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THE TECHNIQUE AND PRINCIPLES OF AUDITING

BY
ANDREW BINNIE, F.C.A., C.A.
AND
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SECOND EDITION BY
BRIAN MANNING, D.L., J.P., F.C.A.



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PREFACE
TO THE SECOND EDITION

THE death of Mr. Andrew Binnie, which occurred eleven years ago, not long after the writing of the preface to the first edition, has deprived me of his collaboration in the production of this second edition. He wrote to me a few months before he died, when he was examining the proofs, expressing doubts as to his continued good health, though he can have had little idea then that he would not live to see the publication of the first edition of the book. He was greatly mourned at his death.

This second edition is required for two good reasons. The first is that no further copies of the first edition are available. The second, and perhaps a more compelling reason, is that changes in auditing practice, and a new Companies Act, have made much of the old edition out of date. Many of the provisions of the Companies Act, 1948, are still matters of controversy and final views may not obtain for some time; but an endeavour has been made in this volume to be as definite on these matters as circumstances will allow.

I acknowledge the courtesy and help of three bodies who have agreed to the inclusion of extracts, some of them considerable, from publications which they have made. First of all, The Institute of Chartered Accountants in England and Wales in regard to recommendations on accounting principles, and their memorandum incorporating the opinion of Counsel on certain provisions of the Companies Act, 1948; secondly, the Council of The Law Society in regard to their memorandum on the Solicitors' Accounts Rules; thirdly, the Council of the Stock Exchange in regard to their regulations relating to prospectuses and advertised statements. Quotations from these documents are included either in the text or in appendixes and will be of assistance to the reader in the understanding of the subjects with which they deal.

BRIAN MANNING

PREFACE

TO THE FIRST EDITION

SOME years ago Mr. Pixley asked Mr. Binnie to collaborate with him in producing a further edition of his well-known work on the duties of auditors, written largely from the legal standpoint of a Chartered Accountant who was also a Barrister-at-Law. Mr. Pixley's lamented death brought this collaboration to an end. The present writers have prepared a treatise on the subject which is dedicated to his memory. With the consent of Mr. Pixley's Executors, they have incorporated part of his valuable work but have developed the more technical side of auditing as adopted nowadays by the expert auditor. Gee & Co. (Publishers) Ltd. have kindly allowed the writers to make use of Mr. Binnie's book, *Audit Programme and Procedure*, written many years ago for the Accountant Student's Library, and *The Accountant* has allowed the reproduction of the Table of Wear and Tear Allowances which it published in September last.

As the ability to balance a set of books in an expert way is a vital part in the equipment of an accountant, a special chapter has been introduced under the heading of "Method in the Balancing of Books."

A. D. BINNIE
BRIAN MANNING

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INTRODUCTION

SINCE the first edition of this book was published more than ten years ago, many changes have taken place in the practice of Auditors. The present edition, while retaining the general features of its predecessor, contains much that is new. The late Mr. Pixley, whose original work and expressed desire inspired the earlier volume, would find that many principles which he expounded, based on the best procedure of his day, had not survived or had undergone drastic alteration.

Adjustments in the practice of Auditors over the past decade have, however, been gradual, and the accountancy profession has endeavoured, in spite of the difficulties which accompanied six years of war, and subsequent years presenting difficulties almost as great, to adapt its methods to the changing demands of the times, and to ensure that those persons to whom Auditors report receive a true account of the dealings of the concerns in which they are interested. In this, Auditors have been assisted by Boards of Directors and Managers who, in the great majority of cases, desired to ensure that this was done. That there were cases in which this was not so, must unfortunately be recognized, and there has been an inclination by some Boards, whether from good motives or from bad, to furnish shareholders and others with the minimum of information which would satisfy them and the law, information which in its presentation fell short of frank disclosure, and provided problems for the Auditor, who was often faced with the unhappy possibility that effectual comment on his part, instead of assisting, might well damage the interests of his clients.

It was this practice of the few, coupled also with the extended use of the subsidiary company, which undoubtedly pointed to reform of the law affecting companies. The Committee under the Chairmanship of Mr. Justice (now Lord Justice) Cohen which was appointed to

> consider and report what major amendments are desirable in the Companies Act, 1929, and, in particular, to review the requirements prescribed in regard to the formation and affairs of companies and the safeguards afforded for investors and for the public interest,

made many recommendations, a large number of which were embodied in the Companies Act, 1947. This Act has since been consolidated with the Companies Act, 1929, to form the Companies Act, 1948. It is inevitable that when a net is cast widely, many fish will be caught which the fishermen never intended to include

in their catch. The Act which now governs the procedure of companies and the presentation of accounts, places very considerable additional burdens on the shoulders of Managements and Auditors. Many of these would probably have been unnecessary if in earlier days everyone in a position of accountability had had regard to the best practice. It is again a case of the innocent suffering for the guilty.

The Act is too young, and experience at present is too limited, to justify the submission of conclusive opinions on the implications, or in some cases the meaning, of much that has been enacted. Sections, for example, dealing with classification of items in the Balance Sheet, reserves, and emoluments of Directors, have furnished a fund of argument in the accountancy profession since the Act reached the statute book, which shows that difficulties of interpretation are likely to survive for some time. In many cases the wording of the Auditor's report itself has presented problems, particularly in the case of companies for which special provisions involving exemptions from certain requirements are laid down.

In a period of uncertainty it would be unjustifiable, in this volume, to express emphatic opinions, except where interpretation of a section leaves no room for doubt. An effort has, however, been made to guide the reader, and also, by appropriate quotations from the sections in the text, to enable him to form his own view or to consult the appropriate authority. Much has been done by the Council of the Institute of Chartered Accountants to resolve certain doubts, by publication to its members and others of the opinion of Counsel on matters which appeared to call for interpretation. These opinions have been made available to members of the Institute and other persons interested. Reference to this publication of the Institute is made in certain parts of the present volume, and we acknowledge the courtesy of the Council in agreeing to the quotations.

The Auditor, for his part, while mindful of the greater obligations imposed upon him by the Act, not only as to presentation of accounts, but as to the matters upon which he is required to report, must continue to have regard to the shareholders and their desire for information. It is inevitable that for a time, until the new method of presentation is assimilated, many shareholders will be puzzled by the Balance Sheets presented to them, and will understand less about them than they did about the accounts in their old form. The Auditor's report will tell them so much that they will probably wonder what it does tell them, and their chances of finding any qualification of the report are considerably reduced. It must, however, be recognized that the full meaning of the Auditor's report is only likely to be understood by the expert, who makes a detailed study of the accounts, and who will examine the

wording of the report with care. The shareholders, and there are many, who look at accounts merely to ascertain the amount of the profit and the intended dividend, will learn where to look for these items, and will probably not trouble themselves any more with niceties of wording than they did before.

It is inevitable in these days, when the conduct of business through the medium of Limited Liability Companies is widespread, that a work on auditing should be devoted largely to matters affecting these companies. The same general principles, however, apply to the audit of firms and other bodies, though, where the obligation for audit is not statutory, it will in most cases be open to the persons employing the Auditor to state their requirements and perhaps to limit his work. It may be that what is required is not an audit at all, and that the client merely desires to have his accounts prepared by his accountant for his own information and for submission to the tax authorities. The professional accountant should, none the less, recognize that, even if he is not required to carry out an audit, he will be regarded by his client as exercising professional skill in the preparation of the accounts, and he should satisfy himself, so far as he can, that they are correct. The importance of ensuring that there is a clear understanding between the accountant and his client as to the extent of the duties in such cases is emphasized in this work.

THE TECHNIQUE AND PRINCIPLES OF AUDITING

CHAPTER I

HISTORICAL

THE office of Auditor is one of high antiquity, and the date of its origin is difficult, if not impossible, to ascertain. It has certainly existed for six centuries, as in 1299 there is mention of an Auditor of the Accounts of the Corporation of the City of London. On the 24th March, 1324, Master John de Pykesleye and two others were appointed "to demand, audit, and take all accounts of those who are or will be held to render them in the counties of Oxford, Berks, Southampton, Wilts, Somersetshire, and Dorset; and to do and determine all things which the King's Auditors of accounts should do." In Langland's *Vision of Piers Plowman*, published in 1377, we find the following lines, "Of my reue to take Al that myne auditour, or elles my stuwarde Conseilleth me by her acounte"; and in Paston's *Letters*, 631, II, 388, in 1469, "Send downe . . . to some awdyter, to take acomptys of Dawbney's byllys." In 1557, *Ord. Hospitalls*, B. IV, b, occurs, "There shall also be chosen Auditors generall of the Accomptys." Shakespeare, in *Timon of Athens*, puts into the mouth of Flavius the steward—

> If you suspect my husbandry, or falsehood,
> Call me before the exactest Auditors,
> And set me on the proof.

The first record of Auditors in Dublin is in the year 1452, and it would seem that the powers of the Auditor in those days even exceeded those of the Local Government Auditors of the present time. The surcharge of these Auditors has to be sued for in the ordinary way; while we read that in 1599, upon the Auditors of Dublin reporting two citizens (videlicet Master Nicholas Umfrey and Master Michael Pentney) to be indebted to the city in the sum of six score eight pounds, eleven shillings, seven pence (CXXVIIJ^{l} XJ^{s} VIJ^{d}), it was ordered "by the authority of this post assembly . . . if they do not deliver the said silver pawns accordingly that then the said Master Umfrey and Master Pentney shall yield their bodies to the gaol of Tholsell within this city, and there shall remain to time they do pay and satisfy the said sum of six

score eight pounds, eleven shillings, seven pence, or deliver into the Treasury of this city sufficient silver pawns for the same sum."

THIRTEENTH CENTURY VIEWS ON AUDITORS

In Sir Walter of Henley's *Tretyce off Housbandry*, a manuscript of the thirteenth century, which has been printed by the Royal Historical Society, occurs the following sentence in the chapter "The Office of Seneschal"—

> The Auditors ought to be faithful and prudent, knowing their business, and all the points and articles of the account in rents, in outlays, and in returns of the garage and stock and other things belonging thereto. And the accounts ought to be heard at each manor, and then one can know the profit and loss. . . . The Seneschal ought to be joined with the Auditors, not as head or companion of the account, but as subordinate, for he must answer to the Auditors on the account for his doings, and for his commandments and approvements done by him on the manors. . . . It is not necessary so to speak to the Auditors about making audit, because of their office, for they ought to be so prudent, and so faithful, and so knowing in their business, that they have no need of other teaching about things connected with the account.

In July, 1645, Archibald Sydserfe presented a petition to the Scottish Parliament, which is referred to as follows in the Acts of the Parliament of Scotland: "Archibald Sydserfe humblie desyred the Estates of parliament That they would appoynt some auditoures for heiring and Fitting of his accomptes of these moneyes received by him for the publicts wse W^{ch} the Estates of parliament takeing to their consideratione Findes it fitting that the committie for the moneyes shall appoynt the saides Auditors."

ETYMOLOGY

The word "Auditor" is derived from the Latin, the ancient practice being for the parties whose accounts were to be audited to attend before the Auditor and vouch them orally. An example is given in the paragraph just quoted, "The accounts ought to be *heard* at each manor."

AUDITORS OF THE CROWN

Prior to Queen Elizabeth's reign, the accounts of the Crown were examined by auditors specially constituted for the purpose, or by the Auditors of the Land Revenue; or at times by the Auditor of the Exchequer, which office, the most ancient of all offices of control, was established in 1314, and continued until 1834, when it was abolished, and a new Department created, termed the Exchequer Office, or the Office of Comptroller-General of the Exchequer.

AUDITORS OF THE IMPRESTS

In 1559, the second year of the reign of Queen Elizabeth, two Auditors of the Imprests were first appointed. They continued in existence until the year 1785, when they were abolished, and their revised duties were taken up by the Office for auditing the Public Accounts. The Auditors of the Imprests were paid by fees chargeable on the accounts they examined. These were at established rates, but were sometimes increased by the Lord High Treasurer, on a memorial from the Auditors that the accounts were more voluminous than they had formerly been, or by a voluntary grant from the Lord High Treasurer, "for the pains" which the Auditors had been at in making up particular accounts.

NAVAL ACCOUNTS

The Accounts of the Treasurer of the Navy appear to have occasioned the first memorial from the Auditors for an increased allowance; this was in 1630. The two Auditors of the Imprests, as originally appointed, had no power to call upon parties to render accounts, but were dependent on the Treasury for obtaining them.

In 1649 the Auditors were empowered by the Committee of Public Revenue, sitting at Westminster, to call before them all such persons as had received any moneys upon Imprest or otherwise, to pass their accounts according to the usual course of the Exchequer. The same Committee abolished fees, and the two Auditors were allowed a fixed salary of £500 a year each "for themselves and their clerks, including all charges for house rent, pens, ink, paper, parchment, and all other incident expenses."

AUDITORS UNDER CHARLES II

With the Restoration of Charles II, the two Auditors returned to the former system of payment by fees and dependence on the Treasury, a practice which remained in force till the abolition of their duties in 1785. In 1783, owing to the increase in the Accounts, the Principals each obtained upwards of £16,000. The retired allowance to each Auditor on the abolition of the office was £7000 a year. Each Auditor had his Deputy and staff of six or seven clerks.

As an example of the scale of remuneration to the Auditors of the Imprests, the Account of the Chief Cashier of the Bank of England may be quoted, for the Audit of which £100 was allowed for every million of Capital Stock managed by that Company. The fees paid for auditing the Bank Account for the year 1784 exceeded £20,000.

FIRST AUDIT INDEPENDENT OF GOVERNMENT

The first attempt by the House of Commons to establish a control over the grants of Parliament, and to check the appropriation of supplies, was made in 1667, when it was determined by the House that the money voted for the Dutch War should be *applied only to the purposes of the War.* Commissioners for this purpose were appointed by "An Act for taking the Accompts"; and this may be considered as the first establishment of a Parliamentary Audit, or, in other words, of an Audit to a certain extent independent of the Government.

In 1785, on the abolition of the office of Auditors of the Imprests, its revised duties were taken up by the Office for Auditing Public Accounts. Various other officials for the auditing of the Accounts of Government Departments were from time to time appointed.

The first step was taken towards the establishment of a system of Account, based upon more practical principles, on the occasion of the revision of the Naval accounts in 1832, when the books in which the details of the Naval expenditure are recorded were recast on a connected plan on the principle of Double Entry.

PUBLIC ACCOUNTANTS

From a Treasury Minute, dated 16th June, 1848, it appears there were about 350 Public Accountants rendering Accounts to the Commissioners of Audit, and the Treasury complained of the delay in many cases, in presenting these Accounts. The following sentence is worth recording, as being applicable to all audits—

> My Lords do not understand on what grounds so much delay can have occurred in rendering these Accounts, it being the first duty of an Accountant to submit for audit, in a regular and punctual manner, his Account of the expenditure of the public money entrusted to him; and if this rule is not strictly enforced, the great advantage of an audit is lost, and it becomes impossible to exercise by means of it an effectual check over the public expenditure.

EXCHEQUER AND AUDIT DEPARTMENT CREATED

The Exchequer and Audit Departments Act, 1866, which received the Royal Assent on the 28th June, 1866, consolidated the previously independent Offices of the Comptroller-General of the Exchequer and of the Commissioners of Audit, and placed them under an Office, entitled the "Comptroller-General of the Receipt and Issue of Her Majesty's Exchequer and Auditor-General of Public Accounts" (29 & 30 Vict., cap. 39).

The Comptroller and Auditor-General is the guardian of the public purse, and in the exercise of this control his functions are broadly dual—

1. As Comptroller of the Exchequer it is his duty to see that all public moneys payable to the Exchequer are duly received and accounted for. On the other hand, no issues of money from the Exchequer can be made without his order, which is granted to the Treasury for the supplies voted by the House of Commons.

2. As Auditor-General it is his duty, as succinctly defined by the Exchequer and Audit Departments Act, "to ascertain, first, whether the payments which the Accounting Department has charged to the grant are supported by vouchers or proofs of payment, and, second, whether the money expended has been applied to the purpose or purposes for which such grant was intended to provide."

A general supervision is reserved to the Treasury, which has the power to require the Comptroller and Auditor-General to ascertain that the expenditure has been supported by their authority, and to report to them any expenditure which has been incurred without such authority. The right to appeal to the Treasury is also secured to any Accountant who may be dissatisfied with any disallowance which has been made in his Accounts by the Comptroller and Auditor-General. On the completion of the examination of the Accounts for the financial year, the Comptroller reports to the House of Commons on each of the Accounts submitted to him, and his criticisms are considered by certain members of the House who constitute the Public Accounts Committee.

With the duties of the Officials of His Majesty's Exchequer and Audit Department this work, however, is not concerned; like those of other servants of the Crown, the duties are prescribed by Acts of Parliament and by Rules and Regulations issued from time to time by the Authorities.

It is evident from the above remarks that the term "Public Accountant" was formerly applied to those Government officials who had to account to the Treasury for the manner in which they had expended public revenue entrusted to them. Towards the close of the eighteenth century, however, mercantile men and others who were unable, either by themselves or their clerks, to keep their books of account, or even, if the books were properly kept, to prepare statements from them, found it to their advantage to seek the aid of expert book-keepers, who were able to devote to this occupation some of their leisure time. In this way arose the growth and development of the accountancy profession, the practising members of which were styled Public Accountants.

CHARTERED ACCOUNTANTS

The leading members practising in Scotland were successful in obtaining grants of Royal Charters, those practising in Edinburgh receiving one in 1854, followed by Glasgow in 1855, and Aberdeen

in 1867. The members of the Societies incorporated by these Charters, have since been known as "Chartered Accountants."

No similar steps appear to have been taken in England until 1870, when an institute of practising professional Accountants was formed. This institute was successful in obtaining a Royal Charter on 11th May, 1880.

In 1885 a society was formed by professional and other Accountants who were not eligible for membership of the Institute of Chartered Accountants. The society was registered under the Companies Act, 1862, as the "Society of Accountants and Auditors," and its members are known as "Incorporated Accountants."

In recent years, since the grant of the Royal Charter to the Institutes, other bodies of Accountants have been formed. The shareholders of public companies have gradually ceased to appoint, from their body, Auditors of their accounts, and have replaced the amateur Auditor by a Chartered, Incorporated, or other professional Accountant.

The vast sums of money embarked in joint stock enterprise in Great Britain have caused the position of those who audit the accounts of such enterprises to assume great importance, and the responsibility attaching to the post of auditor of a public company is, consequently, very onerous.

INCREASE OF JOINT STOCK COMPANIES SINCE 2nd NOVEMBER 1862

Since the 2nd day of November, 1862, the day on which the Companies Act, 1862, came into operation, there has been a marked increase in the number of associations formed for enabling persons of all classes, trades, and denominations to combine together for the purpose of carrying on to their mutual advantage a single trade or any enterprise for the development of which the joint stock principle, as amended by the Act, offered increased facilities.

For a considerable time prior to the passing of this Act these associations had been in existence, but until 1844 they were subject to the law which governed ordinary partnerships of two or three persons, and the promoters of railway and other companies had the entire charge of their undertakings, made contracts with landowners and others, and issued prospectuses, on the faith of which subscriptions were received and certificates of shares issued without interference or control on the part of the legislature.

The first Joint Stock Companies Act (called the Joint Stock Companies Registration Act) was passed in 1844, and it remained in force until 1856, when it was repealed, except with regard to

insurance companies, for which companies it remained in force until the Companies Act, 1862, came into operation.

The first Act of Parliament making limited liability attainable by joint stock companies was passed in 1855, but this was not brought forward as an independent measure, and was in fact a graft on to the Act of 1844.

JOINT STOCK COMPANIES ACT, 1856

In 1856, however, Mr. Robert Lowe (afterwards Lord Sherbrooke), who was at that time the Vice-President of the Board of Trade, brought into the House of Commons the Joint Stock Companies Act, 1856, which repealed the previous Acts referred to, and reduced their provisions into a practical system. In 1857 and 1858 four additional Acts were passed, and in order to consolidate the Acts relating to joint stock companies Lord Chelmsford brought a fresh one in twice in 1859, but it did not pass, neither was Lord Campbell more successful in 1860. In 1862, however, the Act, which remained in force for forty-six years, and which gave so great an impetus to joint stock enterprise, was passed.

No provision, however, was made in this Act for the audit of accounts, although a schedule was attached, which was applicable to companies registered without Articles of Association, containing regulations as to audit for those particular companies only.

PROVISIONS FOR AUDIT IN ACT OF 1844

The omission of all reference in the Act of 1862 to the presentation of accounts to the shareholders, and their previous audit, is surprising, when it is borne in mind that eighteen years before it was evidently considered that legislation on this subject was desirable. In an Act entitled "An Act for the Registration, Incorporation, and Regulation of Joint Stock Companies," which received the Royal Assent on 5th September, 1844, very full clauses were inserted, providing for the proper keeping of accounts, the balancing of the books, the preparation of a Balance Sheet, the audit of the Balance Sheet, and the reporting thereon by the Auditors. It further enacted that a printed copy of the Balance Sheet and of the Auditors' Report should be sent ten days before the annual meeting to every shareholder and be filed, fourteen days after the meeting, with the Registrar of Joint Stock Companies.

Several Acts were subsequently passed which were supplemental to the Act of 1862, the first Act of importance to Chartered Accountants being the Act of 1879, which enacted that the accounts of every banking company registered after the passing of the Act should be examined by an Auditor, and when within the

following years many of the leading joint stock banks registered under this Act, they took the opportunity of displacing the shareholder-auditor and elected Chartered Accountants to the office.

ACT OF 1900

The Companies Act, 1900, enacted for the first time since the Act of 1844 that every company should have at least one Auditor, and prescribed his mode of appointment, and to a limited extent his rights and duties.

An entirely new provision was introduced into this Act by which, seven days before the statutory meeting of a new company, the Directors were required to send a report to each shareholder, which report, so far as it related to the shares allotted by the company, and to the cash received in respect of such shares, and to the receipts and payments of the company on capital account, had to be certified as correct by the Auditors, if any were appointed.

In 1907 a further Act, supplemental to the Act of 1862, was passed, which contained some important sections relating to Auditors and their duties, and a short Act was also passed early in 1908.

COMPANIES (CONSOLIDATION) ACT, 1908

As a result of this legislation, the law relating to limited liability companies had to be found in the Act of 1862 and in such a number of subsidiary Acts as to be of great inconvenience, both to professional men and to the public, and on the 21st December, 1908, an Act was passed repealing the Act of 1862, the subsidiary Acts referred to, and certain sections in a number of other Acts which applied to companies, and incorporating all the provisions of such sections of the Act of 1862 and the subsequent Acts which were in force, in one Act.

This Act, intituled "The Companies (Consolidation) Act, 1908," applied to all companies registered under the Companies Acts, 1862 to 1908, and to companies subsequently registered under the Act.

The Companies Act, 1929, superseded this Act and repealed the following Acts relating to limited companies—

The Companies (Consolidation) Act, 1908.

The Companies Act, 1913.

The Companies (Particulars as to Directors) Act, 1917.

The Companies Act, 1908.

A committee to consider the amendment of company law was set up in June, 1943, by the President of the Board of Trade, and reported in 1945. Following this report the Companies Act, 1947,

amending the Companies Act, 1929, was passed, and in 1948 these Acts were consolidated in the Companies Act, 1948, which is now the Act applying to limited liability companies.

The provisions of the Act so far as they affect Auditors will be set out in the appropriate chapters of this work.

ASSURANCE COMPANIES ACT, 1909

The Assurance Companies Act, 1909, enacts that the accounts of all assurance companies shall be deposited annually with the Board of Trade. Where the accounts of an assurance company carrying on an assurance business of all or any of the following classes: (*a*) Life Assurance, (*b*) Fire Insurance, (*c*) Accident Insurance, (*d*) Employers' Liability Insurance, (*e*) Bond Investment Business. are not subject to audit in accordance with the provisions of the Companies Act, relating to audit, they shall be audited annually in such manner as the Board of Trade may prescribe, and the regulations made for the purpose may apply to any such company the provisions of the Companies Act relating to audit, subject to such adaptations and modifications as may appear necessary or expedient.

The Assurance Companies Act, 1946, made additional provisions with regard to Assurance Companies, and the Auditor will be concerned in dealing with these Companies with the Assurance Companies Acts, 1909, to 1946, and the Companies Act, 1948.

COMPANIES INCORPORATED BY SPECIAL ACTS

In addition to the companies registered under the Companies Act, there are those registered under various other public Acts (including water companies, building societies, friendly and industrial and provident societies, and savings banks), as also those incorporated by special Acts of Parliament. The latter are, naturally, subject to certain public Acts in addition to their own private Acts.

BUILDING SOCIETIES

The first building society was founded in 1809, and was followed by many others. Previously to 1836, no special legislation existed for them, and they were considered ordinary joint stock companies. About this time a proposal was made by the Chancellor of the Exchequer to charge a duty on shares in joint stock companies which were transferable. This alarmed the building societies, who protested so successfully against the proposed duty being applied to them that an Act was passed for their regulation, and although this Act was described by the Royal Commissioners as "one of the worst drawn which yet remain in the Statute-book," it remained in force for nearly forty years.

In 1874, the Building Societies Act, 1874 (37 & 38 Vict., c. 42), was passed, under which most of the building societies now in existence are incorporated; but as it does not affect societies registered under the Act of 1836, unless they become incorporated under the new Act, the provisions of the Act of 1874 do not apply to all building societies. The Act of 1836 is, however, by the Building Societies Act, 1894 (57 & 58 Vict., c. 47), repealed from the 25th August, 1896, as to societies certified thereunder after 1856.

The Act of 1894 prescribed that a form of accounts should be prepared by the Chief Registrar of Friendly Societies for use by Building Societies, and contain certain information; it also enacted that one of the Auditors of each Society should be a person who publicly carries on the business of an Accountant.

In the reports of the Chief Registrar of Friendly Societies for the year ending 31st December, 1894, presented to Parliament, that official states that a number of questions have been addressed to him as to who fulfils this requirement of the Act. In the opinion of the Registrar, a person who publicly carries on the business of an Accountant is one "who could, if required, under Section 21 of the Act, append to his signature as Auditor a statement that he is a person who publicly carries on, at some specified place, the business of an Accountant, and would be subject to the penalty provided by Section 22 of the Act if the statement should be proved to be false," and further, he adds, "It would seem that the turning-point of the definition in the Act lies in the word 'publicly,' and, therefore, that many men who possess excellent credentials as Accountants in private employ, or in positions where the public cannot come to them and give their accountancy work to them, are not within it. To put the matter in familiar terms, the essential part of the qualification is a brass plate or other public notification that the business of an Accountant is carried on."

The latest Act is the Building Societies Act. 1939, which made important amendments in the Law as to the making of advances by building societies, as to the security taken for such advances, and the payment of commissions in connection with their business.

SAVINGS BANKS

On the 11th July, 1817, was passed an Act for the purpose of encouraging the establishment of Banks for Savings in Ireland, and on the following day a similar Act was passed for the encouragement of Savings Banks in England, which Act was amended in the following year. Savings Banks were first legally recognized in Scotland in 1819 by the Act 59 Geo. III, c. 62.

The Act 1 Geo. IV, c. 83, altered the procedure of dealing with the funds of Savings Banks as an investment with the Commissioners for the Reduction of the National Debt at the Bank

of England, and prescribed that receipts bearing interest at 3d. per cent per diem were to be given for moneys invested.

Under the Acts 5 Geo. IV, c. 62, and 9 Geo. IV, c. 92, the state of the law relative to trustee savings banks began to assume its present form, and the former of these Acts of Parliament was the earliest statute dealing with banks in both England and Ireland.

ACT OF 1844

Several Acts were passed in the reign of William IV, and an Act was passed in 1844 which, amongst other amendments of the law, prescribed that Auditors were to be appointed, and certain duties to be performed by them were specified. The depositors' Pass Books were to contain a copy of the rules, which rules were to provide for the production of Pass Books for the purpose of their being inspected, examined, and verified. Acts were passed in 1854, 1859, and 1860, and in 1861 Post Office Savings Banks were first established.

ACT OF 1863

In 1863 so many Acts were in force relating to Savings Banks that a new Act was passed, known as the Trustee Savings Banks Act of 1863, which repealed, so far as trustee savings banks were concerned, all previous savings bank legislation, with the exception of the provisions contained in 24 Vict., c. 14, and 26 Vict., c. 14, and set forth in one measure the statutory enactments relating to trustee savings banks. This is still the chief Act of Parliament controlling the conduct and management of this class of savings bank. By this Act it was provided that a public Accountant or one or more Auditors was to be appointed by the Trustees and Managers, but not out of their own body, to examine the books of the bank and to report in writing to the Board or Committee of Management the result of such audit not less than once in every half-year; also to examine an extracted list of the depositors' balances, made up every year to the 20th November, and to certify as to the correct amount of liabilities and assets of the bank. It also prescribed that a book containing such extracted list of every depositor's balance, omitting the name, but giving the distinctive number and separate amount of each deposit, and showing the correct number and amount of the whole, checked and certified by such public Accountant or Auditors, should be open, at any time during the hours of public business, for the inspection of every depositor in relation to his own account.

ACTS OF 1880, 1887, AND 1891

A further Act was passed in 1880, and another one in 1887, and in 1891 was passed the Act for the establishment of an Inspection

Committee of Trustee Savings Banks, which, in addition to giving certain powers to this Committee, also prescribed that if, in the opinion of the Committee, the rules of a savings bank are insufficient for the purpose of maintaining an efficient audit, the bank shall with all convenient speed make such additional rules as may, in the opinion of the Committee, be required for the purpose.

FRIENDLY SOCIETIES

A number of societies formed to encourage thrift are registered under the Friendly Societies Act, 1896, and supplementary Acts, and are required by Section 26 of this Act to submit their accounts once at least in every year to one of the Public Auditors appointed by the Treasury, or to two or more Auditors appointed by the Society or each of its branches for the audit of the accounts of each branch.

AUDITOR'S POWER UNDER HEALTH ACTS

An Auditor, appointed by the Local Government Board under the Public Health Acts to audit the accounts of a Metropolitan Borough Council, is authorized and required by that Act to decide whether any member or official of the council has been guilty of negligence or misconduct in relation to the accounts whereby a loss has been incurred by the council, and to assess the amount of the loss. The auditor of a company does not possess such powers, but it is open to shareholders to take legal steps against the Directors as a result of the Auditor's report in connexion with the periodical accounts issued to the shareholders, and it may be useful to quote the remarks of the late Lord Moulton, when L.J., referring to the powers of an Auditor of the Local Government Board, as it may be deduced from this judgment that the persons accounting to the Auditor of a company are the Directors, and it is not the duty of the Auditor to inquire into the negligence or misconduct of an official which he may encounter during the course of his audit. He may make a report to the Directors, leaving them to deal with the offending official.

The following is the case referred to—

R. v. *Carson Roberts*

On an application for a certiorari under Section 247, Subsection 8 of the Public Health Act, 1875, to remove and quash disallowances and surcharges made by an Auditor acting in pursuance of that section, the jurisdiction of the Court is not confined to error in point of law, but extends to error in point of fact.

So *held* by the Court of Appeal, [1908] 1 K.B. 407, affirming the decision of the Divisional Court, [1907] 2 K.B. 878.

R. v. *Haslehurst* (1887), 51 J.P. 645, followed and approved.

Per Cozens-Hardy, M.R., and Farwell, L.J. An Auditor appointed by the Local Government Board under Section 247 of the Public Health Act, 1875, to audit the accounts of a Metropolitan Borough Council is authorized

and required by Subsection 7 to decide whether any member or officer of the Council has been guilty of negligence or misconduct in relation to the accounts whereby the loss has been occasioned to the Council, and to assess the amount of the loss.

Per Fletcher Moulton, L.J. The powers and duties of the Auditor under Subsection 7 of Section 247 are strictly confined to auditing, and the words "person accounting" in the latter part of that Subsection, which requires the Auditor to "charge against any person accounting the amount of any deficiency or loss incurred by the negligence or misconduct of that person," mean the person who brings in accounts for audit. Therefore, where the accounts submitted for audit are the accounts of a Metropolitan Borough Council the person accounting is the Council, and the Auditor has no power to inquire into the negligence or misconduct of the individual members or servants of the Council.

AUDITORS OF UNIVERSITIES AND COLLEGES

The Universities of Oxford and Cambridge Act, 1877 (40 & 41 Vict., c. 48), enacted that the Commissioners for each University appointed by the Act should in Statutes made by them make provision for the audit of the accounts of the University and of its Colleges, and accordingly the University of Oxford Commissioners made a Statute on the 16th June, 1881, that the Hebdomadal Council should annually appoint a University Auditor, who must be either a professional Accountant carrying on business in London or Westminster, or (if they think fit) a person conversant with accounts approved by the Permanent Secretary to the Treasury. Most, if not all of the colleges have statutes to the same effect for the audit of the college accounts, and the accounts of the University Chest and of the Colleges of Oxford referred to are audited by professional Accountants.

In conferring the honorary degree of M.A. on a Chartered Accountant who for many years had acted as Auditor of the University Accounts, the following was the Public Orator's felicitous account of the duties discharged by him: "Sexcenta fere sunt, quae ad calculos sunt vocanda—vectigalia, impensae, reditus, praediorum mercedulae, pignora, hypothecae, usurae, decumae, reparationes atque hujusmodi caetera; his accedunt pecuniae fiduciariae quae in proprios usus debent asservari. Quae quidem omnia non cujusvis est hominis digerere, discutere, inter se compensare. Postulat animi experientiam, postulat ingenii acumen, fidem incorruptam." ["The things which have to be brought to a strict account are almost beyond number—taxes, outlays, returns, revenues from estates, mortgages, securities, interest, tithes, purchases and all other things of this kind: in addition there is money held in trust which must be kept to gain the interest due on it. All of which it is not in the power of every man to handle, or examine, or balance. It requires a trained mind, a keen intellect, and complete trustworthiness."]

This Act was followed by the Universities of Oxford and Cambridge Act, 1923, making further provisions as to the form of Accounts and the audit and publication thereof.

The following certificate to be signed by the Auditor or Auditors was prescribed—

We hereby certify that the accounts are duly kept in the form prescribed by University Statute, that the foregoing Revenue and Capital Accounts and the Statement of Revenue Balances are correct, and that these Accounts and the Statement of Revenue Balances represent a true statement of the affairs of the College according to the best of our information and the explanations given to us and as shown by the Books of the College. We also certify that (according to the best of our information) the items of Account are compiled in accordance with the rules at this present time prescribed by the Statutory Committee of Bursars set up in accordance with the Statutes of the University made in this behalf by the Statutory Commissioners under the Universities of Oxford and Cambridge Act, 1923.

Various rules were laid down as to the obligations of colleges regarding Kitchen Management, one of which is as follows—

To nominate in each third year for approval by the Curators of the University Chest a Firm of Accountants, being Chartered Accountants actually carrying on business and not being Accountants who audit the accounts of any College or Society in the University, to carry out the inspections hereinbefore mentioned. The Accountants shall be Accountants who have had experience in the auditing of the accounts of firms or Institutions engaged in catering. The Accountants shall examine the accounts, statistics, and methods of catering administration in each College once in every period of three years.

Very full details as to the Oxford Colleges are to be found in a publication called *Statuta et Decreta Universitatis Oxoniensis* published in 1927. The accounts of the Colleges of the University of Cambridge are now audited by professional accountants.

AUDIT OF ACCOUNTS OF CONSERVATORS

By the Salmon Fishery Act, 1865 (28 & 29 Vict., c. 121, s. 29), an account of the receipts and disbursements of every Board of Conservators, in such form and with such particulars as may be required by the Court of Quarter Sessions that appoints the Board, or any case of a Joint Board by the Court of Quarter Sessions of the Audit County, shall be laid annually before such Courts of Quarter Sessions as aforesaid, and the Justices assembled at such Courts may disallow any item that they consider to be illegal.

COUNTY ASSOCIATIONS

By the Territorial and Reserve Forces Act, 1907 (7 Edw. VII, c. 9), the accounts of county associations are required to be made up annually and audited.

PORT OF LONDON

By the Port of London Act, 1908 (8 Edw. VII, c. 68), the accounts of the Port of London Authority, and of its Committees, are to be made up annually and audited by an Auditor to be appointed by the Board of Trade.

AUDIT OF ACCOUNTS OF JUDICIAL TRUSTEES

By the Judicial Trustees Act, 1896 (59 & 60 Vict., c. 35, s. 17), the accounts of every trust of which a judicial trustee has been appointed are required to be audited, and a report thereon made to the Court by the prescribed persons, and by the rules made under this Act the person to audit these accounts shall be an Officer of the Court, but the Court, if it considers that the accounts are likely to involve questions of difficulty, may refer them to a professional Accountant for report.

ACCOUNTS OF CHARITIES

The regular presentation of the accounts of Charitable Funds is important and all institutions seeking subscriptions from the public should submit their accounts to professional Auditors. The Boards of Management of King Edward VII's Hospital Fund and of the Hospital Sunday and Hospital Saturday Funds will not make any awards to those institutions which do not present their accounts in a prescribed form duly certified by a professional Auditor.

As a result of the First World War a number of Charities were formed to relieve the distress of civilians and sailors and soldiers in the countries of our Allies and in the United Kingdom. These became so numerous that the First War Charities Act, in 1916, was passed requiring such Charitable Societies to be registered, to keep proper accounts, and to have these accounts audited at such intervals as might be prescribed by regulations under this Act.

AUDITORS OF ACCOUNTS OF MERCHANTS

At present there is no legal obligation on merchants and others, trading either alone or in co-partnership with others, to submit their accounts periodically to Auditors; the practice, however, of doing so voluntarily is becoming very general. The certificate of a professional Auditor is useful in many ways. In addition to the moral effect of the periodical visit of a professional Auditor on the cashier and other members of the staff, questions of Income Tax, adjustments of accounts between partners (especially where the management of affairs is left to one or only some of the partners), negotiation of loans from bankers and others, are all more easily arranged.

In the event of the death of a partner, or the dissolution of the partnership either by consent or by effluxion of time, the fact that the accounts have been periodically audited is of the greatest assistance in the settlement between the various parties interested.

Every partner has a right to have accurate accounts kept and to have free access to them.—*Rowe* v. *Wood* (1822), 2 Jac. & W. 558; *Goodman* v. *Whitcomb* (1814), 3 V. & B. 36.

The Limited Partnerships Act, 1907, Section 6, Subsection (1), gives power to a limited partner to employ an Auditor to inspect, as his agent, the books of a firm in which he is a limited partner, and examine into the state and prospects of the partnership business.

It is a common occurrence for persons to advance money to others in business, receiving either a fixed rate of interest or a share of the profits, or both, without taking any part in the management of the business. In these cases it is most important, more especially on behalf of the limited partner, that the accounts be periodically audited.

AUDITORS ON BEHALF OF SLEEPING PARTNERS

It is frequently arranged, in these circumstances, that the accounts as certified by the Auditor shall be binding on all parties. When this is the case, the Auditor should be made aware of the fact, otherwise a new account may have to be taken.

In a case decided by the House of Lords, taken on appeal from a judgment by the First Division of the Court of Session, Scotland, the appellant had advanced £15,000 to the respondent, to be used in the business of the respondent for five years. In return for the advance, the appellant was to receive interest and 37½ per cent of the profits of the respondent's business. The contract stipulated that there should be an annual audit of the respondent's business by a firm of Chartered Accountants, and that their certificate as to the profits should be binding on both parties. For four years the respondent's books were audited by a member of the firm of Chartered Accountants. Subsequently the appellant raised this action against the respondent for a Judicial Account, on the ground that the audits had not been in terms of the agreement, in that the Auditor did not know that his estimate of the profits was to be binding on the appellant and respondent. The Auditor said in his evidence that he did not know of this agreement, and that, if he had, he would have made the account in a somewhat different form. The House of Lords held that there must be a new account taken, the Auditor being unaware that his audit was to be final between the parties.—*Teacher* v. *Calder*, [1899] A.C. 451.

AUDIT OF ACCOUNTS OF EXECUTORS AND TRUSTEES

Persons interested under a will are not usually content nowadays to accept what may be handed to them without the certificate of a professional Auditor that the amount has been ascertained after an examination of the books and papers of the Executors and Trustees, while Executors and Trustees themselves are entitled on their own initiative to employ Accountants to audit their accounts.

The desirability of their doing so is clearly indicated in a case where a Trustee, who was himself one of the beneficiaries had inadvertently overpaid the other beneficiaries their share of income, and died before any adjustment had been made. It was held that the Executors of the deceased Trustee were not entitled to recover from the other beneficiaries the amount so overpaid, or to have accrued or future income impounded till the shares were equalized, by reason of the fact that the testator himself was the person responsible for the mistake that had been made.—*In re Horne: Wilson* v. *Cox Sinclair*, [1905] 1 Ch. 76.

AUDIT OF OTHER TRUST ACCOUNTS

By the Public Trustee Act, 1906 (6 Edw. VII., c. 55, s. 13), the accounts of any trust may, subject to notice being given in the prescribed manner, be investigated and audited by a professional Accountant, as may be agreed upon by the applicant and the trustees, or, in default of agreement, by the Public Trustee or some person appointed by him.

AUDIT OF ACCOUNTS OF LANDED PROPERTIES

The proprietors of landed estates, as a rule, require the books of their Agents to be submitted to a professional Auditor for the purpose of ascertaining that their rents and other revenues are collected and accounted for.

Many persons also now entrust to Auditors the examination of the accounts of their private businesses, or, when not engaged in business, of their private investments, and even of their household expenses.

AUDITOR APPOINTED ADMINISTRATOR

Where all parties interested in the estate of a deceased person had entered into a compromise, with a view to putting an end to all further disputes and litigation, upon the basis that a Chartered Accountant, a stranger in blood, who had been employed by the deceased in auditing his accounts, should apply for and obtain a grant of Letters of Administration, with the will and codicils annexed, the Court, upon his application, and subject to the

consents of all the persons interested in the estate, and subject to an affidavit of the fitness of the proposed Administrator being filed, made the grant to him under the Probate Act, 1857, s. 73.—*In the Goods of Potter, Potter* v. *Potter,* [1899] P. 265.

AUDITOR AS ASSESSOR

An Auditor is sometimes appointed under a policy of fire insurance as an Assessor to settle the amount payable where, by reason of a fire, the turnover of the business has decreased. By a policy of insurance against fire on business premises an insurance company agreed to pay to the insured, in the event of damage by fire to their property on account of annual net profit, an agreed percentage on the amount by which the turnover in each month after the fire should in consequence of the fire be less than the turnover for the corresponding month of the year preceding the fire. The policy further provided that the amount of all losses under the policy should be assessed by the insured's Auditors. During the currency of the policy property of the insured was damaged by fire. The Auditors gave certificates stating the difference between the turnover for the months after, and the corresponding months in the year before the fire, and the percentage payable. An arbitration was held to determine the amount payable under the policy. The Auditors' certificates were put in evidence, and a member of the firm of Auditors was called as a witness by the insured and stated that when he gave the certificates he was satisfied that the losses of turnover stated therein were in fact sustained in consequence of the fire.

Held, that the assessments of the Auditor were conclusive evidence of the amount of the loss recoverable under the policy unless it were shown that the Auditor had misdirected himself in point of law or had omitted to take into consideration some material fact; and that the Auditor might be cross-examined, and the insurance company might call direct evidence, to show that the Auditor had omitted to take into consideration the fact that the losses of turnover were wholly or in part due to other causes than the fire, but not to show that the Auditor's conclusions of fact were erroneous.—*Recher & Co.* v. *North British and Mercantile Insurance Company,* [1915] 3 K.B. 277.

AUDITS GENERALLY

The development, during the last three-quarters of a century, of limited liability companies administered by Boards of Directors has been considerable and a large part of the undertakings in the United Kingdom take this form.

At the end of each financial period, and in some cases at the end

required by the Companies Act for the approval and adoption of the shareholders. The function of the Auditor is to examine the accounts and to make a report to the shareholders, which will satisfy the requirements of the Act.

The object of this treatise is to set out the duties, responsibilities, and methods of procedure of the Auditors.

It is important that the Auditor should be aware of his duties and responsibilities and that he should recognize that it is no part of his duty to interfere in the management. It is for him to ensure that the results of the administration by the accounting parties are correctly shown in the accounts, according to the best of his knowledge and belief, and where they fall short of this requirement he should report accordingly.

CHAPTER II

THE OBJECT OF AN AUDIT

THE object of an audit is to establish, by an examination of the books, vouchers, and other appropriate records, that a Balance Sheet at a given date gives a true and fair view of the state of affairs of the undertaking and that the Profit and Loss Account (or similarly designated account) gives a true and fair view of the results or operations for the financial period under review. This general proposition applies where the undertaking is an incorporated company, a trust, a partnership or other body. The implications of this brief description will be dealt with more fully in this work, and it will be seen that, particularly so far as incorporated companies are concerned, very far-reaching responsibilities are involved. The Auditor should satisfy himself that the accounts submitted to him are correct in principle and are in accordance with the facts as disclosed by the books and other records, and he should report accordingly. If he is not satisfied, he should point out what he considers to be wrong in principle or in fact.

The extent of the Auditor's duty is determined by statute or by his instructions. In some cases, as, for example, in the case of companies governed by the Companies Act, 1948, where it is provided by law that he must report on certain facts, it is necessary for him to make an examination which will enable him to give that report. In other cases, where he acts for individuals or firms, he should be instructed as to the scope of the audit required. He then will limit his work accordingly, taking care, if he is prudent, to receive his detailed instructions in writing, so that no question as to the duties he has undertaken may be raised at a later stage.

The main considerations arising in the majority of audits may be summarized as follows—

(1) To verify the accuracy of the books and of the transactions recorded in the books, and to ensure that the transactions are proper to be included as well as being correctly entered.

(2) To ensure that a proper distinction has been made between items chargeable to Capital and items chargeable to Income. (This is of the essence of an audit and a vital point.)

(3) The verification, so far as is within the reasonable power of the Auditor, of the existence of the assets and liabilities appearing in the Balance Sheet.

