that the auditors had not obtained all the information required; and that the balance sheet did not exhibit a true view of the company's affairs. This will not suffice,[52] there being an implied duty to report what actually is the true view, and what information actually has been refused.

It goes without saying that the auditor must not report that which he knows to be untrue.[53] The scope of the positive duty to report is, however, less clear. A frequent problem is the extent to which the auditor must draw the attention of the meeting to potentially irregular payments, particularly loans. As a general rule, it would seem that the auditor is, strictly, under no duty to call the attention of the company to the fact that the directors have lent money to persons closely connected with the company's affairs, *e.g.*, the general manager, or the company's brokers.[54] Where, however, the money is advanced to an agent of the company, ostensibly on the company's business, the auditor, whilst being under no duty to enquire as to authorisation, is nevertheless obliged to point out to the company any insufficiency in the manner in which that agent accounts for the deployment of the company's funds.[55] What is obligatory is not, of course, the same as what is prudent. This distinction must be borne in mind not only in considering what must be reported, but also the manner of its reporting:

> There may be circumstances under which information given in the shape of a printed document circulated amongst a large body of shareholders would, by its consequent publicity, be very injurious to their interest, and in such a case I am not prepared to say that an auditor would fail to discharge his duty if, instead of publishing his report in such a way as to ensure publicity, he made a confidential report to the shareholders and invited their attention to it and told them where they would see it.[56]

At the same time, Lindley, L.J., was not prepared to give prior endorsement to such a practice but, on the contrary, expressly warned against the assumption that it would be countenanced. The moral for the prudent auditor is clear. He will only withhold full and detailed information in the most extreme circumstances, and even then, only against arrangements for provision of such information to such members as wish to obtain it — a facility of which they must be told.

51. Text at p. 107, above.

52. *Newton* v. *B.S.A.* [1906] 2 Ch. 278.

53. *Re London & General Bank (No. 1)* [1895] 2 Ch. 166.

54. *Re City Equitable, etc.* [1925] Ch. 407.

55. *Re Republic of Bolivia, etc.* [1914] 1 Ch. 139.

56. *Per* Lindley L.J. in *Re London & General Bank (No. 2)* [1895] 2 Ch. 673.

There are obvious serious omissions so far as the auditor's duty to report is concerned. Almost as soon as the 1929 Act was law in England, unsavoury practices were being reported in the professional journals. In particular, the function of the auditor in reporting on the affairs of groups was unsatisfactory. The statutory provisions might be satisfied, it was suggested,[57] by the mere statement in the holding company's accounts, of the fact that losses of a subsidiary had been carried forward in its own accounts. Such a statement would say nothing of the fact that a call on the subsidiary's shares might be imminent. It is submitted that, in truth, the statutory provisions might require more or less than this, but not this alone. On one view, there would be no necessity whatever to reveal the losses of the subsidiary, except in so far as such losses might affect the value of the subsidiary's shares as appearing in the holding company's balance sheet.[58] On the other view, failure to advert to imminent calls in the statement of liabilities in the balance sheet, might well mean that the balance sheet did not present a "true and correct view of the state of the company." [59] But if this latter view be accepted, it must be recognised that the duty would not be discharged simply by adverting to the subsidiary's losses. The Cohen Committee accepted the principle of group accounts,[60] and the 1948 Act, acting on this recommendation, required them, for the first time.[61] The auditor's duty in this connection is stated in the Ninth Schedule.[62] This requires the auditors to state whether, in their opinion, the requirements of the Act have been complied with. It is evident that without such a requirement, possibilities for evasion of the audit safeguard remain numerous.

The other great defect of the scheme of the 1929 Act (and of the Ordinances) was the failure to require certification of the profit and loss account. This again was early recognised[63] but tardily put right. The Cohen Committee initiated the treatment in 1945[64] and the cure was finally effected by the 1948 Act.[65]

57. "Auditor's Reports and Subsidiary Companies" (1930), 74 *Sol. J.* 631.

58. S.127 of the Ordinance (s.126 of the 1929 Act), requiring annexation to the balance sheet of a statement stating how subsidiaries' losses have been dealt with in the accounts would seem satisfied by the mere statement that the relevant shareholdings had been valued accordingly.

59. Ordinance, s.134(l)(*b*); 1929 Act, s.134(l)(*b*).

60. Cohen Report, para. 117.

61. Ss. 151-2.

62. Para. 4.

63. "The Duties of Auditors," (1931) 72 *L.T.* 400.

64. Cohen Report, para. 114.

65. Ninth Sched., para. 3(1) and (2)(*b*).

A minor defect which existed prior to 1948 was also put right by the 1948 Act, in the United Kingdom. It had been thought that the auditor's duties did not extend to reporting on the state of the internal accounting system, or at least, required no more than that he should inform the directors of its defectiveness.[66] The duty to state "whether, in their opinion, proper books of account have been kept by the company, so far as appears from their examination of these books, and proper returns adequate for the purposes of their audit have been received from branches not visited by them", is now expressly required.[67]

These defects remain in the Malayan legislation and require to be remedied.

