

THE COMPANY AUDITOR'S DILEMMA - RESPONSIBILITY
WITHOUT ADEQUATE AUTHORITY

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The Company Auditor's Dilemma - Responsibility
Without Adequate Authority

I INTRODUCTION

Probably no professional group, particularly in Australia and the United States has been more criticised (and maligned) during recent years than auditors. And except perhaps during the first years of the depression of the thirties, the voices of the critics have never been stronger. Normally the claim is either that insufficient information is being conveyed in published accounts, or that such information as is given is misleading and does not comply with the general legal standard of "true and fair view" - as interpreted by the critic.¹

These claims may be partly true and the auditor may be open to some criticism, for though the responsibility for the preparation of the accounts is clearly that of the directors, it is the auditor who has a quasi-judicial duty to express an opinion as to whether they show a true and fair view and otherwise comply with legal requirements. And obviously those relying on accounts have some right to depend upon this opinion of a member of a profession.

But is the auditor wholly at fault? Has he been given sufficient authority, in several senses of the word, to carry out his quasi-judicial task? These are the questions which it is the aim of this paper to consider by briefly examining:

- (a) some aspects of the history of the relevant statutory provisions;
- (b) the legal responsibilities of the auditor;
- (c) present sources of authority and their limitations;
- (d) reforms currently being suggested;
- (e) a further suggestion consistent with the underlying principles of company law.

At the outset I should mention that my conclusions are that since the auditor must rely so much on 'extra-legal' principles or rules not binding on directors, and as yet not sufficiently defined, he has not sufficient authority to carry out his duties. Furthermore, as already submitted in an earlier paper, unlike other arbiters and tribunals, he is not sufficiently independent, particularly when called upon to administer a vague general standard such as "true and fair view".² Until these institutional defects are remedied, it is unlikely that accounting reports will be significantly improved. Yet it should also be strongly pointed out that many persons are expecting much more of accounting than it is able to give. Accounting is not an exact science and, like all social arts, it cannot help but be dependent on and embody custom and convention; its nature and limitations should therefore be fully understood by those relying on, or drafting legislation or instruments relating to, its results.

II SOME ASPECTS OF THE HISTORY OF THE RELEVANT STATUTORY PROVISIONS

It is significant that it was not until 1901 in New Zealand (1900 in the United Kingdom) that the Companies Act delegated to the auditor the duty to report on the truth and fairness [correctness] of the accounts of companies of the type which came into being in 1860. But it was not until 1933 (1929 in the United Kingdom) that the Companies Act included compulsory provisions relating to the presentation, filing

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1. Refer for example J.F. Northey, "Recommendations for Company Law Reform", pp.41-42, Business Law Symposium, 1965 (Legal Research Foundation); Mr Justice Wallace, "Modern Problems in Company Law", Record of the Third Commonwealth and Empire Law Conference, 1965, 334-335.
 2. T.R. Johnston, "Is the standard 'true and fair view of the State of affairs' attainable in a balance sheet?" Business and Law, November 1966, 17-22; The Accountants Journal July 1967, 449-450.

and contents of annual accounts. At the same time (but not until 1947 in the United Kingdom) it was prescribed that the auditor be a member of a recognised professional body. All these points have a bearing on what is discussed later in this paper, but perhaps a more important question at this stage is why these requirements were not introduced until many years after the passing of the Companies Act 1860.