(4) To ensure that the items in the Balance Sheet and accounts are so described as to give a sufficiently clear and correct view of their nature.

It is obviously the duty of Directors, Partners, Trustees or others, submitting the accounts for audit, so to conduct and arrange the affairs of the body for which they are responsible that the possibilities of fraud are reduced to a minimum. If these responsibilities are recognized and an effective internal control is in operation, the duties of the Auditor are considerably lessened and the routine work which he feels obliged to undertake may be curtailed.

The Auditor should not be a slave to routine, and he should undertake his work in a spirit of inquiry. A sense of imagination is a valuable attribute, and the Auditor should give his mind all the time to the origins of the entries in the books, and visualize the transactions which they record. He should avoid being a hack worker who merely satisfies himself that one entry matches another, that postings are correct in amount, that the columns add up, and that the total on the debit side agrees with the total on the credit side. An employee contemplating fraud will soon discover the loopholes in an audit of that kind, and pursue methods which will leave all the arithmetical tests unimpaired. If, on the other hand, the Auditor examines the method of dealing with cash, inquires into delayed payment of cash into the bank, makes an occasional comparison of the dates of entries in the books of prime entry and the ledgers, and examines the records of the physical movement of goods and their reconciliation with the financial records of sales and purchases, he may reveal or prevent irregularities which so frequently have their origins in these transactions.

In the following chapters the work of the Auditor is dealt with in more detail.

In theory the Auditor should audit accounts which have already been prepared by his clients. In practice, in many cases, the Auditor is asked to raise the accounts from the books and even to make the closing entries. In performing this work, the Auditor is acting as an accountant; the work is not audit work and frequently a special fee is paid for it. However, such a course does have the effect of reducing the work on the audit, for entries made by the Auditor himself are verified at first hand.

It is important to bear in mind that the statutory and other duties of Auditors do not affect the obligations and duties of Directors of Companies. It is the duty of the Directors to have proper books kept, and the Balance Sheet and accounts prepared therefrom, and to decide in what form the accounts are to be presented to the shareholders. Although the Auditor may suggest to the Directors some alteration in the form of the accounts which may appear to him to be advisable or necessary, he cannot enforce any alteration. The duty of the Auditor is to report to the shareholders on the accounts which are submitted to them at the annual

general meeting, and to refer to any matter on which he is not satisfied, and which he feels should be brought to their notice. On the other hand, the shareholders in general meeting may ask for explanations and, subject to the Articles of Association, may by resolution decide on the form to be adopted in the presentation of the accounts, though this form must satisfy the requirements of the Companies Act, 1948.

The Auditor's report to the shareholders is referred to more in detail in Chapter IX. Where the Auditor is in every way satisfied he will make a report which in substance conforms to the wording used in the Ninth Schedule to the Companies Act, 1948, or other appropriate statute, applying to the undertaking in question, defining the requirements of the Auditor's report. Shareholders and others become familiar with the form of the unqualified report of the Auditors, and will, therefore, pay attention to any variation of the wording, which will be interpreted to mean that the Auditor has considered it necessary to call attention to some matter as to which he is not satisfied, and which the directors have not made clear in the accounts. Directors are, as a rule, willing to consider the Auditor's advice as to the form of presentation of the accounts, and the Auditor should advise that if such information is clearly given on the face of the accounts, he will regard it as unnecessary to make any qualification of his report. It is well known by the professional and commercial community that this is the usual procedure, and it is for this reason that any qualification in the Auditor's report is given special weight. The Auditor should only qualify his report after the most careful consideration of the facts and the interests of the shareholders, and after a genuine endeavour, consistent with his duty and responsibilities, to avoid any qualifications. He must remember that while the report is his, the accounts are the accounts of his clients, and the accounts and report are published together as one document. It is reasonable, therefore, that he should consider with the Directors any proposed qualification, though the final form of the report must rest with him.

The usual form of the Auditor's report on the Balance Sheet of a company has always been governed by the wording of the Companies Act in force at the time. The report is frequently referred to, somewhat loosely, as a certificate but, in fact, it is not, for the Auditor does not certify the accounts but reports on them. In the case of companies, this report is to the members. A report which records conformity, without qualification, with the requirements of the Companies Act is called colloquially a "clean report." A report which includes any comment by way of qualification is referred to as a "qualified report." It should be borne in mind that the term "qualified report," as commonly used, implies that the

accounts as presented fall short of requirements in some respect, or that there is some limitation either in the presentation of the accounts or in the work which the Auditor has been able to perform which, in his opinion, makes it impossible for him to give the "clean" report. Sometimes there is an addition to the report by way of further information or explanation which in no way implies that the accounts fall short of requirements. Any such addition would not be regarded as a "qualification," in the accepted sense of that term as applied to the Auditor's report.

The common form of "clean" report under the Companies Acts, 1908 and 1929, was in the following terms—

> "We have audited the above Balance Sheet, dated ...., and have obtained all the information and explanations we have required.
>
> "In our opinion, such Balance Sheet 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 our information and the explanations given to us and as shown by the books of the company."

The above report was reasonably brief and the wording of it became familiar to persons who were considering accounts presented to them. Any variation of the wording by way of qualification attracted the attention of shareholders and others, who realized that the Auditor had considered it necessary to call attention to some matter, either because he was not satisfied, or because some clarification was needed.

The Companies Act, 1948, requires a much fuller report from the Auditors and this is rendered necessary chiefly by the provisions under which the Auditor is called upon to report, not only on the Balance Sheet but upon the Profit and Loss Account, and in the case of a holding company upon the group accounts. Apart altogether from these specific matters, the duties of Auditors have been widened by the Act, and the report covers these wider duties.

Section 162 (1) of the Companies Act, 1948, provides that the Auditors shall make a report to the members on the accounts examined by them, and on every Balance Sheet, every Profit and Loss Account, and on all group accounts laid before the company in general meeting during their tenure of office, and the report shall contain statements as to the matters mentioned in the Ninth Schedule to the Act. The Ninth Schedule reads as follows—

NINTH SCHEDULE

Matters to be expressly stated in Auditors' Report.

1. Whether they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purposes of their audit.

2. Whether, in their opinion, proper books of account have been kept by the company, so far as appears from their examination of those books, and proper returns adequate for the purposes of their audit have been received from branches not visited by them.

3. (1) Whether the company's Balance Sheet and (unless it is framed as a Consolidated Profit and Loss Account) Profit and Loss Account dealt with by the report are in agreement with the books of account and returns.

(2) Whether, in their opinion and to the best of their information and according to the explanations given them, the said accounts give the information required by this Act in the manner so required and give a true and fair view—

(*a*) in the case of the Balance Sheet, of the state of the Company's affairs as at the end of its financial year; and

(*b*) in the case of the Profit and Loss Account, of the profit or loss for its financial year;

or, as the case may be, give a true and fair view thereof subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Part III of the Eighth Schedule to this Act are not required to be disclosed.

4. In the case of a holding company submitting group accounts whether, in their opinion, the group accounts have been properly prepared in accordance with the provisions of this Act so as to give a true and fair view of the state of affairs and profit or loss of the company and its subsidiaries dealt with thereby, so far as concerns members of the company, or, as the case may be, so as to give a true and fair view thereof subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Part III of the Eighth Schedule to this Act are not required to be disclosed.

Section 162 further provides as follows

(2) The Auditors' report shall be read before the company in general meeting and shall be open to inspection by any member.

(3) Every Auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, and shall be entitled to require from the officers of the company such information and explanation as he thinks necessary for the performance of the duties of the auditors.

(4) The Auditors of a company shall be entitled to attend any general meeting of the company and to receive all notices of and other communications relating to any general meeting which any member of the company is entitled to receive and to be heard at any general meeting which they attend on any part of the business of the meeting which concerns them as auditors.

A form of "clean" report which it is considered satisfies the requirements of the Act is as follows —

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit. In our opinion proper books of account have been kept by the company so far as appears from our examination of those books *and proper returns adequate for the purposes of our audit have been received from branches not visited by us.* We have examined the above Balance Sheet and annexed Profit and Loss Account which are in agreement with the books of account. In our opinion and to the best of our information and according to the explanations given to us the said accounts give the information required

by the Companies Act, 1948, in the manner so required and the Balance Sheet gives a true and fair view of the state of the company's affairs as at 31st December, 1948, and the Profit and Loss Account gives a true and fair view of the profit (loss) for the (year) ended on that date.

The words in italics will, of course, not be used where they are inapplicable.

Under the Acts of 1908–1929, the Auditor's report in the form mentioned earlier was in general use (with insignificant variations of wording) where no qualification was necessary. The same uniformity does not yet apply to reports under the 1948 Act, and quite considerable variations of form will be found, though in each case the information required by the Ninth Schedule is given. In time, no doubt, a certain uniformity will be achieved though the extended wording of the report may make this more difficult. In the case of group accounts, other than consolidated accounts, the following addition to the ordinary form of report suggested above has been recommended.

We have also examined the annexed group accounts with the audited accounts of the companies dealt with thereby, *certain of which have not been audited by us. Subject to the foregoing,* in our opinion the group accounts have been properly prepared in accordance with the provisions of the Companies Act, 1948, so as to give, *in conjunction with the Balance Sheet and Profit and Loss Account of X Ltd.*, a true and fair view of the state of affairs and of the profit (loss) of X Ltd., and its subsidiaries dealt with by such group accounts so far as concerns members of X Ltd., *and so far as is practicable having regard to the fact that accounts of some of the subsidiaries are made up to different dates and cover different periods from those of X Ltd.*

The words in italics will be omitted or varied if they are not applicable in any particular case. The reference to X Ltd. is to the holding company. If the holding company's accounts are incorporated in the group accounts, the words "in conjunction with the Balance Sheet and Profit and Loss Account of X Ltd." will be omitted.

If consolidated accounts are submitted, the following form of "clean" report has been recommended—

We have also examined the annexed Consolidated Balance Sheet and Consolidated Profit and Loss Account of the company and its subsidiaries dealt with thereby with the audited accounts of those companies, *certain of which have not been audited by us. Subject to the foregoing,* in our opinion such Consolidated Balance Sheet and Consolidated Profit and Loss Account have been properly prepared in accordance with the provisions of the Companies Act, 1948, so as to give a true and fair view respectively of the state of affairs and of the profit (loss) of X Ltd. and its subsidiaries dealt with thereby so far as concerns members of X Ltd., *and so far as is practicable having regard to the fact that the accounts of some of the subsidiaries are made up to different dates and cover different periods from those of X Ltd.*

Part III of the Eighth Schedule to the Companies Act, 1948, exempts banking companies, discount companies, and assurance

companies from giving information in regard to certain matters relating chiefly to reserves and the market value of investments, and the Board of Trade, if it appears to them to be desirable in the national interest, may include companies other than those defined. National interest is the governing consideration, as it may be undesirable in the case of the companies mentioned to make the sort of disclosure about reserves which is required by other companies under the Act.

There has been a feeling amongst Auditors, called upon to report on the accounts of such companies, that they cannot properly make their report without referring to the fact that there has been non-disclosure of the matters in regard to which non-disclosure is permitted under Part III of the Eighth Schedule. The question is debatable and it might well be argued that if accounts of such companies are submitted in the form permitted under the Act, it is unnecessary to say that they are correct subject to the non-disclosure of items which the Act authorizes the company not to disclose. In the case of companies part of whose operations are overseas, any reference, for example, to the non-disclosure of reserves may suggest to a foreigner not conversant with the provisions and dispensations of the Companies Act, that the accounts are open to criticism and may, for that reason, undermine confidence. On the other hand, the wording of Section 3 (2) of the Ninth Schedule presents a difficulty if all reference is to be omitted, for the Auditor is called upon to report that the accounts give a true and fair view, subject to the non-disclosure of any matters (to be indicated in the report) which, by virtue of Part III of the Eighth Schedule of this Act, are not required to be disclosed.

Accounts so far published since the Act came into force contain qualifications in the following or similar terms—

(i) In the case of a banking company:

> In our opinion . . . the said accounts give the information required by the Companies Act, 1948, in the manner thereby authorized for banking companies, and, on such basis, the Balance Sheet gives a true and fair view . . .

An alternative to the wording "thereby authorized" is "information required by the Companies Act, 1948, in the manner applicable to the accounts of banking companies and on the basis therein laid down . . ."

(ii) In the case of an assurance company:

> In our opinion . . . the said accounts give the information required by the Companies Act, 1948, in the manner so required, which in relation to assurance companies is modified in regard to reserves and provisions by Part III of the Eighth Schedule to that Act, and on this basis in our opinion the accounts give . . .

(iii) In the case of a shipping company:

In our opinion . . . the said accounts give the information required by the Companies Act, 1948, as modified by the Companies (Shipping Companies Exemption) Order, 1948, in the manner so required . . .

There are, of course, variants of these reports. For example, one shipping company uses the following wording—

. . . in the manner so required, other than the information which the company is exempt from disclosing, as referred to in note (i).

The notes on the accounts are submitted by the Directors, and note (i) reads—

By the Companies (Shipping Companies Exemption) Order, 1948, the company is exempt from disclosing certain information relating to reserves and provisions and changes therein and certain details of fixed assets and the depreciation thereof, and these accounts have been prepared accordingly.

In another case the reference in the report is as follows—

. . . in the manner so required, subject to the non-disclosure of certain information relating to reserves and provisions and changes therein and certain details of fixed assets and the depreciation thereof, as prescribed by the Companies (Shipping Companies Exemption) Order, 1948.

As in the case of the ordinary report on the accounts of other companies, it is probable that in time a certain uniformity will be achieved in the reports made by Auditors on the accounts of companies of the class mentioned above, and that it will be recognized that they are acting properly in preparing their accounts without disclosure of the information in question. It must still be borne in mind, however, that the real difficulty is the language of the Ninth Schedule to the Act, which is mandatory.

It is customary for the Auditor to delay the signature of his report until the accounts have been signed by the Directors. The Directors will probably not sign the accounts until they have been approved by the Board. In the case of a firm or sole trader, if the Auditor makes a report on the accounts, he will be well advised to obtain the signatures of the partners or the sole trader to the accounts before he signs it.

The omission or neglect of a Trustee, Director, or Manager to comply with statutory provisions as to audit may constitute misfeasance.—*Davies's Case, re Cardiff Savings Bank* (1890), 45 Ch. D. 537.

CHAPTER III

AUDITOR'S REGISTER OF AUDITS, RECORDS, NOTES, AND ROUTINE WORK

THE method of keeping audit records will take many forms and it is difficult, therefore, to suggest that any particular system should be followed. Certain general principles will, however, apply to all efficient methods.

A register of audits, containing the name of each audit and the date to which the accounts are made up, should be kept, and arranged in alphabetical order. There should be an audit file of papers relating to each audit, and it is a matter of choice whether these files are kept in alphabetical order or are numbered. If the latter procedure is adopted the appropriate number can be recorded in the register of audits. This register may be in book form or in the form of a card or loose-leaf index. At the conclusion of each audit the appropriate papers should be collated and filed away for reference and for use on a subsequent audit. It may be convenient to file certain documents separately, such as certificates from bankers and others, and forms of verification. It is also convenient to carry forward from one year to another certain fundamental documents which will have to be examined on the occasion of each audit.

AUDIT FILES OF PAPERS

Separate records should be kept for each audit comprising —

1. Information of a permanent nature.
2. Instructions as to routine work.
3. Queries arising in the course of the audit and replies thereto.

For these records it is convenient to use foolscap books or loose foolscap sheets which, when bound together, form a complete file as to the audit.

1. INFORMATION OF A PERMANENT NATURE

As regards companies—

Name of company.
The objects of the company.
Address of Registered Office.
Date of registration of company.
Date entitled to commence business.
Names of Directors.
Qualification in shares required to be held by Directors.
Names of Secretary, Solicitors and Bankers.
Complete list of books kept, names of staff responsible for the books and

transactions and their respective duties, and the system of internal control adopted to guard against error or fraud.

By reference to the prospectus, or statement in lieu of prospectus, and Memorandum and Articles of Association and Debenture Trust Deed (if any) and Minutes of Board Meeting—

Qualification and remuneration of Directors.

Agreements with Directors, Managing Directors and others for remuneration, salaries, and commission.

Amount of purchase money, how to be satisfied, and amount of goodwill.

Short particulars of material contracts and particulars of debentures or shares to be issued otherwise than for cash.

Underwriting commission (which must be stated in prospectus or statement in lieu, and authorized by the Articles of Association).

Minimum subscription upon which the company may go to allotment.

A summary of all investments whether in property, debentures, or shares, or loans on security.

The powers of the Directors, and their authority (if any) to delegate to others, and how many make a quorum of the Board.

Note. A Director who may not vote because of a personal interest in any matter under consideration must not be taken into account in reckoning a quorum.

The company's borrowing powers, and how they may be exercised.

Summaries of all binding contracts referred to in the prospectus, Memorandum and Articles of Association, or Minutes of the Directors.

Note. The Memorandum and Articles override the prospectus should there be any variation.

A summary of the authorized debenture issue (if any), what is charged to the debentures, how and when repayable and at what premium (if any), the rate of interest, and the remuneration payable to the trustees for the debenture-holders. Similar particulars of any mortgages which have been created. A summary of the classes of share capital (whether Preference, Redeemable Preference, Ordinary, Deferred, or Founders' Shares), or shares issued at a discount, and of the specific rights as to dividend attaching to each class, stating whether dividends are payable on the amount paid up in respect of share capital, or, as is unusual, upon the nominal amount of capital issued.

A summary of any articles, or regulations of Table A of Schedule I, to the appropriate Companies Act, if applicable, relating to the accounts and the Auditors, paying due regard to the sections of the Companies Act, 1948, so far as they relate to Auditors. (These Sections will be considered under their appropriate headings.)

As regards Partnerships—

Names of partners.
Date of Partnership Deed.
Duration of Partnership.

Capital to be contributed by each partner.
Rate of interest on capital and drawings.
Rate of interest on loans made by partners in addition to capital.
Division of profits.
Provisions as to drawings.
Dissolution provisions.

As regards Trust Estates—

Names of trustees.
Date of Will.
Précis of general provisions of the Will.
Summary of Estate Duty Affidavit and Corrective Affidavits (if any).
Summary of Legacies and conditions attaching thereto.
Directions as to division of Income and Residue.
Summary of special legal decisions and rules thereunder which may have to be observed according to the conditions of the Will or of the Estate.

The foregoing particulars should be recorded at the first audit and be revised so far as necessary at each periodical audit, regard being paid to any subsequent Act of Parliament requiring additional books to be kept for any purpose.

At the commencement of the audit, unless it be a continuous audit, the Auditor should have before him the Balance Sheet and the Profit and Loss Account upon which he is asked to report, with Schedules showing how the various items are constituted. Prior to the Companies Act, 1947, the Auditor was not required to report upon the Profit and Loss Account, though he had duties in regard to it which arose out of the general normal requirements of an audit, and the fact that the balance of the Profit and Loss Account was one of the items in the Balance Sheet, and called for verification.

The Auditor will have formed his view, from his knowledge or examination of the system of records of the undertaking, as to the work which he considers necessary for an effective audit. He will be assisted, however, in this regard by a preliminary scrutiny of the Balance Sheet and other accounts and schedules, if these are available, when he begins his duties. It may be, on the other hand, that he will be asked to agree the books and to prepare the accounts himself, and in the course of doing so he will make similar records.

2. Routine Work—Checking the Books

The checking of the books will be dealt with in more detail in later chapters. On undertaking an audit for the first time, the Auditor should obtain from a responsible official a list of the books in use. The extent of the detailed work will depend upon the nature of the audit, the system of internal control in force and the facilities for proving the totals in the books. The Auditor must exercise his judgment in determining how much detail work

to do. Detailed checking includes testing the correctness of the posting of items from Day Books, Journals, Cash Books, and other subsidiary books to the appropriate Ledgers. The respective items should be ticked in each book and it must be seen not only that the amount is correct but that it is posted to the correct account and to the proper side of the Ledger. The additions (or "casts") of the various books should be checked or tested; if they are numerous a saving of time is effected by the use of an adding machine. Varying forms of ticks should be adopted to denote the checking of additions, postings, cross entries, and vouching. The ticks should be made in coloured ink and it is helpful, from the point of view both of control and of facility in balancing the books, to change the colour in each year or other balancing period. Change of colour in ink often assists the later detection of errors. If a figure has been altered before the audit the Auditor should himself write the figure in his coloured ink beside his tick or make a special tick to show that it is the altered figure which has been checked. A figure should not be altered by the client's staff after it has been checked by the Auditor; if any such alteration is found by the Auditor he should at once examine it; it may be a proper correction, but it may on the other hand be fraudulent.

The extent to which checking need be done depends in some measure upon the manner in which the books have been kept. Where checking by the Auditor is curtailed, it should be varied from year to year, and at each audit a sufficient all-round test made. In this way the Auditor satisfies himself, so far as he reasonably can, that the books submitted to him are correct. Checking of this nature cannot, in the nature of things, be more than a test. The Auditor's work can be materially lightened by expert book-keeping on the part of his clients. Analysis—columnar and otherwise—in books of prime entry saves a great deal of posting in detail to the ledgers and enables the Auditor to satisfy himself more readily that the various items have been posted to the correct accounts.

The tedium of ticking postings and checking casts may sometimes be avoided by applying other tests of a more comprehensive nature. For instance, in the case of rents receivable a duly authenticated rent-roll will show the total which ought to be received. Where the columnar system of book-keeping is in use the total rents received can be readily ascertained from the Cash Book. By adding the receipts to the arrears, at the end of the year, and deducting the arrears at the beginning of the year, a complete agreement of totals should be reached. To arrive at this agreement will usually take less time than ticking and casting the Rent Ledgers, but it is necessary to ensure that the amounts

in arrear are in order and to trace the rents received through the Cash Book to the bank. The same principle may be applied to rents payable. To take another example, it is possible in the case of Insurance Companies to obtain an independent statement of the premiums which ought to have been collected in any year, and to agree that figure with the cash received, together with the agents' and other balances outstanding, and so prove the accuracy of the cash received in respect of premiums, instead of ticking off the whole of the ledgers and examining countless counterfoil receipts. In making agreements of this type the facts are likely to be sifted much more closely than by ticking and casting. An expert auditor will usually adopt these more incisive methods where it is possible to do so, but it will be appreciated that although totals may be proved in this way compensating errors and frauds as between one account and another will not be detected.

CHAPTER IV

EXAMINING THE LEDGER BALANCES FROM WHICH THE BALANCE SHEET AND ACCOUNTS ARE RAISED

THE routine of checking having been completed, the next step is a considered scrutiny of the various Ledger accounts and balances, paying regard to any legal considerations arising thereon. These matters are dealt with in the following pages. To facilitate reference they are arranged in alphabetical order as follows—

Bank Charges and Bank Interest.
Bills Payable.
Bills Receivable.
Branch Returns.
Calls in Advance.
Cash Balances, Petty Cash, and Floats.
Commission.
Corporation Duty.
Debentures and Borrowed Moneys.
Debenture Interest.
Depreciation.
Directors and their Remuneration.
Directors' Travelling Expenses and other outlays.
Discounts.
Dividends.
Drawings and Patterns.
Foreign Exchange.
Forfeited Shares.
Forward Contracts.
Freight and Carriage.
Goodwill.
Income Tax.
Insurance, and National Health Insurance.
Interest during construction charged to capital.
Interest on Bank Deposits (see Bank Charges and Interest).
Leasehold Property Concessions, etc.
Loans by Companies.
Loose Tools.
Patents.
Plant and Machinery, Engines, Furniture and Fittings.
Preliminary Expenses.
Premium on Shares.
Professional Charges—
  Accountants.
  Estate Agents.
  Patent Agents.
  Solicitors.
Purchases.

Rates and Taxes.
Rents and Ground Rents receivable or payable.
Repairs and Renewals.
Royalties.
Salaries.
Sales, Consignments, etc.
Stock in Trade.
Stocks and Shares.
Subscriptions to Trade Societies and Charities.
Sundry Expenses.
Trade Debtors.
Trade Creditors.
Transfer Fees.
Wages.
Work in Progress.

BANK CHARGES

The comparison and agreement of the Cash Book and Bank Book (see page 108) ensures that all bank charges and interest receivable or payable appearing in the Pass Book are duly entered up and taken into account. Where accounts are made up at irregular or intermediate dates, a reserve should be made for such charges as may be outstanding.

BILLS PAYABLE

The balance of this account should be agreed with a list prepared from the Bills Payable Book of bills payable not due, or not taken up at the date of the Balance Sheet, and therefore not marked off as paid in the Bills Payable Book. The individual items in the Bills Payable Account can readily be checked with the bills not marked off as paid in the Bills Payable Book. If the bills are few in number it is usually convenient to insert in the Ledger a list of outstanding bills the total of which will agree with the balance on the account. By the date of the audit probably a number of bills will have matured, and those which have been paid may be inspected by the Auditor and marked by him as having been produced to him.

The balance due on bills payable at the date of the Balance Sheet is a liability of the business and is usually shown separately. The Auditor should satisfy himself that the amount of the individual bills has been duly debited to the accounts of the appropriate creditors.

If suitably ruled, the Bills Payable Book may be treated as a Ledger account. The bills are recorded on the credit side and posted to the debit of the drawer. The cash payments are posted against the bills, the difference between the two sides being the balance outstanding on bills payable which is agreed with the total of the bills which have not been paid.

BILLS RECEIVABLE

The balance of the Bills Receivable Account should be agreed with the total of the bills on hand at the close of the year; the bills themselves should be inspected, or if they are held by the bank a certificate from the bank should be produced. If any bills which were on hand at the close of the year have been discounted before the date of audit, the proceeds should be traced to the Cash Book and Bank Pass Book.

There is a contingent liability on the drawer or an endorser in respect of bills receivable discounted which have not matured at the date of the Balance Sheet, arising out of the possibility that they may not be met by the acceptor at maturity. A list of these bills should be prepared and a note should be made on the Balance Sheet that there is a contingent liability in respect of bills under discount totalling £———.

The Auditor should see that bills receivable have been posted to the credit of the acceptor and that the bills are prima facie good, applying the tests mentioned under "Trade Debtors." As in the case of debtors, a reserve should be made for the amount of any bill likely to be dishonoured at maturity. The Auditor should inspect the books between the date of the Balance Sheet and the audit to verify that all bills maturing in that period have been met, or if not that a reserve has been made.

When bills of exchange are received from debtors, they may either be retained until maturity or discounted before maturity. In the latter case the holder receives a smaller sum than the face value of the bill, the difference depending on the current bank rate of discount and the period which the bill has still to run.

The amount received will be vouched by reference to the Bank Pass Book.

As explained under the heading "Bills Payable," the Bills Receivable Book, suitably ruled, may be used as a Ledger account.

BRANCH RETURNS

These returns take various forms. Head Office sometimes requires a copy of all the branch books with supporting vouchers. The accounts are then raised at the Head Office. In other cases returns, certified by a responsible person and if possible audited by a local Auditor (especially where the branches are abroad), are submitted. Where there are local Auditors available, a Balance Sheet and Accounts with their report are sent to the Head Office and incorporated in the Head Office accounts. The Head Office Auditor naturally refers in his report to the fact that the accounts include the certified returns. He should agree the accounts between the Head Office and the respective branches.

He should also satisfy himself that the foreign exchange has been dealt with in a proper manner and on the same principle from year to year. If any material change is made it should be explained in the accounts or referred to in the Auditor's report.

The audit of branch accounts abroad cannot, as a rule, be carried out from Head Office, and, although the facilities of air mail have reduced the time taken to obtain answers to inquiries, some delay is bound to arise. If possible, the summaries referred to can be examined from time to time by a local Auditor or by a travelling Auditor appointed by Head Office who should visit the branches periodically and certify the summaries. The provisions of the Companies Act, 1948, in regard to these accounts and returns should be carefully examined. (See page 24. See also under FOREIGN EXCHANGE, page 71.)

CASH BALANCES, PETTY CASH, AND FLOATS

The cash balances in most undertakings consist of petty cash balances and various floats. Unless the amount be trifling, it is convenient that the cash be counted on the last day of the year, or period to which the accounts relate. If, however, the counting takes place at the date of the audit, the Cash Book and the Petty Cash Book should be written up to date, the Cash Book compared with the Bank statement or Pass Book and the respective balances agreed at the time when the counting takes place. If the petty cash balances and the floats be paid into the Bank on the last day of the year or period to which the accounts relate, the counting of the money can be avoided; this is especially convenient in the case of audits in the country. In these cases a cheque is drawn to re-open the Petty Cash Account and re-establish the floats. In many ways it is more satisfactory to count the cash at unexpected dates, for it is possible for a fraudulent cashier to borrow or otherwise obtain possession of money, for a day or so, the amount so obtained being paid into bank and withdrawn on the following day.

If the cash and petty cash balances or floats are increasing from year to year, this should be looked into and explanations obtained, and in particular it should be ascertained that the maximum cash balance does not greatly exceed the expenditure which it is intended to meet from time to time.

When examining the cash in hand the Auditor may find that part of the balance consists of payments made in advance to clerks for salaries, to be repaid when the monthly or weekly salary is due and other small advances; the Auditor must satisfy himself that these advances are properly authorized, and he may consider it desirable in such circumstances to report to the Board how the

cash balance is constituted. Where possible petty cash should be operated on the imprest system, as to which see VOUCHING AND VERIFYING THE CASH, Chapter V.

CALLS IN ADVANCE

The Articles of Association of companies registered under the Companies Acts usually authorize the Directors to receive, from any member willing to advance it, all or part of the money uncalled or unpaid upon the shares held by him, and to pay interest on the money so paid in advance at an agreed rate. Table "A" contains such a clause, and provides that the interest must not exceed 5 per cent per annum, unless a higher rate has been sanctioned by the company in general meeting.

(*a*) Interest is payable out of the general assets of the company, including its available capital, and not merely out of profits. —*Dale* v. *Martin* (1883), 11 L.R. Ir. 371, C.A.

(*b*) The Directors of a company limited by shares may receive payment from a shareholder of any amounts remaining unpaid on his shares, and may pay out of capital interest on sums so paid up in advance of calls, either under Table A (if applicable), or under provisions to the same effect in the Articles of Association, provided they do so in good faith and in the honest exercise of the discretion confided to Directors.—*Lock* v. *Queensland Investment and Land Mortgage Co., Ltd.*, [1896] A.C. 461.

Calls paid in advance should be set out separately in the Balance Sheet. They are not share capital.

In a winding-up calls in advance must be repaid before a return is made to shareholders on the amount called up.—*Re Wakefield Rolling Stock Company*, [1892] 3 Ch. 165.

They are, however, postponed to the claims of the ordinary creditors of the Company.—*Re Exchange Drapery Co.* (1888), 38 Ch.D. 171.

COMMISSION

(*a*) **Payable to Directors, Managers, Travellers, Agents, and other Employees.** Reference should be made to agreements or minutes relating to commission and a list compiled of those persons who are entitled to commission, the conditions of payment and the rate of the commission. A record should be made in the audit notebook and this should be kept up to date.

Commission may be based on net sales, or on net cash received in respect of sales (in which case no commission will be paid on sales in respect of which losses arise through bad debts), or on net profits earned or only on profits distributed as dividend. Unless the agreements or minutes are carefully worded disputes may arise as to the way in which the commission should be

calculated. Disputes as to what is a sale may even arise, on the expiry of an agreement, where commission is based on sales. For example, standing timber sold but waiting to be cut and dressed might be taken partly into account in accordance with the principle of "quantum meruit."

Where the commission is based on profits *distributed* the question may arise whether profits reserved and subsequently distributed by way of bonus shares should be included, although if the profits were earned during the currency of the commission agreement it would clearly be equitable to include them.

In the absence of any agreement to the contrary commission to a Manager should be calculated on profits arrived at before charging income tax.

(See Section 196 of the Companies Act, 1948, as to particulars which must appear in the accounts of payments to Directors, page 50.)

CASE

The Balance Sheet for one year showed a certain amount of profits, including the income tax payable by the company, and the Auditors gave a special certificate that the percentage payable to the Manager was calculated on the amount of profits less income tax.

Held (1) on the principle laid down in *Attorney-General* v. *Ashton Gas Co.*, [1904] 2 Ch. 621 (affirmed, [1906] A.C. 10), that the income tax was part of the net profits available for dividends, and that the Manager was entitled to be paid his percentage on the net profits before deduction of the tax; and (2) that, the Certificate being based on a wrong principle, the Court was not bound by it.—*Johnston* v. *Chestergate Hat Manufacturing Co. Ltd.*, [1915] 2 Ch. 338.

Presumably this decision would also apply in the case of company Directors entitled to a commission on profits.

Preliminary expenses and other capital items which have been charged to profits should, in the absence of any arrangement to the contrary, be added back to profits before calculating the commission. The commission itself is a charge on profits and in the absence of an agreement to the contrary should be deducted in arriving at the amount on which it is calculated. If it is not intended that this course should be followed, the agreement or minute fixing the commission should make it clear. If the commission be a percentage on dividends paid, excluding dividends by way of bonus shares, any disputes on questions of principle are avoided, but there may be some conflict of opinion between the other Directors and a Director entitled to commission as to the amount of dividend which should be distributed.

The legal decisions, of which particulars are given hereunder,

emphasize the necessity of having expert advice when drawing up commission agreements. It is a common practice to agree that the Auditor should determine the amount of the commission and that his decision should be binding on all parties. The terms should be clearly defined so that he may be in a position to give the decision.

The amount appearing in the accounts as commission should include not only what has been actually paid, but also any sums accrued but not paid.

When an agent or traveller has received money in advance in respect of commission to be earned by him in the future, the amount so advanced should be treated as an ordinary cash advance, and the agent should be included among the debtors, or stated separately.

The Auditor should ascertain that the commission, brokerage, etc., has not been participated in by any person acting in a fiduciary capacity towards the company, unless the participation is expressly provided for in the Special Act of Parliament or in the Articles of Association relating to the company.

(*b*) **On the Underwriting or Placing of Debentures or Shares.** Section 53 of the Companies Act, 1948, continuing Section 89 of the Companies (Consolidation) Act, 1908, provides that it shall be lawful for limited companies to pay a commission in connexion with the issue of share capital. The Eighth Schedule, paragraph 3 (*c*) of the 1948 Act, following earlier Acts, enacts that where a company has paid any sums by way of commission in respect of any shares or debentures, or allowed any sums by way of discount in respect of any debentures, the total amount so paid or allowed, or so much thereof as has not been written off, shall be stated in every Balance Sheet until the whole amount thereof has been written off. The Auditor should see that the commission paid is in accordance with the agreement entered into and that the provisions of paragraph 3 of the Eighth Schedule are duly observed in the accounts of the company.

Section 53 deals with the payment of underwriting commission and commission on placing shares. The following conditions must be observed—

(*a*) The payment of the commission must be authorized by the Articles.

(*b*) The commission paid or agreed to be paid must not exceed 10 per cent of the issue price of the shares or such lower amount or rate as is authorized by the Articles.

(*c*) The amount of rate per cent of the commission paid must be disclosed—

(i) in the case of shares offered to the public for subscription, in the prospectus;

(ii) in the case of shares not offered to the public for subscription, in the statement in lieu of prospectus, or in a statement in the prescribed form signed in like manner as a statement in lieu of prospectus and delivered before the payment of the commission to the Registrar of Companies for registration, and, where a circular or notice, not being a prospectus, inviting subscription for the shares is issued, also disclosed in that circular or notice.

(*d*) The number of shares which persons have agreed for a commission to subscribe absolutely is disclosed as in (*c*).

Unless the foregoing conditions are fulfilled, a company may not apply its shares or capital money in payment of the above-mentioned commissions, but the restrictions of this Section would not apply to their payment out of profits, and payment in this way is lawful if the Articles so authorize.

Commission paid under Section 53 must be set out as a separate item in the Balance Sheet until completely written off and may not be included under "Preliminary Expenses."

Frequently, brokerage is paid to brokers whose clients subscribe for shares. This brokerage on placing shares is not subject to the restrictions of Section 53. The client's application form will bear the brokers' stamp, and this should be noted in vouching the payment of the brokerage.

CASES

The payment by a limited company of a reasonable amount of money to brokers by way of commission or brokerage for placing shares is not an act *ultra vires* the company.—*Metropolitan Coal Consumers' Association* v. *Scrimgeour*, [1895] 2 Q.B. 604. (In this case 2½ per cent was authorized.)

The payment of brokerage or commission to a stockbroker for placing a company's shares was in 1889 held to be an improper application of its capital, and not authorized even by a power given by the Memorandum of Association to do whatever may be "conducive to" the specified objects of the Company.—*Re Faure Electric Accumulator Co.* (1889), 40 Ch.D. 141.

This case, however, has been interpreted by the Court of Appeal to have referred to "payments of commission to brokers . . . not *bona fide* payments for work and labour done—that they were not payments in the ordinary way of business, but rather in the nature of bribes." . . . "In any case, when it is made out that the services of the broker are reasonably necessary, that the brokers are properly employed in the issue of the capital of the company, and that the payment of a commission of so much per share is a fair and just repayment for services rendered, there is no ground, either of reason, of justice, or of principle, why the

payment shall not be held to be *intra vires* and unimpeachable."—*Metropolitan Coal Consumers' Association* v. *Scrimgeour*, [1895] 2 Q.B. 609.

Section 89, Subsection (3) of the Companies (Consolidation) Act, 1908, gave a statutory sanction to this decision of the Court of Appeal, and Section 53 of the Companies Act, 1948, continues it.

In estimating the amount of the secret profit for which a promoter was accountable to a company he was held entitled to be allowed the legitimate expenses incurred by him in forming and bringing out the company, such as the reports of Surveyors, the charges of Solicitors and Brokers, and the cost of advertisements; but not a sum of money which he had expended in obtaining from another person a guarantee for the taking of shares.—*Lydney and Wigpool Iron Ore Co.* v. *Bird* (1886), 33 Ch.D. 85.

CORPORATION DUTY

This is a duty imposed by the Revenue Act, 1885, upon corporate bodies, as some compensation to the Revenue, on account of the fact that certain of their property escapes liability to probate and legacy duties. The duty is assessed at the rate of 5 per cent on the annual value, income or profits accruing to the corporation. The duty is also imposed on all unincorporated bodies, such as clubs, societies, professional bodies, etc., having a permanent succession and existence.

Certain exemptions are allowed, including *inter alia* property held for religious or charitable purposes, or for the promotion of education, literature, science, and the fine arts. Exemption is also allowed in respect of property which is held in such a manner as to be liable to legacy or succession duty. Limited liability companies and local government bodies established under Act of Parliament are not liable.

Annual Returns of the property held must be made to the Commissioners of Inland Revenue, by whom the duty is assessed and collected. Appeals may be made to the High Court.

This duty fell into desuetude for practical purposes for many years, but it has now been revived. It should not be confused with Corporation Profits Tax, which was abolished in 1924.

DEBENTURES AND BORROWED MONEYS

The Auditor should ascertain that the company has power, under its Memorandum of Association to borrow, or has an implied right to do so owing to the nature of its business. By reference to the Articles of Association, the Auditor should ascertain the power of the Directors to exercise the borrowing powers of the company; the restrictions, if any, as to the total

amount to be borrowed; and any other conditions governing the borrowing powers. The amount borrowed should be authorized by a Minute passed at a properly constituted meeting of the Directors. In the case of borrowing by debenture, the Auditor should note the conditions contained in the debenture trust deed or debentures. The conditions may provide for repayment of the debentures or loans at a premium or there may be a stipulation for a Sinking Fund to be created for the repayment of the principal, and premium on redemption, if any, and he should see that the conditions have been duly complied with, and generally speaking that the debentures have been lawfully issued.

Since the outbreak of war in 1939, there has been a control, effected in Regulation 6 of the Defence (Finance) Regulations, on issues of capital and borrowings. The control applies to issues of securities, whether for cash or otherwise, and to the raising of unsecured loans; it extends to mortgages. Modifications take place from time to time and under a Capital Issues Exemption Order of May, 1945, the consent of the Treasury is not now required to capital issues and other transactions to which Government control applies, if the total does not exceed £50,000 within twelve months. In the case of new companies, this exemption does not apply until the Treasury has given a special direction to the company.

Auditors should therefore be careful to notice whether the company has observed the regulations in respect of any borrowings or issues of capital. The penalties for disregard of the regulations are heavy.

Mortgage debentures are debentures secured by a charge, fixed or floating, on the property of the company; debentures having no such charge, that is, naked debentures, are only certificates of indebtedness.

Where debentures are being purchased out of a Sinking Fund, the Auditor should ascertain whether the conditions under which the Sinking Fund is created or the debenture issued permit of the company keeping the debentures alive for re-issue.

The total due in respect of specific mortgages on property is sometimes stated in the Balance Sheet as a deduction from the total book value of the property so mortgaged, and the balance extended. It is preferable, however, to show the total of the mortgages on the liabilities side of the Balance Sheet and the properties on the assets side, and a note should be made against the former to the effect that they are secured (Companies Act, 1948, Schedule 8 (9)).

Where a company is buying its own debentures, the relative debentures or debenture certificates should be produced to the Auditor in the course of verifying the investments.

If the Articles of Association restrict the borrowing powers to the amount of subscribed share capital, and some of the shares have been issued as fully paid, the borrowing powers are limited to an amount equal to the share capital shares actually subscribed. Should the directors inadvertently borrow up to the amount of the issued capital where this has not all been subscribed but some issued as fully paid, it would be necessary to have the Articles amended and the loans ratified by the shareholders in general meeting.

Table "A" provides, in clause 79, that the amount for the time being remained undischarged of moneys borrowed or raised by the directors for the purposes of the company (otherwise than by the issue of share capital) shall not at any time exceed the nominal amount of issued share capital of the Company without the sanction of the Company in general meeting.

Debenture-holders must be furnished without charge with a copy of the last Balance Sheet of the company, including every document required by law to be annexed thereto, together with a copy of the Auditor's Report on the Balance Sheet. (Companies Act, 1948, Section 58.)

Debenture-holders are creditors of the company, but the amount due to them should be kept distinct from the sums due to ordinary creditors. In a few companies they have the privilege of voting at meetings and also of having their own Auditor.

Companies sometimes issue debentures at a discount. In such cases, as the liability is to pay back to the debenture-holders the nominal amount at some future date, however remote, the nominal amount of the debentures issued must be included on the debit side of the Balance Sheet. The discount must be either written off in the period during which the debentures were issued, or, if it is not prohibited by the Memorandum and Articles of Association, the writing off may be spread over a term of years, leaving the proportion not written off as a nominal asset in the Balance Sheet.

Specific and Floating Charges on Property. A specific charge is one that, without more, fastens on ascertained and definite property, or property capable of being ascertained and defined; a floating charge is ambulatory and shifting in its nature, hovering over and, so to speak, floating with the property which it is intended to affect, until some event occurs or some act is done which causes it to settle and fasten on the subject of the charge within its reach and grasp.—*Illingworth* v. *Houldsworth*, [1904] A.C. 358.

Register of Mortgages. Every limited company, and also every company incorporated by special Act of Parliament, is obliged to keep a Register of Mortgages which specifically affect properties of the company. (Companies Act, 1948, Section 104.)

This Register should contain a short description of the property

mortgaged or charged, each mortgage or charge, and (except in the case of securities to bearer) the names of the mortgagees or persons entitled.

When debentures are issued to bearer it is the practice to register the name of the person to whom each debenture is first issued. When a debenture trust deed is executed it is the practice to register the Trustees or the persons entitled to the charge.

The Companies Act, 1948 (Section 95), requires registration with the Registrar of Companies of all charges covered by the section, and the instrument, if any, by which the charge is created or evidenced within twenty-one days after its creation.

A reference to the Register of Mortgages should show what charges have been created. Where any debentures, mortgages, or other charges have been paid off, the cancelled mortgage debentures or debenture certificates should be seen by the Auditor.

Where a company has, either before or after the commencement of the Companies Act, 1948, deposited any of its debentures to secure advances from time to time on current account or otherwise, the debentures shall not be deemed to have been redeemed by reason only of the account of the company having ceased to be in debit whilst the debentures remained so deposited. (Companies Act, 1948, Section 90 (3).) In the circumstances mentioned, where debentures have been issued as collateral security for an overdraft or otherwise, the amount of the overdraft or loan is the figure which will appear as a liability in the Balance Sheet and not the issue as collateral, the amount of which should be entered in the narrative.

CASES

No satisfactory definition of a debenture has so far been given. Chitty, J., discussed the term very fully in *Edmonds* v. *Blaina Furnaces Co.* (1887), 36 Ch.D. 215, and stated, "The term itself imports a debt, an acknowledgment of a debt, and, speaking of the numerous and various forms of instruments which have been called debentures without anyone being able to say the term is incorrectly used, I find that, generally, if not always, the instrument imports an obligation or covenant to pay. This obligation or covenant is, in most cases at the present day, accompanied by some charge or security; so that there are debentures which are secured, and debentures which are not secured."

Section 455 of the Companies Act, 1948, gives the following meaning to a debenture for the purposes of the Act —

> Debenture includes debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of the Company or not.

A company incorporated by Statute can borrow money only within the limits and in the manner authorized by Statute.

Where, therefore, there is no power to borrow, it is *ultra vires* to overdraw the banking account, this being in effect borrowing.—*Blackburn Building Society* v. *Cunliffe Brooks & Co.*, (1882), 22 Ch.D. 61.

If a company is authorized to borrow up to a certain amount, that means that it may not borrow beyond that amount, and it is well established that any attempt by the company to do so is *ultra vires.*—*Payne* v. *The Cork Co., Ltd*, [1900] 1 Ch. 316.

When property is conveyed by a company to trustees to secure debentures or debenture stock, and the trust deed empowers the trustees to sell any part of the property conveyed before the security is enforceable, and with the proceeds to purchase other property, which is to be held upon the like trusts, and the trustees sell part of the property, and with the proceeds of sale purchase other property which is conveyed by the vendor to them upon the trusts of the trust deed, the company not being a party to the conveyance, the conveyance is not a mortgage or charge requiring registration under this section.—*Bristol United Breweries, Ltd.* v. *Abbot*, [1908] 1 Ch 279.