In considering the auditor's duties, but two matters remain. The first of these is the obvious but important rule that the duties are statutory and cannot be dispensed with merely by an alteration of, or provision in the company's articles. An attempt to do just this met with short shrift in *Newton* v. *B.S.A.*[68] The second point is that the statutory duties are entirely separate from any contractual duty which may subsist between the auditor and the company. Any attempt by contract to derogate from the statutory duty would fail under the doctrine of *Newton* v. *B.S.A.* But there would seem to be no objection at all to the company requiring higher standards under its contract with the auditor.

4. RESPONSIBILITY

Elaborate provisions for securing the appointment of auditors, for ensuring their qualification, for imposing standards of efficiency, would all be purposeless were not the auditor answerable for his failure. Detailed consideration of his position in general law would range beyond the scope of this paper. Suffice it to say that a vast net of civil and criminal liabilities are waiting to enmesh him should he fail. He may be in breach of his contract with the company; he may find himself liable for damages for deceit, or negligence (provided always that he owed a duty to the injured party).[69]

According as to what form his defalcation may take, the auditor may involve himself in criminal liability for criminal breach of trust[70] or,

66. *Pendlebury's Ltd.* v. *Ellis, Green & Co.* (1936) 181 L.T. 410.

67. 1948 Act, Sched. 9, para. 2.

68. [1906] 2 Ch. 378.

69. *Candler* v. *Crane, Christmas & Co.* [1951] 2 K.B. 168.

70. Criminal Codes, s.405.

conceivably, theft,[71] dishonest misappropriation[72] or cheating.[73] The Companies Ordinances, however, state the chief grounds of responsibility so far as the auditor is concerned. Civilly, the auditor is liable in damages for breach of statutory duty if he fails to discharge any of the duties listed above, provided only that the right to an action for damages is not impliedly excluded by the Act's providing otherwise. In respect of most of the duties of auditors, no penalty is provided (such provision being a favourite source of implied exclusion). So far as his criminal responsibility is concerned, the auditor's position is governed mainly by section 334:[74]

> If any person in any return, report, certificate, balance sheet, or other document, required by or for the purposes of any of the provisions of this Ordinance specified in the 10th Schedule hereto, wilfully makes a statement false in any material particular, knowing it to be false, he shall be liable on conviction to imprisonment for a term not exceeding two years, or to fine, or to both such imprisonment and fine.

By the 10th Schedule, this provision extends to the auditor's report.

The common human tendency to escape one's responsibilities leads, inevitably, to attempts to contract out of the consequences of breach of the auditor's duty. Considering that attempts to negative the provisions of the statute had been considered by the court in *Newton* v. *B.S.A.*[75] to be ineffective, it was somewhat surprising to discover the Court of Appeal, in *Re City Equitable Fire Insurance Co.*[76] upholding a wilful default clause. Whilst there would seem to be little objection to the principle of this decision so far as private civil actions are concerned, and whilst, at the other extreme, there can be little doubt that an attempt so to avoid criminal liability would be completely ineffective, some cause for alarm must be felt in respect of protection of the public interest. The unfortunate truth is that the public as tax beneficiaries, consumers or employees, enjoy no *locus standi* whatever at present, and that insofar as their interest is vindicated at all, it is vindicated by the company which owes no public duty in this respect. It is the potential damage to the public interest by resort to wilful default clauses (ostensibly between the company and the auditor) which gives cause for alarm. It is for this reason that section 154[77] of the Ordinance, invalidating wilful default clauses for Malaya, is to be most welcomed. By

71. *Ibid.,* s.378.
72. *Ibid.,* s.403.
73. *Ibid.,* s.415.
74. See 1948 Act, ss.328-334.
75. [1906] 2 Ch. 378.
76. [1925] Ch. 407.
77. *Cf.* 1948 Act, s.205.

section 318,[78] the court is empowered to release a defaulting auditor from responsibility if he has acted "honestly and reasonably" which is a better basis for release than the lottery of article-drafting.

But there remains the question of responsibility to the public. Here, it must be pointed out that in respect of carelessness, the auditor is simply not answerable at all. His public responsibility is a criminal one and arises only in respect of intentional or, at least, reckless default. Mere careless failure to detect a company fraud to benefit the shareholders is not going to be remedied by the company and cannot be remedied by the public.

CONCLUSION

From the foregoing, it can be seen that the history of the past century is one of increasing recognition of the right of the public to protection secured by audit. What is disturbing is the extent to which scope for abuse still exists even in the United Kingdom under the 1948 Act. Even more so is the position unsatisfactory in Malaya where the machinery of protection is almost vintage.

There are, unfortunately, some inherent vices in the present audit system. The fundamental weakness of it, derives from the concept of company initiative — the idea, (historically tenable but no longer appropriate) that auditors are appointed by an organisation solely for its own satisfaction. Perhaps the time has come to recognise that public protection is best secured by public initiative and control. Such an idea would not be universally welcomed. But then, nor is collection of taxes.

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78. *Cf.* 1948 Act, s.448.

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