The Companies Act 1860, like those of all British Commonwealth countries, was based on the United Kingdom Act of 1856 which was an enabling statute making possible the easy formation and registration of companies with limited liability, founded on contract, and quite distinct from those incorporated by charter or statute, which at least initially were subject to supervision by the crown or government. But it is important to note that some attempt was made to introduce measures, which if passed, might have had a very significant effect on the development of accounting and accounting reports. The first draft of the United Kingdom Companies Act 1856 provided for the preparation, audit, presentation and filing of a uniform balance sheet in a prescribed form. Mr Robert Lowe, Vice-president of the Board of Trade, in introducing the Bill claimed that he was arguing in favour of human liberty - "that people might be permitted to deal how and with whom they chose without officious interference from the State" - except in one respect, namely to give "the greatest publicity to the affairs of such companies that every one might know on what grounds he is dealing".³ In keeping with those submissions he made a special feature of the accounting and auditing provisions and the "uniform sheet". But in the second and subsequent bills, and in the Act itself, and all Companies Acts which followed in other parts of the Commonwealth, the requirement relating to filing was omitted, and the clauses relating to presentation, form and audit of the balance sheet were relegated to the model but optional set of articles then in Table B. And there they remained until the dates already mentioned, despite the many efforts made in most countries in the intervening periods to introduce measures providing for greater disclosure and audit. Yet the leaving of such matters for inclusion in the articles is consistent with the ideal of freedom of contract and the general principle, still applicable, that subject to compliance with specific provisions of the Act, the members of the company, or the directors to whom the detailed administration of a company's affairs is delegated, are free to select the concepts and procedures to be applied in matters of internal management including the determination of profits and preparation of accounts.⁴

Conclusions which may be drawn from a study of this and other aspects of the history of the legislation are:

(a) Modern company law is still basically a product of the traditional ideal of freedom of contract.

(b) Such inroads as have been made into this traditional ideal over the last hundred odd years have been designed merely to do what Mr Robert Lowe had in mind in 1856 - at "giving the greatest publicity to the affairs of such companies that every one might know on what grounds he is dealing".³

(c) The very late introduction of legislation providing for the compulsory publication and audit of accounts and for the recognition of accountancy bodies delayed considerably the development of accounting and auditing standards and the firm establishment of a profession providing specialised services in this area.

(d) This development is still being retarded by the fact that in the conflict between the ideals of disclosure and freedom of contract the balance is still in favour of the latter, and as a

3. Hansard (U.K.) 1856, 140, 131.

4. Lambert v. Neuchatel Asphalte Co. Ltd. (1882), 51 L.J. (Ch) 882.

result insufficient authority is vested in the profession or its members to develop and apply principles and standards which would better serve the many who rely on published accounts.

III LEGAL RESPONSIBILITIES OF THE AUDITOR

Regarding statutory responsibilities there is no need to quote in full the sections of the Companies Act 1955 relating to the presentation and audit of annual accounts. But there may be a need to give emphasis to the following aspects of these requirements which have a particular bearing on the matters discussed in this paper:

First, that the primary responsibility for the preparation of the annual accounts (and in this connection, subject to any legal restraints, the selection of techniques and concepts) lies with the directors upon the results of whose management the accounts purport to report.

Second, that the primary responsibility of the auditor is to report to members (in terms of the Act) on the accounts of the directors; though recent legislation has imposed certain other duties towards trustees for debentureholders.

Third, that the normal legal sanctions included in the Act for non-compliance with the general requirements that the accounts show a true and fair view and otherwise comply with the provisions of the Act are seldom, if ever, applied in New Zealand. Rather the legislature in delegating to the auditor the responsibility to report on the accounts has clearly indicated that the administration and enforcement of the accounting requirements rests with the auditor as a quasi-judicial tribunal and not on normal legal processes.

The common law duties and responsibilities of the auditor will also be well known and may be summed up in the general principle that "it is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable, care, skill and caution must depend on the particular circumstances of each case;" In re Kingston Cotton Mills Co. (No.2), [1896] 2 Ch.279, 288. It is also important to note that recent decisions make it clear that this duty is not only towards the company with whom the auditor has a direct contractual relationship, but also to at least some third parties whom he knows will be relying on the accounts.

If these responsibilities, and the aims of company legislation with regard to protecting and informing members and other investors are to be carried out by the auditor exercising judgment at a level consistent with his obligations, like any other tribunal he must have authority in the form of pertinent, objective, determinable and enforceable laws or other rules.