A deed by which property covered by a floating charge is subsequently made the subject of a specific charge is required to be registered.—*Cornbrook Brewery Co., Ltd.* v. *Law Debenture Corporation, Ltd.*, [1904] 1 Ch. 103.

A floating security is an equitable charge on the assets for the time being of a going concern. It attaches to the subject charged in the varying condition in which it happens to be from time to time.—*Government Stocks, etc., Co., Ltd.* v. *Manila Railway Co., Ltd.*, [1897] A.C. 86.

The Act requires registration, not of the instrument creating the charge, but of the property charged. It extends therefore to the case where there is no instrument, such as where the security is created by deposit.—*Smith's Case, re South Durham Iron Co.* (1879), 11 Ch.D. 579, 585.

A company incorporated under the Companies Clauses Consolidation Act, 1845, cannot, without express powers, issue bills of exchange.—*Bateman* v. *Mid-Wales Railway Co.* (1865), L.R. 1 C.P. 499.

It can, however, incur debts in the ordinary course of its business.

In October, 1904, a company raised £50,000 by 5000 £10 Income Bonds, repayable in seven years with a bonus of £25 exclusively out of the net profits from time to time of the company. By the conditions the registered holders of these bonds might exchange them for first mortgage debentures, but this was not to affect the bonus; by another condition the company had the option at any time after December, 1906, of giving notice to pay off the bonds, and six months afterwards the principal (if not

converted) and the bonus were to become payable. In 1909, most of the bonds had been converted into debentures, leaving only the £25 bonus payable; no profits had been earned, but it was proposed to extinguish this £25 by the issue, in exchange for the bonus, of twenty fully paid-up new shares of the nominal value of £1 each. An action having been brought to test the validity of this proposed issue of further capital—

It was held by the Court of Appeal that there was nothing in the bond which authorized the company to turn a contingent liability on income into a present liability payable out of capital; that the proposed arrangement with the bondholders was equivalent to a payment of dividends out of capital and provided a means of issuing shares at a discount, for there was no consideration given to the company for the issue of these new shares; and that on these grounds the arrangement was *ultra vires* the company and must be restrained.—*Bury* v. *Famatina Development Corporation, Limited*, [1909] 1 Ch. 754.

There is nothing in the Companies Acts expressly or by necessary implication prohibiting a limited company from mortgaging its unpaid capital; consequently, where power to mortgage future or unpaid-up capital is given by the Memorandum of Articles of Association, a mortgage of such is valid.—*Re Pyle Works* (1890), 44 Ch.D. 534. This decision was approved by the Judicial Committee of the Privy Council on an appeal from the Supreme Court of New South Wales, the Companies Act being for this purpose identical with our Act of 1862, on the 6th March, 1895.—*Newton* v. *Debenture-holders, etc., of Anglo-Australian, etc., Co.*, [1895] A.C. 244. The Companies Act, 1948, Section 95 (2) (*b*) implies that uncalled share capital can be mortgaged or charged. But a company has no power to create any charge on that portion of its capital which, in accordance with a resolution passed under that Section, can only be called up in the event of and for the purposes of the company being wound up (see page 297).

The right of a creditor or member of a company to inspect the Register of Mortgages includes a right to take copies of the Register.—*Nelson* v. *Anglo American Land Mortgage Agency Co.*, [1897] 1 Ch. 130.

DEBENTURE INTEREST

The Auditor should agree the total sum paid with a schedule of the payments to the individual debenture-holders as shown by the Register of Debenture-holders, setting out the gross amount, the period covered, the rate of interest, tax deducted (unless issued free of tax), and the net amount payable. Coupons or Interest Warrants should be produced in support of the individual payments. A separate Banking Account should be opened for

debenture interest, and the balance of the account agreed with the unclaimed interest as shown by an inspection of the schedule in which the individual amounts are marked off in course of comparison of the list with the coupons or warrants. If periodical payments be made inclusive of repayments of capital, as well as of payments of interest, it should be verified that the payments are correctly divided as between capital and income, for which purpose a redemption schedule should be available or be raised. Occasionally, debentures or bonds, sometimes called "Income Bonds," on which the interest is payable only *if the profits of the year* admit of payment, are issued. Whether or not interest is payable in any year on bonds of this character may be a contentious point depending on questions of depreciation, the right to create reserves and to write down capital assets of a nominal nature out of profits, and so forth. The conditions attached to debentures or bonds of this type require, therefore, to be carefully studied.

The Auditor should see that tax at the proper rate, at present the standard rate at the date of payment, is deducted from all payments of debenture interest, and that provision is made for all interest accrued up to the date of the accounts.

Interest not claimed should not be taken to the credit of Profit and Loss Account until the claim is statute-barred, and not even then unless the Directors have decided not to recognize the claim should it subsequently be made.

CASES

In the case of a railway company incorporated by a special Act, authorizing it to issue debenture stock, bearing interest, subject to Part III (which includes Sections 22 and 27) of the Companies Clauses Act, 1863, which issued debenture stock, for which it gave certificates under its common seal, and also a warrant for interest under the signature of its Secretary, it was held that, the liability being statutory, the period of limitation was twenty years.—*Re Cornwall Minerals Railway Co.*, [1897] 2 Ch. 74.

Interest on debentures issued to raise funds for construction may be charged to capital as part of the cost of construction.—*Hinds* v. *Buenos Ayres Grand National Tramways Co., Ltd.*, [1906] 2 Ch. 654.

DEPRECIATION

An adequate provision for depreciation is a necessary charge in arriving at profits, and it should be provided for whether there are profits or not. The provision to be made should be settled in the first place by the Directors and officials of the company. The

Auditor should satisfy himself that the provision made is sufficient; if he is not satisfied he should refer to the matter in his report to the members.

Depreciation arises mainly through—

(*a*) Wear and tear of assets, such as plant and machinery, which may also be superseded by new inventions and become obsolete, eventually realizing only scrap value.

(*b*) Decrease in value owing to effluxion of time of leasehold property, concessions, and patents. It sometimes happens that leasehold property improves in value during its lifetime, but even if the property be realized, the increase in the case of a company not dealing in leases is of the nature of a capital profit.

There are several methods of making provision for depreciation, of which the principal are the following—

(*a*) The fixed instalment method, whereby a given fixed percentage is written off the original cost of the asset each year, reducing it to nil at the end of its life. This is suitable in the case of leases, patents, etc., where the length of the life is known.

(*b*) The reducing instalment method, whereby a fixed percentage is written off the reducing balance of the asset each year. Repairs and small renewals are charged to revenue. Although the depreciation charge reduces year by year, it is probable that the cost of repairs will increase as the asset gets older: for this reason the burden borne by Revenue will not vary much.

(*c*) The annuity method, whereby the asset is assumed to earn interest and a fixed amount is written off every year which, after adding interest to the asset account, will reduce the asset to nil at the end of its life.

Sometimes it is desired that the amounts set aside each year should be invested outside the business so that the cash will be available at the end of the life of the asset, when it is desired to replace it. In this case the fund accumulates at compound interest, the interest received each year being invested also, and the yearly provision is calculated on the basis that when this interest is added a sum equal to the original cost of the asset will be available for its replacement at the end of its life.

Alternatively an endowment policy may be taken out for the sum required, in which case the amount of the annual premium is charged to Revenue in lieu of depreciation and credited to a Redemption or Replacement Fund, the premiums themselves, when paid, being debited to the Policy Account.

Revaluation. Where it is not possible to estimate the likely depreciation, or the life of an asset, a revaluation should be made each year, and any diminution written off to Revenue.

For the purpose of ascertaining whether the amounts charged

for depreciation as submitted to him for audit are proper, the Auditor has five points to consider—

1. The original cost of the asset.
2. The outlay, if any, of a capital nature which has since been made on the asset.
3. The estimated efficient life.
4. The estimated value at end of efficient life of asset.
5. Having regard to all these points, whether the value in the books is a reasonable one.

The original cost of the asset will, in most cases, be ascertainable from the books. The Auditor should ascertain whether the asset was new when it was acquired, or whether it had been in use by any previous owner. This will affect the rate and the period of depreciation. There must also be taken into consideration whether there has been any additional outlay thereon of a capital nature, or whether a part, or even the whole, of such outlay ought to have been charged against revenue.

It is a question for consideration, particularly at a time of advancing costs, whether in addition to providing depreciation which will have the effect of writing off the original cost of an asset over the appropriate period, revenue should also bear a charge to provide for estimated increased cost of replacement. An asset which cost a given sum at the time of purchase may well cost twice that sum to replace when it has reached the end of its useful life, but the new asset may have little or no greater earning capacity than the old one. In theory, the increased cost, as a capital charge, may be said to be an item for which, if necessary, additional capital should be provided. But this is not always a very practical way of dealing with the matter and it is desirable, if provision can be made without embarrassment, to set aside a reserve to meet this addition to the cost. In some cases the amount of the replacement cost may not be sufficient to cause any difficulty in the current finance of the undertaking; in other cases it may be substantial, and difficulty might arise if no provision had been made. The matter of depreciation may be dealt with further under the following headings—

1. Leases and similar wasting assets (see page 77).
2. Loose tools (see page 81).
3. Plant, machinery, engines, furniture and fittings (see page 82).
4. Stock (see page 94).
5. Stocks and shares (see page 92).

DIRECTORS AND THEIR REMUNERATION

The amount of the remuneration of the Directors may be fixed by the private Act incorporating the company, or by the Articles

of Association, or by the shareholders by resolution at the general meeting. Without such an authority the Directors may not draw remuneration. It is usually a fixed sum. Sometimes however, there is payable an additional sum calculated by way of a percentage on sales, income, gross profit or net profit, or in some other way. Possibly a combination of these bases of remuneration may be adopted. If the Directors have not received the amount due to them, any amount still owing must be included as a liability in the Balance Sheet.

The question of Directors' remuneration, and the form which it may take, has been under considerable review in recent years, and far-reaching provisions are made in the Companies Act, 1948, in regard to the manner in which these items are to be shown in the accounts. One of the provisions makes it unlawful for a company to pay remuneration to a Director (whether as Director or otherwise) free of income tax, except under a contract which was in force on the 18th July, 1945, and which provides expressly, and not by reference to the Articles, for payment of tax-free remuneration. (See Section 189 (1) page 54.) The Finance Act, 1948, also makes new provisions for the taxation of Directors' emoluments and brings under the heading of income items which have hitherto been regarded as outside the incidence of taxation. The implications of the Finance Act, 1948, are, however, outside the scope of the present work.

The Companies Act, 1948 (Section 196), provides—

196. (1) In any accounts of a company laid before it in general meeting, or in a statement annexed thereto, there shall, subject to and in accordance with the provisions of this section, be shown so far as the information is contained in the company's books and papers or the company has the right to obtain it from the persons concerned—

(*a*) the aggregate amount of the directors' emoluments;

(*b*) the aggregate amount of directors' or past directors' pensions; and

(*c*) the aggregate amount of any compensation to directors or past directors in respect of loss of office.

(2) The amount to be shown under paragraph (*a*) of sub-section (1) of this section—

(*a*) shall include any emoluments paid to or receivable by any person in respect of his services as director of the company or in respect of his services, while director of the company, as director of any subsidiary thereof or otherwise in connexion with the management of the affairs of the company or any subsidiary thereof; and

(*b*) shall distinguish between emoluments in respect of services as director, whether of the company or its subsidiary, and other emoluments;

and for the purposes of this section the expression "emoluments," in relation to a director, includes fees and percentages, any sums paid by way of expenses allowance in so far as those sums are charged to United Kingdom income tax, any contribution paid in respect of him under any pension

scheme and the estimated money value of any other benefits received by him otherwise than in cash.

(3) The amount to be shown under paragraph (*b*) of the said subsection (1)—

(*a*) shall not include any pension paid or receivable under a pension scheme if the scheme is such that the contributions thereunder are substantially adequate for the maintenance of the scheme, but save as aforesaid shall include any pension paid or receivable in respect of any such services of a director or past director of the company as are mentioned in the last foregoing subsection, whether to or by him or, on his nomination or by virtue of dependence on or other connexion with him, to or by any other person; and

(*b*) shall distinguish between pensions in respect of services as director, whether of the company or its subsidiary, and other pensions;

and for the purposes of this section the expression "pension" includes any superannuation allowance, superannuation gratuity or similar payment, and the expression "pension scheme" means a scheme for the provision of pensions in respect of services as director or otherwise which is maintained in whole or in part by means of contributions, and the expression "contribution" in relation to a pension scheme means any payment (including an insurance premium) paid for the purposes of the scheme by or in respect of persons rendering services in respect of which pensions will or may become payable under the scheme, except that it does not include any payment in respect of two or more persons if the amount paid in respect of each of them is not ascertainable.

(4) The amount to be shown under paragraph (*c*) of the said subsection (1)—

(*a*) shall include any sums paid to or receivable by a director or past director by way of compensation for the loss of office as director of the company or for the loss, while director of the company or on or in connexion with his ceasing to be a director of the company, of any other office in connexion with the management of the company's affairs or of any office as director or otherwise in connexion with the management of the affairs of any subsidiary thereof; and

(*b*) shall distinguish between compensation in respect of the office of director, whether of the company or its subsidiary, and compensation in respect of other offices;

and for the purposes of this section references to compensation for loss of office shall include sums paid as consideration for or in connexion with a person's retirement from office.

(5) The amounts to be shown under each paragraph of the said subsection (1)—

(*a*) shall include all relevant sums paid by or receivable from—

(i) the company; and
(ii) the company's subsidiaries; and
(iii) any other person;

except sums to be accounted for to the company or any of its subsidiaries or, by virtue of section one hundred and ninety-three of this Act, to past or present members of the company or any of its subsidiaries or any class of those members; and

(*b*) shall distinguish, in the case of the amount to be shown under paragraph (*c*) of the said subsection (1), between the sums respectively

paid by or receivable from the company, the company's subsidiaries and persons other than the company and its subsidiaries.

(6) The amounts to be shown under this section for any financial year shall be the sums receivable in respect of that year, whenever paid, or, in the case of sums not receivable in respect of a period, the sums paid during that year, so, however, that where—

(*a*) any sums are not shown in the accounts for the relevant financial year on the ground that the person receiving them is liable to account therefor as mentioned in paragraph (*a*) of the last foregoing sub-section, but the liability is thereafter wholly or partly released or is not enforced within a period of two years; or

(*b*) any sums paid by way of expenses allowance are charged to United Kingdom income tax after the end of the relevant financial year;

those sums shall, to the extent to which the liability is released or not enforced or they are charged as aforesaid, as the case may be, be shown in the first accounts in which it is practicable to show them or in a statement annexed thereto, and shall be distinguished from the amounts to be shown therein apart from this provision.

(7) Where it is necessary so to do for the purpose of making any distinction required by this section in any amount to be shown thereunder, the directors may apportion any payments between the matters in respect of which they have been paid or are receivable in such manner as they think appropriate.

(8) If in the case of any accounts the requirements of this section are not complied with, it shall be the duty of the auditors of the company by whom the accounts are examined to include in their report thereon, so far as they are reasonably able to do so, a statement giving the required particulars.

(9) In this section any reference to a company's subsidiary—

(*a*) in relation to a person who is or was, while a director of the company, a director also, by virtue of the company's nomination, direct or indirect, of any other body corporate, shall, subject to the following paragraph, include that body corporate, whether or not it is or was in fact the company's subsidiary; and

(*b*) shall for the purposes of subsections (2) and (3) be taken as referring to a subsidiary at the time the services were rendered, and for the purposes of subsection (4) be taken as referring to a subsidiary immediately before the loss of office as director of the company.

Section 196 makes a distinction, in paragraph (1), (*a*), (*b*), and (*c*), between various forms of remuneration which are not easy to define. As will be seen from paragraph (2) of the section, the expression "emoluments" in relation to a Director distinguishes between payments for services as a Director and other emoluments. Broadly speaking, such a distinction, which must be made in the accounts, would be between Directors' fees and Directors' remuneration where remuneration would be taken to apply to the payments which a Director who holds a managerial or executive position receives in the latter capacity. In the opinion of Counsel, obtained by the Institute of Chartered Accountants, the view is expressed that emoluments in respect of services as a Director are fees which would normally be those fixed by the Articles or by the

company in general meeting, but would include, in their opinion, remuneration paid to Directors for special services, as, for example, for going or residing abroad or for serving on Committees.

Section 196 (2) provides that emoluments in relation to a Director include—

(*a*) Fees and percentages.

(*b*) Any sums paid by way of expenses allowance in so far as those sums are charged to United Kingdom Income Tax.

(*c*) Any contribution paid in respect of him under any pension scheme.

(*d*) The estimated money value of any other benefits received by him otherwise than in cash.

It has been the custom in the past, in many cases, to make allowance for expenses in a round sum which is paid to the Director in addition to his remuneration. Frequently, the full amount has not been accepted by the Inland Revenue Authorities as established expenditure allowable as a charge in arriving at profits. The above-mentioned provision will mean that, so far as these sums are not allowed as a charge for income tax purposes, they must be included under the heading of Directors' Emoluments.

Similarly, a Director may receive certain benefits, as a holder of his office, otherwise than in cash. Such benefits have been described more fully in the Finance Act, 1948, Section 39 (1) as provision of living or other accommodation, entertainment, domestic or other services or other benefits or facilities of whatsoever nature. For income tax purposes, these are regarded as perquisites of the office of Director and assessable to tax. The opinion of Counsel, obtained by the Institute of Chartered Accountants, in regard to the duty of an Auditor on this matter is as follows—

In our opinion it is the duty of the Auditor to make inquiry from the company and from the Directors in order that he may verify the benefits obtained by the Directors otherwise than in cash. This duty is imposed by the Ninth Schedule which requires an Auditor to report whether in his opinion and to the best of his information and according to the explanations given to him the accounts give the information required by the Act. Section 196 (1) requires the aggregate of the Directors' emoluments to be shown in the accounts or in a statement annexed thereto, and subsection (8) imposes a direct obligation on the Auditor to supplement the information in his report, if it is deficient. The Auditor must assess the value of the benefits to the best of his ability and satisfy himself that the value of benefits has been shown at a fair figure.

We do not think that an Auditor could place himself in a position to perform his duties unless he obtained an assurance from the Directors that no benefits had been received otherwise than in cash or alternatively a statement of such benefits.

In our opinion the fact that an independent quorum of the Board passes a resolution to the effect that some particular expense is incurred for the

benefit of the company and not for the benefit of a Director is in no way conclusive of the facts. The two things are not necessarily in opposition. An expense although incurred for the benefit of the company may none the less benefit a Director, e.g. the Managing Director of a hotel lives with his family in a flat in the hotel free of charge. This would no doubt be a benefit to the company but it is also a benefit to the Director and its value would be an emolument.

The recommendation made by the Council of the Institute on this matter is as follows—

Where the notice to be given by each Director under Section 198 (1) is not given in writing in the form of a statement of pensions, compensation, and emoluments, including all benefits received otherwise than in cash, approved by the Board and recorded in the minutes, the Auditor should require (under Section 162 (3) of the Companies Act, 1948) such a statement in writing approved by resolution of the Board.

The question of tax-free payments to Directors is dealt with in Section 189 as follows—

189. (1) It shall not be lawful for a company to pay a director remuneration (whether as Director or otherwise) free of income tax or of income tax other than surtax, or otherwise calculated by reference to or varying with the amount of his income tax or his income tax other than surtax, or to or with the rate or standard rate of income tax, except under a contract which was in force on the eighteenth day of July, nineteen hundred and forty-five, and provides expressly, and not by reference to the articles, for payment of remuneration as aforesaid.

(2) Any provision contained in a company's articles, or in any contract other than such a contract as aforesaid, or in any resolution of a company or a company's Directors, for payment to a Director of remuneration as aforesaid shall have effect as if it provided for payment, as a gross sum subject to income tax and surtax, of the net sum for which it actually provides.

(3) This section shall not apply to remuneration due before the commencement of this Act or in respect of a period before the commencement of this Act.

Where the remuneration of the Directors is either partly or entirely a percentage of the profits, whether such profits are or are not distributed by way of dividend, an Auditor must satisfy himself that provision has been made for all outstanding charges in a fair and adequate manner.

A difficult question may arise when the Directors of financial companies are entitled to a percentage on the profits, for it is not always easy to determine the profits on which the necessary calculation is to be based. The ascertainment of profits of companies of this description is referred to under "Profits of Issuing Houses."

Where the remuneration of the Directors is left in the hands of the shareholders, to be voted at the general meeting, a statement should be made on the face of the accounts that the profit shown is subject to the amount which the shareholders may vote to the

Directors for their services during the period embraced by the Accounts.

When a Managing Director or Manager of a company is paid either partly or entirely by a commission on the "net profits," the Auditor may have difficulty in satisfying himself whether the amount inserted in the accounts has been arrived at on a proper basis. The cases mentioned later show the necessity for careful consideration of the matter, and it is advisable, where there is doubt, for a legal opinion to be obtained before the accounts are signed by either the Directors or the Auditor.

Where the Directors or Managers are entitled to a commission on the "profits" or "the profits available for distribution" the commission itself is not a charge in arriving at the net profits, nor is income tax, unless there is a provision to the contrary in the agreement.—*Edwards* v. *The Saunton Hotel Co. Ltd.*, [1942] T.L.R. 359.

When the Directors receive the maximum remuneration authorized by the Articles of Association, the shareholders have no power to pass a resolution voting the Directors the payment of the income tax thereon in addition, as Articles fixing the qualification and remuneration of Directors being binding on the company as well as the Directors, the company cannot ratify an act of the Directors in contravention of such Articles without first altering them by special resolution.—*Boschoek Proprietary Co., Ltd.* v. *Fuke*, [1906] 1 Ch. 148; 75 L.J. Ch. 26.

By reference to the Articles of Association the Auditor should ascertain and agree the amount payable and see that it is duly taken into account. If the fees are paid periodically, or for broken periods, as in the case of a Director ceasing to act, he should see that the Articles express that the fees are to be *at the rate of* so much per annum, otherwise the fees are only payable for a complete year, or whatever term is fixed by the Articles.—*Re Central de Kaap Gold Mines*, [1899] W.N. 216; 69 L.J.Ch. 18; 7 Manson 82. There is usually a power in the Articles enabling the shareholders in general meeting to increase the fees.

If the Directors renounce their fees, a minute to that effect passed at a meeting at which all the Directors are present, and signed by the chairman, may suffice as evidence, but strictly speaking the renunciation, being without consideration, ought to be under seal. When it is left to the shareholders in general meeting to fix the remuneration, the Auditor should see a minute signed by the chairman of the meeting.

In the case of a Managing Director, it should be seen that all payments are in accordance with the company's agreement with him. In whatever way the fees be fixed provision should be made for the fees in the accounts. If no provision is made, the Auditor should draw attention to the fact in his report.

CASES

The assets of an incorporated company, even when a private company, are not the property of the shareholders for the time being, and if the Directors misapply those assets by applying them to purposes for which they cannot be lawfully applied by the company itself, the company, upon being properly set in motion, can make the directors liable. Directors cannot pay themselves for their services, or make presents to themselves out of the company's assets, unless authorized to do so by the instrument regulating the company, or by the shareholders at a properly convened meeting.—*Re George Newman & Co.*, [1895] 1 Ch. 674.

By an Agreement of April, 1893, a company arranged with the plaintiff to manage, develop, and realize his estates on certain terms as to remuneration, and in the course of such management employed one of its Directors, who was a Solicitor, to act professionally for the estates and paid his bill of costs, which included profit items; another Director, who was an estate agent, to manage at a salary a business connected with the estates; another Director, who was an auctioneer, to act as auctioneer on all sales of the estates at the usual commission; and gave its secretary, who was a Chartered Accountant, an additional salary for keeping the books of the estates, which were of a complex nature —

Held, that on the construction of the agreement the company were not entitled to make any charge for or in respect of the keeping of the accounts required to be kept by the company.

Held also that the Directors stood in a fiduciary relation to the company, but not to the plaintiff, and that the profit, costs, salary and commission paid to the Directors in their professional capacity might be allowed in taking the accounts between the plaintiff and the company under the Agreement.—*Bath* v. *Standard Land Co., Ltd.*, [1911] 1 Ch. 618.

By a clause in an agreement between a company and its Manager the latter was to receive a fixed salary, and also, as soon as the profits for the year had been ascertained and certified by the company's auditors, a percentage of the "net profits (if any) of the company for the whole year." The agreement provided as follows—

"For the purpose of this clause the words 'net profits' shall be taken to mean the net sum available for dividends as certified by the Auditors of the company after payment of all salaries" and other items, which did not include certain items which would be deducted before arriving at the net profits or the income tax payable by the company.

The accounts for one year showed a certain amount of profits including the income tax payable by the company, and the Auditors gave a special certificate that the percentage payable to

the Manager was calculated on the amount of profits less income tax—

Held (1) on the principle laid down in *Attorney-General* v. *Ashton Gas Co.*, [1904] 2 Ch. 621 (affirmed [1906] A.C. 10), that the income tax was part of the net profits available for dividends, and that the Manager was entitled to be paid his percentage on the net profits before deduction of the tax; and (2) that, the certificate being based on a wrong principle, the Court was not bound by it.—*Johnston* v. *Chestergate Hat Manufacturing Co., Ltd.*, [1915] 2 Ch. 338.

Under an agreement of service, made in 1914 between the defendant and the plaintiff company, the defendant became the Managing Director of the company for a term of ten years at the fixed salary of £600 per annum plus "a commission of 25 per cent, on the net profits of the business" of the company. Clause 5 of the agreement provided how these net profits were to be ascertained, and directed that from the gross profits earned by the company there should be deducted, in addition to the usual trade expenses and charges, (1) a certain percentage for depreciation of land and buildings and trade machinery and plant; (2) a sum for displacement of buildings and plant; (3) a sum for repairs and renewals; (4) the amount necessary to pay a dividend of 8 per cent on the issued share capital of the company; (5) Directors' fees; and (6) interest on loans and bank overdrafts; but that no deductions should be made for (*a*) any bonus to Directors; (*b*) life insurance premiums on the defendant's life; (*c*) income tax on profits under Schedules A and D; and (*d*) any commission or bonus paid out of profits to any employee of the company. The company made large profits for the years 1915 and 1916, in respect of which the excess profits duty under the Finance Acts was payable, and issued a summons to determine whether, in ascertaining for each year the net profits of the business for the purpose of the Agreement of service, the excess profits duty ought or ought not to be deducted before the defendant's commission was calculated.

It was held by Neville, J., that the excess profits duty ought not to be deducted from the profits of the company before the commission of the defendant was ascertained. In his Lordship's opinion the judgment of Buckley, J. (as he then was), in *Attorney-General* v. *Ashton Gas Co.*, [1904] 2 Ch. 621, which was affirmed by the Court of Appeal (*ib.* page 626), and upheld in the House of Lords [1906], A.C. 10, was a guide in arriving at a conclusion on the matter.—*Fellows Limited* v. *Corker*, [1918] 1 Ch. 9.

By an agreement dated 30th October, 1916, the defendant was appointed works manager of the business of the plaintiff company at a salary. The company agreed also to pay him at the end of each business year of the company, and within seven days of the

holding of the annual general meeting, a further sum by way of commission being a percentage upon the "net profits" for the year. There was a proviso that the certificate of the company's Auditor should be conclusive as to what constituted net profits at the end of any such business year—

Held, on construction, that "net profits" of the business for the year were the excess of the receipts for the year over the current expenses and outgoings of the same year—i.e. the fund which for that year was capable of being lawfully applied by the company to the payment of a dividend.

Held, as a matter of law, that that fund could only be arrived at after deducting excess profits duty, which was a debt of the company to the Crown.

Held, therefore that the commission ought to be calculated after deduction of excess profits duty.—*Patent Castings Syndicate Ltd.* v. *Etherington*, [1919] 2 Ch. 254.

By an agreement made in 1912 the defendant was appointed works manager of the business of the plaintiff company at a salary, and he was also to be paid a commission equal to £50 for every 5 per cent "profit earned by the company" (or fraction of 5 per cent *pro rata*) after 10 per cent had been earned by the company—

Held, that the words "profit earned by the company" meant profits divisible among the shareholders, in other words, "net profits," and upon the authority of the decision of the Court of Appeal in *Patent Castings Syndicate Ltd.* v. *Etherington*, *supra*, that in arriving at the fund upon which commission was payable excess profits duty must first be deducted.—(*Hollins & Co.* v. *Paget*, [1917] 1 Ch. 187 overruled.)— *Vulcan Motor and Engineering Company* (1906) *Ltd.* v. *Hampson*, [1921] 3 K.B. 597.

Under an agreement made in 1933 for purchase of goodwill by a sum based on profits, it was held that Excess Profits Tax and National Defence Contribution were deductible in computing those profits (Lords Simon and Macmillan dissenting).—*L. C. Ltd.* v. *G. B. Ollivant, Ltd.*, [1944] 1 All E.R. 510; 23 A.T.C. 54.

A company was a private limited company with five shareholders, all children of the original founder of the business. The defendant Directors, by virtue of their voting power, obtained the passing of a resolution, the effect of which was to increase their remuneration. The resolution provided (1) for an increase in their remuneration; (2) for payment to each of them of a sum of £260 per annum for entertaining expenses; and (3) for payment of a commission to them as additional remuneration. The plaintiff, who was a shareholder, brought an action to set aside this resolution. He maintained that the passing of the resolution was a fraudulent use of voting power by the Directors in order to appropriate to themselves funds which were the property of the

company, and that it was *ultra vires* of the company, in respect (1) that the increase in remuneration of the second-named defendants under the first part of the resolution was not warranted by the financial position of the company; (2) that the so-called entertainment allowance was wholly unnecessary and unreasonable, having regard to the facts (*a*) that this allowance was not to be accounted for to the company in the same way as ordinary expenses as provided for by the Articles, and (*b*) that it was intended to be used largely by the Directors on themselves in entertainment at theatres, restaurants, and the like, and (3) that the commission payable to the second-named defendants under the third head of the resolution was excessive, considering the remuneration already received by them.

In the High Court judgment was given for the defendants, and in the Court of Appeal it was held by a majority (1) that, applying the principle laid down by Lord Davey in *Burland* v. *Earle*, [1902] A.C. 83 the Court will not interfere with the acts of a majority of shareholders unless those acts are fraudulent in character or *ultra vires* of the company; (2) that, in the present case, the evidence did not disclose anything in the nature of fraud on the part of the defendant directors; that the resolution was confined to matters which were purely a domestic concern of the company, involving additional remuneration for services to be rendered by them and which had not been opposed by the minority shareholders other than the plaintiff; and that in consequence the resolution was not *ultra vires* of the company.—*Harris* v. *Harris Ltd., and Others (two Directors)* (1936), 94 *Acct.* 437.

Special notice of intention to vote remuneration to Directors must be given.—*Hutton* v. *West Cork Railway Co.* (1883), 23 Ch.D. 654.

In the absence of a contract or agreement Directors cannot claim remuneration for their services according to their value.—*Dunstan* v. *Imperial Gas Co.* (1833), 3 B. & Ad. 125.

The Articles of Association of a company provided that at the ordinary meeting in 1906 all the Directors should retire from office. No ordinary meeting was called or held in 1906 or 1907. It was held (Sargant, J.), that all the Directors vacated office on 31st December, 1906, being the last day on which a meeting of the company for that year could have been held.—*Re Consolidated Nickel Mines, Ltd.*, [1914] 1 Ch. 883.

Under the Articles of Association of the plaintiff company the remuneration of each Director had to be fixed by the company in general meeting, but if not so fixed should be £25 per annum. In 1932, at a Directors' meeting, at which the defendant was present as a Director, it was resolved that no fees be paid, and thereafter no fees were paid or claimed until 16th October, 1934, when at a

Directors' meeting it was agreed that Directors' fees of £25 for the year to 31st March, 1935, should be paid. The company in general meeting on 16th July, 1935, objected to this payment, and claimed its return. The defendant counterclaimed in respect of £25 Directors' fee for the year ended 31st March, 1934.

Held, (1) that the provision for remuneration in the Articles of Association was retrospective.

(2) That it was *ultra vires* the Directors to fix their own remuneration.

(3) That the company in general meeting was entitled to disallow any Directors' fees, and to have the £25 returned.

(4) That since the Balance Sheet for 1934 had not, in accordance with Section 128 of the Companies Act, 1929, disclosed any Directors' fees and the defendant had made no previous claim, the fees must be deemed to have been waived and the counterclaim failed.—*West Hartlepool Cold Storage Co., Ltd.* v. *MacAlpine* (1936), 94 Acct. 272 (*West Hartlepool County Court*); *The Law Journal County Court Reports*, 25th January, 1936.

A clause in the Articles of Association empowering Directors on behalf of the company to "lend money" and generally undertake such other financial operations as might, in their opinion, be incidental or useful to the general business of the company, has been held to authorize a loan to a faithful and confidential servant of the company.—*Rainford* v. *James Keith & Blackman Co., Ltd.*, [1905] 2 Ch. 147.

In one case a Balance Sheet had been prepared showing a net profit of £11,493; but the Directors, with the approval of the company's Auditor, caused a supplemental Balance Sheet to be prepared, in which the net profit was increased to £176,493, by transferring £165,000 from the "Suspense" Account to the Profit and Loss Account. At a general meeting of the company both Balance Sheets were approved, and in the same year the company went into liquidation.

Ten years afterwards, the creditors having been paid, certain Directors claimed to be paid their shares of 10 per cent of the residue of net profits, in accordance with a clause in the Articles of Association. This was opposed by the Liquidator on the ground that the value of the assets had been largely over-estimated, and that the proposed distribution of the residue could not be made without a dividend being paid out of capital.

It was however, held that as it was not impossible for reasonable men, at the time when the resolutions of the general meeting were passed, to take the view then taken as to the value of the assets, the claim must be allowed, but without interest.—*Re Peruvian Guano Co., Ex parte Kemp*, [1894] 3 Ch. 690.

It was held that a director, if he acts in good faith, is entitled

to rely on the officers of the company to prepare true and honest accounts. This case did not concern the Auditors, but is an interesting exposition of the legal view as to responsibilities of Directors.

The liquidator of the company sought to make the defendant liable in respect of dividends paid on the faith of Balance Sheets which included many bad debts. If the bad debts had been written off there would have been no profits.

The Lord Chancellor said—

The charge of neglect appears to rest on the assertion that Mr. Cory, like the other Directors, did not attend to any details of business not brought before them by the general manager or the chairman, and the argument raises a serious question as to the responsibility of all persons holding positions like that of Directors—how far they are called upon to distrust and be on their guard against the possibility of fraud being committed by their subordinates of every degree. It is obvious if there is such a duty it must render anything like an intelligent devolution of labour impossible. That the letters of the Auditors were kept from him is clear. That he was assured that provision had been made for bad debts and that he believed such assurances is involved in the admission that he was guilty of no moral fraud; so that it comes to this—that he ought to have discovered a network of conspiracy and fraud by which he was surrounded, and found out that his own brother and the managing Director (who have since been made criminally responsible for frauds connected with their respective office) were inducing him to make representations as to the prospects of the concern and the dividends properly payable which have turned out to be improper and false. I cannot think that it can be expected of a Director that he should be watching either the inferior officers of the bank or verifying the calculations of the Auditors themselves. The business of life could not go on if people could not trust those who are put into a position of trust for the express purpose of attending to details of management.—(*Dovey* v. *Cory*, *National Bank of Wales Case*, [1901] A.C. 477–487; 17 T.L.R.732.)

Directors' Qualification Shares. Sections 181 and 182 of the Companies Act, 1948, enact as follows—

181.—(1) A person shall not be capable of being appointed director of a company by the articles, and shall not be named as a director or proposed director of a company in a prospectus issued by or on behalf of the company, or as proposed director of an intended company in a prospectus issued in relation to that intended company, or in a statement in lieu of prospectus delivered to the registrar by or on behalf of a company, unless, before the registration of the articles or the publication of the prospectus, or the delivery of the statement in lieu of prospectus, as the case may be, he has by himself or by his agent authorized in writing—

(*a*) signed and delivered to the registrar of companies for registration a consent in writing to act as such director; and

(*b*) either—

(i) signed the memorandum for a number of shares not less than his qualification, if any; or

(ii) taken from the company and paid or agreed to pay for his qualification shares, if any; or

(iii) signed and delivered to the registrar for registration an undertaking

in writing to take from the company and pay for his qualification shares, if any; or

(iv) made and delivered to the registrar for registration a statutory declaration to the effect that a number of shares, not less than his qualification, if any, are registered in his name.

(2) Where a person has signed and delivered as aforesaid an undertaking to take and pay for his qualification shares, he shall, as regards those shares, be in the same position as if he had signed the memorandum for that number of shares.

(3) References in this section to the share qualification of a director or proposed director shall be construed as including only a share qualification required on appointment or within a period determined by reference to the time of appointment, and references therein to qualification shares shall be construed accordingly.

(4) On the application for registration of the memorandum and articles of a company the applicant shall deliver to the registrar a list of the persons who have consented to be directors of the company, and, if this list contains the name of any person who has not so consented, the applicant shall be liable to a fine not exceeding fifty pounds.

(5) This section shall not apply to—

(*a*) a company not having a share capital; or

(*b*) a private company; or

(*c*) a company which was a private company before becoming a public company; or

(*d*) a prospectus issued by or on behalf of a company after the expiration of one year from the date on which the company was entitled to commence business.

182.—(1) Without prejudice to the restrictions imposed by the last foregoing section, it shall be the duty of every director who is by the articles of the company required to hold a specified share qualification, and who is not already qualified, to obtain his qualification within two months after his appointment, or such shorter time as may be fixed by the articles.

(2) For the purpose of any provision in the articles requiring a director or manager to hold a specified share qualification, the bearer of a share warrant shall not be deemed to be the holder of the shares specified in the warrant.

(3) The office of director of a company shall be vacated if the director does not within two months from the date of his appointment, or within such shorter time as may be fixed by the articles, obtain his qualification, or if after the expiration of the said period or shorter time he ceases at any time to hold his qualification.

(4) A person vacating office under this section shall be incapable of being re-appointed director of the company until he has obtained his qualification.

(5) If after the expiration of the said period or shorter time any unqualified person acts as a director of the company, he shall be liable to a fine not exceeding five pounds for every day between the expiration of the said period or shorter time or the day on which he ceased to be qualified, as the case may be, and the last day on which it is proved that he acted as a director.

The fact that a Director has not taken up his qualification shares does not invalidate any of the proceedings to which he has been

a party, but leaves him liable to the heavy fine mentioned in Section 182. It does not appear to be the duty of an Auditor to see that the Directors are fully qualified, but it is convenient from a Director's point of view and advisable that he should do so.

CASES

In the absence of a contrary provision in the Articles a Director who is the registered holder of the required qualification shares is qualified even though he holds them merely as trustee for some other person.—*Pulbrook* v. *Richmond Consolidated Mining Co.* (1878), 9 Ch.D. 610; *Bainbridge* v. *Smith* (1889), 41 Ch.D. 462.

A liquidator of another company does not hold the shares in his own right so as to qualify him as a Director.—*Boschoek Proprietary Co. Ltd.* v. *Fuke*, [1906] 1 Ch. 148; 75 L.J. Ch. 26.

A Director is fully qualified if he is one of several joint holders of the required qualification.—*Re Glory Paper Mills, Dunster's Case*, [1894] 3 Ch. 473.

Subject to Section 181 of the Companies Act, 1948, and to the Articles of Association, qualification may be properly obtained either by taking the shares from the company or acquiring them by transfer.—*Brown's Case* (1874), 9 Ch. App. 102.

DIRECTORS' TRAVELLING EXPENSES AND OTHER OUTLAYS

The payment of Directors' travelling expenses to attend Board meetings should be authorized by the Articles of Association or by a resolution of the company; otherwise the expenses are presumed to be covered by the Directors' fees.—*Young* v. *Naval, Military and Civil Service Co-operative Society of South Africa, Ltd.*, [1905] 1 K.B. 687.

Expenses incurred in connexion with the company's business are an allowable charge.

The expense of printing and sending out proxy forms containing the names of certain of the Directors as proxies for a general meeting of shareholders, and for stamping and paying the return postage thereon, has been held to be properly payable out of the funds of the company in a case where it was the duty of the Directors to inform the shareholders of the facts governing their policy, and the reasons why they considered that this policy should be maintained and supported by the shareholders.—*Peel* v. *London and North-Western Railway Co.*, [1907] 1 Ch. 5.

The expenses of issuing proxies to procure votes, not for the interests of the company, but in the interests of the Directors personally, would probably be held not to be a proper payment out of the funds of the company.

LOANS TO DIRECTORS AND OTHER OFFICERS

It is not lawful for a company to make a loan to a Director except in the circumstances provided for in the Companies Act. The matter is dealt with in Section 190, which is as follows—

190.—(1) It shall not be lawful for a company to make a loan to any person who is its director or a director of its holding company, or to enter into any guarantee or provide any security in connexion with a loan made to such a person as aforesaid by any other person:

Provided that nothing in this section shall apply either—

(*a*) to anything done by a company which is for the time being an exempt private company; or

(*b*) to anything done by a subsidiary, where the director is its holding company; or

(*c*) subject to the next following subsection, to anything done to provide any such person as aforesaid with funds to meet expenditure incurred or to be incurred by him for the purposes of the company or for the purpose of enabling him properly to perform his duties as an officer of the company; or

(*d*) in the case of a company whose ordinary business includes the lending of money or the giving of guarantees in connexion with loans made by other persons, to anything done by the company in the ordinary course of that business.

(2) Proviso (*c*) to the foregoing subsection shall not authorize the making of any loan, or the entering into any guarantee or the provision of any security, except either—

(*a*) with the prior approval of the company given at a general meeting at which the purposes of the expenditure and the amount of the loan or the extent of the guarantee or security, as the case may be, are disclosed; or

(*b*) on condition that, if the approval of the company is not given as aforesaid at or before the next following annual general meeting, the loan shall be repaid or the liability under the guarantee or security shall be discharged, as the case may be, within six months from the conclusion of that meeting.

(3) Where the approval of the company is not given as required by any such condition, the directors authorizing the making of the loan, or the entering into the guarantee, or the provision of the security, shall be jointly and severally liable to indemnify the company against any loss arising therefrom.

Although loans to Directors are prohibited, except in the circumstances mentioned, loans may be made to officers of a company, but it is necessary that particulars of any such loans should be shown in the accounts, unless the circumstances mentioned in (2) *infra* apply. The Section of the Act governing the matter reads as follows—

197.—(1) The accounts which, in pursuance of this Act, are to be laid before every company in general meeting shall, subject to the provisions of this section, contain particulars showing—

(*a*) the amount of any loans made during the company's financial year to—

(i) any officer of the company; or

(ii) any person who, after the making of the loan, became during that year an officer of the company;

by the company or a subsidiary thereof or by any other person under a guarantee from or on a security provided by the company or a subsidiary thereof (including any such loans which were repaid during that year); and

(*b*) the amount of any loans made in manner aforesaid to any such officer or person as aforesaid at any time before the company's financial year and outstanding at the expiration thereof.

(2) The foregoing subsection shall not require the inclusion in accounts of particulars of—

(*a*) a loan made in the ordinary course of its business by the company or a subsidiary thereof, where the ordinary business of the company or, as the case may be, the subsidiary, includes the lending of money; or

(*b*) a loan made by the company or a subsidiary thereof to an employee of the company or subsidiary, as the case may be, if the loan does not exceed two thousand pounds and is certified by the directors of the company or subsidiary, as the case may be, to have been made in accordance with any practice adopted or about to be adopted by the company or subsidiary with respect to loans to its employees;

not being, in either case, a loan made by the company under a guarantee from or on a security provided by a subsidiary thereof or a loan made by a subsidiary of the company under a guarantee from or on a security provided by the company or any other subsidiary thereof.

(3) If in the case of any such accounts as aforesaid the requirements of this section are not complied with, it shall be the duty of the auditors of the company by whom the accounts are examined to include in their report on the balance sheet of the company, so far as they are reasonably able to do so, a statement giving the required particulars.

(4) References in this section to a subsidiary shall be taken as referring to a subsidiary at the end of the company's financial year (whether or not a subsidiary at the date of the loan).

Although the term "Officer" as defined in Section 455 (1) of the Act includes a Director, Manager or Secretary, the prohibition in Section 190 (1) excludes a Director from the application of Section 197.

It should be noted that a Managing Director is not a clerk or servant for the purposes of Section 319 which deals with preferential claims for unpaid wages or salary.

DISCOUNTS

Provision should be made for the usual trade discount in respect of the debtors and creditors. Cash discounts granted need not be brought into account until the debts are received, nor should discount receivable be taken into account until the creditors are paid. In the case of any exceptional discounts being allowed

explanations should be obtained. An entry of discount in a ledger account may be fraudulent and used to show an account as having been settled, whereas the fact may be that a larger sum was paid by the debtor and either no discount or a smaller discount allowed. In such a case, a fraudulent cashier could retain part of the actual payment without its being disclosed in the ledger account.

DIVIDENDS—PREFERENCE AND ORDINARY

The total dividend should be agreed with the aggregate of the separate dividends paid. A schedule of the preference and ordinary shareholders made up from the Register of Shareholders at the date to which the payment of the dividend relates should be submitted to the Auditors. It should set out the gross amount, the tax deducted and net amount payable.

In the case of preference dividends and interim dividends, if the Articles so provide, the Directors may resolve to declare the dividends without reference to the shareholders. In other cases (including a final dividend) the Directors recommend the dividend to the shareholders, in whose hands the declaration of the dividend rests. They may approve the amount or resolve that a smaller dividend be paid, but they cannot resolve that a higher dividend be paid nor can they resolve that a dividend be paid where the Directors do not recommend it.—*Bond* v. *Barrow Haematite Steel Co.*, [1902] 1 Ch. 353.

The Auditor should inspect the Minute Books to verify that the necessary resolutions have been passed, and ascertain that they are in accordance with the Articles. He should verify that income tax has been deducted from the dividend, unless the dividend is payable free of tax. It is the exception for dividends to be paid free of tax in the case of preference shares. The net amount of the dividend should be transferred to a separate Banking Account for dividends, and the balance of the Banking Account should be agreed with the dividends not claimed as shown by the schedule, the dividends paid being marked off in the schedule in course of comparison with the Dividend Warrants.

If preference dividends are cumulative and in arrear there shall be stated by way of note, or in a statement or report annexed, if not otherwise shown, the amount of any arrears of fixed cumulative dividends and the period for which the dividends or, if there is more than one class, each class of them are in arrear. The amount is to be stated before deduction of income tax, except that, in the case of tax-free dividends, the amount shall be shown free of tax and the fact that this is so shown shall also be stated. (Companies Act, 1948, Eighth Schedule, paragraph 11 (3).)

In the rare case where dividends become payable if profits to meet them are available, without the necessity of declaration by

Directors, there is definitely a contingent liability which should be shown on the Balance Sheet.

ORDINARY DIVIDENDS

The procedure which used to be adopted by Directors of companies in submitting the accounts to the shareholders, was to show the results of the operations of the appropriate period and, in their report accompanying the accounts, to make recommendations as to the disposal of the balance to the credit of Profit and Loss Account (or Profit and Loss Appropriation Account), if the account showed a balance on that side. The payment of the dividend approved by the shareholders was reflected in the accounts of the subsequent period. In the inquiry into accounting principles which was made by the Council of the Institute of Chartered Accountants, the results of which were embodied in recommendations issued in 1943, it was suggested that provision be made in the books and in the annual accounts for proposed profit appropriations, those subject to confirmation by the shareholders being so described. Provision for dividends should be shown as a separate item in the Balance Sheet. It was stated that although certain appropriations of profits, including dividends recommended by Directors, are subject to subsequent confirmation by shareholders, the inclusion of all appropriations in the accounts shows the amount which will be required for distribution to the shareholders and completes the accounts for the financial year by showing the results of trading and their application in one account. This course avoids the inclusion in the accounts of the next period of appropriations which were set out in the Directors' report for the previous period, and have already been dealt with and disposed of. Also, it facilitates the linking up of the accounts from one period to another, the balance carried forward to the following period being clearly shown in the accounts of each year.

It was further recommended that whether dividends are described "less income tax" or "free of income tax," the amounts shown in respect thereof in the accounts should be the net amounts payable.

These recommendations have now been embodied in the Companies Act, 1948. The Eighth Schedule, paragraph 8 (1) (*e*), provides that there shall be shown under a separate heading in the Balance Sheet the net aggregate amount (after deduction of income tax) which is recommended for distribution by way of dividend.

In the case of interim dividends, the Auditor should see in the Minutes that a resolution declaring the dividend has been duly passed by the Directors, and that they have power under the Articles to make the declaration. In the case of final dividends,

he should see that the dividend is recommended by the Directors and the appropriate resolution passed by the shareholders in general meeting, and that it is in accordance with the Articles of Association.

Note. Many Boards of Directors instruct the Auditors to check and agree all dividends and interest payments, checking the respective lists relating thereto with the Registers, and examining and initialing the Dividend Warrants before their issue.

Dividends not claimed should not be taken to credit of a Profit and Loss Account until the claim is statute-barred, and not even then unless the Directors have decided not to recognize a claim should it subsequently be made.

When a company declares a dividend on its shares, a debt immediately becomes payable to each shareholder in respect of his dividend, for which he can sue at law, and the Statute of Limitations immediately begins to run. This, however, may not apply in the case of an interim dividend, as this is usually a decision of the Directors.—*Lagunas Nitrate Co.* v. *Schroeder* (1901), 85 L.T. 22. The declaration of a dividend by the members does not make the company a trustee of the dividend for the shareholder, and an entry of the liability in the company's books —at any rate when no special part of its assets is set aside as representing the dividend and no notice of the entry is given to the shareholders—does not take the case out of the Statute. Being payments under the Articles of Association, dividends are specialty debts, and consequently the period of limitation is twenty years.—*Re Drogheda Steam Packet Company,* [1903] Ir. R. 512. The same principle was followed in *Re Artisans' Land and Mortgage Corporation,* [1904] 1 Ch. 796.

CASES

The holders of preference shares, the dividends on which are "dependent upon the profits of the particular year only," are entitled to a dividend out of the profits of any year after setting aside a proportionate amount for depreciation, maintenance, repairs, and renewals for the year only, and are not to be deprived of that dividend in order to make good any sums which in previous years should have been set aside by the company for maintenance, but which had been improperly applied by them in paying dividends.—*Dent* v. *London Tramways Company* (1879), 16 Ch.D. 344.

When the Memorandum of Association of a company incorporated under the Companies Act, 1862, stated that a portion of the shares were to have a right of receiving a dividend by preference to the other shares, resolutions passed by the company altering the priorities and payments of the net revenue as between

the preference and ordinary shareholders were held to be not valid, and that no resolution of the company, special or otherwise, could alter the contract made between the company and all the shareholders, and that the revenue of the company available for dividend must be applied in the manner originally prescribed by the Memorandum of Association.—*Ashbury* v. *Watson* (1885), 28 Ch.D. 56, and 30 Ch.D. 376.

The Memorandum of Association of a company contained this clause: "The capital of the company is £150,000, divided into 10,000 ordinary shares of £10 each, and 5000 preference shares of £10 each. The holders of preference shares shall be entitled out of the net profits of each year to a preference dividend at the rate of £10 per cent per annum on the amount for the time being paid or deemed to be paid up thereon. After payment of such preferential dividend, the holders of ordinary shares shall be entitled to a like dividend at the rate of £10 per cent per annum on the amount paid on such ordinary shares. Subject as aforesaid, the preference and ordinary shares shall rank equally for dividend." It was held that the preference shareholders were not entitled to a cumulative dividend of £10 per cent so as to have the deficiency in one year paid out of the profits of a subsequent year before paying anything to the ordinary shareholders.—*Staples* v. *Eastman Photographic Materials Co., Ltd.*, [1896] 2 Ch. 303.

The word "dividend" in its ordinary sense means the sum paid and received, or the quotient forming the share of the divisible sum payable to the recipient.—*Lamplough* v. *Kent Waterworks Proprietors*, [1904] A.C. 27.

The Articles of a company provided for the submission of accounts up to a date within three months and reports thereon, the sanction of a dividend, and the transaction of the ordinary business at the annual general meeting. It was held by North, J., that a final dividend could not be sanctioned except at an annual general meeting, at which accounts up to the prescribed date and reports thereon were submitted.—*Nicholson* v. *Rhodesia Trading Co., Ltd.*, [1897] 1 Ch. 434.

"Profits available for dividend" mean the net profits after making any deductions which Directors can properly make before declaring a dividend.—*Fisher* v. *Black and White Publishing Co., Ltd.*, [1901] 1 Ch. 174.

A company's capital consisted of 5 per cent cumulative preference shares and ordinary shares, the preference shares having priority as to both capital and dividend, and the preferential dividend being payable before any profits could be carried to reserve.

The Articles provided that no dividends should be payable except out of profits, and that, in the event of the company being wound up, the surplus divisible assets for the time being remaining

"after paying the liabilities of the company" should be applied first in repaying the preference capital and "secondly in paying the arrears (if any) of the 5 per cent preferential dividends thereon to the commencement of the winding up." The remainder of the surplus assets was to belong to the ordinary shareholders.

No dividends were ever declared, but the profits accumulated until the company was wound up—

Held, that the preference shareholders were entitled to their arrears of preferential dividends, though not declared, but only to the extent of the accumulated profits.—*Re W. J. Hall & Co., Ltd.*, [1909] 1 Ch. 521.

Re Crighton's Oil Co., [1901] 2 Ch. 184; [1902] 2 Ch. 86 Distinguished. In that case it was held that on a true construction of the Articles the preference shareholders were not entitled in a liquidation to the arrears of preference dividend inasmuch as the Directors had not declared a dividend as required by the Articles of Association.

Where a company issues preference shares carrying dividend at 10 per cent per annum, payable half-yearly, and with no words restricting the holders of such shares to the profits of the current year, the deficiency in the profits of any one year to pay the 10 per cent in full was, as between the preference and ordinary shareholder, to be made good out of subsequent profits.—*Foster* v. *Coles and M. B. Foster & Sons, Ltd.*, [1906] W.N. 107.

If the yearly profits are divisible among the holders of the ordinary shares, subject to the half-yearly dividend to the holders of the preference shares, the preference dividend is not cumulative. —*Adair* v. *Old Bushmills Distillery Co., Ltd.*, [1908] W.N. 24.

When the Directors take credit for an increase in the value of any property over the amount at which the same property stood in the preceding Balance Sheet—what is technically known as "writing-up" an asset—the Auditor, however much he may disapprove of the step from the point of view of financial prudence, has no legal power to object, provided he is satisfied it is done in a *bona fide* manner and that the fact is disclosed on the face of the accounts. The amount of the writing-up should be credited to a Reserve account in the first instance even if it is proposed to set against it a debit balance on Profit and Loss Account. If the debit balance on Profit and Loss Account is written off in this way. current profits are available for the payment of a dividend.— *Ammonia Soda Co., Ltd.* v. *Chamberlain*, [1918] 1 Ch. 266.

If the appreciation in value of the property arises from excessive provision for depreciation, or otherwise, charged to Profit and Loss Account in past years, it would not be inappropriate to carry the amount to the credit of the latter account or the appropriation account, but it should be shown as a separate item.

DRAWINGS AND PATTERNS

The Auditor should scrutinize this account carefully in order to see on what basis the account is built up. The unexhausted value of such items is essentially a matter for expert opinion, and a certificate may be taken from a responsible person that the value is reasonable, though, as a matter of sound finance, assets of this description should be written down as quickly as possible.

If the drawings and patterns are not written off when the expenditure is incurred, they will be capitalized, in which case a proportion should be written off each year. The item should not, however, remain in the Balance Sheet after the drawings and patterns have been superseded and are not of further use.

FOREIGN EXCHANGE

An actual realized difference in exchange can only arise where a completed exchange has been made in cash or goods, but in a Balance Sheet foreign moneys have to be brought in at some agreed rate, and so a difference in exchange arises. At one time it was the practice to adjust the accounts at the rate prevailing at the close of the year. Where exchanges were unstable, this led to such large differences of exchange as to obscure the true result of the trading, and the practice was adopted of converting revenue transactions at the average rate of the trader's own remittances throughout the year or at the average rate ruling during the year.

Fixed assets are retained at the rate at which they were originally converted. Any actual gain or loss could only arise on realization, and would be a gain or loss of Capital. The floating assets should be converted at the rate ruling at the date of the Balance Sheet, though where there are wide fluctuations it may be appropriate to convert stock, stores, etc., at the average rate.

FORFEITED SHARES

When shares have been forfeited in consequence of calls due thereon not having been paid, the Auditor should read the provisions of the Articles as to forfeiture and see that the registered holders have been duly served with the notice required by the Articles of Association, or other regulations of the company, and that the necessary Minutes have been passed. After forfeiture the cash received on account of the forfeited shares should be transferred from Share Capital Account to Forfeited Shares Account and the Register of Shareholders amended.

The Annual Return of the company must show the total number of shares forfeited. Companies Act, 1948, Sixth Schedule, paragraph 3 (*i*).

The shares may be re-issued at a discount not exceeding the

amount received from the original holders of the shares. If the discount equals the amount forfeited the share capital will be restored to the original amount as if no forfeiture had taken place. Any profit derived from the forfeiture and re-issue is available for distribution as a dividend unless the Articles provide otherwise, but it is usually carried to Reserve.

Forfeited shares may be re-issued as paid up to an amount not exceeding the amount paid by the previous holder, and may be so re-issued in consideration of a sum less than the sum credited as paid on them.—*Morrison* v. *Trustees, Executors, and Securities Insurance Corporation, Ltd.*, [1898] W.N. 154.

FORWARD CONTRACTS

Buying commodities for forward delivery is a normal and necessary feature in many businesses in order to ensure delivery at convenient dates and also to enable the manufacturer or merchant to rely on a settled price upon which to base his cost or selling prices. Transactions of this nature are not entered in the ordinary books until they mature but particulars should be recorded in a Register of Contracts. A reference should be made on the accounts that forward contracts are open. The view is, however, held that from the nature of the business it may be expected that there are open contracts at the date of the Balance Sheet, and that it is unnecessary, unless they are exceptional or if losses are anticipated and have not been provided for, to mention them. In the ordinary way a general reference would be sufficient information. In extreme cases, where the contracts are speculative and out of the ordinary course of business, the Auditor would feel it his duty to draw attention to the contracts, but he would have to be very sure of his ground, and errors of judgment on his part might have serious consequences.

The importance of this matter receives emphasis from the case of the *Pepper Pool* (*Rex* v. *Bishirgian*). In this case a prospectus was issued by James and Shakespeare Ltd., an old-established business. The prospectus contained no reference to substantial and quite exceptional forward contracts. Financial disaster followed and one of the Directors was found guilty of issuing a prospectus knowing it to be false in a material particular. Two others were found guilty of aiding and abetting him. This case should be carefully studied.

FREIGHT AND CARRIAGE

If any part of the expenditure has been charged to capital, the Auditor should ascertain whether the charge is justified. Reference to the Freight and Carriage Accounts will show whether sufficient provision has been made for outstanding amounts and

that any necessary apportionments have been made as between one year and another.

GOODWILL

The Auditor is only concerned to see that the amount of goodwill is correctly stated in the Balance Sheet in accordance with the facts of the case. As a general principle goodwill is based in theory on a number of years' purchase of the "super profits." Sir Arthur Cutforth, in his book *Methods of Amalgamation*, says: "To the mind of an accountant the word 'goodwill' may, perhaps, be well described by saying that it represents the capitalized value of actual or prospective 'super earnings.'"

Capitalization on the basis of super earnings will usually provide a sounder method than a number of years' purchase of the full profits. If a business cannot produce a higher yield of profit than a gilt-edged or first-class investment, there is little inducement to invest money in it. On the other hand, if it produces a higher yield than is normally expected from the type of business the excess over the normal yield may be regarded as "super earnings" and the consideration for goodwill may be a number of years' purchase of this excess. To ascertain it, the accounts of past years must be examined and appropriate adjustments made to allow for exceptional items and for possible variations in the future, since the purpose of the examination is to judge from the facts of the past what may be expected in the future. The number of years selected to determine the multiplier in ascertaining goodwill must vary with the circumstances, the underlying principle being that in the result the amount of the goodwill should be the sum which a purchaser ought to pay for the opportunity of earning super profits.

The foregoing is the principle which in most cases a Professional Accountant would adopt if called upon to value goodwill, but in the case of the audit of a company or partnership the value of the goodwill has been settled and it is no part of the Auditor's duty to comment upon it.

Where a company is formed for the purpose of acquiring and carrying on an established business and takes over the assets and the liabilities, the consideration for the purchase may be money, debentures or shares (fully paid up) or partly one and partly another.

The difference between the assets acquired and the liabilities taken over, and the actual consideration is assumed to represent the goodwill of the business; it may however be quite disproportionate to the goodwill valued on the general principle referred to above. It is in fact the balance of the purchase consideration attributable to goodwill.

The real value of goodwill obviously fluctuates from year to year according to the profits earned. It would not be practicable to give effect in a Balance Sheet to the fluctuation which is in fact an unrealized accretion to or diminution of capital. Goodwill is, therefore, usually stated in the Balance Sheet at its original cost less amounts (if any) written off. As a matter of sound finance it is desirable, though not legally necessary, that goodwill be gradually written down out of profits and still more so if the business has been acquired for only a number of years.

The Eighth Schedule, paragraph 8 (1) (*b*) of the Companies Act, 1948, provides that there shall be stated under separate headings in the Balance Sheet, so far as not written off—

> "if it is shown as a separate item in or is otherwise ascertainable from the books of the company, or from any contract for the sale or purchase of any property to be acquired by the company, or from any documents in the possession of the company relating to the stamp duty payable in respect of any such contract or the conveyance of any such property, the amount of the goodwill and of any patents and trademarks as so shown or ascertained."

CASES

There is no precise definition of the term "goodwill." It has no signification except in connexion with a continuing business. It is not easily susceptible of valuation, if susceptible at all. It is never sold apart from the business itself.—*Crutwell* v. *Lye* (1810), 17 Ves. 335; *Austen* v. *Boys* (1857), 30 L.T.O.S. 216; *Churton* v. *Douglas* (1859), 33 L.T.O.S. 57.

The goodwill of a trading company is *fixed* capital, and in ascertaining profits it is not necessary to make good any depreciation in respect of it. *Wilmer* v. *McNamara & Co., Ltd.*, [1895] 2 Ch. 245.

INCOME TAX

The computation of liability to income tax is usually a difficult and involved question. The checking of the correctness of the computation is not a matter of audit, except that an Auditor should satisfy himself that, on the face of it, a computation appears to be reasonable. He is concerned with verifying payments which have passed through the books with the relevant assessment notices, demand notes and receipts, and that proper provision is made for any outstanding liability. In many cases, the Auditor is asked by his client to agree the liability with the Inland Revenue Authorities but, in doing so, he is not acting in the capacity of Auditor. The basis of the inclusion of the income tax liability and provisions and reserves for income tax are dealt with fully in Chapter XIX, under the heading of "Reserves and Provisions."

INSURANCE, INCLUDING FIRE, EMPLOYERS' LIABILITY, LIVE STOCK AND LOSS OF PROFITS

By reference to the policies and receipts the Auditor should ascertain that the premiums have been duly charged and apportioned. It is not his duty, but the Auditor may compare the amounts insured in respect of some of the assets with the corresponding values in the accounts. If there is any considerable disparity an inquiry should be made into the circumstances.

INSURANCE—NATIONAL

As regards National Insurance, the Auditor should make a test examination of the insurance cards and see that they are stamped and that the charge for the stamps corresponds with the amount in the account. These cards may be examined in conjunction with the salaries and wages books. The Auditor may also consider it advisable to test the stamping of the cards from time to time, more particularly towards the close of a calender year. Misappropriations of money drawn for stamps may occur if the cards are not stamped regularly on the due dates.

INTEREST DURING CONSTRUCTION CHARGED TO CAPITAL

The capital of a company in certain cases may be expended on the construction of a railway in a foreign country or in the commonwealth, or in the erection of a factory or other building or on some asset of a permanent character.

Parliamentary companies are usually authorized to pay interest on capital to their members during construction, and the interest is regarded as permanent capital expenditure. Under Section 65 (1) of the Companies Act, 1948, companies are empowered to pay interest out of capital in certain cases, and to charge it to capital.

The Section is as follows—

65.—(1) Where any shares of a company are issued for the purpose of raising money to defray the expenses of the construction of any works or buildings or the provision of any plant which cannot be made profitable for a lengthened period, the company may pay interest on so much of that share capital as is for the time being paid up for the period and subject to the conditions and restrictions in this section mentioned, and may charge the sum so paid by way of interest to capital as part of the cost of construction of the work or building, or the provision of plant:

Provided that—

(*a*) no such payment shall be made unless it is authorized by the articles or by special resolution;

(*b*) no such payment, whether authorized by the articles or by special resolution, shall be made without the previous sanction of the Board of Trade;

(*c*) before sanctioning any such payment the Board of Trade may, at the expense of the company, appoint a person to inquire and report to them as to the circumstances of the case, and may, before making the appointment, require the company to give security for the payment of the cost of the inquiry;

(*d*) the payment shall be made only for such period as may be determined by the Board of Trade, and that period shall in no case extend beyond the close of the half year next after the half year during which the works or buildings have been actually completed or the plant provided;

(*e*) the rate of interest shall in no case exceed four per cent per annum or such other rate as may for the time being be prescribed by order of the Treasury;

(*f*) the payment of the interest shall not operate as a reduction of the amount paid up on the shares in respect of which it is paid;

(*g*) nothing in this section shall affect any company to which the Indian Railways Act, 1894, as amended by any subsequent enactment, applies.

(2) The power conferred by this section on the Treasury shall be exercisable by statutory instrument which shall be subject to annulment in pursuance of a resolution of either House of Parliament.

The Companies Act, 1948 (Eighth Schedule, paragraph (2) (*b*)), provides that—

The Balance Sheet of the company shall show, so far as the information is not given in the Profit and Loss Account, any share capital on which interest has been paid out of capital during the financial year, and the rate at which interest has been so paid.

Apart from this enactment, the practice of adding interest on capital to capital outlays during construction or development and treating the interest as income often obtains, as, for example, in the case of Tea Estates. The process, although it takes money out of one pocket as capital, and passes it into the other as income, is defensible in theory, but it is not prudent to apply the principle to undertakings of which the ultimate success is not assured, and in view of Section 65, legal advice should be taken in the case of any company which is paying interest out of capital without complying with the Section. If the Articles provide that actual cost is to be regarded as capital outlay, interest on the outlay may not be added.—*Public Works Commissioners* v. *Hills*, [1906] A.C. 368.

Interest on debentures or money borrowed for a like purpose may be so treated.—*Hinds* v. *Buenos Ayres Grand National Tramways Co., Ltd.*, [1906] 2 Ch. 654.

In the case of a construction on freehold land, depreciation should be written off, and the full maintenance and repairs charged against revenue. The rate of depreciation will probably be small and will be determined mainly by the expectation of life of the building.

CASES

In a case where a tramway company, for the purpose of converting its undertaking to a system of electric traction, issued conversion debenture stock, and the Directors passed resolutions that the interest on this stock should be treated as part of the cost of construction and charged to Capital Account during the construction of the works, the Memorandum and Articles of Association containing no provision relating to this subject, it was held there was no general rule of law which compelled companies to charge to Revenue Account interest on moneys borrowed for the purpose of constructing works, or prohibited them from charging it during construction to Capital Account; that, in the absence of any provision to the contrary, companies were entitled to act in the same way as commercial men dealing honestly in their own business; and, therefore, that the company were at liberty to charge the interest in question to Capital Account.—*Hinds* v. *Buenos Ayres Grand National Tramways Co., Ltd.*, [1906] 2 Ch. 654.

A company incorporated by Act of Parliament, being already in possession of works constructed by means of capital raised by the issue of shares, obtained by a later Act power to raise more capital for the construction of additional works. These works were of a peculiar kind, and could not be constructed by means of contracts taken in the usual way, but required that the company should find the plant and employ workmen to act as directed by their engineer. The capital for the works was raised by the exercise of borrowing powers and by the issue of preference shares, the holders of which had certain options to convert them into ordinary shares. It was held that the company were entitled to add to the capital required for the construction of the works the amount of the interest or dividends on the loans or shares by means of which it was raised until the completion of the works.—*Bardwell* v. *Sheffield Waterworks Co.* (1872), L.R., 14 Eq. 517.

LEASEHOLD PROPERTY, CONCESSIONS, ETC.

The Ledger Balance may consist of the original cost of the lease, or cost less amount written off as depreciation. While there appears to be no legal obligation to write off the expenditure on leases, any reduction in value being regarded as a loss of Capital, sound finance demands that provision be made for depreciation, in such a manner that the lease will be written down to nil or a nominal value on its expiration. It may also be necessary to make provision for dilapidations payable at the termination of the lease and for losses in respect of any fittings or fixtures. This depreciation is not allowed as a charge for income tax purposes.

The Auditor should be satisfied that a sufficient proportion has

been written off each lease and charged against the Revenue Account, so that accumulated annual provisions will reduce the amount standing at the debit of the account of each lease in the books to nil at its expiration. This statement is, however, subject to a consideration of the case of *Lee* v. *Neuchatel Asphalte Co.* (1889), 41 Ch.D. 1. (See Chapter X.)

Leasehold property may be held either as an investment or for occupation. In either case the above remarks apply. If it be an investment the rents received, after deducting the incidental expenses, such as law costs, repairs, rates, taxes, etc., should be brought in as income. If the owner occupies the leasehold premises, the amount written off in effect takes the place of rent.

The original cost can be ascertained at the first audit by reference to the Title Deeds and the Solicitor's Completion Statement. Strictly speaking the cost should be written off in accordance with leasehold tables and this more exact method is preferable in the case of leases of any length and should be recommended.

A Schedule should be prepared setting out the original cost of the lease, its date and duration, date of expiration, ground rent payable, and names of the lessors and lessees. By reference to the Schedule the Auditor will ascertain whether any leases held as security or otherwise have expired, and have the accounts amended accordingly. It may happen that the lease is of more value than either its cost or written down value even though a considerable part of the term of the lease has expired. This appreciation is of a Capital nature and in principle should not affect the provision for depreciation out of Revenue. Any appreciation of the lease is an increase of capital which, unless the Articles of Association provide otherwise, is not available for dividend purposes. Moreover, it would seem to be neither legal nor sound to take into account the capital profit of one particular item and ignore losses, ascertained or estimated, in respect of other capital items.

In partnership matters the question of the treatment of leases and capital appreciation should be determined by reference to the Articles of Partnership. If, however, they do not deal with the subject, it should be agreed by the partners. Exceptional depreciation of leases may also arise and be a justifiable charge to capital, but this is usually met by writing the lease down, either at once or gradually out of profits.

If appreciation or depreciation of the leases is considered to be of a capital nature then its division would apparently depend upon the proportion in which the partners share the capital, depreciation being charged to revenue and borne in the proportion in which the partners share profits, and capital appreciation divided according to the proportion in which the partners share capital.

CASES

The case of *Lee* v. *Neuchatel Asphalte Co.* (1889), 41 Ch.D. 1, in which the doctrine was laid down that there was nothing in the Companies Act, 1862, and subsequent Acts to prohibit a company formed to work a wasting property, as, e.g. a mine or a patent, from distributing, as dividend, the excess of the proceeds of working above the expenses of working, nor to impose on the company any obligation to set apart a sinking fund to meet the depreciation in the value of the wasting property, has been to some extent misunderstood. The Court decided nothing more than the particular proposition that some companies with wasting assets need have no depreciation fund.—*Bond* v. *Barrow Haematite Steel Co.*, [1902] 1 Ch. 367.

Whether a company formed to work a wasting asset can so treat its expenditure in its accounts depends entirely on its Memorandum and Articles of Association. In those companies where it is permitted, if the expenses of working exceed the receipts, the accounts must not be made out so as to show an apparent profit, and so enable the company to pay a dividend out of capital, but the division of the profits without providing a sinking fund is not such a payment of dividends out of capital as is forbidden by law. In the course of his judgment in *Lee* v. *Neuchatel Asphalte Co.* (p. 154 *post*), Stirling, J., made the following remarks: "It may be that in some future year the company will have to set apart a substantial sum to represent depreciation in the value of the concession; but so long as the capital remains intact, and the current receipts exceed the current expenditure, both according to the general law and under the provisions of these particular Articles of Association, it rests entirely with the shareholders to decide whether the excess shall be divided among them or set apart as a reserve fund for replacing wasting assets, and the Court has no power to interfere with their decision, however foolish or imprudent it may seem to be."

In the Court of Appeal, Lindley, L.J., remarked: "Now we come to consider how the Companies Act is to be applied to the case of a wasting property. If a company is formed to acquire and work a property of a wasting nature, for example, a mine, a quarry, or a patent, the capital expended in acquiring the property may be regarded as sunk and gone, and if the company retains assets sufficiently to pay its debts, it appears to me that there is nothing whatever in the Act to prevent any excess of money obtained by working the property over the cost of working it from being divided amongst the shareholders, and this, in my opinion, is true, although some portion of the property itself is sold, and in some sense the capital is thereby diminished. If it is said that such a course involves payment of dividend out of

capital, the answer is that the Act nowhere forbids such a payment as is here supposed."

Lopes, L.J., also remarked: "It is said by the Appellant that a company is not at liberty to pay a dividend unless they can show that their available property at the time of declaring the dividend is equivalent to their nominal or share capital. In my opinion such a contention in untenable. Where nominal or share capital is diminished in value, not by means of any improper dealing with it by the company, but by reason of causes over which the company has no control, or by reason of its inherent nature, that diminution need not, in my opinion, be made good out of revenue. In such a case a dividend may be paid out of current annual profits, out of profits arising from the excess of ordinary receipts over expenses properly chargeable to the Revenue Account, provided there is nothing in the Articles of Association prohibiting such an application, and provided it is done honestly. It appears to me that if a contrary view were adopted it might be successfully contended that where, owing to extraneous circumstances, the capital is increased in value, that increase might be dealt with as revenue or profits, and go to increase the dividend. This is contrary to all practice, and I think contrary to principle. The capital and the revenue accounts appear to me to be distinct and separate accounts, and for the purpose of determining profits, accretions to and diminutions of the capital are to be disregarded. . . . The capital in an undertaking like this is in its inherent nature wasting. The scheme of this undertaking is that there should be a gradual exhaustion of material; the wasting is the business of the company, and without such gradual exhaustion there would be no revenue."

The decision of the Court of Appeal relieves the Auditor of responsibility in those cases where the Articles of Association are on similar lines, but it is desirable that he should point out to the Directors that to declare dividends without creating a reserve for wasting property is, in most cases, unsound finance.

LOANS BY COMPANIES

A schedule of all loans made by the company, setting out the amount of the loan, security, rate of interest, date when interest is due, and repayment of capital, should be furnished to the Auditor, the list being revised at each audit.

The Memorandum and Articles of Association should be examined in order to ascertain the power of the company to make loans and under what conditions, and what authority the Directors have to exercise such powers. The loans should be authorized by the Directors and particulars recorded in the Minutes. The documents relating to each loan, and the securities held against it,

should be examined by the Auditor, who should also ascertain whether the various conditions have been complied with.

Interest received should be apportioned over the period to which it relates. If interest accrued, but not received, has been brought into account, evidence should be produced that the loan is good.

The Auditor should satisfy himself as far as possible that the securities given in respect of the loan are adequate. It is well to produce to the Directors a Schedule of the loans and to have their opinion as to the security recorded. As in the case of book debts, the Auditor should inquire into them carefully, to ascertain whether they are good.

For provisions governing loans to Directors and officers other than Directors, see LOANS TO DIRECTORS AND OTHER OFFICERS, page 64, *ante*.

LOOSE TOOLS

An inventory is usually made each year of the loose tools, and a valuation made and certified by a responsible official. The Ledger balance, if it exceeds the valuation, is adjusted accordingly. Sometimes no inventory is made, depreciation being written off the Ledger balances. This practice, however, is not so satisfactory, as losses and shortages are not disclosed. The Auditor should satisfy himself by inquiry that the rate of depreciation is sufficient and is what is commonly adopted in the trade.

PATENTS

Expenditure on patents which have a limited life is not an asset of a permanent character, and provision ought to be made in each year's accounts for depreciation. In settling the rate of depreciation it may be borne in mind that under certain conditions the life of the patent may be extended by an order of the Court. On the other hand, the risks of supersession must be considered, for the introduction of competitive or more up-to-date patents may render existing patents valueless before the end of their normal life. If this risk can be foreseen, it is prudent to make additional provision for depreciation. From a legal point of view it may be argued that any loss in respect of patents is a loss of capital, but as a matter of sound finance the loss should be written off out of profits. The Auditor cannot insist on this being done, but if it is not he may draw attention to the matter in his Report.

In some cases the patent may be of a greater value than its original cost but it is not usual to bring the increase into account.

PLANT AND MACHINERY, BOILERS, ENGINES, TOOLS, FURNITURE AND FITTINGS

The invoices relating to the expenditure on these items should be examined to ensure that the expenditure is a legitimate

charge to capital and does not include repairs which should be charged to Revenue. Provision made for depreciation should also be carefully considered, and in conjunction with this the way in which repairs and renewals are charged. This is a matter in respect of which a responsible official of the company can be asked to advise and if necessary to give a certificate supporting his opinion. In many cases the rates of depreciation to be allowed for income tax purposes have been settled by the Board of Referees. These rates, having been fixed after careful consideration, are some guide as to what should be written off, though in most cases prudence demands a higher rate. Depreciation may be written off the asset at the agreed rate either on the original outlay or on the diminishing figures year by year. On the other hand some business people prefer to make a reserve as they feel that in the case of claims under fire insurance policies or for other reasons a better basis is created on which to argue the question of actual values. There is probably very little in this point. The view is that where the assets are actually written down it may be used as evidence against the claimant, whereas sums carried to reserve are always open to argument.

For the purpose of arriving at the rates of depreciation the expenditure on these items should be subdivided in the books. This permits of closer comparison from year to year and enables rates to be fixed in accordance with the needs of the respective items. Rates of depreciation vary very widely in respect of tools, heavy plant, and running machinery. There is sometimes a tendency to make provision for depreciation in a rough and ready way by writing off lump sums according to the amount of profits. Depreciation must be regarded as a charge in arriving at profits and must be provided for whether there are profits or losses, since depreciation occurs whether profits are being earned or not. It is, on the other hand, true that a business is not carried on solely for the purpose of writing off depreciation, and the matter should be treated with a sense of proportion.

It is always desirable that the Auditor should, where possible, go round the works and stores of a concern of which he is Auditor, and gain a first-hand knowledge of the assets representing the figures in the books.

If the Auditor thinks it advisable he may obtain from a responsible official a certificate somewhat in the form given on page 83.

Should any article of plant have been completely superseded, the Auditor should be careful to ascertain that the asset account does not include any of the cost of the original plant and machinery so superseded.

The tools used by workmen in the factory are practically always

I certify as follows—

1. That the Plant, Machinery, Furniture, Fittings, etc., belonging to the company and included as assets in its Balance Sheet of 19 , remained in its possession during the ending .. . 19 , and were in its possession at the latter date (minor sales of old material (if any) alone excepted), and are included as assets in the Balance Sheet at 19 , in the following items:

2. That the amount expended during the ... in repairs and renewals, which has been charged to Revenue, has sufficed to keep the said plant, etc., in good order and condition, and that the amount written off for depreciation is in my opinion adequate.

3. That all amounts charged as additions to the said Plant, etc., during the represent real additions to capital value, as opposed to expenditure on repairs and renewals.

Signature
Office
Date

the property of their employers, and although in many concerns it is the custom for the total amount to be charged direct against the Revenue Account, in many cases credit is taken in the Balance Sheet for "Workmen's Tools." The Auditor must ascertain that full allowance has been made for wear and tear which, as a rule, is very considerable, the rate chargeable against the Revenue Account commonly varying from 25 as a minimum to 50 and even 60 per cent as a maximum. On the other hand, an annual revaluation may be preferred.

Plant and machinery are sometimes purchased under a hiring agreement, that is, an agreement in which it is provided that after the lessee has paid a rent for the use of an article for a certain number of years it shall become his absolute property on the payment of a nominal sum at the expiration of the period.

It is proper to capitalize a proportionate part of any payments of this nature, after charging Revenue with a fair and reasonable amount for the use of the articles acquired under the hiring agreement and providing for depreciation on the original value.

As to the requirements of the Companies Act, 1948, in regard to the treatment of plant and machinery and other fixed assets in the accounts, see Eighth Schedule, paragraphs 5, 12, and 14, quoted in Chapter IX, *post*.

The Auditor should be satisfied that the amount included for Office Furniture is reasonable. An appropriate depreciation, calculated on the diminishing value, should be written off periodically, and charged against profits. Additions to furniture from

time to time make a calculation on the original cost a matter of difficulty. Repairs should be charged to revenue.

CASE

In his judgment in an action brought under the Employers' Liability Act, 1880, Lindley, L.J., defined plant in the meaning of this Act to include "whatever apparatus is used by a business man for carrying on his business, and not his stock-in-trade, which he buys or makes for sale; but all goods and chattels fixed or moveable, live or dead, which he keeps for permanent employment in his business."—*Yarmouth* v. *France* (1887), 19 Q.B.D. 647.

PRELIMINARY EXPENSES

I. The expenses incurred in the formation of a company, if they are not borne by the vendor, are usually charged to a "Preliminary Expenses Account." Although a capital outlay, it is usually written off over a term of years, the balance of the account appearing on the assets side of the Balance Sheet each year until finally written off.

This method of dealing with the Preliminary Expenses Account is frequently provided for in the special Act or the Memorandum and Articles of Association. In any case the preliminary expenses must, so far as they are not written off, be stated separately in the Balance Sheet (C.A. 1948, Sch. VIII, Para. 3). The practice of spreading expenditure of a special or exceptional nature over a term of years is recognized in the accounts of companies. "These companies are commercial partnerships, and are, in the absence of express provisions, statutory or otherwise, subject to the same considerations."—*Griffiths* v. *Paget* (1877), 6 Ch.D. 511.

A case dealing directly with this subject is one heard in 1864, in which an action was brought by a shareholder against two Directors, the Solicitor, and one of the Auditors of a company registered under the Joint Stock Companies Act, 1856, Section 71 of which recognized the distribution of certain items of expenditure over several years, for false representations in a Balance Sheet, one of such representations being that only a portion of the "Preliminary Expenses" was brought into the year's account.

The second Auditor had resigned after the declaration of a dividend which, in his opinion, had not been earned, and he was not made a defendant. In his opinion there had been a loss, apart from any question of writing off part of the preliminary expenses, and he had concurred with the other Auditor in addressing a report to the Directors suggesting that the meeting should fix upon such sum as it might consider fairly chargeable to the Preliminary Expenses Account, and that it be written off that account at the rate of from 10 to 20 per cent per annum. While he

was being examined as to the manner in which the preliminary expenses had been dealt with in the Directors' Balance Sheet, in which they had been treated on the basis that they would be written off over several years, Martin, B., observed that he remembered that the subject had been a good deal discussed as to railway companies some years previously, and there was a great objection to the course taken, "but now it appeared that there was an agreement among Auditors to spread such expenses over a number of years; that, indeed, was objected to, and it was the reason why the North Western Railway Company were able to declare large dividends soon after they opened their line. But no doubt it was now done, and it would never do to impute it to the Directors as a fraud that they had done what was usually done by Auditors."

After these remarks by the Judge, Counsel then abandoned this part of his contention.—*Bale* v. *Cleland* (1864), 4 F. & F. 117.

II. The Auditor's first duty in dealing with this account is to ascertain by whom the expenses of forming the company have to be borne. If the agreement between the vendor and the trustee, on behalf of the proposed company, adopted by the company and embodied in the Prospectus, provides that the expenses are to be paid entirely or partly by the vendor, the Auditor should see that the company is bearing only what is in accordance with the agreement and that the amount payable has been approved by the Directors.

Where a prospectus has been issued, the Auditor should satisfy himself that the preliminary expenses do not exceed the amount mentioned therein subject to the provisions of the above-mentioned agreement. The following disbursements may be properly brought into the "Preliminary Expenses" Account as well as any other legitimate and proper expenses, connected with the formation and establishment of the company—

(1) The legal expenses for the preparation of the Memorandum and Articles of Association and the necessary agreements for the purchase of any business or property and the cost of printing,

(2) the cost of filing the necessary documents with the Registrar of Companies,

(3) the cost of all the legal work transacted on behalf of the Promoters and Directors of the company until the first allotment of shares has been made,

(4) accountancy charges,

(5) stamps and other out-of-pocket expenses,

(6) the legal and Parliamentary expenses for obtaining a private Act of Parliament incorporating the company, and for obtaining, if necessary, an extension,

(7) the cost of printing the private Act, Parliamentary papers, Memorandum and Articles of Association, prospectuses, notices, plans, shares and debenture certificates, etc.,

(8) the cost of printing, circulating and advertising the prospectus,

(9) the cost of printing allotment letters and share certificates, debenture certificates and debenture trust deeds,

(10) stamp duties on capital and contracts.

III. "Although a promoter of a company cannot be considered an agent or trustee for the company, the company not being in existence at the time, yet the principles of the law of agency and trusteeship are applicable to his case, and he is accountable for all moneys obtained by him from the funds of the company without the knowledge of the company."

"The fact that a promoter is acting as agent for the vendors in getting up a company for the purchase of their property does not exonerate him from accounting to the company, when formed, for any secret profit made by him.

"In estimating the amount of the secret profit for which a promoter was accountable to a company he was held entitled to be allowed the legitimate expenses incurred by him in forming and bringing out the company, such as the report of Surveyors, the charges of Solicitors and Brokers, and the cost of advertisements; but not a sum of money which he had expended in obtaining from another person a guarantee for the taking of shares."—*Lydney and Wigpool Iron Ore Co.* v. *Bird* (1886), 33 Ch.D. 85.

PREMIUMS ON SHARES

When a company carrying on a successful business requires additional capital, it may be in a position to issue the new capital at a premium.

There are many reasons why this should be done, one being that when the market value of the shares of a company is above par, the issue of new shares at less than market value of the existing shares may cause a depreciation in the value of the latter. On the other hand existing shareholders may be given the opportunity of subscribing for shares on bonus terms which preserves their rights if shares are issued at less than the market price. It would not be fair to the original shareholders, who have taken the risk of establishing the company, to allow others to come in on an equal footing after the company has proved successful.

The application of premiums received on the issue of shares is governed by Section 56 of the Companies Act, 1948, which is as follows—

56.—(1) Where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums

on those shares shall be transferred to an account, to be called "the share premium account," and the provisions of this Act relating to the reduction of the share capital of a company shall, except as provided in this section, apply as if the share premium account were paid up share capital of the company.

(2) The share premium account may, notwithstanding anything in the foregoing subsection, be applied by the company in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares, in writing off—

(*a*) the preliminary expenses of the company; or

(*b*) the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;

or in providing for the premium payable on redemption of any redeemable preference shares or of any debentures of the company.

(3) Where a company has before the commencement of this Act issued any shares at a premium, this section shall apply as if the shares had been issued after the commencement of this Act:

Provided that any part of the premiums which has been so applied that it does not at the commencement of this Act form an identifiable part of the company's reserves within the meaning of the Eighth Schedule to this Act shall be disregarded in determining the sum to be included in the share premium account.

PROFESSIONAL CHARGES

The Auditor should ascertain that the bills relating to Law Costs and Accountant's charges, and those of Estate Agents, Valuers, and Patent Agents, have been approved and passed for payment by the Board of Directors or other responsible persons. If any portion thereof has been charged to capital, he should satisfy himself that this is justified by the facts and is correct in principle, and also that the costs and charges relate to the company's business.

In the case of a company, the audit fee must be fixed by the company in general meeting or in such manner as the company in general meeting may determine, except that the remuneration of an Auditor appointed before the first annual general meeting, or an Auditor appointed to fill a casual vacancy, may be fixed by the Directors, and that the remuneration of an Auditor appointed by the Board of Trade may be fixed by the Board. For the purposes of the subsection in the Act dealing with this matter, any sums paid by the company in respect of the Auditor's expenses shall be deemed to be included in the expression "remuneration." (Companies Act, 1948, Section 159 (7).) See also Chapter XII, APPOINTMENT, REMUNERATION, RIGHTS AND DUTIES OF AUDITORS.

PURCHASES

The less effective the internal control the greater is the need to compare the invoices, or a part of them, with the Purchases Day Book and also with the Stock Books.

In any case the Auditor should see that provision has been made for trade discount, and that all invoices dated forward are brought into account. Invoices filed subsequently to the date of the accounts should also be examined to ensure that they do not relate to the period under review. It is essential to verify that nothing which ought to be charged to revenue has been allocated to capital, thus swelling the profits. The Auditor should be conversant with the system by which the advice notes and invoices inwards are checked prior to entry in the Purchases Book, and he may vary the checking of detail by comparing the purchases with the subsidiary records and Goods Inwards Book.

RATES AND TAXES

Examine rate demand notes and receipts and verify that due provision has been made for outstanding amounts or credit taken for payments in advance, and that all necessary apportionments have been made between one year and another. So far as is possible, ascertain that the rates refer to the property owned or occupied by the company, and that due allowance has been granted in respect of void properties on which either no rates or reduced rates will be payable. The fact that demand notes have been addressed to the client in his name, is, prima facie, evidence that they deal with properties owned by the company.

RENTS AND GROUND RENTS RECEIVABLE AND PAYABLE

A schedule or a Rent Register giving all particulars should be produced and this should be compared with the leases or rental agreements. It can then be ascertained that the receipts and payments are in accordance with the Register.

The Auditor should see that income tax has been deducted on making payment. The deduction from rents in respect of Schedule "A" tax should not exceed tax computed on the actual rent paid, and this tax should be deducted from the next instalment or instalments of rent payable to the landlord after the tax has been paid by the tenant. Income tax at the standard rate should be deducted from each payment of ground rent. In certain cases where the landlord himself pays or is assessed to income tax under Schedule "A" no deduction will be made by the tenant.

The high rate of income tax ruling in 1938 and since has, in most cases, made it impossible for the tenant to recover the full amount of the tax from the next quarter's rent, the tax being greater than the instalment of rent. It was therefore enacted in the Finance Act, 1938, Section 16, that, in such circumstances, the tenant occupier might, on giving notice to the Collector in the

form and within the time prescribed in the section, pay the tax in two instalments, as follows—

(1) On or before the day or the last day on which the tax would, but for the section, be due and payable, the whole amount of the tax less the excess over the amount of instalment of rent.

(2) On or before the expiration of three months from that date, the remainder of the tax.

The provisions of the Income Tax Acts as to recovery of tax shall apply to each instalment as they apply to the whole amount of the tax.

Any rents or ground rents paid in respect of a period which has not expired at the date of the accounts should be treated as a payment in advance. Any arrears should be brought into account.

If any part of the premises is sub-let, the rent received from the sub-tenant should be treated as a separate item.

It has been held that tax paid by the tenant under Schedule "A" must be deducted from the *next* payment of rent and cannot legally be deducted thereafter.—*Hill* v. *Kirshenstein*, [1920] 3 K.B. 556, C.A. But there is now the above modification.

REPAIRS AND RENEWALS

The Auditor should examine carefully the records of expenditure on repairs and renewals so that he may check the amount charged to revenue under these headings. The charge will affect mainly such accounts as plant, machinery, buildings and furniture.

In exceptional cases where expenditure in any one year is unusually heavy and may properly be regarded as covering two or three years, it is permissible to carry forward a part and to write off the expenditure over an appropriate period.