IV PRESENT SOURCES OF AUTHORITY AND THEIR LIMITATIONS

Present sources of authority in company accounting, the area in which the auditor is called upon to act as a quasi-tribunal are:

- (a) Statute law.
- (b) Memoranda and articles of association (and other legal instruments such as trust deeds).
- (c) Common Law principles.
- (d) Accounting principles.

Legal or other customary rules derived from these sources may be said to be pertinent if their application results in producing financial information of the type most apt or relevant for the purposes for which it is required by the persons for whom the accounts are prepared; objective if their application will not be unduly affected by the personal opinions of those applying them; determinable if both those applying them and those using the resulting accounts can readily ascertain which rule or rules should be or have been applied; and enforceable if those wishing to exercise authority are able to insist on their application by those responsible for preparing the accounts.

Unfortunately experience shows that it is almost impossible to evolve rules conforming to all these ideal criteria at the same time. For example, statute law tends to embody customs developed in the

past and often stems from a crisis; as a result, it generally includes many rules which lack pertinence as new problems develop. Much of the Eighth Schedule of the Companies Act embodies recommendations of accountancy institutes when the revelations of the Royal Mail Case induced them to support radical amendments to company legislation. But the edifice built on the foundations then recommended and since supported by the profession, even with the slight amount of patchwork and tinkering carried out, is proving inadequate for today's needs. However, specific rules embodied in the Companies Act are determinable and of course enforceable.

Significant provisions in memoranda, articles and other legal instruments, if properly drafted, would conform to most of the criteria mentioned. But during recent years the requirements of the Companies Act have superseded most clauses which used to appear in articles. It is important to realise, however, that it is still open for companies to provide in their articles for accounting matters, and a suggestion that clauses be included in articles which would result in more satisfactory disclosure and support for the auditor is made later in this paper.

Such common law principles as have been evolved in this area have the merit that they are flexible since the tendency of the Courts is to enunciate general principles rather than specific rules. For example the general principle already quoted above from the Kingston Cotton Mills Case may be said to be flexible and to need no adjustment as standards change; but it lacks certainty and is of little help to the practitioner. How it will be applied by the Courts depends on what evidence is given at the time.⁵

The fourth source of authority mentioned is accounting principles. Accounting techniques and principles of recording are now fairly settled, and today few problems arise in this connection. (Though the fact that this is so should not be taken for granted, since accounting in this respect directly or through the auditor plays a very constructive role in promoting legal and social stability within our communities.) In contrast those principles concerned with the conceptual basis of financial reporting are far from settled and their unsatisfactory features become very obvious if the criteria mentioned are applied.

First, it is seldom possible to determine clearly what principles have been applied in the preparation of accounting statements (particularly when there are generally accepted alternative practices.) Recent accounting literature includes many statements such as the following which indicate a dissatisfaction with this state of affairs:

In Australia the practical effects of this lack of uniformity were rather alarmingly demonstrated in some of the company failures which occurred in the years 1961 and 1962 The point of importance was that readers of financial statements prepared by these companies did not know of the differing accounting methods being used, even though in some cases the accounting did greatly affect the amount of profit reported year by year.⁶

Given 910 ways of finding cost, and 8190 ways of finding 'cost or

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5. Refer Nelson Guarantee Corp'n. Ltd. v. Hodgson and Ors., [1958] N.Z.L.R. 609, and compare The Royal Mail Case (Collin Brooks Editor). In both these cases leading members of the profession gave evidence on behalf of the defendant or accused in support of practices clearly below best auditing standards of the time.
 6. K.C. Keown, "Improvement in Accounting Standards throughout the World", a paper delivered at the Fifth Conference of Asian and Pacific Accountants (1968), 5.

market whichever is the lower', there are 9100 ways of valuing inventory, disregarding the two open ended methods, above cost and below cost. But even this "is a conservative estimate And again, in finding depreciation charges, any two firms in a given industry may use different expected service lives. The number of ways of ascertaining the price of an inventory is thus indeterminate, but very large indeed. So, therefore, is the number of ways of computing net profit and the number of ways of obtaining the financial position.⁷

(To those who think that accounting is or should be an exact science these statements are no doubt alarming. But it must be emphasised that financial measurements have not the "self-enforcing" characteristics inherent in measurements in areas such as the physical sciences.)