ROYALTIES

The royalty agreements should be scrutinized to ensure that all royalties payable or receivable have been brought into account and have been properly calculated. In the case of patent royalties, income tax should be deducted when the payment is made, whether the recipients are resident or non-resident in the United Kingdom. In the case of copyright royalties, income tax is not deducted unless the usual place of abode of the owner is not within the United Kingdom.

SALARIES

The vouchers should be examined.

Where vouchers are not given, a list of the staff, with full particulars, certified by a responsible official, should be produced and

the payments made should be in accordance with these particulars. Provision should be made for amounts accrued or accrued due. Where there are agreements with the staff, these should be examined in order to ascertain that the payments are in accordance with the agreements.

Where there is a Salaries Book this should be signed by a responsible official.

Prior to the year 1940, employees were responsible for the payment direct to the Collector of Taxes of income tax on their income from salaries. When the rates of income tax reached the very high level ruling in 1940, it was recognized that the collection of substantial sums at quarterly or half-yearly intervals from salary or wage earners would present practical difficulties, and arrangements were made by the Inland Revenue whereby notification was made to the employer of the tax liability on salary in the case of each employee and the employer was made responsible for deduction each month or week from salaries of an amount, to be accounted for by the employer to the Collector of Taxes, which would discharge the employee's tax liability for the stated period. The employer was accountable to the Collector of Taxes for these sums.

In most cases, the tax was based on the salary of a preceding period, a method which, with steady earnings, was not unsatisfactory. Later, however, it was felt that it would be more practical to relate tax liability to current earnings. Accordingly, in 1944 a different system, still providing for deduction of tax by the employer, was introduced. This was the "Pay as you earn" system (known as P.A.Y.E.), now in force, under which the employer deducts tax shown in tables provided by the Tax Authorities, such tax being directly related to the current salaries.

Under this system, employees are given a code number, which gives effect to allowances and reliefs to which they are entitled. The employer is notified of this number and he can ascertain from the tables how much tax should be deducted in each case from the payment of salary. This has the effect of spreading the tax deductions as evenly as possible over the tax year. The employer is furnished each year by the Inspector of Taxes with a card for each employee, on which he enters, amongst other particulars, the salary and the tax to be deducted. From this card can be ascertained the net amount, subject to any other deductions for National Insurance, etc., which the employee will receive.

Each month the employer should summarize the deductions shown on the employees' cards, the total being entered on the tax remittance card which should be sent monthly to the Collector of Taxes with a cheque for that amount. The Collector returns the card with his receipt.

The system in force should be examined by the Auditor. If the audit is continuous it will be possible for him to test the entries on the cards and to examine the remittance card to verify that the appropriate sums are being paid regularly to the Collector of Taxes. If the audit is annual it is probable that the cards, and the annual return which is required shortly after the end of the fiscal year, will have been sent to the Inland Revenue. But it is still open to the Auditor to check the cards in current use and to satisfy himself that the tax is being correctly dealt with.

It is important that the Auditor should verify that the tax is paid with reasonable promptitude. This is not always done, and sometimes employers are as much as some months in arrear with their accounting to the Collector. Since the amount represents a deduction from the employees' salaries this should not be the case. If there is delay, the door is open to fraud.

The Auditor should try to ensure that the cheque drawn for the total salaries, if these are paid in cash, is for the net amount after deduction of the P.A.Y.E. tax. In some cases the cheque drawn is for the gross amount, which means that there is a sum of cash representing the tax which is retained in the cashier's hands until it is used to make the payment to the Collector. The Collector is not in a position until after the end of the fiscal year to know whether the payments are correct, and a fraudulent cashier may well keep money in hand by making delayed or inadequate payments to the Collector.

National Insurance contributions are dealt with under INSURANCE on page 75, *ante*. (See also under COMMISSION, on page 37.)

SALES, CONSIGNMENTS, ETC.

Verify that the sales are all trading sales and do not include sales of plant and machinery or other capital assets; also ascertain that due provision has been made for trade discount. If goods sold but not actually delivered are included amongst the sales, ascertain that the goods have been excluded from the stock, and that the purchase price, or cost of manufacture, has been duly charged in the books, and cost of delivery reserved, if sold at a "delivered price." The Auditor should be conversant with the system by which the records of sales and deliveries of goods reach the Sales Department for entry in the books. He may usefully vary the checking of details by comparing the sales with the copy invoices and copy advice notes outwards, and by making an examination of the Goods Outwards Book.

Consignment Accounts. Consignments should be recorded in a Day Book specially ruled to record full particulars, including insurance, carriage and freight, commission, and any other charges. It is convenient that each consignment be given a

distinct number in consecutive order. This number should be impressed on all documents relating to the relevant consignment. The total amount of the consignment should be debited to a Consignment Account. The Auditor can see any documents he may require relating to the consignment at the consignor's office, or have certified copies. Eventually the consignee's accounts will be available showing the amount realized and any costs or charges deductible therefrom. The proceeds as shown by the account should be credited to the appropriate Consignment Account and debited to the consignee unless he has remitted cash in settlement. It is advisable that the profits of any one consignment should not be taken into account until the whole consignment has been disposed of. Correspondence with and accounts from the consignee will show what the position is at the date of the audit. A question will arise how the consigned stock remaining unsold should be brought into account. It may be necessary to write it down. This is a question of fact depending on the circumstances of each case.

Goods on Sale or Return (" On Appro."). These goods should be charged at cost price to an Appro. Account, or if there are many of them to separate accounts. When the goods have been sold, the Appro. Account can then be adjusted and the profit or loss carried to Profit and Loss Account. Goods out "on appro." should be brought into stock at cost price, unless there has been a fall in the value of the stock to a figure less than cost.

STOCKS AND SHARES

As to the stocks and shares comprised in the Ledger balances, a schedule should be submitted to or raised by the Auditor setting out their precise designation, the number of shares or amount of stock held, the rate of dividend (if there be a fixed dividend). Particulars should be entered as to the gross amount of the dividend actually received in the period under review, the tax deducted and net amount, the date due, the cost price or market value where ascertainable, in whose name held if there be a nominee, with spare columns in which to enter particulars as to documents produced at the verification of the existence of the investments. If the stocks or shares are charged as security, further columns should be provided in which to enter particulars showing to whom charged, the amount of the charge, the interest payable, when payable, and who holds the securities.

Where the stocks are officially quoted, a broker's certificate may be procured if deemed necessary as to the values; where not quoted, the value is a question of circumstances, involving careful inquiries and a considered judgment based on such evidence as is available in the shape of accounts, reports, or expert opinion as to the values. The Auditor should see that the dividends have all

been received and accounted for, and, by reference to the counterfoils of the dividend warrants, whether they have been received gross, or less tax, or free of tax. To this extent he will at the same time be able to vouch the cash received.

Where stocks and shares have been bought and sold, see that the numbers of shares or the nominal amounts of stocks bought and sold (and not simply the money received or paid) are entered in the Ledger in respect of each transaction, and agree the number or amount of stocks and shares on hand with the difference between the purchases and sales.

Stocks and shares (especially investments of a permanent nature) are sometimes taken into the Balance Sheet at cost and sometimes at market value, if lower, but are not written up to market value if it be higher than cost. The Companies Act, 1948, Eighth Schedule, paragraph 11 (8), provides that there shall be stated by way of a note or in a statement or report annexed to the Balance Sheet, if not otherwise shown—

> The aggregate market value of the company's quoted investments, other than trade investments, where it differs from the amount of the investments as stated, and the Stock Exchange value of any investments of which the market value is shown (whether separately or not) and is taken as being higher than their Stock Exchange value;

but this provision does not apply to a banking or discount company (Eighth Schedule, paragraph 23 (1)).

In the case of financial companies dealing in stocks and shares, the value in the accounts should be cost price or market value, whichever is lower, as in the case of trading stocks. Reserves may also be considered necessary to meet anticipated losses.

In principle, profits or losses in respect of a sale of stocks or shares may be either a gain or a loss of capital or income, according to whether the stocks or shares represent investments of capital or of accumulated profits. Except in the case of trusts, estates, and subject in partnership matters to the conditions of the Articles of Partnership, it is desirable, as a matter of sound finance, that all such losses be written off out of profits at once, or over a reasonable period of years, to avoid inclusion of assets of a nominal nature. The Auditor should satisfy himself that the company has power to invest in the stocks and shares which it holds. Should the company hold partly paid shares, the contingent liability in respect of uncalled capital should be disclosed on the face of the Balance Sheet. In the case of stocks and shares not producing income, inquiry should be made, and reserves created, if necessary, to meet any anticipated loss.

In the case of investment trust companies, where profits on the sale of investments are not made available for distribution as dividends as in the case of finance companies, the usual practice is

to show investments at cost, the note on the Balance Sheet giving the market value. Any specific reserve for the depreciation of investments may be shown separately on the liabilities side of the Balance Sheet, or as a deduction from the book value of the investments.

Stocks and shares held only as security do not appear as ledger balances.

STOCK-IN-TRADE AND MANUFACTURING STOCKS

Quantities. The Auditor does not take stock, and depends upon an examination of stock inventories and a certificate from responsible officials to the effect that the quantities have been carefully and correctly taken; in certain cases—for example, where there are warrants for goods in warehouse—documents of title will be produced. In some industries a reliable statement may be available, or may be prepared, of the stock on hand at the beginning of the period, and the quantities bought and sold; the stock which should be in hand at the end of the period can thus be ascertained and a rough agreement with the Stock Sheets made after allowing for waste, shrinkage, and other variations.

In different trades the mode of procedure in taking the stock naturally varies; but the object of stock-taking is to ascertain, by number, quantity, measurement, or weight, the entire stock-in-trade, that is, the unsold portion of goods, either manufactured or purchased with the object of being resold in the ordinary course of business, and to arrive at a fair valuation on the principles laid down, which should not vary from year to year.

Value. A broad general formula has been that stocks should be valued at cost or market price, whichever is the lower. "Market value" is difficult to define with complete accuracy but it is generally regarded as being cost to replace, or selling price if the latter is lower. Stock must not, in any circumstances, be valued at more than cost as the effect of such procedure is to anticipate a profit. If a loss in a succeeding period in relation to stock is anticipated, it is prudent to make a provision for it, but account should not be taken of an anticipated profit. The formula implies that due allowance has been made for old, damaged, or depreciated goods. A certificate as to the basis of valuation, signed by responsible persons, should be obtained by the Auditor, and it is desirable that it should be specifically stated in the certificate that the allowance mentioned in the previous sentence, if it arises, has been made. The whole question of the valuation of stock-in-trade for accounting purposes has been considered by the Institute of Chartered Accountants, and is dealt with in Recommendation No. X on Accounting Principles. This is given in Appendix III hereto.

It will be seen that no particular basis is considered suitable for

all types of business, but that it is important that the basis adopted should be applied consistently. It will be further seen that there are various bases for arriving at cost, such as "unit" cost, "first in first out," "average," "standard," "adjusted selling price." The first three of the above are founded on the principle of cost as an historical fact, and this gives rise to the term of "historic cost" used in connexion with the valuation of stocks.

The Auditor should endeavour to satisfy himself that the principle adopted is reasonable and consistent from year to year. In some cases even market quotations as a basis for ascertainment of market value are not conclusive, since much depends upon individual capacity in handling markets and even upon the quantities which may be put upon the market. Some stocks are not readily marketable except at stated seasons, and the market value on a particular day, therefore, may not be appropriate for accounting purposes. The sound financial policy is to make a conservative estimate of values, but a writing down of the nature which would have the effect of creating a material hidden reserve must be avoided. It is sometimes possible to compare the valuation of finished stock with sales made at about the time of stocktaking, and so to obtain a key to the principle on which the valuation has been made. A rough and ready test may be applied to stocks by working out the percentage of gross profit on sales from year to year. If the percentage be found to vary considerably, further inquiries should be made. In some trades the regular practice is to take stock at selling value less a discount, in which case the valuation may also to some extent be tested. There are also trades in which certain "base" stocks are taken at a constant value from year to year.

At a time of considerable rises in price levels, the capital required in the business to finance stocks is increased, and even where stock is turned over rapidly businesses may be handicapped for want of working capital.

Where a trader has hitherto determined his capitalization on the basis of prices ruling in an earlier period, a substantial rise in the price level, if heavy stocks are dealt with, may mean the provision of additional capital. If this is not done, the alternative may be to build up a reserve by retaining in the business money which might otherwise be distributed in dividends or drawn by the trader. Present-day taxation makes it difficult for many undertakings to build up such a reserve, but where this basis can be adopted it is recommended. Since such a provision would be made by an appropriation of profits, it is desirable to treat it as a reserve and not as a provision to be made before the profits of the year are ascertained. Since it will not be regarded as available for distribution, it should be treated as a specific capital reserve.

This matter is fully dealt with in Recommendation No. XII of the Institute of Chartered Accountants.

The valuation of stock is of vital importance, for by over-valuation the profits may be inflated or by under-valuation understated. It follows that the accounts of the following year would also be incorrect, since the closing stock of one year is the opening stock of the next. A case occurred in which the Manager at the end of the first year of a company's existence valued the stock at selling value. The practical effect of this was to add the whole of the difference between the cost and the selling value of the stock to sales and so show a very handsome profit, as if all the stock had been sold during the year. The second year showed a very different result and led to an inquiry which brought out the facts.

In the main, however, the Auditor, unless he specializes in a particular manufacture or trade, must depend very largely upon the certified statements of those who are engaged in the manufacture or trade and can gauge the proper valuation to be placed upon the stock. The recognized practice is for the Auditor to accept a certificate from a reliable official in a form similar to that adopted by the income tax authorities. It may be advisable that the certificate should also state that the stock has been taken on the same basis as in previous years, that all goods taken into stock have been charged as purchases, and that no plant is included, and no stock which has been charged out to customers, either as sales or on sale or return, "on appro.," or items such as cases, casks, etc., and included in book debts.

Extensions, Casts, etc. The working out and checking of the extensions and casts should be certified by those who are responsible for the work. The Auditor exercises his own discretion as to checking the whole or part of the extensions and casts.

Certificate as to Stock. A common form of certificate is given below.

CERTIFICATE AS TO STOCK

I hereby certify that the above is a correct list of the stock as at 19 amounting in value to £ , that it has been taken at cost price or at market value, whichever is lower, and that due allowance has been made for old, damaged, and depreciated goods.

Quantities taken by
Prices and proper allowances fixed by
Extensions and additions made by
Checked by
Finally approved by

I further certify that the said stock-in-trade was the property of the company on the said date and was then in its possession, and that it includes no plant, machinery, fixtures, or fittings, or items charged to customers.

(Signed)

(General Manager or other responsible official.)

To obviate the delays and inconvenience of a yearly stocktaking, the quantities of stock are sometimes taken down from the Stock Ledgers at the close of the year, the actual stock being frequently compared during the year with the Stock Ledger records. The periodical comparison should be made by responsible persons and the Stock Ledger balances agreed, written down, and certified by them at reasonable intervals.

CASE

It is no part of an Auditor's duty to take stock. He must rely on other people for details of the stock-in-trade on hand. In the case of a cotton mill he must rely on some skilled person for the materials necessary to enable him to enter the stock-in-trade at its proper value in the Balance Sheet.—*Re Kingston Cotton Mill Company No.* 2, [1896] 2 Ch. 279.

SUBSCRIPTIONS TO TRADE SOCIETIES AND CHARITIES

These two classes of subscription should be kept distinct. In the case of companies it should be ascertained that the subscriptions are duly authorized by the Board, and as regards charities —failing power in the Memorandum of Association to make such contributions, and authority in the Articles to the Directors to exercise the power—these payments should strictly speaking be authorized or confirmed by the shareholders at the annual general meeting.

For income tax purposes it is convenient to separate those subscriptions which are allowable for income tax from those which are not, so that the information may be readily furnished to the Inspector of Taxes when the income tax computation is being made.

SUNDRY EXPENSES, including Cables, Telegrams, Heating, Lighting, Stationery and Printing, Postages and Telephones

These expenses having been duly vouched and checked with the books, it is only necessary to ascertain by a reference to the invoice files that all outstanding amounts have been brought in. As to the telephone, lighting and heating charges, where supplied from outside sources, a reference to the demand notes or receipts will enable any necessary apportionments or reserves for outstanding amounts to be made or checked. In the case of regular charges—e.g. quarterly or half-yearly—the Auditor should see that the last account entered in the books covers the period to which the accounts relate, or that an adequate provision is made for the broken period. If the periodical account has been received prior to the completion of the audit an exact apportionment can be made.

TRADE DEBTORS

An Auditor cannot be expected to know, or even to ascertain, the financial position of the debtors, but it is part of his duty, by all reasonable means, to ensure that debts not likely to be recovered are written off, or that a sufficient reserve is made to cover such debts as appear to be doubtful. The following method should be adopted.

A list of the trade debtors should be submitted to the Auditor, who should ascertain which debts have subsequently been paid and on which probably no question should arise. Where a debt is in arrear inquiries should be made and, if necessary, the file of correspondence with the debtor perused. Where the payments on account are irregular and not in accordance with the prescribed terms of credit, the accounts should be carefully scrutinized and reference made to the correspondence file to verify that the payments have actually been made by the debtor in question. It may be that irregularities will have occurred and that the revolving system is being operated whereby moneys received from certain debtors are credited to the accounts of other debtors of older date whose payments have been misappropriated. This applies particularly in businesses where payments are made by cash as well as by cheque.

Where debts have been written off as bad, evidence should be available in the shape of letters, or official bankruptcy or liquidation documents. If, as sometimes happens, the debts include cash sales where cash has not been promptly collected, see that the cash is accounted for and that this balance is not increasing in a disproportionate manner.

One method of procedure in reserving for bad debts is to set aside a percentage on the total amount of the debts outstanding or on the sales, thus creating a reserve to which the debts found to be bad are charged. Although this method is not scientific, there may be sufficient experience in previous years to indicate a percentage which will ensure a reasonable provision. But the percentage should be kept under review and revised from time to time in the light of experience.

The Auditor should ascertain whether the debtor is also a debtor in respect of Bills Receivable. He should examine the course of the account and note whether the debt is increasing out of proportion to the sales made to the debtor. Similarly he should examine the figure of total debtors and compare it with the sales made during the year to ascertain whether, year by year, the relationship is reasonably constant. A growth in the percentage of debtors to annual sales may be the result of misappropriations and debtors may not have been credited with amounts which they have paid. The effect of an irregularity of this kind may be

masked by the procedure mentioned above, whereby the older debtors may be credited with amounts paid more promptly by other debtors, and so allay the Auditor's suspicion in regard to protracted credit.

Some concerns issue, at the close of each year, a notice (which should be posted from the Auditor's office) addressed to each individual debtor or creditor, stating the balance shown to be due to or by them in the books. This notice should contain a request that, in the event of the balance not being agreed, a direct communication should be made to the Auditor. This check may be an effective precaution against misappropriation.

It is necessary to ensure that adequate provision has been made for the usual trade discounts so far as not forfeited by the failure to pay within the prescribed time of credit. Cash discounts are allowed at the time of payment, and if payment is not made at the due date may be withheld. It is not usual to make provision in advance for this form of discount.

Where it is the practice to date invoices forward, care must be taken to see that the amounts are not included in the debtors and also in the stocks on hand at the date of balancing.

It should be ascertained that the individual debts are good, and that they do not include items which ought to be written off, such as payments for goods bought or for free samples, payments for services, rent, rates, taxes, law costs, or advances to Directors or drawings by partners.

When a concern employs agents to obtain business, it is desirable that the amounts which either remain in agents' hands, or have to be collected by them and accounted for, should be stated separately, and not included with "Amounts Due from Sundry Debtors."

The Auditor should be careful that commission and all other charges which have to be allowed to the agents are deducted from the balances at their debit, and charged against profits under the proper headings.

A list of the agents' balances should be prepared in the same manner as has been suggested previously for the sums due from the ordinary debtors, and those amounts which it is considered will not be ultimately realized should be treated as bad or doubtful debts.

CASES

When the Auditor, after discussion with the Manager or Secretary of a company, is not satisfied that a sufficient amount has been allowed for probable loss on realization of debts, he should, in the interests of the shareholders, bring his views before the Directors, so as to fix them with responsibility in the event of

their also disagreeing with his views, as it has been held that the Directors of a banking company were not liable to the company for including in their accounts as good, debts which were, in fact, bad, unless they could be fixed with knowledge of the fact.—*Turquand* v. *Marshall* (1876), 4 Ch.D. 376.

No balance sheet can be made out for any useful purpose without distinguishing good, bad, and doubtful debts.—*Re Frank Mills Mining Co.* (1883), 23 Ch.D. 57.

TRADE CREDITORS

The Companies Act, Section 147, provides that proper books of account shall be kept with respect to various matters which include the liabilities of the company. The Eighth Schedule requires that the summary of the liabilities in the Balance Sheet shall be such as to disclose their general nature, and that liabilities and provisions shall be classified under headings appropriate to the company's business, though if the amount of any class is not material it may be included under the same heading as some other class.

Clarity of presentation will generally make it desirable that trade creditors should be shown in a separate total from other creditors in respect of expenses such as rates and taxes, rents, interest, and so on. In the case of the latter, frequently an apportionment has to be made so that the part of an item which relates to a future period may be excluded.

The amounts due to the trade creditors may be checked by reference to the monthly invoices or statements rendered by them. The invoices may also be checked or tested by reference to the records of stocks and stores received. The entries in the goods inwards books at the end of the financial year and at selected dates during the year may usefully be examined with the invoices to show that the goods have been received. Bills payable are usually set out as a separate item in the Balance Sheet.

Evidence of the examination of invoices and monthly statements by responsible officials should be seen by the Auditor. It is usual for these documents to be impressed with a stamp such as the following, showing that they have been checked as to delivery of goods, prices, extensions, and additions, independently of the cashier—

Goods received by
Quantities checked by
Prices do.
Extensions do.
Passed for payment

A certificate may be obtained by the Auditor from someone in authority that all known and ascertained liabilities have been included in the books, that no outstanding amounts have been omitted, and that all invoices dated forward have been brought into account where the goods are brought into stock.

As a further check invoices filed and paid after the date to which the accounts are made up should be examined, so that the Auditor may ascertain that they do not relate to the period covered by the accounts.

It is a matter for consideration by the Auditor how far it is necessary to check the entry of invoices in the Purchases Book and the postings therefrom to the Bought Ledgers. He should satisfy himself that the purchases made relate to the business and that they have been duly passed for payment. The allocation of the purchases to the appropriate nominal accounts should also be examined and, in particular, the allocation between capital and revenue. The usual periodical statements from the creditors will assist in the verification of the items in the Ledger and the balances, but they will not show the nature of the purchases, which can only be ascertained from the invoices referred to in the statements.

TRANSFER FEES

A source of revenue in nearly all companies is the fees received for the registration of the transfer of shares, usually called "Transfer Fees." In those companies whose shares are quoted in the official list of the Stock Exchange and dealt in freely, the transfer fees often form an appreciable item of revenue. The total fees should be checked by reference to the Register of Transfers. If necessary the transfer deeds themselves can be counted. (See also Chapter XX.)

WAGES

The Auditor should verify that the wages have been properly allocated as between capital and revenue. If the Ledger shows that there is a floating balance in hand, he should see that the cash has been counted and agreed with the balance in the course of verifying the cash. If any part of the wages—for example wages spent on erection of fixed plant and machinery, or on buildings, etc.—has been capitalized, he should procure a certificate from a responsible official that the addition to capital is justified. The Auditor should also satisfy himself, so far as he can, that the expenditure is of a capital nature; he need not necessarily rely on the certificate alone. (See also VOUCHING AND VERIFYING THE CASH, Chapter V. As to P.A.Y.E. deductions, see under SALARIES, *ante*.)

WORK IN PROGRESS

This item is usually the aggregate of a number of balances representing wages paid, material purchased and used, and a percentage of establishment charges in respect of unfinished contracts. It may also include some allowance for profit considered to have been made on the completed part of the contracts and so a credit to profits. The debits for wages and material are questions of fact which can be tested and verified by reference to the invoices and wages summaries. The percentage for establishment charges may be based on the total productive wages paid or on the total hours worked at the factory or calculated by some appropriate method and charged accordingly to the work in progress. The calculation of the percentage should be carefully examined and the Auditor should satisfy himself that it is correct in principle, and inquire how far it is in accordance with the custom of the particular industry. A summary of wages paid or hours worked and a summary of establishment charges should be produced and tested by reference to the books.

The amount of profit which may fairly be included is rather a difficult question, depending upon estimates as to the cost of completing the contracts, as to which the Auditor must rely mainly on expert advice. He should inspect the figures upon which the estimates of profits are based and satisfy himself as far as possible that they are reasonable. An inspection of past estimates and the actual results will often help him to form an opinion as to the reliability of the figures placed before him. It is advisable to adopt the policy of making conservative calculations, and even in some cases it is the practice to limit the profit to interest on capital employed, though even then it is necessary to ensure that it is not excessive.

The question, like that of stock-taking, is mainly one of expert knowledge. Certificates as to the value of the work in progress should therefore be obtained from the appropriate officials, such as the managing director, general manager, works manager, and chief costs clerk. These certificates should state that the value of the work in progress does not exceed the contract value and that provision is made for the cost of completion. (See *re The Westminster Road Construction and Engineering Co., Ltd.*, page 159.) The Auditor will find it useful to compile for his own private use a schedule of the percentage of establishment charges as computed in various undertakings and of the basis upon which the percentages are calculated.

Stock in process of manufacture (not under contract), and subject to being sold, should be included in stock at cost, or at selling price, if lower. Receipts on account of work in progress should be traced and deducted from the work in progress.

In the case of running contracts periodical certificates are issued by the architect or engineer, recording the progress of the work and the amount payable to date to the contractor. Subject to adjustment for stocks, plant, etc., on hand and reserves for anticipated losses before completion, the profit to date will be the difference between the certified amount and the expenses incurred, including oncost as mentioned above. Where a contract is likely to cover more than one accounting period it is reasonable to take into account part, if not all, of this earned profit. Further, if this course is not adopted, the final profit or loss will be dealt with in one sum on completion, with the result that there will be considerable variations in profits as between one account and another. Some contractors carry forward the net expenditure or net credit on a contract until it is nearly—say 75 per cent or 80 per cent—completed, before taking any profit to Profit and Loss Account; but losses should in any case be provided for. (See also page 179.)

CHAPTER V

VOUCHING AND VERIFYING THE CASH

THE object of vouching is not only to test the accuracy of the receipts and payments as recorded in the Cash Book, but to prove that the receipts and payments are posted to the proper accounts, and that correct apportionments have been made. The entries should be sufficiently clear and full to enable this to be done. Where there is efficiency in the direction and management and in the general organization and book-keeping, and the vouchers and other documents are properly arranged and readily available, vouching can be carried out effectively and quickly. Where the book-keeping is defective, and the documents and vouchers are ill-arranged or missing, the Directors or partners are obviously taking a risk, and the Auditor, for his own protection and in the interests of his clients, would do well to draw their attention to the defects. Directors and partners, in their own interests and as a matter of duty, should take proper precautions against misappropriation. The discovery of irregularities by the Auditor in the course of examining the accounts after the close of the year, does not restore what has been taken. Apart from this employees should be deprived, as far as possible, of opportunities for misappropriation. If the audit is intended to prevent irregularities by employees it should take the form of a continuous, specially devised internal control. In this case appropriate remuneration should be arranged, for part of the machinery of management is being undertaken by the Auditor in addition to his ordinary functions.

CASH RECEIVED

Apart from exceptional items or special matters, receipts are generally on account of book debts or cash sales, which to some extent are indirectly vouched in the carrying out of the work already referred to in scrutinizing the Ledger balances. A comparison of cash received with the counterfoils of receipt books should be made, but it is not of full value unless a system is in operation by which the counterfoils themselves are adequately controlled. In one case of misappropriation it transpired that the cashier himself handed particulars of the receipts to the counterfoil receipts clerk, whose duty it was to make out the receipts.

To control the cash received and the counterfoil receipts the manager, in opening the letters, should make a memorandum,

preferably in a book, of the remittances which they contain. The cashier should be present, and should take the remittances as well as the covering letters, afterwards handing the letters to the counterfoil receipt clerk to make out the receipts. The memorandum made by the manager should be compared by him or on his behalf with the counterfoils of the receipts, after which the counterfoils should be compared with the Cash Book, or vice versa. The Auditor should also test the memorandum record with the Cash Book. In this way the major part of the cash received may be effectively vouched at the source. In small businesses, where dispersal of the work is not easy, the principal himself should exercise a strict control.

The Auditor should pay attention to dates, testing from time to time the dates of entries in the memorandum cash record with the Cash Book, and the Cash Book with the Ledger, to verify that they correspond. A delayed entry in the Cash Book may be used to hide an earlier fraudulent abstraction of cash, but the posting to the Ledger may be correctly dated so that the account will appear in order and up to date. Comparison of the dates may lead to discovery of a fraud.

Auditors should discourage their clients from using the takings to finance expenditure, without payment into the bank. All takings should be paid into the bank promptly, and petty cash should be provided by cheques specifically drawn for the purpose and entered in the Cash Book.

Other cash items may be vouched as follows—

Cash sales, by reference to properly controlled counterfoil receipts, or to statements of cash sales duly authenticated by the signatures of two independent persons or by a cash register. Receipts from travellers by reference to the travellers' returns, or by reference to the travellers' counterfoil receipts if they collect money, supported by a scrutiny of the customers' Ledger Accounts; dividends on bad debts by reference to official documents or correspondence; withdrawals from Deposit Account by reference to the Bank statement or Pass Book and by agreement of the balance on deposit as certified by the bank; bills receivable by reference to the Bill Book and customers' Ledger Accounts; loans by reference to the Register of Mortgages, to the documents of loan, minutes, and correspondence; rents receivable by reference to the rent roll as settled by reference to the leases; dividends by reference to the counterfoils of the warrants, or to the securities themselves, or to the *Stock Exchange Official Intelligence*; sales of investments by reference to the brokers' contract notes; sales of property by reference to the solicitors' completion statements and agents' accounts; return of tax by reference to the claims submitted and to the official correspondence.

As to banks, building societies, provident societies, and the like, see VARIOUS CLASSES OF AUDITS (Chapter XVII).

(See also preceding articles under heading EXAMINING THE LEDGER BALANCES, Chapter IV.)

CASH PAID

The Auditor should ascertain what signatures are required to cheques, how the cheques are crossed, and what precautions are taken by the Directors or partners before signing them. Cheques should be signed by the Directors, or other person empowered to draw, only on the production of invoices or other statements which have been duly checked and passed for payment independently of the cashier. If this procedure is observed cheques signed by two Directors and countersigned by the secretary, or signed by partners and regularly endorsed by the payee, are prima facie evidence that a proper payment has been made; still more so if the cheques are crossed "Account Payee only," and the name of the payee's banker is added to the crossing. Although in many cases receipts are given on invoices, the Auditor will more frequently find receipted statements of account. It is desirable to have official forms of receipt as they provide a safeguard. In many businesses a form of receipt printed on the back of the cheque is adopted, in which case an acknowledgment is given when the cheque is endorsed. It is particularly important in these cases to examine the invoice or statement unless the payment is of such a nature that sufficient explanation may be given on the back of the cheque, e.g. salaries, rent, etc. If the invoices or other statements are entered in a columnar Invoice Day Book, the debits being posted in total to the appropriate Impersonal Accounts, the Auditor can satisfy himself as to the allocation of the amounts by examining the Invoice Day Book with the respective invoices or statements. The Invoice Day Book entries are checked to credit of accounts in the Bought Ledger, the cash payments vouched in the Cash Book and called to the Bought Ledger, and the Bought Ledger balances examined, thus making a complete check. As already mentioned, endorsed cheques should not be accepted as vouchers where receipts ought to be available, and in any case not without supporting evidence; the auditor should be satisfied that a system of internal control is carefully carried out. (See also FRAUD IN ACCOUNTS, Chapter XIV.)

The payments in the Cash Book should be numbered consecutively, and the vouchers numbered to correspond, and bound together or filed in that order, in such a way that they can be examined without loss of time in unfolding and refolding them. The vouchers, after comparison with the Cash Book entries, should be distinctly marked by the Auditor either with his initials, or

preferably with a distinctive rubber stamp, so that the voucher cannot be altered and used again. The Auditor should see whether the date corresponds closely with that in the Cash Book, and that the statement is made out in the name of the client; if not he should ascertain why not. Where the voucher is also an invoice, it should be ascertained whether on the face of it the payment relates to the business.

A list of missing vouchers should be made and submitted to a responsible and independent official, who should be asked to certify that the corresponding payments are in order. Apart from stamped vouchers, evidence of payment may also be available in the shape of correspondence, agreements, or other documents, supported by endorsed cheques. Where the receipt is on the back of a cheque issued by the client, in what is now a fairly common form, it may be necessary to examine the invoices and the payee's Ledger Accounts as already mentioned, in order to see that the payments are made against proper credits. In the case of directors' fees, auditor's charges, and other similar payments, the amount of which is readily ascertainable from independent sources, such as Articles of Association, minutes of meetings, etc., an endorsed cheque may be taken as evidence of payment, due regard being paid to the date of the cheque and the endorsement, and the total payments.

Bills payable retired should be produced. Official receipts for rates and taxes should be available, and the Auditor should take notes of the details necessary to check the apportionments. In the case of insurance premiums, the policy is the voucher for the first payment, and the renewal receipts should be produced for subsequent payments. For interest payable, a voucher should be produced showing that income tax has been deducted, except in the case of bank interest, which is checked by reference to the Bank Pass Book or statement, and from which tax is not deducted. Where debentures are paid off, or charges redeemed, the debentures or documents should be produced, *duly cancelled*, unless, in the case of debentures, they are being kept alive for re-issue. Payments for properties should be verified by reference to the solicitors' completion statement and agents' accounts; investments by reference to the brokers' contract notes and the share certificates; applications for shares by reference to the bankers' receipts for the amounts payable on application and allotment, and calls by the bankers' receipts, or by the endorsement on the share certificate where the receipts have been exchanged for the share certificate.

WAGES

A summary of the wages sheets, supported by the wages sheets themselves, and duly certified as to the time, the rates of pay,

calculations, extensions, and checking by the persons responsible and countersigned by the official who actually pays the money as well as by the works manager, is the usual form of evidence and record available to the Auditor. He may, however, check the details sufficiently to satisfy himself that the officials are carrying out their duties in a careful manner. When the hands are paid by time the time may be tested by reference to the timekeeper's records. An effective additional check is provided by a surprise wages audit, at which, by arrangement with the Directors or partners, the Auditor unexpectedly presents himself, checks everything in detail, and supervises the actual payment of the wages, accompanied by a manager who knows the hands. The Auditor may also test the wages by calling for a number of the insurance cards of the hands employed, and he should see that the cards are duly stamped and agree the stamps used with the cash paid for stamps and the stamps on hand. (For reference to P.A.Y.E. system of income tax deductions, see under SALARIES, Chap. IV.)

PAYMENTS INTO PETTY CASH

These should be agreed as to date and amount with the entries in the Petty Cash Book; this book, in its turn, should be reasonably vouched and tested as to casting and analysis.

CUSTOMS DUTIES

No receipts are given. The payments are made either in cash or by a transfer on the Bank of England. In the latter case the returned transfers are available as evidence. The payments should, however, be substantiated by a certificate given by an independent person, stating that the amounts have been duly paid in respect of Customs Duties.

GENERALLY

A comparison of the names in the Cash Book with the names in the Bank Pass Book (or Statement) may sometimes lead to the discovery of irregularities—where, for example, the cheque is drawn in one name, but another name entered in the Cash Book.

(See also under Loans, Borrowed Moneys, Stocks and Shares, Leases, Rents and Ground Rents, Bank Charges, Salaries, Commission, Royalties, Subscriptions, Law Costs, Debenture Capital, Preliminary Expenses, Underwriting, Commission, Debenture Interest, Directors' Fees and Expenses, Dividends, Partners' Salaries and Drawings, Wages, etc.)

AGREEMENT OF CASH BOOK AND BANK PASS BOOK (OR STATEMENT) BALANCES

Each side of the Cash Book should be compared item by item with the corresponding entries in the Bank Pass Book or Statement,

after which a reconciliation statement should be drawn up in the following form—

X.Y.Z. LIMITED

Statement reconciling the balance shown in the Banker's Pass Book with the Cash Book balance at 1st January, 1949.

Balance as in Pass Book					£3842	7 6
Deduct cheques drawn as under but not presented						
Dec. 22nd (name)	£81	4	2			
Dec. 26th (name)	23	1	7			
Dec. 30th (name)	6	8	4			
					110	14 1
					£3731	13 5
Add payments into Bank not cleared						
Dec. 30th (name)	£246	3	6			
Dec. 31st (name)	74	8	8			
Dec. 31st (name)	26	5	2			
					346	17 4
Balance as in Cash Book					£4078	10 9

Outstanding cheques should be traced through the bank into the next period, and cheques which ought to have been cleared, but have not, inquired into. The Auditor should inquire particularly into cheques drawn at the end of the period and not cleared for some days, as this may mean that they have been held back and have been entered in the Cash Book for window dressing purposes to reduce the creditors appearing in the Balance Sheet.

The Auditor should always request the bankers to certify to him the balance as shown by the books of the bank at the close of the year, for it is possible for the Bank Statement or Pass Book to be tampered with before production to the Auditor. The Auditor should write himself to the bank asking for the balances on all accounts, though it will probably be necessary to obtain the client's signature to the request before the bank will furnish the information. In this way the existence of an account of which the Auditor was unaware may be disclosed. Where branches pay in locally for the credit of Head Office Banking Account, care should be exercised to see that the branch payments are not in arrear, or being used to cover up any discrepancies in paying in at the Head Office. For this purpose the branch returns should be scrutinized and the date of paying in moneys by the branches compared with the date on which they appear in the Pass Book.

Where the receipts side of the Cash Book is not compared in detail with the Bank Account, the amounts paid in should be tested here and there to ascertain that they are being paid in promptly, and items should be compared with those appearing on the counterfoil of the paying-in book.

CHECKING CASH IN HAND

Where, as is usual, all moneys received are paid into the Bank, and all payments other than petty cash payments made by cheque, the only cash balances in most classes of business consist of the petty cash balances and in some cases various "floats." Unless trivial in amount the cash should be counted on the last day of the year. If it is counted later, both the Cash Book and the Petty Cash Book should be written up to date, and the Cash Book compared with the Bank Account, and the respective balances agreed at the point at which the counting takes place. A more convenient practice is that the petty cash balance and the "floats" be paid into the bank on the last day of the year, and a cheque drawn to re-open the Petty Cash Account and re-establish the "floats." This avoids the counting of the money. If the petty cash balance or floats are increasing from year to year, satisfactory explanations should be obtained. Unless the cash is checked from time to time, as it should be, by the management, it is obviously better that the checking by the Auditor should take place at irregular intervals.

DEPOSITS AT BANK

Deposit receipts should be produced, or a certificate from the bank, stating the amount on deposit at the date of the Balance Sheet. The interest received on the deposit should be traced in the Cash Book.

CHAPTER VI

VERIFYING THE INVESTMENTS

THE verification of investments as a part of the Auditor's duties arises to the greatest extent in the case of banks, building and friendly societies, insurance companies, discount houses, trust companies, trust estates, and similar undertakings. This is carried out by—

(*a*) The inspection of share or stock certificates in the name of the client.

(*b*) The inspection of share or stock certificates in the name of other persons or bodies, accompanied by transfers signed by them as transferors in favour of the client or in blank and undated, or accompanied by a declaration of trust.

(*c*) The inspection of bearer bonds.

(*d*) The inspection of a certificate from a bank or other body or person holding the titles to the investments that they held them on a given date for account of the client, and whether or not there was a charge on them.

See later under STOCKS AND SHARES. Other securities and documents will be inspected in a similar manner, as mentioned below.

Inspection should take place as soon as possible after the close of the financial year, if not on the actual date of closing. If this is not done, the transactions after the close of the year to the actual date of inspection will have to be traced through the books.

The routine of the inspection should be carefully arranged. If the number of securities to be inspected is not large, all the documents should be produced at once and dealt with in such a way after checking that they cannot be produced again. It is desirable, if not essential, that a representative of the clients be present at the inspection and that his attention be called to any discrepancy immediately it has been found. If a representative of the clients were not present and a shortage should afterwards arise, the clients might be tempted to draw unjustified but embarrassing conclusions.

The Auditor should be furnished with a list of the securities and documents to be inspected, and the list should be checked not only with the securities and other documents but with the corresponding balances in the books.

The extent of the work, particularly in the case of banks and similar bodies, will depend on the system of internal control in force. It may be that the test applied will, by comparison with

the total, be only nominal, but it is for the Auditor to satisfy himself that he has made such an examination as is in his judgment practicable, reasonable and sufficient in the circumstances of each case.

In the examination of documents production may be conveniently made in the following order, the documents likely to be parted with earliest in the course of business being inspected first; next those in respect of which time may elapse before the necessary certificates can be secured, and finally those which relate to matters of a more permanent character—

Bills of exchange and promissory notes.
Trade documents.
Temporary investments.
Stocks and shares.
Debentures, bonds, etc.
Life assurance policies, life interests and reversions.
Loans to public bodies.
Patents and trade marks.
Title deeds, including mortgages, leases, etc.

BILLS OF EXCHANGE AND PROMISSORY NOTES

In the case of banks and discount houses, the bills should be examined at the close of business on the last day of the year and agreed with the Bill Books, and agreed in total with the Ledger balance. Bills held as security for advances (usually kept in separate portfolios) should be examined in the same way. Bills remitted for collection should be verified by the subsequent receipt of the proceeds. In business houses, bills receivable will possibly have been discounted. Bills on hand should be compared with the Bills Receivable Book, and the total agreed with the balance of the Bills Receivable Account in the Ledger.

TRADE DOCUMENTS

For goods in transit, bills of lading, marine insurance policies and invoices relating to goods should be produced. For goods in warehouses, invoices, warrants to order, and fire insurance policies should be produced.

TEMPORARY INVESTMENTS

Temporary investments are generally made on account of money at short notice, or of moneys held over until a suitable permanent investment is found. The temporary investments are mainly either (1) Money on deposit at interest with a bank or with a discount company or financial house. A deposit receipt will probably be available, but in any case a certificate from the house

with which the money is deposited should be obtained; (2) Loans to stockbrokers or others on security. It is convenient that they be securities capable of transfer by delivery, such as bonds or stocks to bearer, but they may be certificates with signed transfers. The documents should be produced, and also a memorandum of deposit or an account setting out the advances.

STOCKS AND SHARES

Stocks in the United Kingdom are registered or inscribed, or to bearer, and shares are registered or to bearer.

Registered. The certificates should be examined, attention being paid to the following points—

That the certificate bears the usual note that a transfer will not be accepted by the company unless the certificate is produced.

That the certificate is in the name of the appropriate person.

Whether the shares are fully paid, and if they are not fully paid, the amount paid up, including payments in respect of calls, which are usually endorsed on the back of the certificate.

In the case of new issues it is possible that the share certificate has not yet been issued. In this case the investment will be verified by the examination of the scrip or other relative document. This may be—

(*a*) An allotment letter recording the payment of application and allotment money and having attached to it bankers' receipts for calls paid.

(*b*) An interim scrip certificate to bearer. This document is sometimes issued in exchange for the allotment letter, when all calls have been paid, pending the preparation of the definitive share certificate.

(*c*) A "Balance Receipt" where some of the shares have been sold.

(*d*) A transfer receipt where the shares have been purchased.

It is customary nowadays, in the case of a majority of share issues, to send out allotment letters which are current for a stated period. During this period the allotment may be renounced in favour of another person, or in blank. If renounced in blank, the allotment letter becomes a bearer document until the name of the person who accepts the shares is entered above the renouncer's signature. The former can then sign the form of acceptance endorsed on the letter and submit the document for registration with the company making the issue. When this is done, the shares will be registered in the name of the acceptor instead of that of the original allottee. The document must be lodged with the company by the date mentioned on it as the latest date for renunciation; if this is not done the shares will be put into the name of the original allottee and can only be transferred, by deed

or otherwise, in the ordinary way, involving the payment of the appropriate stamp duty.

Allotment letters may usually be split once during the greater part of their currency, for which purpose they must be deposited with the company and a small fee paid.

It will be seen therefore that allotment letters, either in the name of the client or in the name of another person who has renounced the shares, may be produced as evidence of a holding of shares.

Inscribed. Inscribed stocks include Consols, various Government and municipal stocks (inscribed at the Bank of England, the Crown Agents for the Colonies, or some of the principal joint stock or private banks). They are inscribed in the names of the holders in Registers kept by the inscribing houses, and a transfer can only be made by the signature in the registers of the holders attending personally, or by their attorneys. No certificates are issued, but a memorandum is issued to the holders setting out that the stocks have been inscribed in certain names. This document is often retained by the holders of the stock, and produced under the impression that it is a document of value, and is sometimes accepted as such by inexperienced Auditors. It is of no value as a voucher, and should be disregarded. It is not surrendered on a sale of the stock. To verify inscribed stocks the first step is to fill up and submit to the inscribing banks or houses one of the official forms supplied by them for the purpose. The Auditor should enter on the form the amount and name of the inscribed stock, the person or persons in whose names it is inscribed, and the date (at the close of business) at which it should be certified as having been held. The form contains a request, addressed to the bank of inscription, to certify to the person or firm entered thereon that the stock was so held. The application must be signed by at least one of the stockholders, and after it has been certified the form is sent direct by the bank of inscription to the person named in the application as the intended recipient (who should be the Auditor). The verification is made at each audit, a separate form being obtained and sent in each year. Where no official forms are issued, a letter is sent by the Auditor to the bank of inscription, together with an authority by the stockholders authorizing the giving of the information. In the case of certain stocks a fee of 1s. is charged for each verification, but in many cases no fee is charged. Where several stocks in the same names are entered on one form the nominal amounts should be added to a total recorded on the line below the last entry and a double line ruled underneath.

Until a few years ago it was not the practice of banks of inscription to notify, when verifying the inscription of stocks,

whether there was any charge or restraint against them, but now a statement is made as to whether or not any charge or restraint is registered against the holding.

Where an inscribed stock is being sold care must be taken to give to the bank of inscription or to the broker the address registered in the bank's books. Persons who have several addresses, or who change their addresses from time to time, may suffer delay if they do not choose the correct one in furnishing particulars. Similarly, persons who change their professions should remember how they were occupied when their particulars were furnished to the bank. To obviate this difficulty stockholders frequently adopt the description of "gentleman."

Bearer Shares. The certificates should be produced. In the case of many U.S.A. and foreign securities, the transfer of the shares is effected by an endorsement on the back of the certificate, and the document has the effect of a bearer certificate so far as title is concerned.

DEBENTURES, BONDS, ETC.

Debentures include debentures payable to the registered holder or to bearer, or a debenture trust deed or debenture stock certificate issued under a debenture trust deed. The name of the holder and date of issue should be examined. If the debenture is redeemable, the date of redemption and the provisions for and conditions of repayment should be noted, and any repayments made traced to the Cash Book. The Auditor should see that a copy of the certificate of registration at Somerset House is printed or impressed on the documents in accordance with the Companies Act, 1948, Section 99. Where there are coupons for interest attached to the debentures or bonds, the Auditor should see that they are intact, or if the coupons for the next payment of interest have been detached, that they are satisfactorily accounted for.

Not infrequently securities are in the hands of a banker, stockbroker or other person with whom it is customary to deposit securities for safe custody or temporarily. The Auditor must use his judgment as to whether he will accept a certificate from the banker or other person as evidence of the existence and custody of the documents, or whether he desires to inspect them. In most cases a certificate can be accepted without question, but in some cases the Auditor may consider it well to make a personal inspection of the securities.

LIFE ASSURANCE, REDEMPTION AND SIMILAR POLICIES, LIFE INTEREST, REVERSIONS, ETC.

See the policies of assurance, the receipts for the last premium payable, and the deed of assignment assigning the policies to the

client. As regards insurance companies, where loans have been made by the company in respect of the surrender value of policies issued by them, the policies should be produced together with the documents of loan. If all the policies are not examined, a sufficient number should be selected by the Auditor from the Register of Loans for production. As to life interests and reversions, the assignment should be seen, together with any policies taken out to cover contingencies in respect of life interests and reversions. Notice of the assignment has to be given to the respective companies, and in some cases the Auditor may deem it well to satisfy himself that notice has been given. As a rule an acknowledgment of notice will be attached to the policy.

LOANS TO MUNICIPAL CORPORATIONS, LOCAL AUTHORITIES, ETC.

The deed or certificate issued as a receipt for the principal sum should be produced. The arrangements as to repayment should be noted, and care taken that any repayments due have been accounted for.

TRADE MARKS, COPYRIGHTS, AND PATENTS

A certificate of registration should be produced for trade marks, and for copyrights. The Register of Copyrights at Stationers' Hall may also be examined. For patents the patent should be seen, also the certificate of payment of renewal fees. If acquired by assignment, the deed of assignment should be produced.

TITLE DEEDS TO PROPERTY

The "Abstract of Title" gives full particulars of all the deeds relating to property. The Auditor should take special care to see the conveyance into the names of his client by which the legal estate is vested in the client. In the absence of other evidence as to the authenticity of the deeds, on the occasion of the first audit at any rate, it is advisable to have them produced in the presence of a solicitor and verified by him. But this is a counsel of perfection and an Auditor is entitled to accept a document which on the face of it and by its endorsement appears satisfactory. Where mortgages of property are among the securities, the Auditor should see that a conveyance of the property is embodied in the mortgage, or that there is a separate conveyance. Where there is an equitable mortgage by deposit of title deeds as security, the memorandum of deposit is usually produced, also the conveyance vesting the legal estate in the borrower. A mortgage deed of later date, by which the real estate is vested in another lender, has been held by the Court to take precedence over an equitable mortgage by

deposit of the deeds. In the case of companies, even an equitable mortgage should be registered at Somerset House, pursuant to Section 96 of the Companies Act, 1948. If life assurance or redemption policies have been effected in connexion with any of the leases, they should be produced, also renewal receipts for the last premium payable. The fire insurance policies in connexion with the properties are not marketable securities, but the policies or renewal receipts are usually seen when vouching the cash. The Register of Rents may be compared with the deeds, and the various rents compared with the Cash Book. Registration of titles is compulsory in the Administrative County of London as regards freeholds and leaseholds with forty years or upwards to run. Registration of deeds is compulsory in the Middlesex Registry, and in some parts of Yorkshire, Croydon, Eastbourne and Hastings. The Land Certificate issued by the Land Registry constitutes a possessory title, and consequently the conveyance into the name of the purchaser referred to above is not necessary.

COPYHOLDS

This form of tenure has now been abolished.

SHIPS AND MORTGAGES ON SHIPS

The register at the Port of Registry should be inspected to see that the ship is duly registered and to ascertain that the mortgages appear on the register and that no other mortgages or charges ranking in priority have been registered. (See also SHIPPING ACCOUNTS, page 277.)

CHAPTER VII

THE JOURNAL

THE Journal in its original form, in which the fundamental principle of double-entry, that every debit must have a credit, was clearly brought out, is not now in use in England to so great an extent as formerly.

In many countries on the Continent the use of the Journal, which is governed by the Code Napoléon, is compulsory; no entry may be made until each folio has been numbered and signed by the appointed official, Judge of the Tribunal of Commerce, Magistrate in the domicile of the trader, or whoever it may be. On the last page of the Journal a certificate is inserted of the number of folios making up the book.

These formalities do not imply that the contents of the Journal are correct; frequently it is not so. The main purpose is to prevent substitution of books, in case there should at any time be legal proceedings, or should bankruptcy ensue. A complete and well-kept Journal in the continental form sets out conveniently the summarized transactions of the business, and from this point of view is extremely useful to the Auditor; as it is common form it can be readily followed.

In England the use of the Journal has been reduced to a minimum in most businesses, and instead subsidiary books, such as Sales Day Books, Purchases Day Books, Returns Books, which are in fact Journals designed specially for the record of transactions of one class, are used. The advantages of such a subdivision are obvious, the chief being—

(1) All entries in each book are of the same kind.

(2) Analysis can conveniently be made in appropriate columns.

(3) Periodical totals can be made—weekly, monthly, etc., as desired—so giving a periodical total of sales, purchases, returns, etc.

(4) Periodical totals can be posted to the Ledger, instead of separate items, as in the case of the standard two-column Journal.

(5) Explanatory narrative is reduced to a minimum, since the general nature of the items is clear from the form and title of the book.

(6) Total accounts are more easily extracted and sectional or total balancing effected.

As a result of this dissection, the Journal is now used sparingly, and the entries are frequently limited to adjustments, opening

entries of a new business or company, transfers and closing entries, for which no special book is provided—though where transfers are numerous a special Transfer Journal may even be used. The narrative of a Journal entry, if carefully and fully worded, can be very helpful to the Auditor. The practice of making transfers from one Ledger account to another, without the intervention of the Journal, should be discouraged. There was a time when this practice was cited as one of the cardinal sins of book-keeping. Entries of this kind may be clear to the mind of the book-keeper at the time of record, but later his recollection may be blurred and in the inevitable absence of narrative he will be quite unable to explain why he made them. Some book-keepers consider that the transfer of balances at the end of the year to the Profit and Loss Account or elsewhere may safely be made direct in the Ledger, without danger of misunderstanding, and this may be conceded. The ability to make a Journal entry which gives an intelligible record is the mark of a sound book-keeper who knows his work.

The vouching of the Journal is usually very important, supporting data being examined by the Auditor, in respect of the separate entries. Where several items make up an entry the additions should be checked to verify that the debits equal the credits. Postings should be checked to the various Ledgers. Supporting data will take many forms such as contracts, minutes, correspondence, and, in the case of closing entries, the Ledger accounts. The opening entries for the share capital of a company will be made from application and allotment books, records of calls, and similar particulars. The entries are in many cases so much dependent upon the nature of the business that it is not possible to give comprehensive guidance to the requirements of the Auditor in every case.

CHAPTER VIII

CAPITAL AND INCOME

ONE of the important duties of an Auditor is to satisfy himself that capital and income are properly distinguished in the accounts, and more particularly that nothing is charged to capital which ought to be charged to income, thus improperly adding to the income available for distribution. All additions to capital should, therefore, be carefully vouched and when necessary the allocation certified by a responsible official. From a financial point of view, sound practice requires that only those outlays which are directly productive and increase the earning capacity should be permanently capitalized, and that other forms of capital outlay, such as preliminary expenses, alterations to premises, fines on renewal of a lease, and such-like, should be written off as quickly as may be, and in addition to the provision made for depreciation of wasting assets. If possible, any losses of capital should also be written off out of profits over a term of years. This is the conservative practice instinctively adopted in partnerships and in soundly managed companies, and it is one with which the Auditor will naturally concur.

In theory all capital expenditure should be met out of capital, additional capital being raised when necessary to meet additional capital expenditure. This principle is clearly set out in what is known as the double account system which is applied to certain statutory companies, the object being to show separately in an account the amount of capital issued and its disbursement. In commercial undertakings this method is not followed. Losses in respect of trading are on a different footing. On a strictly legal view they need not be made good out of profits in subsequent years before dividends are paid, but may be left, so to speak, in the air (*Ammonia Soda Co., Ltd.* v. *Chamberlain*, [1918] 1 Ch. 266). In practice this legal principle is not followed. It is impracticable and inconvenient, financially unsound, and open to abuse. For example, if accounts were taken monthly, quarterly or half-yearly, the same principle would seem to apply. To comply with the legal theory additional capital would have to be raised in one form or another to replace the money lost in trading, otherwise insolvency would follow. In the Ammonia Soda case, Warrington, L.J., in the course of his Judgment in the Court of Appeal said: "I am, of course, far from saying that in all such cases dividends can properly be paid without making good the previous loss; the nature of the business and the amount of the loss

may be such that no honest and reasonable man of business would think of paying dividends without providing for it."

The usual practice where losses have accumulated but the undertaking is considered capable of earning profits under efficient management, is to reconstruct the company and reduce the share capital so that past losses may be written off.

Although the distribution of profits up to the hilt might not be open to objection in law, it is the custom in practice to put a proportion to reserve or to carry it forward to subsequent years. It is then either used in the business as working capital, or invested. It follows that, although the original share capital remains the same, undivided profits are being used as a form of capital, which does not carry interest or participate in dividends. The effect is to make the percentage of dividends calculated on the nominal capital higher, and it may therefore be misleading for statistical purposes. This practice of making reserves and restricting dividends arises out of the business instinct to build up a strong financial position. This was in fact the policy adopted by traders in pre-company days when they drew out of profits what they needed for their personal requirements and, out of profits, wrote down all the assets to a nominal figure, investing the surplus cash which inevitably arose out of their drastic methods of finance. A limited company cannot in fairness to its shareholders go to such extremes, but experience shows that sound companies have always adopted this policy to a reasonable extent and so built up a strong liquid position. As long as the matter is made clear in the accounts, as indeed the Companies Act, 1948, now requires, the Auditor will welcome these conservative financial methods.

The tendency to build up strong reserves will seem less attractive to shareholders if their shares are likely to be acquired by the State, under measures of nationalization, at Stock Exchange prices on dates selected by the purchaser. The tendency is for such prices to be governed very largely by dividend yield, and shareholders are deprived of the fruits of earlier thrift if their shares are purchased. However, while limitation of dividends, as a policy requested by the Government, applies, there is little that shareholders can do about it, and profits earned in excess of dividend and tax requirements, must automatically be put to reserve or carried forward.

Where the interests of capital and income may conflict, as for example in the case of life-owner and remainder-man, persons sharing in profits under agreements of various types, preference and ordinary shareholders, or retiring partners, financial considerations have to give way, and the accounts should be drawn up in strict accordance with the legal rights of the

respective parties. In such cases the testator's Will, the agreements or Articles of Association, as the case may be, should be carefully studied, and it may often be necessary to procure legal advice before settling the accounts. The leading legal cases bearing on the question of capital and income should be read. (See THE ACCOUNTS OF EXECUTORS AND TRUSTEES, Chapter XV, page 229.) Many income tax cases also indicate the judicial view as to the distinction between capital and income. A full report of the case *The Ammonia Soda Co., Ltd.* v. *Chamberlain*, [1918] 1 Ch. 266 mentioned above, should be carefully studied. This case reaffirmed the legal principle that, subject always to the contents of the Articles of Association of any particular company, the profits earned in any one year may be distributed as dividend without providing for losses sustained in previous years, or, to put it in another way, although there be a debit to Profit and Loss Account. The principle is, however, a dangerous one in practice as, Warrington, L.J., indicated in his judgement.

It seems clear that if profits are paid away, although a debit to Profit and Loss Account is being carried forward, cash representing capital is being entrenched upon to provide the dividend. In such a case, should it arise, the duty of the Auditor is to see that the facts are fully disclosed to the shareholders, as in fact they were in the case referred to. It has been suggested, on the strength of this case, that capital assets may be written up on a revaluation, the increase carried to a reserve, and the reserve divided in the shape of bonus shares. A study of the case does not bear out this suggestion, for the decision turned on the principle already mentioned, that previous losses need not be made good out of subsequent profits before paying a dividend. In any case, an addition to the valuation of what is already the company's property does not seem to be good consideration for an allotment of shares. The following cases should also be read: *Lee* v. *Neuchatel Asphalte Co.* (1889), 41 Ch.D. 1; *Verner* v. *General & Commercial Investment Trust*, [1894] 2 Ch. 239; *Re National Bank of Wales, Cory's case*, [1899] 2 Ch. 629, which went to the House of Lords as *Dovey* v. *Cory*, [1901] A.C. 477; 17 T.L.R. 732.

CHAPTER IX

REVENUE AND EXPENDITURE, INCOME AND EXPENDITURE, TRADING AND PROFIT AND LOSS ACCOUNTS, AND THE BALANCE SHEET AND AUDITOR'S REPORT

THE Ledger balances extracted from the Trade Ledgers, Impersonal and Private Ledgers having been checked or tested and scrutinized, as set out in Chapter IV, the Auditor is now in a position to consider the Balance Sheet (prepared from the Ledger balances) and the relative accounts. In the case of a manufacturing or trading concern, these will be a Trading Account, Profit and Loss Account, and Balance Sheet. There may, in addition, be an account which would precede the Trading Account, called the Manufacturing Account. In the case of trusts, charities, colleges, schools, and similar bodies, an Income and Expenditure Account or a Receipts and Payments Account will take the place of a Profit and Loss Account. Other bodies, such as insurance companies and building societies, will prepare the accounts which are prescribed by law, dealt with more specifically in Chapter XVII.

So far as companies under the Companies Acts are concerned, the contents of the Balance Sheet and Profit and Loss Account must conform to the provisions of the Eighth Schedule of the Companies Act, 1948.

MANUFACTURING ACCOUNT

The purpose of this account is to show the total cost of manufacture, which is carried to the debit of the Trading Account. The items of expenditure, such as raw materials, coal and coke, power, wages, stores, etc., are given in detail.

TRADING ACCOUNT

The purpose of this account is to show the gross profit or loss on trading for the period reviewed. Broadly, this will be the difference between the stock on hand at the beginning of the period, purchases, wages, and other expenses incidental to production, on the one hand, and the sales and stock on hand at the end, on the other. The opening stock, purchases and expenses are shown on the debit side, and the sales and closing stock on the credit side. An excess on the credit side over the debit side of the account represents a gross profit; an excess on the debit side represents a gross loss. The balance, whether profit or loss, is carried to the Profit and Loss Account. The expenses which relate directly to

purchases and manufacturing (unless a separate manufacturing account is prepared), and the expenses which relate directly to sales, except carriage outwards, should be shown separately in the Trading Account. The following is an example –

TRADING ACCOUNT

Year Ended 31st December, 19..

Dr.	*Cr.*
To Stock, 1st January, 19..	By Sales
,, Purchases	,, Stock, 31st December, 19..
,, Wages	
,, Packing	
,, Carriage	
,, Freight and Duty	
,, Rates, Water, etc.	
,, Balance being Gross Profit carried to Profit and Loss Account	

Sometimes, for the purpose of more exact costing, the Manufacturing and Trading Account is charged with interest upon the capital invested in the buildings, plant, and machinery, and also upon the stock held from time to time, and with appropriate depreciation. Except for the purpose of costing, interest should not be added to stock, thus implying an addition to profits.

From the Trading Account there can be ascertained not only the gross profit or loss, but also the ratio of expenses and other items to sales. In this way variations as between one period and another become apparent and should be the subject of inquiry. The book-keeping system should be so planned as to furnish these figures readily, and they should be ascertained on the same basis from year to year.

PROFIT AND LOSS ACCOUNT

The purpose of this account is to show the net profit for the period after all the remaining expenses, mainly of the nature of management, have been charged. The account will be credited with the gross profit (or debited with the gross loss) on trading brought down from the Trading Account, and any other income such as rents, transfer fees, and dividends, and any unusual, exceptional or non-recurrent items, if material in amount. On the other side there will be charged such items as rent of offices, salaries, repairs, postage, and telephone, and other items of expense not chargeable on the foregoing account. There will also be charged Directors' fees and debenture interest.

If an appropriation account is given, it may be a matter of opinion in the case of certain items as to whether they are appropriations of profit or charges incurred in arriving at profit.

In the case of companies registered under the Companies Act, it is now provided by the Companies Act, 1948, Section 148 (1),

that, in addition to presenting a Balance Sheet to the company in general meeting, the Directors shall also present a Profit and Loss Account or, in the case of a company not trading for profit, an Income and Expenditure Account for the appropriate period, and the Auditors are called upon, in their report on the Balance Sheet, to state that the Profit and Loss Account gives a true and fair view of the profit or loss of the company for the financial year. The latter requirement is, it will be seen, entirely new.

There is a general requirement under Section 147 of the Companies Act, 1948, that every company shall cause to be kept proper books of account with respect to—

(*a*) All sums of money received and expended by the company and the matter in respect of which the receipt and expenditure takes place.

(*b*) All sales and purchases of goods by the company.

(*c*) The assets and liabilities of the company.

Such books must be kept as are necessary to give a true and fair view of the state of the company's affairs and to explain its transactions. The Auditor is called upon in his report to state whether, in his opinion, proper books of account have been kept by the company so far as appears from his examination of those books (Companies Act, 1948, Ninth Schedule).

The requirements of the Act with regard to the contents of the Profit and Loss Account are contained in the Eighth Schedule, paragraphs 12 to 14, as follows—

12.—(1) There shall be shown—

(*a*) the amount charged to revenue by way of provision for depreciation, renewals or diminution in value of fixed assets;

(*b*) the amount of the interest on the company's debentures and other fixed loans;

(*c*) the amount of the charge for United Kingdom income tax and other United Kingdom taxation on profits, including, where practicable, as United Kingdom income tax any taxation imposed elsewhere to the extent of the relief, if any, from United Kingdom income tax and distinguishing where practicable between income tax and other taxation;

(*d*) the amounts respectively provided for redemption of share capital and for redemption of loans;

(*e*) the amount, if material, set aside or proposed to be set aside to, or withdrawn from, reserves;

(*f*) subject to sub-paragraph (2) of this paragraph, the amount, if material, set aside to provisions other than provisions for depreciation, renewals or diminution in value of assets or, as the case may be, the amount, if material, withdrawn from such provisions and not applied for the purposes thereof;

(*g*) the amount of income from investments, distinguishing between trade investments and other investments;

(*h*) the aggregate amount of the dividends paid and proposed.

(2) The Board of Trade may direct that a company shall not be obliged to show an amount set aside to provisions in accordance with sub-paragraph

(1) (*f*) of this paragraph, if the Board is satisfied that that is not required in the public interest and would prejudice the company, but subject to the condition that any heading stating an amount arrived at after taking into account the amount set aside as aforesaid shall be so framed or marked as to indicate that fact.

13. If the remuneration of the auditors is not fixed by the company in general meeting, the amount thereof shall be shown under a separate heading, and for the purposes of this paragraph, any sums paid by the company in respect of the auditors' expenses shall be deemed to be included in the expression "remuneration."

14.—(1) The matters referred to in the following sub-paragraphs shall be stated by way of note, if not otherwise shown.

(2) If depreciation or replacement of fixed assets is provided for by some method other than a depreciation charge or provision for renewals, or is not provided for, the method by which it is provided for or the fact that it is not provided for, as the case may be.

(3) The basis on which the charge for United Kingdom income tax is computed.

(4) Whether or not the amount stated for dividends paid and proposed is for dividends subject to deduction of income tax.

(5) Except in the case of the first profit and loss account laid before the company after the commencement of this Act the corresponding amounts for the immediately preceding financial year for all items shown in the profit and loss account.

(6) Any material respects in which any items shown in the profit and loss account are affected —

(*a*) by transactions of a sort not usually undertaken by the company or otherwise by circumstances of an exceptional or non-recurrent nature; or

(*b*) by any change in the basis of accounting.

APPROPRIATION ACCOUNT

This account will be credited with the balance of profit brought forward from the previous year and with the profit for the year brought down. If these items are losses they will appear on the debit side. On the debit side of the account will appear the appropriations of profit, which will include reserves for taxation and other transfers to reserve; dividends, whether already declared and paid, or proposed, and the balance carried forward to the Balance Sheet.

The inclusion of the proposed dividend in the appropriation account is a development of recent years. As mentioned in Chapter IV, the method which used to be adopted was to present to the Annual General Meeting of members with the accounts a report of the Directors which showed the balance of profit for the year, to which was added the balance brought forward from the previous year. The recommendations of the Directors with regard to the disposal of the total were embodied in this report, and the members then decided whether they would agree to the recommendations or whether they wished them varied, though certain restrictions were imposed upon them, and they could not require

an increase in the rate of the dividend or the payment of a dividend where none was recommended. The proposals which were adopted were given effect to in the following year's accounts, and it was not always easy to link up the accounts from one period to another.

In their recommendations on accounting principles, the Council of the Institute of Chartered Accountants expressed the view that although appropriations of profits were subject to confirmation by members, there was an advantage in providing in the accounts to be presented to the members for all proposed appropriations. The accounts would then show the amount which would be required for distribution to the members and would thus complete the accounts for the financial year by showing the results of trading and their application in one account. They further recommended that a provision for dividend should be shown as a separate item in the Balance Sheet. This recommendation has now been incorporated in the Companies Act, 1948, and it is a legal requirement that the Profit and Loss Account shall show the aggregate amount of dividends paid and proposed (Eighth Schedule, paragraph 12 (1) (*h*)), and the Balance Sheet must show the net aggregate amount (after deduction of income tax) which is recommended for distribution by way of dividend (Eighth Schedule, paragraph 8 (1) (*e*)).

Section 157 (1) further provides that there shall be attached to every Balance Sheet laid before a company in general meeting a report by the Directors with respect to the state of the company's 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 reserves within the meaning of the Eighth Schedule to the Act. This continues the previous practice.

ACCOUNT OF RECEIPTS AND PAYMENTS (CASH ACCOUNT)

This account differs from an Income and Expenditure Account or a Profit and Loss Account in that it records only the actual cash transactions, and ignores what is outstanding, whether receivable or payable, relating to the period for which the account is drawn up. It therefore does not show the surplus income, but only the balance of cash on hand.

An account in this form is not inappropriate for clubs or societies, but it is not suitable for commercial undertakings. Some professional men—for example barristers and accountants—prepare their accounts on this basis because it is regarded as convenient; expenses are met promptly and outstanding liabilities are small, and it is felt that even if outstanding debtors for fees are substantial they may be much the same at the beginning as at the end. But the method is unscientific, and should be avoided where possible.

It would obviously be absurd for the Directors of a company to

prepare a Cash Account and place it before its shareholders as a document on which they would determine whether or not a dividend might be declared, based on the balance in hand at the end of this period. Under the requirements of the Companies Act, 1948, in regard to the information to be furnished in accounts, it could not be done. It was, however, done in the days when legal requirements in regard to accounts were not so stringent, and in one case, when a company had been in existence only eight months, the Directors declared a bonus, although there was only a Receipts and Payments Account as a source of information and a Balance Sheet had not been prepared, which would enable the true state of the company's affairs to be ascertained. (*Rance's Case, re County Marine Insurance Co.* (1870), 6 Ch. App. 104.)

THE BALANCE SHEET OF A LIMITED LIABILITY COMPANY

A Balance Sheet may be briefly described as a summarized statement of the debit and credit balances in the Ledgers at an accounting date. Such balances include the balance to the credit or debit of Profit and Loss Account.

It should be noted that the position which a Balance Sheet records is at a given date, in contrast to a Profit and Loss Account which is for a period. The Balance Sheet shows in summary form, on the one side, Capital, Reserves, Provisions, and the balance of the Profit and Loss Account if in credit (or, as it is sometimes now called, "the surplus") and the Liabilities, and on the other the Assets and other debit balances, including a debit balance, if there is one, on Profit and Loss Account.

Until the passing of the Companies Act, 1929, there was a reasonable amount of freedom in the form of presentation of the Balance Sheet. The grouping and description of the items was not controlled, except that the Balance Sheet was required to exhibit a true and correct view of the state of the company's affairs, and the Auditors were called upon to report that this was so, or to state in what respect it fell short. The Companies Act, 1929, introduced new provisions governing the presentation of figures in the Balance Sheet, including a reference to the manner in which the value of the fixed assets had been arrived at, a distinction between fixed and floating assets (now called current assets), and a requirement that certain named intangible assets, so far as they were not written off, should be stated under separate headings. Although the requirements of that Act produced a more satisfactory form of account, giving fuller information to the members, it was felt by many that it did not go far enough. In particular, over-condensation of the Profit and Loss Account, and particulars, which were often scanty, with regard to subsidiary companies, while satisfying the law, gave shareholders little opportunity of

commenting on the accounts, and understanding their full import. It must not be implied that in the majority of companies there was failure to give proper information; in fact, the reverse was the case, and the accounts of most companies were presented in a satisfactory form. But many fell short of reasonable requirements.

The case of *Rex* v. *Kylsant*, which concerned the accounts of the Royal Mail Steampacket Company, arose after the Act had been in force little more than two years, and caused misgivings in the accountancy profession and the business world, as to the form of presentation of accounts. It should, of course, be noted that the case, which was brought under the Larceny Act, concerned a company which was incorporated by Royal Charter, and was not governed by the Companies Act; that the accounts dealt with in the case were for the years 1926 and 1927 before the Companies Act, 1929, was passed; and that the defendants, Lord Kylsant and the Auditor of the company, were acquitted of the charge in relation to the accounts. But there were lessons to be learned and the observations of the judge in his summing up to the jury, to which reference is made elsewhere in this book, showed that he felt that improvements in the presentation of accounts and in the manner of informing shareholders of the affairs and dealings of their companies was called for. Two aspects were particularly stressed. One was the manner of showing reserves in the Balance Sheet, the creation of secret reserves, and the utilization of both in aid of the profits. The other was the method of disclosure in the Profit and Loss Account that exceptional items were brought to credit in arriving at the profit for the year.

The examination of accountancy principles, which was undertaken by the Council of the Institute of Chartered Accountants in recent years, led to the issue by them of recommendations to guide their members as to the best practice in regard to certain aspects of the accounts of companies engaged in commercial and industrial enterprises. Then in June, 1943, the Board of Trade appointed a Committee, presided over by Lord Justice (then Mr. Justice) Cohen, to

> consider and report what major amendments are desirable in the Companies Act, 1929, and, in particular, to review the requirements prescribed in regard to the formation and affairs of companies and the safeguards afforded for investors and for the public interest.

In their report two years later, the Committee recommended drastic amendments which, in the main, were adopted in the subsequent Companies Act, 1947. This Act and the Companies Act, 1929, were later consolidated in the Companies Act, 1948, which, with effect from 1st July, 1948, governs the procedure for the presentation of accounts.

As stated earlier in this chapter, it is now required that, in addition to presenting a Balance Sheet to the company in general meeting, the Directors shall also present a Profit and Loss Account or, in the case of a company not trading for profit, an Income and Expenditure Account for the appropriate period, and the Auditors are called upon in their report on the Balance Sheet to state that the Profit and Loss Account gives a true and fair view of the profit or loss of the company for the financial year. The presentation of the Profit and Loss Account is dealt with in this Chapter, and the Auditor's position in Chapter XII. The requirements with regard to group accounts are dealt with in Chapter XXII.

In regard to Balance Sheets, the Companies Act, 1948, enacts as follows:—

148.—(2) The directors shall cause to be made out in every calendar year, and to be laid before the company in General Meeting, a Balance Sheet as at the date to which the Profit and Loss Account or the Income and Expenditure Account, as the case may be, is made up.

149.—(1) Every balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of its financial year, and every profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year.

(2) A company's balance sheet and profit and loss account shall comply with the requirements of the Eighth Schedule to this Act, so far as applicable thereto.

(3) Save as expressly provided in the following provisions of this section or in Part III of the said Eighth Schedule, the requirements of the last foregoing subsection and the said Eighth Schedule shall be without prejudice either to the general requirements of subsection (1) of this section or to any other requirements of this Act.

(4) The Board of Trade may, on the application or with the consent of a company's directors, modify in relation to that company any of the requirements of this Act as to the matters to be stated in a company's balance sheet or profit and loss account (except the requirements of subsection (1) of this section) for the purpose of adapting them to the circumstances of the company.

(5) Subsections (1) and (2) of this section shall not apply to a company's profit and loss account if—

(*a*) the company has subsidiaries; and

(*b*) the profit and loss account is framed as a consolidated profit and loss account dealing with all or any of the company's subsidiaries as well as the company and—

(i) complies with the requirements of this Act relating to consolidated profit and loss accounts; and

(ii) shows how much of the consolidated profit or loss for the financial year is dealt with in the accounts of the company.

(6) If any person being a director of a company fails to take all reasonable steps to secure compliance as respects any accounts laid before the company in general meeting with the provisions of this section and with the other requirements of this Act as to the matters to be stated in accounts, he shall, in respect of each offence, be liable on summary conviction to imprisonment

for a term not exceeding six months or to a fine not exceeding two hundred pounds:

Provided that.—

(*a*) in any proceedings against a person in respect of an offence under this section, it shall be a defence to prove that he had reasonable ground to believe and did believe that a competent and reliable person was charged with the duty of seeing that the said provisions or the said other requirements, as the case may be, were complied with and was in a position to discharge that duty; and

(*b*) a person shall not be sentenced to imprisonment for any such offence unless, in the opinion of the court dealing with the case, the offence was committed wilfully.

(7) For the purposes of this section and the following provisions of this Act, except where the context otherwise requires,—

(*a*) any reference to a balance sheet or profit and loss account shall include any notes thereon or documents annexed thereto giving information which is required by this Act and is thereby allowed to be so given; and

(*b*) any reference to a profit and loss account shall be taken, in the case of a company not trading for profit, as referring to its income and expenditure account, and references to profit or to loss and, if the company has subsidiaries, references to a consolidated profit and loss account shall be construed accordingly.

The general provisions as to the Balance Sheet are contained in the Eighth Schedule to the Act and are as follows—

PART I

GENERAL PROVISIONS AS TO BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

Balance Sheet

2. The authorized share capital, issued share capital, liabilities and assets shall be summarized, with such particulars as are necessary to disclose the general nature of the assets and liabilities, and there shall be specified—

(*a*) any part of the issued capital that consists of redeemable preference shares, and the earliest date on which the company has power to redeem those shares;

(*b*) so far as the information is not given in the profit and loss account, any share capital on which interest has been paid out of capital during the financial year, and the rate at which interest has been so paid;

(*c*) the amount of the share premium account;

(*d*) particulars of any redeemed debentures which the company has power to re-issue.

3. There shall be stated under separate headings, so far as they are not written off,—

(*a*) the preliminary expenses;

(*b*) any expenses incurred in connexion with any issue of share capital or debentures;

(*c*) any sums paid by way of commission in respect of any shares or debentures;

(*d*) any sums allowed by way of discount in respect of any debentures and;

(*e*) the amount of the discount allowed on any issue of shares at a discount.

4. (1) The reserves, provisions, liabilities and fixed and current assets shall be classified under headings appropriate to the company's business: Provided that—

(*a*) where the amount of any class is not material, it may be included under the same heading as some other class; and

(*b*) where any assets of one class are not separable from assets of another class, those assets may be included under the same heading.

(2) Fixed assets shall also be distinguished from current assets.

(3) The method or methods used to arrive at the amount of the fixed assets under each heading shall be stated.

5.—(1) The method of arriving at the amount of any fixed asset shall, subject to the next following sub-paragraph, be to take the difference between

(*a*) its cost or, if it stands in the company's books at a valuation, the amount of the valuation; and

(*b*) the aggregate amount provided or written off since the date of acquisition or valuation, as the case may be, for depreciation or diminution in value;

and for the purposes of this paragraph the net amount at which any assets stand in the company's books at the commencement of this Act (after deduction of the amounts previously provided or written off for depreciation or diminution in value) shall, if the figures relating to the period before the commencement of this Act cannot be obtained without unreasonable expense or delay, be treated as if it were the amount of a valuation of those assets made at the commencement of this Act and, where any of those assets are sold, the said net amount less the amount of the sales shall be treated as if it were the amount of a valuation so made of the remaining assets.

(2) The foregoing sub-paragraph shall not apply—

(*a*) to assets for which the figures relating to the period beginning with the commencement of this Act cannot be obtained without unreasonable expense or delay; or

(*b*) to assets the replacement of which is provided for wholly or partly—

(i) by making provision for renewals and charging the cost of replacement against the provision so made; or

(ii) by charging the cost of replacement direct to revenue; or

(*c*) to any investments of which the market value (or, in the case of investments not having a market value, their value as estimated by the directors) is shown either as the amount of the investments or by way of note; or

(*d*) to goodwill, patents or trade marks.

(3) For the assets under each heading whose amount is arrived at in accordance with sub-paragraph (1) of this paragraph, there shall be shown

(*a*) the aggregate of the amounts referred to in paragraph (*a*) of that sub-paragraph; and

(*b*) the aggregate of the amounts referred to in paragraph (*b*) thereof.

(4) As respects the assets under each heading whose amount is not arrived at in accordance with the said sub-paragraph (1) because their

replacement is provided for as mentioned in sub-paragraph (2) (*b*) of this paragraph, there shall be stated—

(*a*) the means by which their replacement is provided for; and

(*b*) the aggregate amount of the provision (if any) made for renewals and not used.

6. The aggregate amounts respectively of capital reserves, revenue reserves and provisions (other than provisions for depreciation, renewals or diminution in value of assets) shall be stated under separate headings:

Provided that—

(*a*) this paragraph shall not require a separate statement of any of the said three amounts which is not material; and

(*b*) the Board of Trade may direct that it shall not require a separate statement of the amount of provisions where they are satisfied that that is not required in the public interest and would prejudice the company, but subject to the condition that any heading stating an amount arrived at after taking into account a provision (other than as aforesaid) shall be so framed or marked as to indicate that fact.

7.—(1) There shall also be shown (unless it is shown in the profit and loss account or a statement or report annexed thereto, or the amount involved is not material)—

(*a*) where the amount of the capital reserves, of the revenuer eserves or of the provisions (other than provisions for depreciation, renewals or diminution in value of assets) shows an increase as compared with the amount at the end of the immediately preceding financial year, the source from which the amount of the increase has been derived; and

(*b*) where—

(i) the amount of the capital reserves or of the revenue reserves shows a decrease as compared with the amount at the end of the immediately preceding financial year; or

(ii) the amount at the end of the immediately preceding financial year of the provisions (other than provisions for depreciation, renewals or diminution in value of assets) exceeded the aggregate of the sums since applied and amounts still retained for the purposes thereof;

the application of the amounts derived from the difference.

(2) Where the heading showing any of the reserves or provisions aforesaid is divided into sub-headings, this paragraph shall apply to each of the separate amounts shown in the sub-headings instead of applying to the aggregate amount thereof.

8.—(1) There shall be shown under separate headings—

(*a*) the aggregate amounts respectively of the company's trade investments, quoted investments other than trade investments and unquoted investments other than trade investments;

(*b*) if the amount of the goodwill and of any patents and trademarks or part of that amount is shown as a separate item in or is otherwise ascertainable from the books of the company, or from any contract for the sale or purchase of any property to be acquired by the company, or from any documents in the possession of the company relating to the stamp duty payable in respect of any such contract or the conveyance of any such property, the said amount so shown or ascertained so far as not written off or, as the case may be, the said amount so far as it is so shown or ascertainable and as so shown or ascertained, as the case may be;

(*c*) the aggregate amount of any outstanding loans made under the

authority of provisos (*b*) and (*c*) of subsection (1) of section fifty-four of this Act;

(*d*) the aggregate amount of bank loans and overdrafts;

(*e*) the net aggregate amount (after deduction of income tax) which is recommended for distribution by way of dividend.

(2) Nothing in head (*b*) of the foregoing sub-paragraph shall be taken as requiring the amount of the goodwill, patents and trademarks to be stated otherwise than as a single item.

(3) The heading showing the amount of the quoted investments other than trade investments shall be sub-divided, where necessary, to distinguish the investments as respects which there has, and those as respects which there has not, been granted a quotation or permission to deal on a recognized stock exchange.

9. Where any liability of the company is secured otherwise than by operation of law on any assets of the company, the fact that that liability is so secured shall be stated, but it shall not be necessary to specify the assets on which the liability is secured.

10. Where any of the company's debentures are held by a nominee of or trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the books of the company shall be stated.

11.—(1) The matters referred to in the following sub-paragraphs shall be stated by way of note, or in a statement or report annexed, if not otherwise shown.

(2) The number, description and amount of any shares in the company which any person has an option to subscribe for, together with the following particulars of the option, that is to say—

(*a*) the period during which it is exercisable;

(*b*) the price to be paid for shares subscribed for under it.

(3) The amount of any arrears of fixed cumulative dividends on the company's shares and the period for which the dividends or, if there is more than one class, each class of them are in arrear, the amount to be stated before deduction of income tax, except that, in the case of tax free dividends, the amount shall be shown free of tax and the fact that it is so shown shall also be stated.

(4) Particulars of any charge on the assets of the company to secure the liabilities of any other person, including, where practicable, the amount secured.

(5) The general nature of any other contingent liabilities not provided for and, where practicable, the aggregate amount or estimated amount of those liabilities, if it is material.

(6) Where practicable the aggregate amount or estimated amount, if it is material, of contracts for capital expenditure, so far as not provided for.

(7) If in the opinion of the directors any of the current assets have not a value, on realization in the ordinary course of the company's business, at least equal to the amount at which they are stated, the fact that the directors are of that opinion.

(8) The aggregate market value of the company's quoted investments, other than trade investments, where it differs from the amount of the investments as stated, and the stock exchange value of any investments of which the market value is shown (whether separately or not) and is taken as being higher than their stock exchange value.

(9) The basis on which foreign currencies have been converted into sterling, where the amount of the assets or liabilities affected is material.

(10) The basis on which the amount, if any, set aside for United Kingdom income tax is computed.

(11) Except in the case of the first balance sheet laid before the company after the commencement of this Act, the corresponding amounts at the end of the immediately preceding financial year for all items shown in the balance sheet.

There are exceptions for special classes of company in Part III of the Eighth Schedule. By paragraph 23 (1) of the Schedule a banking or discount company is subject to only certain requirements of Part I of the Schedule, as shown in 23 (1) (*a*) and (*b*) below. But where, in its Balance Sheet, such a company does not state separately capital reserves, revenue reserves or provisions (other than provisions for depreciation, renewals or diminution in value of assets), any heading stating an amount arrived at after taking into account such a reserve or provision shall be so framed or marked as to indicate that fact, and its Profit and Loss Account shall indicate by appropriate words the manner in which the amount stated for the company's profit or loss has been arrived at.

In paragraph 24 (1) of the Eighth Schedule a similar dispensation is granted to assurance companies, within the meaning of the Assurance Companies Acts, 1909–1946, which are subject to and comply with the requirements of those Acts as respects the preparation and deposit with the Board of Trade of a Balance Sheet and Profit and Loss Account. Additional dispensations are also granted in regard to the Balance Sheet of assurance companies, to which reference is made later.

The provisions of Section 196 with regard to the amount to be shown under the heading of Directors' Remuneration are referred to under the heading of DIRECTORS AND THEIR REMUNERATION, at page 49, *et seq.*

The form of the Auditor's report in the case of companies covered by Part III of the Eighth Schedule is considered in Chapter II, page 26.

Part III of the Eighth Schedule is as follows—

PART III

EXCEPTIONS FOR SPECIAL CLASSES OF COMPANY

23.—(1) A banking or discount company shall not be subject to the requirements of Part I of this Schedule other than—

(*a*) as respects its balance sheet, those of paragraphs 2 and 3, paragraph 4 (so far as it relates to fixed and current assets), paragraph 8 (except sub-paragraph (1) (*d*), paragraphs 9 and 10, and paragraph 11 (except sub-paragraph (8)); and

(*b*) as respects its profit and loss account, those of sub-paragraph (1) (*h*) of paragraph 12, paragraph 13 and sub-paragraphs (1), (4) and (5) of paragraph 14;

but, where in its balance sheet capital reserves, revenue reserves or provisions (other than provisions for depreciation, renewals or diminution in value of assets) are not stated separately, any heading stating an amount arrived at after taking into account such a reserve or provision shall be so

framed or marked as to indicate that fact, and its profit and loss account shall indicate by appropriate words the manner in which the amount stated for the company's profit or loss has been arrived at.

(2) The accounts of a banking or discount company shall not be deemed, by reason only of the fact that they do not comply with any requirements of the said Part I from which the company is exempt by virtue of this paragraph, not to give the true and fair view required by this Act.

(3) In this paragraph the expression "banking or discount company" means any company which satisfies the Board of Trade that it ought to be treated for the purposes of this Schedule as a banking company or as a discount company.

21. (1) In relation to an assurance company within the meaning of the Assurance Companies Acts, 1909 to 1946, which is subject to and complies with the requirements of those Acts as respects the preparation and deposit with the Board of Trade of a balance sheet and profit and loss account, the foregoing paragraph shall apply as it applies in relation to a banking or discount company, and such an assurance company shall also not be subject to the requirements of sub-paragraphs (1) (*a*) and (3) of paragraph 8 and sub-paragraphs (4) to (7) and sub-paragraph (10) of paragraph 11 of this Schedule:

Provided that the Board of Trade may direct that any such assurance company whose business includes to a substantial extent business other than assurance business shall comply with all the requirements of the said Part I or such of them as may be specified in the direction and shall comply therewith as respects either the whole of its business or such part thereof as may be so specified.

(2) Where an assurance company is entitled to the benefit of this paragraph, then any wholly owned subsidiary thereof shall also be so entitled if its business consists only of business which is complementary to assurance business of the classes carried on by the assurance company.

(3) For the purposes of this paragraph a company shall be deemed to be the wholly owned subsidiary of an assurance company if it has no members except the assurance company and the assurance company's wholly owned subsidiaries and its or their nominees.

25. - (1) A company to which this paragraph applies shall not be subject to the following requirements of this Schedule, that is to say—

(*a*) as respects its balance sheet, those of paragraph 4 (except so far as the said paragraph relates to fixed and current assets) and paragraphs 5, 6 and 7; and

(*b*) as respects its profit and loss account, those of sub-paragraph (1) (*a*), (*e*) and (*f*) of paragraph 12;

but a company taking advantage of this paragraph shall be subject, instead of the said requirements, to any prescribed conditions as respects matters to be stated in its accounts or by way of note thereto and as respects information to be furnished to the Board of Trade or a person authorized by them to require it.

(2) The accounts of a company shall not be deemed, by reason only of the fact that they do not comply with any requirements of Part I of this Schedule from which the company is exempt by virtue of this paragraph, not to give the true and fair view required by this Act.

(3) This paragraph applies to companies of any class prescribed for the purposes thereof, and a class of companies may be so prescribed if it appears to the Board of Trade desirable in the national interest:

Provided that, if the Board of Trade are satisfied that any of the conditions prescribed for the purposes of this paragraph has not been complied

with in the case of any company, they may direct that so long as the direction continues in force this paragraph shall not apply to the company.

26. Where a company entitled to the benefit of any provision contained in this Part of this Schedule is a holding company, the reference in Part II of this Schedule to consolidated accounts complying with the requirements of this Act shall, in relation to consolidated accounts of that company, be construed as referring to those requirements in so far only as they apply to the separate accounts of that company.

The interpretation of certain terms used in the eighth Schedule is given in Part IV thereof, which reads as follows—

PART IV

INTERPRETATION OF SCHEDULE

27.—(1) For the purposes of this Schedule, unless the context otherwise requires,—

(*a*) the expression "provision" shall, subject to sub-paragraph (2) of this paragraph, mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy;

(*b*) the expression "reserve" shall not, subject as aforesaid, include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability;

(*c*) the expression "capital reserve" shall not include any amount regarded as free for distribution through the profit and loss account and the expression "revenue reserve" shall mean any reserve other than a capital reserve;

and in this paragraph the expression "liability" shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

(2) Where—

(*a*) any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, not being an amount written off in relation to fixed assets before the commencement of this Act; or

(*b*) any amount retained by way of providing for any known liability;

is in excess of that which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated for the purposes of this Schedule as a reserve and not as a provision.

28. For the purposes aforesaid, the expression "quoted investment" means an investment as respects which there has been granted a quotation or permission to deal on a recognized stock exchange, or on any stock exchange of repute outside Great Britain, and the expression "unquoted investment" shall be construed accordingly.

It will be noted that there are new requirements with regard to the showing of reserves, with a distinction between what are described as capital reserves and revenue reserves, and there is a new classification called "a provision" which is used to apply to (*a*) amounts written off or retained by way of providing for

depreciation, renewals or diminution in value of assets, and (*b*) amounts retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy.

Reserves and provisions are considered fully in Chapter XIX.