Secondly, when the determinability of accounting principles is improved by the publication of "recommendations" or "statements" by professional bodies, these often tend to lack pertinence through lagging behind the needs of the hour. Thirdly, in general their objectivity tends to vary inversely with their pertinence. And fourthly except to the extent that they become embodied in statutes they are difficult to enforce unless the directors are willing to conform.

Clear evidence of this last mentioned weakness of accounting principles, even when embodied in professional pronouncements, is the following statement in the introductory paragraphs of the Recommendations on Accounting Principles of the Institutes of Chartered Accountants in both Australia and the United Kingdom:

Whilst it is recognised that the form in which accounts are submitted to shareholders is (subject to compliance with the Companies Act) a matter within the discretion of directors, it is hoped that this Recommendation will be helpful to members in advising, in appropriate cases, what is regarded as best practice. The editorial note at the beginning of each of the "Statements" on accounting and auditing practice at present being published by the New Zealand Society of Accountants includes the following rather inconsistent paragraph:

The statements in this series do not purport to represent the ultimate in 'best' accounting practice, nor do they represent official Society policy. Conformity with them will not be regarded as mandatory, but it is expected that members will have regard to them in their accounting practice - thus the onus of justifying departure from them will rest with the member.

These statements clearly suggest that directors may accept or reject the principles set out in these publications and that accountants and auditors have very limited authority except when supported by statutory requirements, provisions in legal instruments, or common law rules.

V REFORMS CURRENTLY BEING SUGGESTED

1. More detailed Statutory Requirements

This is the most obvious method of strengthening the authority of the auditor and ensuring that more information will be disclosed in annual accounts. Many persons in New Zealand would be in favour of incorporating in the Companies Act some of the recent amendments to the United Kingdom Companies Act, and some of the more stringent requirements as to disclosure of the Uniform Companies Acts in Australia. But the greatest weakness of our present requirements, and the changes introduced elsewhere is that they deal only with piecemeal detailed provisions as to the disclosure of specific items,

7. R.J. Chambers, "Financial Information and the Securities Market", Abacus, September 1965, 15.

and that too much reliance is placed on the ideal overriding standard of "true and fair view". In my opinion, there is no evidence that the inclusion of this latter general standard has contributed to the raising of standards of disclosure by the majority of companies beyond the minimum provisions of the Eighth Schedule; and in any event it is an entirely nebulous standard which is not attainable in the manner expected by many readers of annual accounts.⁸

However, there are many accountants who still suggest that there is no need for further legal support, that any suggestions to the contrary are in some way a reflection on their personal professional skill and integrity, and that "leadership of the professional accountant has been and must continue to be based on his persuasive and intellectual influence".⁹ But do auditors persuade many besides those who are eager to be converted?

2. Introduction of an Administrative Body such as the Securities and Exchange Commission in the United States of America

Both the Cohen and Jenkins Committees in the United Kingdom considered fully evidence and submissions about the function of that Commission. The conclusions of the Jenkins Committee may be summed in words from their report:

We are not persuaded that a system of control on the United States model would work as well in this country as the more flexible though theoretically less perfect system which has grown up here over the years.¹⁰

As few people in this country seem to know anything about the nature of the Securities and Exchange legislation or Commission, may I offer the following brief interpretation of the United States scene and its relevance in the present context:

- (a) Securities and Exchange legislation was introduced in the early thirties partly as a result of popular clamour following financial crashes, partly as part of New Deal legislation, and partly because there was not any standard legislation in all states (equivalent to our Companies Acts) relating to the issue of prospectuses, preparation of annual accounts and appointment of auditors, and no general acceptance of the duties and responsibilities of accountants such as those assumed by Chartered Accountants in the United Kingdom (even if by present standards the latter were very meagre).
- (b) Present requirements relate inter alia to the issue of securities by companies whose shares etc. are listed in more than one state (and can thus come under Federal jurisdiction) and to information which must be filed by these companies with the Securities and Exchange Commission; they do not relate directly to the published annual reports of companies or their audit.
- (c) The Securities and Exchange Commission has the power to issue regulations relating to the principles to be followed in financial statements filed with it, but has so far exercised such powers only sparingly and in consultation with the American Institute of Certified Public Accountants.
- (d) It is partly because there is a public demand for the Securities and Exchange Commission to exercise these powers that the American

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8. Refer above to note 2 and to the paragraph from a recent paper by Mr R.T.O. Ryan quoted, infra, note 11.
 9. Compare the claim by K.C. Keown (loc. cit. 7) that the present requirements of the Companies Acts make it difficult for auditors to persuade clients to do more. The fallacy of this argument is clear if one compares the accounts of the majority of New Zealand companies before and after the 1955 Act.
 10. Report of the Company Law Committee (1962) Cmd. 1749, 85.

Institute of Certified Public Accountants has been very active in attempting to formulate principles and standards, and has recently adopted rules which are more strict than those of professional bodies elsewhere regarding the status of its "opinions" and other pronouncements.

(e) Present requirements of the Securities and Exchange Commission provide that financial statements included in the information to be filed with it must be based on principles having "substantial authoritative support" and be accompanied by a "certificate" by an independent public accountant. The following "short" form of report recommended by the American Institute of Certified Public Accountants is normally satisfactory for that "certificate" and is followed in most reports of auditors on the annual accounts published by American companies:

We have examined the balance sheet of X Company as of December 19.. and the related statement(s) of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and other such auditing procedures as we considered necessary in the circumstances.

In our opinion the accompanying balance sheet and statement(s) of income and surplus present fairly the financial position of X Company at December 19.., and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the previous year. (Emphasis added)

It seems unlikely that any body similar to the Securities and Exchange Commission will ever be established in this country. If there arises a need to issue regulations relating to the principles to be employed in the preparation of annual accounts, a scheme of the type recently advocated by a speaker in New South Wales and referred to in the next section of this paper would seem to have much merit.

3. The Establishment of a statutory body constituted under the Companies Act with authority to issue detailed regulations relating to annual accounts

A recent paper on the general theme "true and fair view" by Mr F.T.O. Ryan, Registrar of Companies in New South Wales, includes the following very significant paragraph:

Once the view is accepted that the words 'true and fair' must be understood otherwise than in accordance with their ordinary literal meaning it follows inevitably, in my view, that their invocation as criteria for the verification of accounts becomes largely meaningless. Within certain flexible extremities, 'true' and 'fair' can mean very much what directors and auditors want them to mean. Subject to one important qualification I would like to see the words abandoned in favour of the American formula under which auditors report their opinion that the accounts present fairly the financial position of the company and the results of its operations in conformity with generally accepted accounting principles consistent with that of the preceding period. The qualification is that you should be able to assure me that there is an identifiable code which answers the description of 'generally accepted accounting principles'. Failing such assurance I submit for your consideration the proposal - emphasising in the course of doing so that it is a personal suggestion and has no official backing - that a statutory body be constituted under the Companies Act and authorised to make regulations as to the form and contents of accounts and as to the accounting principles to be applied in their preparation; such a body to be constituted of representatives of the legal, accountancy and secretarial professions and representatives of government, and that the regulations made by such a body be subject to disallowance by Parliament in

same manner as other regulations made under the authority of an Act of parliament. Such a proposal, if given effect to, would, it seems to me carry with it not only the advantages of flexibility and certainty, but also facilitate the process of development and evolution of generally accepted accounting principles. (Emphasis added) "Proceedings of State Conference of the Australian Society of Accountants", October 1967.11

4. Give greater authority to "generally accepted accounting principles"

(a) By including these words in the audit report.