It is provided for the first time that for the future corresponding amounts of all items for the previous financial year shall be shown. These are generally referred to as "comparative figures." This applies equally to the Balance Sheet and the Profit and Loss Account. A dispensation from this requirement is granted for the first accounts submitted after the commencement of the Act. (Paragraph 8 (11), *supra*.)

Every Balance Sheet of a company shall be signed on behalf of the Board by two of the Directors of the company, or, if there is only one Director, by that Director. (Companies Act, 1948, Section 155.)

The Profit and Loss Account and, so far as not incorporated in the Balance Sheet or Profit and Loss Account, any group accounts laid before the company in general meeting, shall be annexed to the Balance Sheet, and the Auditor's report shall be attached thereto.

Any accounts so annexed shall be approved by the Board of Directors before the Balance Sheet is signed on their behalf.

If a copy of the Balance Sheet is issued, circulated or published without having annexed thereto a copy of the Profit and Loss Account or any group accounts required to be so annexed, or without having attached thereto a copy of the Auditor's report, the company and every officer of the company who is in default shall be liable to a fine not exceeding £50. (Section 156 (1).)

The right to receive copies of Balance Sheets and the documents which must be annexed thereto is extended to every member of the company, whether he is the holder of ordinary or preferential shares and whether he is or is not entitled to receive notice of general meetings, and every debenture holder except in the case of a company not having a share capital, when they need not be sent to members and debenture holders who are not entitled to receive notices of a general meeting. (Section 158.)

The above-mentioned requirements apply equally to public and private companies.

The submission of group accounts is considered in a separate chapter (see Chapter XXII).

CASES

A company forwarded to the Registrar a Balance Sheet purporting to be in compliance with Section 26 of the Companies (Consolidation) Act, 1908, which, in the statement of assets, set out the following particulars: "Goodwill, trade marks, machinery,

furniture, and fixtures, £100,000. Goodwill and trade marks at the sum at which they were taken over by the company. Machinery, furniture, and fixtures at cost, less depreciation."

Held, that this Balance Sheet did not comply with the requirements of Section 26, Subsection 4; by Lord Alverstone, C.J., because it stated that different parts of the fixed assets had been valued in different ways and did not state the separate values of those parts; by Pickford, J., because it ought to state the separate values of the tangible and intangible fixed assets.—*Galloway* v. *Schill, Seebohm & Co., Ltd.*, [1912] 2 K.B. 354.

In the present day such an amalgamation of assets would not satisfy the provisions of Schedule 8 of the Companies Act, 1948, which provides for the segregation of such items.

The Articles of a company contained the restrictions, limitations, and prohibitions mentioned in clauses (*a*), (*b*), and (*c*) respectively of Section 121, Subsection 1, of the 1908 Act (see Companies Act, 1929, Sections 26 and 27), but in each of two years the number of its members (exclusive of persons in the employment of the company) in fact exceeded fifty. Informations laid against the company for having in each of the two years respectively made default in forwarding to the Registrar of Companies a statement in the form of an audited Balance Sheet as required by Section 26, were dismissed by a magistrate upon the ground that the company was still a private company within the meaning of Section 121 and was therefore not bound to forward the statement—

Held, that the decision of the magistrate was right, inasmuch as a company whose Articles contained the restrictions, limitations, and prohibitions mentioned in clauses (*a*), (*b*), and (*c*) of Subsection 1 of Section 121 remains a "private company" within the meaning of the definition contained in the Section, even though those restrictions, limitations, and prohibitions are not in fact complied with by the company.—*Park* v. *Royalties Syndicate, Ltd.*, [1912] 1 K.B. 330.

Every calendar year means a year from 1st January to 31st December.—*Gibson* v. *Barton* (1875), L.R. 10 Q.B. 329; *Edmonds* v. *Foster* (1876), 33 L.T. 690.

A Director is not necessarily personally responsible for Balance Sheets and reports stated to be issued "by order of the Directors."—*Re Denham & Co.* (1884), 25 Ch.D. 752.

CHAPTER X

PROFITS AVAILABLE FOR DISTRIBUTION

THE question of the determination and ascertainment of profits is one of special importance. The principles involved are considered elsewhere in this book, and the computation in some respects follows a definite procedure. In other respects, however, points may arise as to the inclusion or exclusion of certain items, where the issue is a matter of opinion. For example, prudence may suggest reserves and special provisions for depreciation, contingencies and similar matters, although it might be impossible to state that the accounts without such provisions are incorrect. Nor can a decision be arrived at without taking into account the various interests concerned—creditors, debenture holders, shareholders and others. The improper payment of a dividend which may result from an excessive statement of profits will possibly affect the position of debenture holders and creditors by depleting the assets to which they look to meet their claims. The understatement of profits, on the other hand, may have the effect of depriving present shareholders of dividends to which they are entitled, or depressing the market value of their shares, though this latter aspect is not one which should necessarily weigh with the directors in determining their policy. The Companies Act, 1948, has reduced the elasticity previously governing the ascertainment of profit, and has prescribed regulations which will assure its computation within well defined limits. Undervaluation of assets, and excessive provisions for liabilities and depreciation, however prudent and well intentioned they may have been, will not be easy in the future and may well prove impossible, unless appropriate references are made in the accounts.

It is not surprising that the question of ascertainment of profits and the propriety of the payment of dividends should have been the subject of many cases in the Courts, and it is appropriate here to cite a number of these cases and the decisions given, so that the principles involved may be understood.

Ammonia Soda Co. Ltd. v. *Chamberlain*, [1918] 1 Ch. 266

In this case it was decided that a company may write up the assets as the result of a *bona fide* revaluation and may divide current profits without making good previous losses.

The company had written up the value of certain lands and used the increase in value to write off a balance at the debit of Profit and Loss Account, goodwill and a cash bonus paid.

Peterson, J., in the course of a long judgment, said—

The Directors, no doubt, would have been better advised if they had obtained a revaluation from some expert valuer, although, if one may judge by the evidence on the subject which I have heard, the margin of difference between the views of values on the subject is very great. But there is no rule of law which requires Directors to obtain outside assistance in such matters or prevents them from valuing the property themselves, provided, of course, that they act honestly in doing so.

There is not any ground for suggesting that any facts were concealed from the shareholders by the Directors. In these circumstances it is not, in my opinion, open to the company to attack the Directors for an honest, though it may be erroneous, estimate which has been expressly adopted by the company in general meeting after the attention of its shareholders had been pointedly called to the resolution by the Auditors' certificate which was attached to the Balance Sheet.

I am satisfied that the Directors acted honestly. What they proposed to do was clearly shown in the Balance Sheet and the Auditors' report, which were submitted to the general meeting of the company in October, 1911. Most, if not all, of the shareholders who attended that meeting were commercial men, and they unanimously approved of the proposal. The Auditors, while they properly called attention to the revaluation by the Directors and to the way in which it was proposed to apply the increase in the value of the land, do not appear to have advised the Directors or the shareholders that there was any impropriety in dealing with the increase in this way; and the same firm of Auditors and an additional firm of Auditors, both of whom were admittedly experienced Chartered Accountants, certified the Balance Sheet at 31st January, 1912, without suggesting any doubts as to the correctness of the course which had been pursued.

Note. The essence of this case is that the fact that there is a debit balance to Profit and Loss Account arising out of previous losses does not make it illegal to pay dividends out of subsequent profits without first of all providing for the previous losses.

From a financial point of view this does not appear to be a sound policy and is open to abuse.

By the special Act of a Gas Company it was provided that the profits to be divided among the shareholders in any year should not exceed a given rate. It was held that in arriving at the rate of dividend the profits ought to be calculated as inclusive and not exclusive of the amount payable for the year in respect of income tax.—*Ashton Gas Co.* v. *Attorney-General*, [1906] A.C. 10.

Boaler v. *Watch Makers' Alliance* (1903), *Accountant Law Reports* 23

The liability of the Directors in respect of dividends improperly paid out of capital ceases when the amount so paid is covered by subsequent profits. This principle would presumably also apply to Auditors.

Bolton v. *Natal Land & Colonization Co., Ltd.*, [1892] 2 Ch. 124

In this case it was held that a company may declare a dividend out of current profits although there has been a loss of part of the capital assets.

In one year the company wrote off a bad debt of £70,000, but on the other hand credited to Profit and Loss Account a sum of £70,000, being an increase in value attributed to certain lands as compared with the amount standing in the books. A few years later the company, having earned a profit, paid a dividend out of these profits. The plaintiff commenced an action to restrain the payment of the dividend on the grounds that the land should be written down to its true value. The judgment was as follows—

Held that, assuming that a part of the capital had in fact been lost, and not subsequently made good, no sufficient ground was thereby afforded for restraining the payment of the dividend; that the fact of the company having written up the value of their land in 1882, and credited the increase to the profit of that year in the manner prescribed, did not place them under any obligation to bring into account in every subsequent year the increase or decrease in the value of their lands; and that, having regard to the case of *Lee* v. *Neuchatel Asphalte Co.* (1889), 41 Ch.D. 1, it was not correct, in estimating the profits of a year, to take into account the increase or decrease in the value of the capital assets of the company.

This procedure has been followed by other companies. It is, however, bad finance to bring in unrealized values as a profit. A dividend paid in cash out of unrealized profits of this character would seem to be inadvisable even though not illegal.

Articles of Association of the usual type would not permit of dividends being paid out of unrealized increases in value, even if the object of the company were to trade in land.

Bond v. *Barrow Haematite Steel Company*, [1902] 1 Ch. 353

This case decided that preference shareholders cannot claim to receive dividends out of current profits as a matter of right and regardless of such provisions for reserves as the Directors may think fit.

The substance of the decision is as follows—

The case of *Lee* v. *Neuchatel Asphalte Co.* (1889), 41 Ch. D.1, in which the doctrine was laid down that there is nothing in the Companies Act, 1862, and subsequent Acts, to prohibit a company formed to work a wasting property, as e.g. a mine or patent, from distributing, as dividends, the excess of the proceeds of working above the expenses of working, nor to impose on the company any obligation to set apart a Sinking Fund to meet the

depreciation in the value of the wasting property, has been misunderstood. The Court decided nothing more than the particular proposition that some companies with wasting assets need have no depreciation fund.

The question whether a company has profits available for distribution must be answered according to the circumstances of each particular case, the nature of the company, and the evidence of competent witnesses.

Bosanquet v. *St. John d'El Rey Mining Co., Ltd.* (1911), 103 L.T. 316

A company formed in 1830 for the purpose of working gold mines in Brazil, made large profits from its principal mine, and paid good dividends from 1835 to 1886, when the top of the mine fell in and blocked it up, making further work impossible without an expenditure of large sums of money for labour and machinery in reopening it. To obtain the necessary funds for this purpose the company was twice reconstructed, and its capital increased by the issue of shares and of debentures bearing interest at £10 per cent per annum; and in November, 1894, the mine was reopened and supplied with new machinery and plant. From the date of the issue of the debentures up to the date of reopening, the company made no profits, and the Directors paid the interest on the debentures, which amounted to a large sum, out of capital, but after November, 1894, the debenture interest and all outgoings were paid out of income. The Directors decided to form a Sinking Fund out of profits for the purpose of recouping the amount paid out of capital, and from the profits of the year 1897 proposed to pay a small dividend and to carry over the remainder to the credit of the Sinking Fund. Upon motion in an action by a debenture-holder and shareholder, on behalf of himself and all other debenture-holders and shareholders of the company, for an injunction restraining the Directors from applying any part of the profits in payment of a dividend until the amount paid out of capital for debenture interest had been replaced, it was held that the company were not bound to apply the profits in replacing debenture interest paid out of capital in previous years before declaring a dividend, and the action was dismissed.

Re Crighton's Oil Company, [1901] 2 Ch. 197

In this case Wrightly, J., said—

I do not think that there is any rule of law that profit on one year's trading account cannot be divided merely because on the Profit and Loss Account there is a deficit over the balance of former years; but it does not follow from that that the amount of the profit of one year is necessarily to be treated as available for dividends. . . . Profit is not an automatic thing, nor is a divisible profit an automatic thing.

Burnes v. *Pennell* (1849), 2 H.L.C. 535

As long ago as 1849, Campbell, L.C., intimated that dividends are supposed to be paid out of profits only, and where Directors order a dividend to any given account, without expressly saying so, that implicitly declares to the world that the company has made profits which justify such a dividend. He added that if no such profits had been made, and the dividend had to be paid out of the capital of the concern, a gross fraud was practised, and in his opinion Directors were not only civilly liable to those whom they had deceived and injured, but were guilty of a conspiracy, for which they were liable to be prosecuted and punished.

Cox v. *Edinburgh & District Tramways Company* (1898), 6 S.L.T. 63

The company had altered its system from horse traction to cable traction. It was held that nothing need be written off capital account before paying dividends out of current profits.

In the course of the judgment Lord Kyllachy said—

I proceed on a principle as old as the beginning of company law—the principle, namely, that in matters of the kind here in question—matters necessarily of estimate and opinion—a company is presumably the best judge of its own affairs. In such matters the Court will not readily interfere with the company's action, and it will not do so at all except on averments which involve practically a case of fraud or dishonesty. But, apart from extreme cases, few things are, I should think, more common in ordinary business than operations of the kind with which we are concerned. A merchant or manufacturer desires to enlarge his premises, satisfied that it will pay him to do so. He accordingly pulls down old buildings which have a certain value and he replaces them by others at perhaps great cost. There is thus, of course, in a sense, the sacrifice of a permanent asset, and it may quite well happen that the new buildings if put into the market would not fetch a sum equal to the value of the old building plus the cost of the new. But for the purposes of the trader's business the result may be entirely the other way, and the presumption is that the trader is satisfied that it is so. If he is so satisfied he will certainly not consider that he has sustained a loss of capital, or feel bound to carry the cost of the old building to the debit of his Profit and Loss Account for the year. Similarly, a manufacturer requires or resolves to discard certain machinery and to replace it with other machinery more effective or more economical. Here, again, the sacrifice in the case of the old machinery is simply an item in the cost of the change. So also, when a railway company, as sometimes happens, alters its gauge, or substitutes, say, steel for iron rails. The operation necessarily involves a sacrifice of old material. But the assumption always is that the operation as a whole enhances the value of the concern or undertaking. And although it may be a prudent and proper thing to provide for the recurrence of such expenditure, and to set up a renewal fund, that is a question which the trader considers for himself, and one as to which, even in the case of limited companies, courts of law are not accustomed to interfere. On the whole matter I am of opinion that the complainer has stated no relevant case for interfering with the proposed dividend, or for granting him interdict in terms of any part of his prayer.

Foster v. *New Trinidad Lake Asphalte Co., Ltd.*,
[1901] 1 Ch. 208

It was held in this case that a realized addition to the estimated value of one item of the capital assets taken over by a company at its formation cannot be deemed to be profit available for dividends without reference to the result of the whole accounts, fairly taken.

Byrne, J., said—

It appears to me that the amount in question is *prima facie* capital, and that I have no evidence which would justify me in saying that it has changed its character because it has turned out to be of greater value than had been expected. If I rightly appreciate the true effect of the decisions the question of what is profit available for dividend depends upon the result of the whole accounts fairly taken for the year, capital, as well as profit and loss, and although dividends may be paid out of earned profits in proper cases, although there has been a depreciation of capital, I do not think that a realized accretion to the estimated value of one item of the capital assets can be deemed to be profit divisible amongst the shareholders without reference to the result of the whole accounts fairly taken.

Note. The contents of the Memorandum and Articles of Association must be studied in considering a case of this character.

Helby's Case, re Portsmouth Banking Co. (1866), L.R. 2 Eq. 167

Kindersley, V.C., said—

The Balance Sheet or summary of account would show, on the one hand, all the assets, and, on the other hand, all the liabilities of the company, and it was only on this sort of statement that any safe conclusion could be drawn as to the question whether there had been any profit for the half-year or not, and whether any and what dividend should be declared.

Note. This bears out the principle that if the Balance Sheet is sound the Profit and Loss Account must also be sound.

Lubbock v. *British Bank of South America Ltd.*,
[1892] 2 Ch. 198

Where a Banking Company with a paid-up capital of £500,000 sold part of its undertaking for £875,000, and after deducting the paid-up capital and other incidental expenses there remained a net balance of £205,000, and the Directors proposed to treat this balance as profit, it was held by Chitty, J., that the £205,000 was profit on capital, and not part of the capital itself, that the Directors were justified in carrying this sum to the Profit and Loss Account, and, after appropriating to the Reserve Fund so much as they thought proper, might distribute the remainder as dividends.

There was nothing in the Articles of Association preventing the company from dividing profits of a capital nature.

Re The Midland Land and Investment Corporation (1886), Unreported

In this case, which was not reported, Chitty, J., said—

In declaring a dividend, in my opinion, in trading concerns, the Directors are entitled to put an estimate on the value of their assets from time to time, in order to ascertain whether there is or is not a surplus remaining after providing for liabilities (including, of course, paid-up capital), and where they make those valuations from time to time on a just and fair basis, and take all the precautions which ordinary prudent men of business engaged in a similar business would do, they are entitled to treat the surplus thus ascertained as profit.

Note. This decision may not always be in accordance with the principles of sound finance since dividends have to be paid in cash, which is not provided by re-valuations.

Moxham v. *Grant*, [1900] 1 Q.B. 88

Where dividends are received by shareholders who know that they have been paid out of capital, the Directors have a right to be indemnified by the shareholders, but not if they have represented that the dividends were paid out of profits.

Stapley v. *Read Bros. Ltd.* (1924), 40 T.L.R. 442

A company which has written down its assets excessively out of profits may write up the assets again by the amount of the excess and apply the amount in payment of dividends.

The plaintiff sought an injunction to restrain the defendant company (1) from distributing in dividend the credit balance of the Profit and Loss Account at 31st December, 1923, or any part thereof, until the debit balance on the Profit and Loss Account at 31st December, 1922, had been discharged, and (2) from treating as profits available for dividend (*a*) any profits originally applied in writing off or down the book value of any of the assets, and subsequently written back on the ground that such assets stood in the company's books at less than their true value; (*b*) any unrealized profit arising from an estimated increase in the value of any capital asset.

Russell, J., refused to grant the injunction. He said—

The sole question was whether profit and loss was to be treated as a continuous account, so that no dividend could be declared out of one year's profits until any debit to profit and loss in respect of prior years had been made good.

His Lordship said that this point was covered by the decision in *Ammonia Soda Co., Ltd.* v. *Chamberlain*, [1918] 1 Ch. 266, and he therefore refused to grant the injunction.

In dealing with the second part of the motion his Lordship said that the point was not covered by direct authority. Had the

company retained the goodwill as an asset in the Balance Sheet, and, instead of writing off its value out of profits, had carried those profits to a goodwill depreciation reserve fund, it could have distributed those profits at any time to the extent by which the amount of the reserve fund exceeded the amount of actual depreciation. It was admitted that the value of the goodwill was at least £40,000, and if therefore there had been £40,000 to the credit of that reserve fund the company could have distributed £40,000 of that reserve as profits. The question was whether it made any difference that the company instead of placing its profits to reserve, had purported to apply them in writing off a corresponding amount of the value of the goodwill. The answer to that question depended on whether the company had finally and unreservedly capitalized those profits so as to disentitle itself for ever from restoring them to reserve and treating them as profits. The accounts which showed the particular method adopted had been approved each year by the shareholders at the annual general meetings, but his Lordship said that he was not satisfied that the shareholders had thereby intended to bind themselves for all time to give up their claim to those profits, and to treat them as capital only. In his opinion the shareholders might, if they thought fit, write back to the profit account the £40,000 which was admitted to be the amount by which the depreciation written off goodwill exceeded the proper requirements. There was no provision in the Companies (Consolidation) Act, 1908, or in the constitution of the company, to prevent this course, which was furthermore not prejudicial to creditors.

He therefore refused to grant this injunction also. The question raised in (2) (*b*) of the motion did not fall for decision.

Towers v. *African Tug Co.*, [1904] 1 Ch. 158

In this case by a *bona fide* error an interim dividend had been paid out of capital. The Directors proposed to deduct the dividend from subsequent profits before paying any further dividends. It was held that a shareholder who had received the interim dividend could not maintain an action against the Directors for repayment of the interim dividend. An action might be maintained by the company or by the liquidator.

Verner v. *General & Commercial Investment Trust, Ltd.*, [1894] 2 Ch. 266

In this case it was decided that an injunction to restrain the company from paying a dividend out of current profits, on the ground that the capital of the company is not intact, must be refused, if the company is solvent and acting within its Articles.

This was an appeal from a decision of Mr. Justice Stirling. It

raised a very important question in company law, viz., whether, where there has been a loss in the capital of a company through depreciation in the value of its assets, the company is entitled to pay dividends out of profits earned by means of its investments without first reducing its capital so as to meet such depreciation.

Lindley, J., in giving judgment for the company, said—

The broad question raised by this appeal is whether a limited company which has lost part of its capital can lawfully declare or pay a dividend without first making good the capital which has been lost. I have no doubt it can—that is to say, there is no law which prevents it in all cases and under all circumstances. Such a proceeding may sometimes be very imprudent, but a proceeding may be perfectly legal and may yet be opposed to sound commercial principles. We, however, have only to consider the legality or illegality of what is complained of. The main fact is that the main condition of limited liability is that the capital of a limited company shall be applied for the purposes for which the company is formed, and that to return the capital to the shareholders either in the shape of dividend or otherwise is not such a purpose as the Legislature contemplated. But there is a vast difference between paying dividends out of capital and paying dividends out of other money belonging to the company, and which is not part of the capital mentioned in the company's memorandum of association. The capital even of a limited company is not a debt owing by it to its shareholders, and if the capital is lost the company is under no legal obligation either to make it good or, on that ground only, to wind up its affairs. If, therefore, the company has any assets which are not its capital within the meaning of the Companies Acts, there is no law which prohibits the division of such assets amongst the shareholders. There is no law which prevents a company from sinking its capital in the purchase or production of a money-making property or undertaking, and in dividing the money annually yielded by it without preserving the capital sunk so as to be able to reproduce it intact either before or after the winding up of the company. A company may be formed upon the principle that no dividends shall be declared unless the capital is kept undiminished, or a company may contract with its creditors to keep its capital or assets up to a given value. But in the absence of some special Article or contract there is no law to this effect, and, in my opinion, for very good reasons. It would, in my judgment, be most inexpedient to lay down a hard and fast rule which would prevent a flourishing company either not in debt or well able to pay its debts from paying dividends so long as its capital sunk in creating the business was not represented by assets which would, if sold, reproduce in money the capital sunk. Even a sinking fund to replace lost capital by degrees is not required by law. But, although there is nothing in the statutes requiring even a limited company to keep up its capital, and there is no prohibition against payment of dividends out of any other of the company's assets, it does not follow that dividends may be lawfully paid out of other assets regardless of the debts and liabilities of the company. A dividend presupposes a profit in some shape, and to divide as a dividend the receipts, say, for a year, without deducting the expenses incurred in that year in producing the receipts, would be as unjustifiable in point of law as it would be reckless and blameworthy in the eyes of business men. The same observation applies to payment of dividends out of borrowed money. Further, if the income of any year arises from a consumption in that year of what may be called circulating capital, the division of such income as dividend without replacing the capital consumed in producing

it will be a payment of a dividend out of capital within the meaning of the prohibition which I have endeavoured to explain. It has been already said that dividends presuppose profits of some sort, and this is unquestionably true. But the word "profits" is by no means free from ambiguity. The law is much more accurately expressed by saying that dividends cannot be paid out of capital than by saying that they can only be paid out of profits. The last expression leads to the inference that the capital must always be kept up and be represented by assets which, if sold, would produce it; and this is more than is required by law. Perhaps the shortest way of expressing the distinction which I am endeavouring to explain is to say that fixed capital may be sunk and lost, and yet that the excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess, in which case to divide such excess without deducting the capital which forms part of it will be contrary to law. But there is no law which compels limited companies in all cases to recoup losses shown by the Capital Account out of the receipts shown in the Profit and Loss Account, although care must be taken not to treat capital as if it were profit. Further, it is obvious that capital lost must not appear in the accounts as still existing intact; the accounts must show the truth and not be misleading or fraudulent.

Wall v. *London & Provincial Trust, Ltd.*, [1920] 1 Ch. 45

In this exceptional case it was held that a company which by its Articles of Association adopts the double account system cannot in law treat profits made on the redemption of its debentures as being available for dividend.

The action was brought against the Trust Investment Company to prevent distribution by way of dividend of profits made by redemption of debentures at a discount.

Younger, J., said—

Where the double account system exists, no transfer can be made from one account to another. An appreciation of capital can never increase the income balance. To do this the single account system must be adopted, which is not in accordance with the constitution of this company. This discount is not either net profit of the company or net profit arising from its business and the directors are not entitled to distribute it as dividend.

Note. In subsequent proceedings reported in [1920] 2 Ch. 582, the decision of Younger, J., was approved and followed.

Wilmer v. *McNamara & Co., Ltd.*, [1895] 2 Ch. 245

In this case it was held that a company cannot be restrained from declaring a dividend out of current profits because no provision has been made for depreciation of fixed assets. The ordinary shareholders in the company sought to restrain the Directors from paying a dividend to the preference shareholders. The object of the action was to ascertain whether the dividend could be lawfully paid, in view of the fact that there had been a loss of capital

which it was contended should be made good before any dividends were paid. Stirling, J., in refusing to make an injunction against the Directors, said—

> Article 117 provides that "no dividend shall be payable except out of the profits arising out of the business of the company." What are these profits? Apart from the use of the word "profits" in Article 117, there is nothing in the Articles to show that the capital of the company (or, rather, assets of the value of those acquired by the company at its formation) must be kept up. Further, the Articles appear to contemplate "profits" as the excess of receipts over all expenditure properly attributable to the year. It is necessary, however, to consider whether the depreciation in goodwill and leaseholds is to be treated as loss of "fixed" capital or of "floating" or "circulating" capital, and on this point I am of opinion that it is to be treated as loss of "fixed" capital. It very closely resembles the loss which a railway company may be said to suffer if it be found that their line, which was made, say, ten years ago, at a certain cost, could now be made at a much smaller cost. Having regard to the remarks of Lindley, L.J., in *Lee* v. *Neuchatel Asphalte Co.* (see page 154), I think that the Balance Sheet cannot be impeached simply because it does not charge anything against revenue in respect of goodwill. I feel much more doubt whether £200 is a sufficient sum to allow in respect of depreciation of leaseholds, but I do not think under the circumstances that a case has been made out for an injunction, and the motion must be refused.

The Balance Sheet of a company engaged in a hazardous trade will not be considered delusive and fraudulent merely because an estimated value was put upon assets of the company which were then in jeopardy, and were subsequently lost, or because the company was obliged to borrow money to pay the dividend, provided the facts fairly appeared in the Balance Sheet, and the balance fairly represented profits.—*Re Mercantile Trading Co., Stringer's Case* (1869), 4 Ch. App. 475.

Where the Articles of Association of a limited company provided that no dividends should be payable except out of "realized profits," it was held that "realized profits" must be taken in its ordinary commercial sense, as meaning at least the profits tangible for the purpose of division, and that the Directors, having treated estimated profits as realized profits, and having in fact paid dividends out of capital, on the chance that sufficient profits might be made, were held generally and severally liable.—*Re Oxford Benefit Building and Investment Society* (1887), 35 Ch.D. 502.

The Memorandum of Association of a company contained this clause: "The capital of the company is £150,000, divided into 10,000 ordinary shares of £10 each, and 5000 preference shares of £10 each. The holders of preference shares shall be entitled out of the net profits of each year to a preference dividend at the rate of £10 per cent per annum on the amount for the time being paid or deemed to be paid up thereon. After payment of such preferential dividend, the holders of ordinary shares shall be entitled to a like dividend at the rate of £10 per cent per annum on the

amount paid on such ordinary shares. Subject as aforesaid, the preference and ordinary shares shall rank equally for dividend." It was held that the preference shareholders were not entitled to a cumulative dividend of £10 per cent so as to have the deficiency in one year paid out of the profits of a subsequent year before paying anything to the ordinary shareholders.—*Staples* v. *Eastman Photographic Materials Co., Ltd.*, [1896] 2 Ch. 303.

Where the Articles of Association provided that the Directors may "declare a dividend to be paid to the members in proportion to their shares," and by the definition clauses the word "capital" was declared to mean the capital for the time being of the company, and the word "shares" the shares into which the capital is divided, it was held that all the shares were entitled to participate equally in dividend, without regard to the amount paid up upon each.—*Oakbank Oil Co.* v. *Crum* (1883), 8 App. Cas. 65.

The Articles of a company provided for the submission of accounts up to a date within three months and reports thereon, the sanction of a dividend, and the transaction of the ordinary business at the annual general meeting. It was held by North, J., that a final dividend could not be sanctioned except at an annual general meeting, at which accounts up to the prescribed date and reports thereon were submitted.—*Nicholson* v. *Rhodesia Trading Co., Ltd.*, [1897] 1 Ch. 434.

Where the Articles of Association of a company made no provision for the payment of dividends other than this: "The Directors may . . . declare and divide an interim dividend out of the profits . . . and pay the same to the members in proportion to the capital held by each," and when the Directors were further empowered to receive advances from any member of any sums due upon the shares held by him beyond what was actually called up, and to pay interest "in lieu of dividends" thereon, and "capital" was not defined in the Articles, it was held that the dividends fell to be apportioned according to the amount of the paid-up capital of each shareholder.—*Hoggan* v. *Tharsis Sulphur & Copper Co.* (1882), 9 R. (Ct. of Sess.) 1191 (Sc.).

Where a company issues preference shares carrying dividend at 10 per cent per annum, payable half-yearly, and with no words restricting the holders of such shares to the profits of the current year, the deficiency in the profits of any one year to pay the 10 per cent in full was, as between the preference and ordinary shareholders, to be made good out of subsequent profits.—*Foster* v. *Coles and M. B. Foster & Sons, Ltd.*, [1906] W.N. 107.

"Profits available for dividend" mean the net profits after making any deductions which Directors can properly make before declaring a dividend.—*Fisher* v. *Black and White Publishing Co., Ltd.*, [1901] 1 Ch. 174.

When a company declares a dividend on its shares, a debt immediately becomes payable to each shareholder in respect of his dividend, for which he can sue at law, and the Statute of Limitations immediately begins to run. The declaration does not make the company a trustee of the dividend for the shareholder, and an entry of the liability in the company's books—at any rate when no special part of its assets is set aside as representing the dividend and no notice of the entry is given to the shareholders—does not take the case out of the statute. Being payments under the Articles of Association, dividends are specialty debts, and consequently the period of limitation is twenty years.—*Re Drogheda Steam Packet Company*, [1903] Ir. R. 512. The same principle was asserted *Re Artisans' Land and Mortgage Corporation*, [1904] 1 Ch. 796.

In a case where the Directors of a company which had been in existence only eight months declared a bonus, James, L.J., said—

> A bonus, which of course can only be lawfully made out of moneys which have been earned, or believed to have been earned, in the way of profit. . . . How was this done? Was there any attempt to make a Balance Sheet or Profit and Loss Account in such a way as any mercantile body, and certainly any Insurance Company, ought to have done? . . . The Directors simply had before them the cash balance of the receipts and payments, and, without making the slightest provision on that account for anything whatever, they proceed out of the balance to declare this bonus. I quite agree that it would have been different if there had been, as there ought to have been, in the ordinary course of business, a Balance Sheet *bona fide* made out with proper assistance, so as to ascertain the true state of the company.—*Rance's Case, Re County Marine Insurance Co.* (1870), 6 Ch. App. 104.

Outstanding interest should not be taken to credit of a Profit and Loss Account until the claim is statute-barred, and not even then unless the Directors have decided not to recognize the claim should it subsequently be made.

The same remark applies to interest unclaimed by debenture-holders, and in the case of a Railway Company incorporated by a special Act, authorizing it to issue debenture stock, bearing interest, subject to Part III (which includes Sections 22 and 27) of the Companies Clauses Act, 1863, which issued debenture stock, for which it gave certificates under its common seal, and also a warrant for interest under the signature of its Secretary, it was held that, the liability being statutory, the period of limitation was twenty years.—*Re Cornwall Minerals Railway Co.*, [1897] 2 Ch. 74

Dividends may not be paid out of borrowed capital, nor can interest on debentures be charged to Capital Account.—*Bloxam* v. *Metropolitan Railway Co.* (1868), 3 Ch. App. 337.

In the following case, reported in *The Times* of 30th July, 1936,

the question for decision was "What were profits?" for the purposes of an agreement under which the plaintiff was entitled to £1000 "out of the first profits of the company and in priority to all dividends payable in respect of any shares in the capital of the company."

In 1930 the defendant company was formed for the manufacture of a flash lamp used in photography, and in consideration of services rendered in the flotation the defendants by an agreement dated 20th December, 1930, agreed to pay to the plaintiff £1000 "out of the first profits of the company and in priority to all dividends payable in respect of any shares in the capital of the company." The company's Balance Sheet for the year ended 31st March, 1935, showed a balance of £698 11s. 10d. to the credit of the Profit and Loss Account, and the plaintiff claimed this sum on account of the £1000 due to him under the agreement. The directors of the company refused to pay the £698 11s. 10d. to the plaintiff and applied it as to £393 odd in writing off the company's preliminary expenses, and the remaining £304 odd they placed to the patents reserve account.

Mr. Justice Branson, in delivering judgment for the defendants, said that the plaintiff contended that the £698 11s. 10d. was the "first profits" earned by the company inasmuch as it appeared in the Profit and Loss Account. The defendants contended that on a true construction of the agreement the plaintiff was to be the first person to benefit out of profits which, if he had not been there, would have gone to the shareholders.

A number of cases had been cited, but it was difficult to get any help from them. It was contended that it was a reasonable and prudent course for the directors of the company to write off the preliminary expenses and put something to reserve. Patents were wasting assets, and directors ought to provide for the replacement of wasting capital. As the authorities were not helpful he was driven back on the construction of the words of the agreement. What were the profits of a company was a question to which different answers might be given (*Lee* v. *Neuchatel Asphalte Co.*, 41 Ch.D. 1). It was essential to look at the whole of the language used by the parties and read the whole together. He thought that the words here must be read "when the directors come to consider the payment of a dividend they must first pay the plaintiff his £1000 out of the money which would otherwise be available for dividend."

It was argued that on that construction the directors might postpone the payment of a dividend and so keep the plaintiff out of his money indefinitely; but the company was floated with the intention of paying dividends to its shareholders and such postponement was unlikely. The plaintiff was safeguarded in that his

claim had to be met before any dividend could be paid. It was not suggested that the directors had postponed a dividend in order to injure the plaintiff, or that they had acted otherwise than with ordinary prudence. In his view the directors were justified in the course which they took, and the action failed.—*Stewart* v. *Sashalite Ltd.* (1936), 80 Acct. L.R. 85.

DISTINCTION BETWEEN CAPITAL AND INCOME; DEPRECIATION; PROFITS AND DIVISIBLE PROFITS; RESERVES; DIVIDENDS

In the following cases of an omnibus character, the law relating to these matters was considered and expounded. Competent Directors should, however, look at these questions from a financial point of view and adopt a prudent course which will preserve the liquidity of the companies with which they are concerned. By doing so they will find they have kept well within the law and avoided the risk of insolvency which might result from acting merely on strict legal decisions.

Drapery Trust Ltd. v. *Drages Ltd.* (1934)

In this case, which is not officially reported, the Trust claimed that the expression "profits available for distribution" included any sum standing to the credit of general reserves, and the balance of profits carried forward from previous years in addition to the actual profit for the year. In other words, the expression "profits available for distribution" included all profits which the defendant company could distribute without acting *ultra vires*. The Court held that on a true construction of the agreement which had been made by the two companies, profits available for distribution in any year meant the profits available after making such reserves as the Directors acting in good faith and in accordance with the Memorandum and Articles of Association thought it desirable to make in the interests of the company.

In the absence of a full report, it is not possible to refer to the agreement or to the Memorandum and Articles, but it affords a guide to the question of "What are profits available for distribution?"

Lee v. *Neuchatel Asphalte Co., Ltd.* (1889), 41 Ch.D. 1

The principal asset of the company consisted of asphalte mines held under a concession. The Articles of the company provided that the Directors need not make a reserve for the replacement or renewal of any concession or property.

An ordinary shareholder brought an action to restrain the company from paying a preference dividend without providing

for depreciation in respect of the concession as being a wasting asset. The Court of Appeal decided in favour of the company.

In the course of his judgment, Stirling, J., made the following remarks—

It may be that in some future year the company will have to set apart a substantial sum to represent depreciation in the value of the concession; but so long as the capital remains intact, and the current receipts exceed the current expenditure, both according to the general law and under the provisions of these particular Articles of Association, it rests entirely with the shareholders to decide whether the excess shall be divided among them or set apart as a reserve fund for replacing wasting assets, and the Court has no power to interfere with their decision, however foolish or imprudent it may seem to be.

In the Court of Appeal, Lindley, L.J., remarked—

Now we come to consider how the Companies Act is to be applied to the case of a wasting property. If a company is formed to acquire and work a property of a wasting nature, for example, a mine, a quarry, or a patent, the capital expended in acquiring the property may be regarded as sunk and gone, and if the company retains assets sufficient to pay its debts, it appears to me that there is nothing whatever in the Act to prevent any excess of money obtained by working the property over the cost of working it from being divided amongst the shareholders, and this, in my opinion, is true, although some portion of the property itself is sold, and in some sense the capital is thereby diminished. If it is said that such a course involves payment of dividend out of capital, the answer is that the Act nowhere forbids such a payment as is here supposed.

Re Spanish Prospecting Co., Ltd., [1911] 1 Ch. 92

In the absence of any special agreements, profits where the rights of third parties are at stake are the actual profits and need not be the profits as shown by the Profit and Loss Account.

The company had agreed with two employees that they were to receive salaries which they were only entitled to draw "out of profits" arising from the business of the company which might be available for the purpose of paying salaries. The salaries were to be cumulative and payable out of subsequent profits. The company went into liquidation, arrears of salaries being outstanding.

The objects of the company included the purchase and sale of shares. At the date of liquidation certain debentures were in the hands of the company but no value had been put upon them. The debentures were realized by the liquidator and the employees claimed that the proceeds should be regarded as profits out of which the arrears of salary should be paid.

The Court of Appeal reversing the decision of Mr. Justice Swinfen Eady decided that the proceeds should be credited to Profit and Loss Account for the purpose of calculating the salaries.

Fletcher Moulton, L.J., said—

Though there is a wide field for variation of practice in these estimations of profit in the domestic documents of a firm or company, this liberty ceases at once when the rights of third persons intervene.

In the absence of special stipulations to the contrary, "profits," in cases where the right of third parties come in, means actual profits, and they must be calculated as closely as possible in accordance with the fundamental conception, or definition to which I have referred. I would have it clearly understood that these remarks have no bearing upon the vexed question of the fund out of which dividends may legally be paid in limited companies.

This case relates only to the division of profits, but it indicates the importance of using care in the preparation of agreements relating to a share in profits.

Re Godfrey Phillips, Ltd. (1949)
Re Austin Motor Co., Ltd. (Court of Appeal, 15th February, 1950)

The above cases dealt with dividends on Preference shares where the intention was that they should be free of income tax up to 6s. in the £. The current rate of tax was 9s. in the £. In Godfrey Phillips's case the company computed the dividend by grossing 6 per cent at 6s. in the £ and deducting 9s. in the £ therefrom. The shareholder who questioned this procedure considered that the proper method was to deduct 3s. in the £ on 6 per cent of the capital. Taking £100 capital, the company's method produced £4 14s. 6d. (£8 11s. 6d. less £3 17s.) and the shareholder's £5 2s. (£6 less 18s.)

In the High Court the company's method was approved. But in a subsequent case upon the same point, though on a slightly different wording of the Articles, concerning dividends of Austin Motor Co., Ltd., the Court of Appeal approved the shareholder's method, which, in fact, that company had always adopted. A similar decision was given in the case of Vickers, Ltd.

CHAPTER XI

LIABILITIES OF AUDITORS

THE object of an audit is set out in Chapter II.

The responsibility of an Auditor to his client, whether a corporation, company, or individual, has been the subject of a number of actions in the Law Courts.

These actions may be brought either under Common Law or under the Companies Act, 1948. There is also a possibility of action being taken under the Larceny Act, 1861, and the Larceny Act of 1916, and the Falsification of Accounts Act, 1875. If a company is carrying on business, action is taken under Common Law; if the company is being wound up, proceedings are usually taken under Section 334 of the Companies Act, 1948, at the instance of the Official Receiver, the liquidator, or any creditor. The Court may be asked to examine into the Auditor's conduct and to make him compensate the company if he be found guilty of negligence by payment of such an amount as the Court thinks just. Prior to the Companies Act, 1929, it was not unusual to find a clause in the Articles of Association indemnifying the Directors and other officers, and also the Auditors, of the company against any damages arising from any act other than from wilful negligence or default. Section 205 of the Companies Act, 1948, declares any provision of this kind to be void, but provides that a company may indemnify any Director, manager, officer or Auditor against any liability incurred in defending an action, whether civil or criminal, in which judgment is given in his favour, or he is acquitted or relief is given under Section 448.

Section 448 is as follows—

448.—(1) If in any proceeding for negligence, default, breach of duty or breach of trust against an officer of a company or a person employed by a company as auditor (whether he is or is not an officer of the company) it appears to the court hearing the case that that officer or person is or may be liable in respect of the negligence, default, breach of duty or breach of trust, but that he has acted honestly and reasonably, and that, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for the negligence, default, breach of duty or breach of trust, that court may relieve him, either wholly or partly, from his liability on such terms as the court may think fit.

(2) Where any such officer or person aforesaid has reason to apprehend that any claim will or might be made against him in respect of any negligence, default, breach of duty or breach of trust, he may apply to the court for relief, and the court on any such application shall have the same power to relieve him as under this section it would have had if it had been a court before which proceedings against that person for negligence, default, breach of duty or breach of trust had been brought.

(3) Where any case to which subsection (1) of this section applies is being tried by a judge with a jury, the judge, after hearing the evidence, may, if he is satisfied that the defendant ought in pursuance of that subsection to be relieved either in whole or in part from the liability sought to be enforced against him, withdraw the case in whole or in part from the jury and forthwith direct judgment to be entered for the defendant on such terms as to costs or otherwise as the judge may think proper.

Actions against the Auditor, in cases of this kind, usually involve a claim for damages for negligence which has caused a loss to his client. There may have been defalcations on the part of Directors or employees, or the Auditor may have failed to detect false statements in the books or in the Balance Sheets and other accounts of the business, which may have involved the improper payment of dividends or commissions.

The full reports of the following cases make instructive reading. It is sufficient to reproduce here short statements of the facts and results and the purport of the judicial pronouncements in each case. The principal cases, arranged for convenience of reference in alphabetical order, are as follows—

Re Allen Craig & Co. (London) Ltd., [1934] Ch. 483

This was a misfeasance summons against the Auditors issued by the Liquidator. The Auditors had made reports to the company which had never reached the shareholders. It was argued that they were required to make a report to the shareholders pursuant to Section 134 (1) of the Companies Act, 1929. The Judge remarked that there were no means by which the Auditors themselves could convene a general meeting. The Auditors themselves were powerless in the matter. The Judge also said that all the circumstances pointed to the conclusion that the duty of the Auditors, when they had affixed their signature to the report attached or annexed to the Balance Sheet was discharged when they had sent that report to the Secretary of the company. It was the statutory duty of the Secretary or the Directors to convene a general meeting to consider the report. The case against the Auditors was dismissed with costs.

Apfel's Trustee v. *Annan, Dexter & Co.* (1926), *The Accountant*, Vol. LXXV, pp. 286, 687

This action was brought by the trustee of the property of Mrs. Adele Apfel, a bankrupt, against the defendants for alleged negligence and breach of contract. The defendants stated that they were only empowered to prepare income tax returns and not to audit. Inadvertently a bill of charges had been rendered, reading as follows—

Professional services rendered for auditing your Accounts for the eight months ending 31st December, 1922.

On the other hand, a certificate had been given reading as follows—

Prepared from the books of Mrs. Adele Apfel and in accordance therewith.

The Judge, however, found that the defendants had only been employed to prepare accounts for special purposes and the plaintiff's action was dismissed with costs.

In the course of his judgment the Judge said—

As I understand the contention, it is said, and I think truly, that an Auditor who is instructed to make a full audit of business books is responsible not only for getting out such accounts as the books when properly made up appear to show, but is also responsible for ascertaining the true position of the business, whether disclosed properly by the books or not.

Now there are two forms of certificates that professional men in the position of the defendants are in the habit of giving. One is an audit certificate stating that the accounts to which they put their hands reflect the true position of the business dealt with in the accounts. The second is a certificate that, treating the books as made up for what they are worth, the accounts prepared reflect, and only reflect, the position of the business as shown in the books.

Armitage v. *Brewer & Knott* (1932), 87 Acct. 836

In the course of the hearing Mr. Justice Talbot put the duty of Auditors on rather an unpleasant footing when he said—

It is the duty of Auditors to be suspicious. That is what they are there for. If everybody was honest and careful there would be no need for Auditors. . . . He saw there were receipts unstamped. I should have thought that those would have attracted the attention, and provoked the comment, of an Auditor.

He also added that one of the objects of an Auditor was to enable the employer to get rid of a fraudulent servant, and the natural result if one left a fraudulent book-keeper was that frauds would follow.

In his judgment he said—

The documents at the beginning set out that the defendants would vouch all payments with receipts in petty cash, check calculations and additions of all wage sheets, check totals of wage sheets into wages book and check weekly totals, with other detailed provisions, and accountants undertaking duties of that kind could not be heard to excuse themselves on the ground that this or that was a small matter; they undertook a rigorous check, and they did so because that was what their client wanted.

The case was brought by Mr. Armitage against the defendants claiming damages for alleged negligence in auditing the plaintiff's books. Judgment was entered for the plaintiffs.

Astrachan Steamship Company and others v. *Harmood-Banner and others* (1900), Acct. L.R. 49. (Lancashire Chancery Court.)