The fact that the "certificate" of the independent public accountant and the "report" of the auditor in the United States include the words "generally accepted accounting principles", and that the financial statements filed with the Securities and Exchange Commission must be based on principles "having substantial authoritative support", obviously gives authority to such principles as are to be found in the pronouncements of professional accountancy bodies and writings of leaders in the profession who have come to be regarded as authorities in their field. (However, as mentioned elsewhere in this paper, these words are not as satisfactory as they suggest, since many alternatives may be used in practice and it is not easy to determine which of the alternatives has been employed by a particular company.)

It is probably not generally known that the first and second Companies Bills prepared in New Zealand in 1952 included reference to compliance with "generally accepted accounting standards" in the clauses relating to the duties of auditors. The first Bill included as sub-clause 166(d):

Whether in their opinion the accounts, the balance sheet, the profit and loss account and group accounts are prepared in conformity with generally accepted accounting standards applied on a basis consistent with that of the immediately preceding financial year. The next Bill substituted "consistent with the provisions of this Act" for "applied on a basis consistent with that of the immediately preceding year". But the final Bill in 1955 omitted all reference to "generally accepted accounting standards" and altered the wording to that of the present s.166(d).

It is to be noted, however, that no similar reference was made, in the clauses requiring the presentation of the annual accounts by the directors, to their being prepared in conformity with generally accepted accounting standards.

(b) By making the pronouncements of professional bodies mandatory.

During the past three decades professional bodies in most English speaking countries have been publishing "bulletins", "recommendations" or "statements" providing direct evidence of what are "generally accepted accounting principles". Recently the American Institute of Certified Public Accountants has taken a lead in giving greater authority to its pronouncements than any other professional body; (though as already mentioned there are political reasons for this development; and the very wording of the auditor's certificate or report in the United States of America gives support to such pronouncements to a greater extent than in British Commonwealth countries).

The Council of the American Institute of Certified Public Accountants has now ruled that the principles set out in the Bulletins of the Committee of Accounting Procedure, which have not been withdrawn by the more recently established Accounting Principles Board as well as all "Opinions" of the Board, are deemed to have "substantial

11. Reprinted in Abacus, December 1967, 95 (refer p. 106)

authoritative support" and therefore properly considered to be "generally accepted accounting principles". Also, when members of the American Institute of Certified Public Accountants express an opinion on financial statements, any departure from such Bulletins or Opinions must be disclosed in a footnote to the statements or in the auditor's report; and a departure from the Bulletins or Opinions should be accepted by an auditor only if it has "substantial authoritative support and is an acceptable practice". Some writers have suggested that the stand taken by the American Institute of Certified Public Accountants has been weakened too much by the latter qualification, but since the ruling has applied only to financial statements for the year which began on 1 January 1967, and its practical effect has yet to be tested, it is too early to judge.

Unfortunately the "recommendations" and "statements" of professional bodies in Australia, the United Kingdom, and New Zealand reveal only what active members of these bodies would like to see done; for as already pointed out, the preambles to such publications indicate only too clearly their very limited authority. Furthermore, in practice their authority is even further limited by the failure of many members of the profession to support the efforts of their own institutes to improve standards unaided by direct legal requirements. However, in New Zealand there is a growing body of opinion, particularly among younger accountants, that the New Zealand Society of Accountants should take steps to make adherence to its "statements" mandatory for members.¹² But there are several practical difficulties which would have to be solved not the least of which is the question of how the Society would enforce the application of the principles set out in the statements.

- (c) By establishing "accounting courts" whose recorded decisions would provide precedents.

In the early days of the Securities and Exchange legislation in the United States the well known writer, A.A. Berle Jnr. recommended the establishment of a Board of Accounting Appeals which could render "advisory opinions [regarding accounting principles] in advance of a controversy; and for general application".¹³ Some years later another well known accountant, Mr L. Spacek made a very strong plea for a court or professional tribunal of accounting principles to be set up by the American Institute of Certified Public Accountants. He suggested that "the tribunal would set up its own rules of procedure as to written briefs, arguments etc.". He assumed "that such rules would be similar to those followed in the United States Supreme Court or any other body where decisions are logically based on briefs and arguments". "After decisions were handed down, all briefs and arguments would be printed, bound and made available to schools, practitioners and others.... We should then have a start on research records comparable to those of the medical and legal professions."¹⁴

Still more recently Professor E. Stamp (then Professor of Accountancy of Victoria University and now Professor of Accounting and Business Method at Edinburgh University) in a Research Lecture to the members of the Australian Society of Accountants in New South Wales, suggested that the role of the independent accountant be changed from that of arbiter to that of professional advocate or liaison officer responsible for submitting the annual accounts of a client company to a final authority - a "judge" or board who would

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12. Compare Mr K.C. Keown's recent plea for such a development in Australia: loc. cit., 7 - 8.
13. "Accounting and the Law", The Accounting Review, March 1948, 9 - 15.
14. "The Need for an Accounting Court", The Accounting Review, July, 1958, 368 - 379.

make the final decision as to whether or not the accounts showed a true and fair view and otherwise complied with the provisions of the Act. Such "judge" or the members of the board would be drawn from the ranks of the most able of the profession and their judgments would be published and have authority in the same way as legal judgments.¹⁵

5. Preparation of the annual accounts by the auditor or some other independent assessor

During quite recent years, suggestions have been made that, instead of the directors and management preparing the annual accounts, this task should be done by completely independent parties. It has been pointed out that directors and managers are subject to a number of pressures which cannot help but influence their reports to external members and investors. One writer has recently stated:

1. Financial statements are to a large degree a report on managerial performance. Managers would not be human if they did not wish the report card to be favourable.
2. Managers are charged by stockholders with the responsibility of minimizing corporate tax burdens. Tax measurements are but one aspect of external reporting, but measurements for tax purposes often influence measurements incorporated into the general system and into published reports.
3. Pressures from stockholders and investors to report results that will favourably influence stock prices may re-inforce managements own self-interest in this direction
4. Published reports are often an element of the propaganda system through which management tries to make a case or to influence public opinion
5. A fifth pressure stems from the internal uses of accounting data¹⁶

Or in the words of another writer:

...those principles are designed in large part to meet the problem of reporting to outsiders on how well or poorly management has done. And ... the participant in a process is hardly the ideal one to establish the rules by which he will be judged. He cannot be a participant and referee at the same time. To encourage or even tolerate this situation for any length of time will make a mockery of our vaunted system of disseminating financial information to all interested parties through corporate reports.¹⁷

This suggestion that some persons other than the directors (or employees of the company) should be responsible for the preparation of the annual accounts is so far removed from established practice that to most it will probably be regarded as being of only theoretical interest. But like other suggestions already considered, it gives particular emphasis to the main submissions of this paper, namely that the selection of the "rules" is in the hands of the directors; that the authority of the auditor is at present much more limited than is normally appreciated; and that there are clear reasons why accountants have not been able to narrow the definitions of their existing accepted accounting principles or to evolve and apply new principles which might result in more satisfactory information being available for investors.

VI A FURTHER SUGGESTION

All the above mentioned suggestions are aimed at "making the rule book more definitive" and thus giving the auditor greater authority to administer it. But most attempts to move in this

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15. "Dilemmas in Modern Accounting Education and Practice", 1966 Australian Society of Accountants N.S.W. Endowed Research Lecture, 26.
 16. C.E. Johnson, "Management's Role in External Accounting Measurements" Research in Accounting Measurement (American Accounting Association, 1966), 91.
 17. Maurice Moonitz, "Discussion Comments", ibid., 123.

direction tend to draw criticism for several reasons. Probably the most important may be summed up as follows:

(a) It is not possible to legislate through the medium of statutes (or even professional pronouncements) for the accounting principles and practices which should be applied by all types of companies and businesses.

(b) Proprietors (shareholders), or the directors on their behalf, should be at liberty to select those principles, which, taking into account the nature of the business and the aims of their contractual relationships, are most appropriate.

(c) Legislation of any kind tends to be either too rigid and thus restrict progress, or too general and then ineffective.

May I offer yet another suggestion for overcoming these and other difficulties, namely that companies be required to include in their articles, or an appendix thereto, a statement, in summary form, of the general principles which it must follow in the preparation of its annual accounts,¹⁸ such statement (and any amendments) to be approved by the auditor (or other qualified public accountant) by his filing with the statement a report along the following lines:

... that in his opinion the principles set out in the statement are consistent with the requirements of the Companies Act and generally accepted accounting principles, and if applied will result in the preparation of a balance sheet and profit and loss account [and consolidated balance sheet and profit and loss account] which will fairly present the financial position at the end of each year and the profit or loss for each such year of the company [and of the company and its subsidiaries respectively].

It is submitted that such a requirement would enable a company to select from the various alternatives which are regarded by the accountancy profession as "acceptable" those principles which are most appropriate for the particular company. This would provide flexibility, since it would be possible to make changes as progress is made, and would give the auditor added authority to enable him to carry out his responsibilities more effectively. A further advantage is that provisions such as this in the articles would result in fuller disclosure and lead to a more satisfactory delineation of the proprietary rights of all classes of shareholders.

In the early part of this paper it is pointed out that the modern company is based on the general principle that there should be freedom of contract coupled with full disclosure (rather than prescription except in this respect). The above suggestion is but a development of this general principle.

VII CONCLUSIONS

The main submissions which I have been endeavouring to make throughout the paper are that until the auditor has greater authoritative support (and independence) he will not be able to satisfactorily carry out his quasi-judicial duties, and the accountancy profession generally will not be in a position to develop and play a major part in applying and enforcing principles and practices which will better serve the investing public. A legitimate criticism which can be levelled at many members of the accountancy profession is that they have failed to understand or admit the weaknesses of their position. Instead they continue to claim that they should be left to "go it alone" - to depend on their own personal skill and integrity unsupported by written authority (and often with conflicting interests), to an extent not expected even of the carefully selected and exceptionally

18. Compare the suggestion of a committee of the American Institute of Accountants in 1932, prior to the establishment of the Securities and Exchange Commission, that each company be required by the Stock Exchange to file with it a statement of its methods of accounting and reporting; G.O. May, Financial Accounting (Macmillan, 1946), 72 - 80.

well qualified members of the highest tribunals of the country.

However, as is usual at any conference dealing with law reform, there will be those who will say that the present institutional position is quite satisfactory and that reform is unnecessary; and those who will suggest that it is impossible either to protect fools from their folly or to reduce malpractices simply by providing for disclosure. For the first group I have no further comments since they must be oblivious to recent happenings. To the second group may I offer the following extract from the minutes of the evidence given by the representative of the London Council of the Stock Exchange to the Cohen Committee:

I would suggest, if I may, that there are in the City three classes - shall I say, the perfectly honest people, the entirely dishonest people, and an intermediate class who are prepared to be dishonest and shady if it is not too difficult or dangerous. I believe that these latter form a very large proportion of the wrongdoers, and that legislation of this kind (i.e. providing for more complete disclosure) would be very effective in deterring them.¹⁹

T.R. Johnston

19. Minutes of Evidence Given before the Company Law Amendment Committee, (1943), 12th day, Q5610.