This was a case concerning five single-ship companies, each company being managed, without Directors, by a manager. As

there were no Directors, the only safeguard of the shareholders was the audit. The manager presented the accounts of the various companies for audit at different times, and by keeping in hand a sum of money contrived to balance each company's accounts in turn. As Counsel put it, the sum of money went round while it lasted, but it was first under one thimble and then under another. Expert witnesses for the plaintiffs agreed that the state of things palpable on the face of the books of the Astrachan Company called on the defendants (1) to demand from the manager his special authority for borrowing the moneys of the company; or (2) to report the position to the shareholders; or (3) to have altered the item in the Balance Sheet "cash in manager's hands" to "cash borrowed by manager at 4 per cent interest."

The case was settled out of Court, the defendants paying a certain sum of money in settlement.

His Honour the Vice-Chancellor said—

The only thing necessary for me to say is that there is no imputation on the honour or capacity of the Auditors, but it is perfectly obvious that the manager had been manipulating the assets, and they were, like other people, taken in by him.

The Calne Gas Co. v. *Curtis*, 59 Acct. L.R. 17,
The Gas World, 31st July, 1918

This case was in respect of the liability of an Auditor for damages caused by his failure to discover the frauds of a former secretary of the plaintiff company. The books had been badly kept and for ten years the secretary committed what is known as the "snowball fraud." The audit fee was five guineas, but the small amount of the fee cannot be pleaded in defence.

One allegation was that the defendant had not tested the lump sum receipts from slot meters by reference to any books and did not know that such books were kept. Evidence was given by well-known chartered accountants both for the plaintiff and for the defendant. Judgment was given for the defendant with costs.

Salter, J., said—

It was important to guard oneself against approaching the matter in the light of subsequent knowledge. Defendant had no cause to suspect the secretary outside the books. Whether the books ought to have put him on suspicion was the main matter he (the Judge) had to determine, but it was important to approach the matter from the point of view that this was an ordinary periodical audit of the books of a trusted and apparently respectable man whom there was no cause to suspect. The book-keeping methods of the company were old-fashioned and the writing up of the books was in arrear.

It was clear that the mere fact that a fraud was not discovered in the course of an audit was not conclusive evidence of negligence in the conduct of the audit. But where an Auditor in fact issued a false certificate in the sense of an incorrect certificate, His Lordship thought it rested upon the Auditor to show that the belief upon which the certificate was based had

not been the result of any lack of proper care or proper skill on his part in conducting the audit.

On the whole his Lordship came to the conclusion that as regards industry and care, the defendant had brought to bear at least a fair and average standard, and as regards competence and skill, the evidence satisfied him that the defendant did not fall below a fair average of competence and ability which he was bound by law to bring to the conduct of this work. He therefore gave judgment for the defendant with costs.

Re City Equitable Fire Insurance Co., Ltd., [1925] Ch. 407

In this case the Official Receiver as liquidator sued the Directors and Auditors in respect of alleged misfeasance.

The following claims were made against the Auditors—

1. That in the Balance Sheets sums due from Ellis & Co. (stockbrokers) and Mansell (the company's General Manager) were misdescribed by being included under "Loans at call or short notice" or "Loans." Part of the debt of Ellis & Co. was described as "Cash at bank and in hand."

2. That in fact the sums actually due from Ellis & Co. were larger than were so included.

3. That certain of the company's securities were in the custody of Ellis & Co. and the Auditors failed to detect and report to the shareholders that these had been pledged by that firm to third parties.

In the course of his judgment, Mr. Justice Romer made the following observations—

If in the course of these long and arduous audits the Auditor has in even one instance fallen short of the strict duty of an Auditor, he cannot, I apprehend, be excused merely because in general he displayed the highest degree of care and skill.

There was a misdescription, but I should hesitate long before holding the Auditor to be guilty of negligence in this respect. I need not, however, pursue this matter further because, even if the misdescription did amount to negligence, it caused no damage to the company.

For an Auditor is not in my judgment ever justified in omitting to make personal inspection of securities that are in the custody of a person or company with whom it is not proper that they should be left.

I am convinced that throughout the audits that he conducted he honestly and carefully discharged what he conceived to be the whole of his duty to the company. If in certain matters he fell short of his real duty, it was because, in all good faith, he held a mistaken belief as to what that duty was. As against him and his partner, the application of the Official Receiver must accordingly be dismissed.

In the Court of Appeal Mr. Justice Romer's judgment was upheld.

Lord Justice Sargant described the duty of an Auditor as "verification and not detection."

Lord Justice Warrington said: " The duty of an Auditor is to

verify the facts which it is proposed to state in the Balance Sheet and to verify them using ordinary and reasonable care and skill."

As a matter of fact, the Auditors were protected by an Article of the company indemnifying the Directors, Auditors and officers of the company against damages incurred in carrying out their duties unless incurred by wilful neglect.

Under Section 205 of the Companies Act, 1948, a protective Article of this nature is void. But see Section 448 of the Act reproduced on page 157, *ante*, as to the power of the Court to grant relief in certain cases.

Thomas v. *The Corporation of Devonport*, [1900] 1 Q.B. 16

Held that an elected Auditor cannot claim remuneration out of the Borough Fund, but is entitled to reasonable remuneration as Auditor of an Urban Sanitary Authority. This case is of interest because of the following statements made by Lord Russell of Killowen—

I do not subscribe to the doctrine that his (the Auditor's) sole duty is to see whether there are vouchers, apparently formal and regular, justifying each of the items in respect of which the authority seeks to get credit upon the accounts put before the Auditors for audit. I think that is an incomplete and imperfect view of the duties of the Auditor. I think an Auditor is not only entitled, but justified and bound to go further than that, and, by fair and reasonable examination of the vouchers, to see that there are not amongst the payments so made payments which are not authorized by the duty of the authority, or in any other way illegal or improper. If he discovers that any such improper or illegal payments appear to have been made, his duty will certainly be to make it public by reporting to the authority itself and the burgesses who created that authority.

The following cases do not relate to Auditors, but throw some light on the interpretation of negligence—

Blyth v. *Birmingham Water Works Co.* (1856), 11 Exch. 781

Negligence was defined as "the omission to do something which a reasonable man, guided by those considerations which ordinarily regulate the conduct of human affairs, would do, or doing something which a prudent and reasonable man would not do." No definition of a reasonable man is given. That would be a question for a jury.

Grill v. *General Iron and Screw Colliery Co.* (1866), L.R. 1 C.P. 612

Negligence was defined as "the absence of such care as it was the duty of the defendant to use."

Wilson v. *Brett* (1843), 11 M. & W. 113

On the question of gross negligence the Judge said: "I can see no difference between negligence and gross negligence; it is the same thing with the addition of a vituperative epithet."

Re Dumbell's Banking Company Ltd. (1900), Acct. L.R. 181

A criminal prosecution of Directors and Auditors for the issue of false Balance Sheets under Manx Criminal Code, 1872, Section 221. This case is reported very fully in *The Accountant*, 1900, L.R. 181, and disclosed an extraordinary state of affairs. The liquidator giving evidence as to the accounts was asked by the Attorney-General: "Is it apparent to anybody on the face of these accounts that they are rotten?" He replied: " I have not the slightest hesitation in saying so." The jury found all the defendants guilty, one of the Auditors in a minor degree.

Fox & Son v. *Morrish Grant & Co.* (1918), 35 T.L.R. 126

It was held that an accountant employed to check books and prepare a Balance Sheet should agree the Cash Book with the Bank Pass Book or inform his client that he has not done so.

The case calls attention to the desirability in such matters of having a clear arrangement in writing defining the duties undertaken by the accountant. In this instance the defendants acted as accountants and not as auditors.

Re Arthur Francis, Ltd. (1911), 44 Acct. L.R. 61

In this case the liquidator issued a summons against a firm of Auditors asking for an order for the handing over of certain books which the Auditors had retained as there were fees owing to them for work done upon the books.

The respondents contended that they had a lien on the books, but he (counsel) submitted that the directors had no power to give any such lien, because, under the Articles of Association, the books were to be kept at the company's office, and therefore they could not be subject to any lien. The only book he wanted was the Private Ledger, and he asked his Lordship to make the necessary order for the respondents to deliver it up.

The Judge observed that he did not think the respondents could be allowed to embarrass the winding-up of the company by keeping the books. He should have thought that the Private Ledger was a most essential book for the purposes of the liquidation.

His Lordship made an order that the books should be produced, without prejudice to the lien (if any) of the respondents.

Arthur E. Green & Co. v. *The Central Advance & Discount Corporation* (1920), 63 Acct. L.R. 1

Held that in certain circumstances Auditors may be held negligent in accepting schedules of bad debts supplied to them by the Managing Director. This was an action brought by the

Auditors for recovery of fees. There was a counterclaim by the defendants based on allegations of negligence in the preparation of the accounts. The Judge said the conclusion he had come to was that the Auditors having made inquiries had received no satisfactory explanations. Judgment was given for the plaintiffs for £157 10s. and for the defendants on the counterclaim for £613 14s. 11d.

Re Joseph Hargreaves, [1900] 1 Ch. 347

Held that an Auditor who refuses to certify the accounts of a company cannot be held liable because no correct accounts were submitted to the shareholders. It was unsuccessfully contended by the plaintiff that the Auditor should either have brought the matter to the knowledge of the shareholders or should have resigned.

Harmer v. *Cornelius* (1858), 5 C.B.N.S. 236

The public profession of an act is a representation and undertaking to all the world that the professor possesses the requisite ability and skill.

As the Romans put it, *imperitia culpae adnumeratur* (inexperience renders you liable).

A treatise by Sir Ernest Pollock contains the following statement—

> Whoever takes on himself to exercise a craft holds himself out as possessing at least the common skill of that craft and is answerable accordingly. If he fails, it is no excuse that he did the best he, being unskilled, actually could.

Metropolitan Railway v. *Jackson* (1878), 3 App. Cas. 193

> The judge has a certain duty to discharge, and the jurors have another and a different duty. The judge has to say whether any facts have been established by evidence from which negligence may be reasonably inferred; the jurors have to say whether from those facts, when submitted to them, negligence ought to be inferred.

In a case of this nature, the judge might withdraw the case from the jury on the ground that there was no evidence from which the jury could infer negligence.

Hoale and Others v. *Tingey* (1926), 74 Acct. 518

This was an action by an accountant for fees due. There was a counterclaim for damages for retention of the defendant's books and papers. The claim for fees was upheld. Mr. Justice Roche decided that the right to a lien existed and the counterclaim was dismissed.

Irish Woollen Company, Ltd. v. *Tyson and Others* (1900), Acct. L.R. 13, Irish Appeal Court

This was an appeal by the Auditor against the decision given by the Master of the Rolls (Irish Court of Chancery, reported

in *The Accountant* Law Reports, 1900). The appeal was dismissed. The judgment should be read in full, but the following extracts are of interest to accountants.

The Auditor seems to have done little of the actual work himself, and the evidence varies as to the nature of the supervision which he gave to it; the investigation of the books he deputed to his assistants and it must be on the faith of their representations that he certified the Balance Sheets. I presume this course is not unusual, and that an accountant with a large business is not supposed to do everything himself. The Auditor is bound to give reasonable care and skill, but this can also be exercised by his deputy. I do not think there is anything to be gained by considering in the abstract the duties of an Auditor of a joint stock company. He is entitled to see the company's books and the materials for their books, and also to ask for explanations. *But he is not called on to seek for knowledge outside the company, or to communicate with customers or creditors.* He is not an insurer against fraud or error; and if fraud is alleged it must be shown with precision the acts of negligence for which he is said to be responsible.

There was certainly no duty cast on the Auditor to take stock. What he did was to have the calculations checked in his office, and this was done with proper care.

Now dealing with "Sundry Creditors"; here evidently there is a fraud, and a curious thing is that no one seemed to have derived any benefit from the fraud. Dealing with the invoices, the learned Judge detailed the practice in connexion with the statements of accounts being laid before the meeting, and said the Ledger was used for the purchases made and for the payments on account thereof.

The creditors' accounts in the Ledger did not show all the goods purchased up to the time of the audit, nor could the Auditor discover the omissions on account of many of the invoices being either "suppressed" or not put into the book until at a later date—a process described as "carrying over."

It seems strange that a system of fraud so long continued, and for so extensive a period, was never detected by the Auditor. Once or twice he noticed something, and the explanation that was given was "that the goods were not taken into stock." The question is, was it negligent not to have seen this?

There is no doubt that both the suppression and carrying over of invoices would have been detected if the Auditor had *called for the creditors' statements of accounts upon which payment was ordered*, and compared them with the Ledger. I should have thought this was part of the Auditor's duty for many reasons; but all the accountants examined, except Mr. Southworth, stated that this course is never taken unless there is something to arouse suspicion.

Mr. Pixley, the eminent London accountant, says it could not well be done except in the case of a very small concern.

Re The Kingston Cotton Mill Co., Ltd., [1896] 1 Ch. 6

Held that in the absence of suspicious circumstances, an Auditor is not guilty of negligence who relies upon the statements made by trusted officers of the company.

In this case there had been a systematic over-valuation of stocks on hand. As a result dividends had been paid out of capital. The Auditors accepted the value of the stock-in-trade as appearing

in the Stock Books and summaries so as to show the total value. The summary was signed by the Manager and entered in the Balance Sheet with the note "as per Manager's certificate." Lindley, L.J., said—

I protest, however, against the notion that an Auditor is bound to be suspicious, as distinguished from being reasonably careful. To substitute the one expression for the other may easily lead to serious error.

It is no part of an Auditor's duty to take stock. No one contends that it is. He must rely on other people for details of the stock-in-trade in hand. In the case of a cotton mill he must rely on some skilled person for the materials necessary to enable him to enter the stock-in-trade at its proper value in the Balance Sheet.

Can it be truly said that the Auditors were wanting in reasonable care in not thinking it necessary to test the managing director's returns? I cannot bring myself to think they were, nor do I think that any jury of business men would take a different view. It is not sufficient to say that the frauds must have been detected if the entries in the books had been put together in a way which never occurred to anyone before suspicion was aroused. The question is whether, no suspicion of anything wrong being entertained, there was a want of reasonable care on the part of the Auditors in relying on the returns made by a competent and trusted expert relating to matters on which information from such a person was essential. I cannot think there was.

Lopes, L.J., in the course of his judgment made the following remarks—

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 skill, care, and caution must depend on the particular circumstances of each case. An Auditor is not bound to be a detective, or as was said to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom, but in the absence of anything of that kind, he is only bound to be reasonably cautious and careful.

The duties of Auditors must not be rendered too onerous. Their work is responsible and laborious, and the remuneration moderate. I should be sorry to see the liability of Auditors extended any further than *Re The London and General Bank*. Indeed, I only assented to that decision on account of the inconsistency of the statement made to the Directors with the Balance Sheet certified by the Auditors and presented to the shareholders. This satisfied my mind that the Auditors deliberately concealed that from the shareholders which they had communicated to the Directors. It would be difficult to say this was not a breach of duty. Auditors must not be made liable for not tracking out ingenious and carefully-laid schemes of fraud, when there is nothing to arouse their suspicion and when those frauds are perpetrated by tried servants of the company and are undetected for years by the Directors. So to hold would make the position of an Auditor intolerable.

There can be little doubt that an action for libel will not lie in

respect of statements used in the Report of an Auditor, if made in a *bona fide* manner. A company whose head office was at Manchester, with factories in Egypt, received from their Manager in Egypt accounts of purchases made, quantity of cotton and oil in stock, and the expenses incurred. In the Revenue Account submitted to the Auditors, the last item entered on one side of the Account was "Deficiency in Stock, £1306 1s. 7d." It was explained to the Auditors that this last item, though entered as deficiency, was, in truth, only a depreciation in the value of the stock, for which the Manager was not answerable; but the Auditors, notwithstanding, affixed the following Certificate—

> We certify that the Accounts as above stated are correct. Shareholders will observe that there is a charge of £1306 1s. 7d. for deficiency of Stock, which the Manager is responsible for. His Accounts have been badly kept, and have been rendered to us very irregularly.

This report, together with that of the Directors, was submitted to the ordinary general meeting of the shareholders of the company, according to the usual practice, and it was resolved by the meeting that the Report should be printed and sent to the shareholders. The Reports (including the above statement) were accordingly sent to a printer, printed and circulated among the shareholders, and used at an adjourned meeting of the shareholders. The Manager brought an action for libel against the company, when it was held that, as it was the duty of the Directors to communicate the Report of the Auditors to the shareholders, and it was for the interest of all the shareholders to be informed of the Report, the printing and publication of the Reports were *prima facie* privileged, and that there was no evidence of expressed malice for the jury.—*Lawless* v. *Anglo-Egyptian Cotton and Oil Co.* (1843), 4 Q.B. 262.

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

In this case it was to the financial advantage of the Directors and the Secretary to make it appear that the state of the company was better than actually was the case. Proceedings for negligence were taken out under the following Article: " No dividends shall be payable except out of the profits arising from the business of the company." It appears that dividends were paid out of capital.

The Judge said: "It was, in my opinion, the duty of the Auditor not to confine himself merely to the task of verifying the arithmetical accuracy of the Balance Sheet, but to inquire into its substantial accuracy and to ascertain that it contained the particulars specified in the Articles of Association (and consequently a proper Income and Expenditure Account) and was

properly drawn up so as to contain a true and correct representation of the state of the company's affairs."

The Auditor was held liable for damages, but pleaded the Statute of Limitations for certain years. The plaintiffs admitted the validity of the plea without arguing the question.

Re The Liverpool and Wigan Supply Association Ltd. (1907), Acct. L.R. 4. Liverpool Court of Bankruptcy

The Court was moved for an Order on the Auditor—

To contribute such sum of money to the assets as to this Court may seem fit and proper, by way of compensation in respect of his misfeasance and neglect of duty as Auditor of the company, for that he being Auditor of the company did make Balance Sheets for the half-years ending the 30th day of June, 1905, and the 31st day of December, 1905, which were incorrect and misleading, and that the said Auditor did not use reasonable care and skill in the making and preparing of such Balance Sheets, and neglected his duties as Auditor of the said company, and thereby caused loss of assets, and damage to the shareholders and creditors of the said company.

The judgment was as follows—

In this case I think that the Auditor was negligent as an Auditor in the sense that he relied on statements made to him by the Directors, and did not put in his certificate the fact that he was relying on the statements of the Directors. The Auditor did not disclose that there was no Cash Book, and, if it were material in this case to say so, I think the Auditor ought to have disclosed it. I don't think he ought to have accepted the statements of a Director as to the taking of stock, and the Balance Sheets should have shown the position of the company on the dates they purport to have shown the position. But none of these acts appears to me to have diminished the assets of the company as such. What may have happened is that the creditors went on dealing with the company longer than they otherwise would have done, but I have no evidence before me that satisfies me that even that was the case, and with respect to creditors this is not the proper form of procedure, if they have any remedy at all. I think Mr. Courthope Wilson is right that under this form of proceedings it must be established that there has been breach of duty that has resulted in some actual diminution of the assets of the company. And in regard to the statement as to the book debts, there is no evidence that at any time those could have been collected, but in fact the report shows to the contrary. In regard to the amount that ought to have been to the credit of the company at the bank, that is accounted for in the statement as to the extent of the company's assets and is not anything that diminishes the company's assets, consequently no evidence has been brought before me to show that the assets of the company have been diminished by anything the Auditor has done, and these proceedings, I think, must fail."

The Auditor was not given his costs.

Re The London and General Bank Ltd. (No. 2), [1895] 2 Ch. 673

Held that an Auditor is guilty of misfeasance who, when dissatisfied with the accounts of a company, does not plainly draw attention to the grounds for his dissatisfaction in his report.

This was an appeal by one of the Auditors against a judgment

by Vaughan Williams by which the Auditors were declared liable for the payment by the company of certain dividends out of capital, it having been decided by the Court of Appeal in the previous action in connexion with this liquidation that the Auditor of a limited company is an officer of the company and therefore liable to misfeasance proceedings. The Auditor had neglected to bring to the notice of the shareholders that the assets shown in the Balance Sheet of the company were over-valued leading to a payment of dividends out of capital. Lindley, L.J., said—

It is no part of an Auditor's duty to give advice either to directors or shareholders as to what they ought to do. . . . An Auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably; it is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that. But then comes the question: How is he to ascertain such position? The answer is: By examining the books of the company. But he does not discharge his duty by doing this without inquiry and without taking any trouble to see that the books of the company themselves show the company's true position. He must take reasonable care to ascertain that they do. Unless he does this, his duty will be worse than a farce. Assuming the books to be so kept as to show the true position of the company, the Auditor has to frame a Balance Sheet showing that position according to the books, and to certify that the Balance Sheet presented is correct in that sense. But his first duty is to examine the books, not merely for the purpose of ascertaining what they do show, but also for the purpose of satisfying himself that they show the true financial position of the company. This is quite in accordance with the decision of Mr. Justice Stirling in *The Leeds Estate and Investment Co.* v. *Shepherd* (1887), 36 Ch.D. 787. 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 guarantee that his Balance Sheet is accurate according to the books of the company. If he did he would be responsible for an 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.

Such I take to be the duty of the Auditor; he must be honest—that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true.

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

A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is

calculated to induce them, or some of them, to ask for more. Information and means of information are by no means equivalent terms.

The Articles of Association cannot absolve the Auditors from any obligation imposed upon them by the statute.

The words "as shown by the books of the company" seem to me to be introduced to relieve the Auditors from any responsibility as to affairs of the company kept out of the books and concealed from them, but not to confine it to a mere statement of the correspondence of the Balance Sheet with the entries in the books. Now, a full and fair Balance Sheet must be such a Balance Sheet as to convey a truthful statement as to the company's position. It must not conceal any known cause of weakness in the financial position, or suggest anything which cannot be supported as fairly correct in a business point of view.

In the last-mentioned report is contained for the first time a statement, "The value of the assets as shown on the Balance Sheet is dependent on realization."

Great stress has been laid on this by counsel for the appellants. They argue that it was sufficient to put members upon inquiry, and that from the course taken at the trial they were debarred from giving the evidence of experts as to the importance and signification of this. I may at once say that it was the duty of the Auditors to convey in direct and express terms to the members any information which they thought proper to be communicated, that the words of the statement are perfectly clear in their meaning, but also entirely unimportant, amounting to a mere truism, and that no evidence of experts would have been of the slightest use for the purpose of giving them a greater importance or signification than they possessed in themselves, even if such evidence were admissible.

There was a strong and growing feeling of dissatisfaction in the mind of the Auditor at the state of the affairs of the bank as shown by the books, and I find no sufficient communication of the facts causing this dissatisfaction in the reports. The Balance Sheets when examined do not in my opinion fulfil the statutory requirements of being full and fair Balance Sheets, and they are not properly drawn up so as to exhibit a true and correct view of the state of the company's affairs as shown by the books of the company.

It is no part of the Auditors' duty to consider what is good or what is bad policy. They have only to examine into facts and see that the members have their opinion as to the Balance Sheet showing the state of affairs of the company.

In short, the Balance Sheet, as it stands, would have given no hint to any ordinary reader of the critical position arising either from the locking-up of capital or from the doubtful nature of many of the debts entered at their full value. In reporting this Balance Sheet without explanation, the Auditors were, in my judgment, guilty of a misfeasance within the meaning of the 10th Section of the Act of 1890, as charged in the summons, and were in this case, at any rate, thoroughly alive to the unsatisfactory state of the affairs of the bank as shown by the books.

The Auditor was ordered to pay the amount of a dividend, wrongfully paid, with interest.

London Oil Storage Co., Ltd. v. *Seear, Hasluck & Co.*, (1904) 31 Acct. L.R. 1

In this case the Petty Cash balance had increased from £21 in 1897 to £796 in 1902, when it was discovered that the Petty

Cash in hand was only £30. Action was taken against the Auditors for alleged negligence in auditing the accounts. The Auditors denied that they had been negligent and said that the alleged loss of £760 was due to negligence on the part of the Directors of the company for entrusting so much money to their cashier. The jury found that the Auditors had committed a breach of trust, but assessed the damages at £5 5s. in view of the fact that the Directors had been guilty of gross negligence.

The Lord Chief Justice summing up to the jury said that they had not to consider whether the Auditor had been sufficiently remunerated or not. Nor could the Auditor shelter himself behind negligence on the part of Directors, as he was there to protect the shareholders. If, by neglect of his duties, he caused damage to the company, he was liable. He should have thought that *prima facie* it would be the duty of an Auditor to check a balance of cash in hand, but how that should be done was another matter; it might be that a certificate from the secretary would be a sufficient voucher. An Auditor was not bound to criticize the policy of the Directors, and the mere increase in the cash balance did not seem in itself to be a suspicious circumstance. If it did not arouse the suspicion of the Directors it seemed rather hard to say that it should have aroused the suspicion of the Auditor.

The conduct of the Directors is no answer to any breach of duty on the part of the defendant, but it is a circumstance which you must take into consideration, because if you are of opinion that the loss was occasioned by a man stealing the money in consequence of there being a want of proper control over him, then the fact of there being a breach of duty by the Auditors is what the lawyers call a *causa causans*, which contributed to but would not be the cause of the loss.

G. J. McCaul & Co. v. *McLean & Co.* (1907), 37 Acct. 104

The plaintiffs took action against the defendant, the Auditor, alleging that it was through his neglect that they had lost money by defalcations of an employee. The defence was that by agreement with a previous partner, the audit undertaken was agreed to be of a limited nature. It was admitted the defendant had taken no steps to bring the arrangement with the previous partner to the knowledge of subsequent partners.

The action was, however, settled and no decision on the point at issue was arrived at.

Maritime Insurance Co., Ltd. v. *William Fortune & Son,* (1931), Acct. L.R. 44–45

In this case the plaintiffs claimed from the defendants damages for alleged breach of duty in certifying the accounts of the branch

office of the plaintiff company and failing to discover defalcations carried out by an employee. The defendants denied negligence, pleading that they were not employed as Auditors but only to see that certain monthly returns were correctly made out from the books kept by the company's servant.

The Judge in his summing up said that in his view the employment of the defendants was limited to examining the books, seeing that they corresponded with the books that had to be kept and in that sense seeing that they were adequately kept and seeing that they were adequately summarized in the return to head office. Of course, it would have been the duty of the defendants to report on the matter if anything suspicious had appeared in the books. In his view there was nothing which excited or ought to have excited their suspicion. They were not in possession of material which would have enabled them to know whether the business of the branch was being satisfactorily conducted or whether the books of account truly showed the state of affairs of the branch. He thought that the misappropriation of money was not detected before it was, because there was no system in vogue by which the cash received could be checked. The acts and omissions which brought about the trouble were not the acts and omissions of the defendants, and they had been guilty of no breach of duty or negligence.

The counting of the cash would have been useless in the circumstances, and there was nothing which required them to go behind the books of account and examine the paying-in book. That was only done in cases where there was reason to suspect inaccuracy or dishonesty and the defendants had no reason to suspect that here.

Judgment was accordingly entered for the defendants with costs.

Martin v. *Isitt* (1898), Acct. L.R. 41

This action was brought against Messrs. Isitt & Co., Chartered Accountants, for alleged negligence inasmuch as they had not compared the Cash Book with the Bank Pass Book. A comparison of the two books would have shown that a clerk was embezzling the funds of the plaintiffs. The embezzlement was eventually discovered by Messrs. Isitt & Co., but the plaintiffs claimed that they should have discovered it earlier. The defendants contended that they were not acting as Auditors, but were only employed to attend monthly and check the books. They also said that they were hampered by the condition of the books and much delay in getting answers to the many queries they had to raise.

The case was settled out of Court. It was agreed that the defendants had not been negligent or unskilful in the way in which they had done their work, and the plaintiffs confined their

claim to a breach of contract by the defendants inasmuch as they had not attended monthly. The Lord Russell of Killowen, C.J., said that, as he understood the case as placed before him, no allegation of negligence or unskilfulness was now made, but it was urged that the defendants should have attended somewhat earlier than they actually did; that was a question to be tried, but he thought the action of the parties in arranging the matter to be very proper.

New Oriental Bank Case

In this case, which is not reported, Vaughan-Williams, J., said—

> It is not for an Auditor to consider the *bona fides* of Directors, but to deal with the books of the company and with commercial details and figures, not to consider the honesty of its officers.

Note. This is not consistent with the leading decisions as to the attitude which Auditors should adopt.

As to how far the Auditors are the agents of the shareholders, Turner, L.J., said, with respect to fraudulent representations made by the Directors of a company as to its position, "There were Auditors of this company appointed by the shareholders. These Auditors were, within the scope of their duty, at least as much the agents of the shareholders as the Directors were, and the false and fraudulent representations were discoverable by them."—*Nicol's Case, re Royal British Bank* (1859), 3 De G. & J. 387, 441.

Pendleburys Ltd. v. *Ellis Green & Co.* (1936), 80 Acct. L.R. 39

This was an action against the Auditors for alleged negligence or breach of duty. The case is noteworthy because of remarks made by Mr. Justice Swift in giving judgment for the defendants. His Lordship said that when one considered the attitude an Auditor had towards a company, one had also to bear in mind what the constitution of that company was. It was all very well to say that an Auditor was there to protect the shareholders. He was there to see the shareholders got a true representation of the finances of the company as disclosed by the books of the company.

Dealing with the matter as a matter of common sense and in deciding whether reasonable care had been taken or not, the Auditor was entitled to consider such a question as this: Is this company one which has 600 or 700 shareholders to whom I am vouching this information, or is it a company with only three shareholders who happen to be three Directors and the three debenture-holders in the company? It seemed to him it must make a material difference whether he was criticizing it to the three men who, in fact, held every pecuniary interest of the company, or whether he was criticizing it to a large body of outside people

who were depending on him to watch the directors and see what they were doing. He was quite satisfied that on more than one occasion the fact that there was no internal check on the cash receipts was brought to the notice of one or other of the two Pendleburys he had seen before him.

The evidence given by Mr. Elliott, an accountant, called for the plaintiff, illustrated the difference between an accountant as an investigator and an accountant who was an auditor. Mr. Elliott was brought in as a detective.

Re Bolivia Exploration Syndicate Ltd., [1914] 1 Ch. 139

"Auditors are *prima facie* responsible for *ultra vires* payments made on the faith of their Balance Sheet, but whether and to what extent they are responsible for not discovering or calling attention to the illegality of payments made prior to the audit must depend on the special circumstances of each case." It was held in this case that they were not liable.

This was a misfeasance summons. No order was made against the Auditors, but having regard to the general manner in which the audit had been conducted, the summons against the Auditors was dismissed without costs.

R. v. *Kylsant and Morland*, [1932] 1 K.B. 442

This action brought against the Auditor of the Royal Mail Steampacket Company under Section 84 of the Larceny Act, 1861, was dismissed. In his summing up Mr. Justice Wright made the following interesting statements regarding reserves—

We have heard a great deal about the keeping of secret reserves, and we have heard a great deal about the commercial troubles which may flow from that practice. We have heard a great deal about what is often done in practice, and it may be reasonably and properly done, but the question may arise some day, and possibly will arise, in some appropriate proceeding in order to find out and elucidate these very special matters. It was said by a very learned judge on one occasion, by way of observation and not by judgment, that a company, that is to say the shareholders, could not complain if the position of the finances of the company was better than the accounts disclosed. That has been quoted from time to time as a justification for this method of keeping reserves secret. But there may be very great evils if those who have the control and management of the companies, and who control and manage companies for the benefit of the shareholders who entrust their moneys to companies, have very large portions of the company's assets left in the secret disposition of the managing authority. It may work very well in many cases; no doubt it does. It is a practice which is being followed, no doubt, by many concerns of the highest standing. On the other hand, it may be the subject of almost intolerable abuse. Such a system may be used to cover up negligence, irregularities, and almost breaches of faith. It is said to be a matter of domestic concern between the company and the shareholders, but if shareholders do not know and cannot know what the position is, how can they

form any view about it at all? How can they consider whether it is something which they are satisfied with or which they are not satisfied with?

It is a little astounding, and one cannot help wondering whether those who manage big companies do not forget sometimes that the body of Directors of a company are the agents and the trustees of the shareholders, that they owe them full information, subject to proper and reasonable commercial necessity, and it is their interests that they have to study. They are not to regard the shareholders as sheep, who may look up if they are not fed; they are the people whose money they are using, and it is to be remembered that a joint-stock company is a creation of law. A joint-stock company has the enormous advantage of limited liability, and the legislature has intended, it seems to me, although by halting steps, to secure that those who enjoy those privileges of limited liability and who control and manage joint-stock companies should be subject to some condition as to publishing their accounts, at least to the shareholders and at least to those who are entitled to be summoned to general meetings.

It may be said that that does not in terms prohibit the creation of any reserve which is not shown specifically on the Balance Sheet, and it may be said that in a matter of domestic concern like the keeping of reserves by appropriate regulations the shareholders may agree to a reserve being accumulated, the exact amount of which is not specified in the Balance Sheet or the Profit and Loss Account. That is a question which, no doubt, will require very careful consideration in some future case, but it does appear to me, as at present advised, that the terms of the sections which I have read cannot possibly justify the omission of any amount of any reserve from the Balance Sheet and the Profit and Loss Account altogether. There may be some justification for the maintenance of an undisclosed or secret reserve, if the fact that there was such a reserve was clearly specified somewhere in the report, so that the shareholders could know, and if the majority of them desired to insist on its disclosure and its utilization they could do so. However that may be, it is clearly the intention of these sections that the accounts of companies in future should be published with greater particularity and with greater information to the shareholders.

The law does not impose an impossible burden on Auditors; it does not make them insurers; it does not require of them skill and vigilance which is beyond their power; but it does require them to report, and to report on the accounts would certainly include a very careful investigation of the Profit and Loss Account as one of the accounts, even if it is not expressly covered in the certificate which is generally accepted as a complete report. Then they have to give a certificate as to 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. Now, if the account on which the dividends are being paid, or if the account on which the current expenses of the company are being met, is being fed by undisclosed reserves, it seems to me very difficult to see how the Auditor can discharge his duty of giving a true and correct view of the state of the company's affairs without mentioning and drawing attention to this fact, which may be of the most vital importance, as indicating the state of the company's affairs. No doubt an Auditor, in his very delicate and difficult duties, must use a certain amount of discretion, but, whatever discretion he may feel that he is justified in exercising within the limits of what is reasonable, he must remember that he is under a statutory duty, and that he may come under the penalties of the law if he fails in that duty, at least in specific ways which I need not trouble about at this moment.

An Auditor is not concerned with questions of policy, and it is not for

him to say whether a dividend is properly or improperly declared, but, if he sees on the accounts there is something in the accounts to which he ought to draw the attention of the shareholders, it is his duty to do so, and either he should not sign the certificate at all or he should sign it with some qualification such as the circumstances require.

The document as a whole may be false, not because of what it states, but because of what it does not state, because of what it implies.

I do not gather now that there is any real question as to the general accuracy of the view that a very heavy or a very long protracted utilization of secret reserves, in order to keep the company going, is a serious matter which, quite apart from anything I have said about the general law, ought to be disclosed, on any view of the position, to the company.

Then you will consider this question, whether the essence of the matter is simply this, that the shareholders ought to have been told that the company was being kept going by means other than current earnings.

On the other hand, it is pointed out that the amount drawn from taxation reserves which figures under the word "Adjustment" is a very heavy amount indeed—£550,000—and it is said, in view of all the circumstances, to make that anything but a misleading document, in view of the large amount drawn from reserves in proportion to all these other figures. that ought to have been clearly and specifically indicated, so that the true position of the company could have been disclosed to the shareholders; and that in view of the fact that it ought to have been disclosed, and that the accountant signed his certificate, which may be is only limited to the Balance Sheet, but which is generally understood to refer to the Profit and Loss Account, which would be incorporated in the Balance Sheet—in view of the fact that he signed the certificate, it is said, and it is for you to consider, that this is not anything other than a written statement, false in a material respect, because it conceals the true position of the company in that year from the shareholders, who are entitled to be told, and to whom this report is addressed.

In the case of the Auditor, it is obvious enough that in the year 1926, when the accounts of 1925 were being dealt with, he was not satisfied with the position, because he thought that some words ought to be added to intimate to the shareholders that the moneys which we know were being used, were being used in order to produce the balance which appears. That being so, he thought, as indeed he has admitted, that without some qualification or another he ought not to give the certificate, and the qualification which he suggested, and which he put in, was those words, which you must all be tired of hearing, "Adjustment of taxation reserves," those words which a witness has turned into plain English in the way in which I have already said. The Auditor says that that satisfied his doubts; he thought then that he had done enough to cure the defective character of the Balance Sheet or Profit and Loss Account with those words. If he was right in that, if he had discharged his duty sufficiently and properly, then it seems, on any view, that the matter is, or ought to be, at an end. If, on the other hand, he was wrong in this sense that in a civil action, or in an action against him for not showing due care and skill, he would be held liable as a defendant because he had broken his duty and not fully discharged his office, then, again, his liability would be a civil liability in damages.

Smith v. *Sheard* (1906), Acct. L.R. 65

This case was brought against Mr. Sheard for damages for neglect in the audit of the plaintiff's books. The defendant denied that he was employed to audit the books. He was only

employed as an accountant to prepare accounts. The whole question turned on what were the terms of the defendant's employment. By inadvertence the defendant in sending in his bill of charges had used the word "audit," but he explained that the word was only used in a loose way. The jury found there had been a contract to audit. Consequently the defendant was liable for damages.

Although the verdict was in favour of the plaintiff, the summing up by the Judge and his review of the evidence appears to be in favour of the defendant.

It would be no part of their office to inquire into the validity of any transactions appearing in the accounts of the company . . . the duty prescribed for the Auditors is to inspect, examine, and check the receipts, payments, vouchers, and accounts of the company."—*Spackman* v. *Evans* (1868), L.R 3 H.L. 236.

Henry Squire (*Cash Chemist*), *Ltd.* v. *Ball, Baker & Co.* (1911), 44 Acct. L.R. 25, and *Mead* v. *Ball, Baker & Co.* (1911), 45 Acct. L.R.

In these actions it was sought to recover damages from the Auditors for negligence in carrying out their duties, especially in respect of irregular increases in stock, which it was alleged the Auditors should have detected. There had been falsification of documents and omissions of liabilities.

It was proved that the Auditors had called the attention of the Directors to what appeared to be an excessive increase in the stocks and that they relied for the valuation of the stock on the statements of the manager and secretary.

In the course of his judgment Lord Alverstone, C.J., made the following observations—

I do not agree that their duty as Auditors would be less than their duty as advising a purchaser who was buying a business.

I do not attach any importance to the low scale of remuneration.

It has been held over and over again, and it has been recognized in the Court of Appeal, that it is not his duty to take the stock.

Can it be truly said that the Auditors were wanting in reasonable care in thinking it not necessary to test the managing director's returns? I cannot bring myself to think they were, nor do I think any jury of business men would take a different view.

Therefore we have a case before us where, if it is negligence at all, it is negligence with regard to Stock Sheets and nothing else.

I further rule, as a guidance to myself, that, with some slight exceptions where judgment and discretion come in, the skill of the clerk must be the same as the skill of the principal. The principal must not excuse himself for his clerk's negligence by saying that he employed a clerk.

Why should it be supposed that it is to arouse the suspicion of the Auditors when the fact of the increase of stock and the existence of increased stock is called to the attention of the Directors by the Auditors and no comment of any sort or kind is made?

All I say is I have yet to learn that if the Auditors call the attention of

the Directors of the company to the fact, they may not also rely upon the fact that the Directors of the company, with that information before them, make no further comment and give no further instructions.

I must say I certainly should have thought that the fact that the attention was being called of Mr. Mead, who was a director, and of Mr. Reece, who was also a director, to this fact, and that neither Mr. Mead nor Mr. Reece—certainly not Mr. Mead—thought it their duty, or fair to the Auditors, to give them any extra caution, is a circumstance not to be lost sight of when we are dealing with alleged negligence in three consecutive years.

It is extremely easy when you are wise after the event to pick out particular things and say that they would have indicated to you that there was something wrong about the Stock Sheets—that is the strongest that it has been put to me—calling for further inquiries. All I can say is that it does not to my mind appear to be a reasonable view.

One cannot help saying that this is evidence given after a fraud has been discovered.

His Lordship also pointed out that the principal witnesses called by the plaintiffs had given evidence as follows—

We agree, *prima facie*, given certified Stock Sheets, all the Auditors need do in the first instance, apart from suspicion being aroused, is to take totals and extensions. That would be an ample discharge of their duty when there is a duly certified Stock Sheet, correcting extensions and totals, and checking a sufficient number of Stock Sheets which are found to be accurate.

Both actions were dismissed with costs.

Re Western Counties Steam Bakeries and Milling Co., Ltd., [1897] 1 Ch. 617

In this case the accountants were employed by one of the Directors to audit the accounts of the company for a certain year. The Balance Sheet was issued containing their Report and, on the strength of the Balance Sheet, dividends were paid. The liquidator of the company brought the action under Section 10 of the Companies Winding Up Act, 1890 (now Section 334 of the Companies Act, 1948), to recover the amounts from the Auditors on the grounds of misfeasance. The decision of the Court was that to be liable as officers of the company, the Auditors must be properly appointed and could not, therefore, in this case be charged with misfeasance. The question to be settled is whether the Auditors are officers of the company. To be an officer there must be an office and an office imports a position with the duty which attaches to it. By acting as an Auditor a person may become a *de facto* auditor, but the Section does not subject the Auditor to proceedings. It is only when he is *de facto* or *de jure* an officer of the company that he can be proceeded against by summons. The question is not whether the accountants were *de facto* auditors, it is were they *de facto* officers.

Re The Westminster Road Construction & Engineering Co., Ltd. (1932), Acct. L.R. 38

This was a misfeasance summons issued by the Liquidator in respect of alleged wrongful payment of dividends. The action turned on the question of work-in-progress and omission of liabilities. The Auditor was found guilty of negligence.

Mr. Justice Bennett said—

It was settled law that an Auditor did not discharge his duty if he merely saw that the Balance Sheet accurately represented what was shown by the books on the material date. His duty with regard to the ascertainment of unrecorded liabilities must depend upon the facts of each particular case and must be determined by the nature of the business carried on and the practice of the persons or bodies with whom the company did business of sending in their invoices. If the Auditor found that a company in the course of its business was incurring liabilities of a particular kind, and that the creditors sent in their invoices after an interval, and that liabilities of the kind in question must have been incurred during the accountancy period under audit, and that when he was making his audit a sufficient time had not elapsed for the invoices relating to such liabilities to have been received and recorded in the company's books, it became his duty to make specific inquiries as to the existence of such liabilities and also, before he signed a certificate as to the accuracy of the Balance Sheet, to go through the invoice files of the company in order to see that no invoices relating to liabilities had been omitted.

With regard to the over-valuation of work-in-progress the expert evidence was that it was the duty of the Auditor to check the figures at which work-in-progress was brought into the Balance Sheet. It was the duty of the Auditor to satisfy himself that nothing was included in the work valued as in progress on 31st March, which was in fact done after that date. He had also to satisfy himself that all expenses or liabilities incurred by the company in connexion with the work so valued had been brought into account.

Wilde and Others v. *Cape and Dalgleish* (1897), 23 Acct. L.R. 81

This is a case in which there was misunderstanding as to the terms of employment. The defendant stated that he had *audited* the plaintiff's books in order to ascertain the Profit and Loss Account as between the partners, accepting the accuracy of the entries appearing in the books. He repudiated all responsibility for not having discovered the defalcations of the plaintiffs' cashier.

The action arose because the defendant had not examined the plaintiffs' pass book, and so had not discovered certain fraudulent entries made therein.

It was represented by the plaintiffs that a previous member of the defendant firm, since deceased, had settled the terms of employment.

In view of the plaintiffs' evidence, the defendant agreed to pay one-half of the loss and the case was settled on that footing.

Having regard to his contention, the defendant seems to have used the word "audited" loosely.

Wood v. *Woodhouse & Rawson United*, [1896] W.N. 4

In an action to realize debentures granted by a company, which was afterwards ordered to be wound up, a summons was taken out by the Official Receiver and Liquidator, asking for the leave of the Court to take misfeasance proceedings against the Directors and Auditors of the company, and that the costs might be provided by the Receiver in the action. A majority of the debenture-holders was opposed to misfeasance proceedings being taken at the expense of the assets covered by the debentures, and also to abandoning the claims of the debenture-holders to any sums recovered in the proceedings. A suggestion was, however, made by a debenture-holder that if there were people who believed they could make a good thing out of a misfeasance summons they would be prepared, for the right to step into the debenture-holders' shoes, to pay a substantial sum, but that the right should not be given up without anything in return. It was held that an order must be made directing the Receiver to sell by auction the claim against the Directors and Auditors.

The conclusions to be drawn from the foregoing cases are that if an Auditor acts with intelligence, skill, and care, and has no reasonable ground for suspicion, he is not guilty of negligence but that, as usual, each case depends on the actual circumstances. In the case of a limited company the Auditor is expected to be aware of the contents of the Memorandum and Articles of Association.

It is also obvious that the terms of the contract between the accountant and his client should be explicit.

Many of the cases are somewhat early in date, and in view of the progress made by the accountancy profession, a higher standard of professional skill and experience may be exacted in the future.

Section 448 of the Companies Act, 1948, which gives the Court power to grant relief in certain cases is quoted on page 157, *ante*.

In an address to the London Members of the Institute of Chartered Accountants on 18th January, 1934 (reported in *The Accountant* of 27th January, 1934), Sir Nicholas Waterhouse made a striking contribution on the subject of "Liability of Auditors."

The address is so much to the point that the authors have obtained the kind consent of Sir Nicholas Waterhouse to reproduce it in full. It will be appreciated that it was delivered several years before the Companies Act, 1948, came into force.

"All of you are no doubt familiar with those fascinating mystery stories at the end of which the brilliant amateur detective confounds the painstaking inspector by pointing to the perpetrator of the crime and at the same time to some small step which the inspector might have taken and thereby have placed himself on the sure road to discovery. When this

denouement occurs it counts for nothing that the inspector has taken all those steps which experience has shown to be most likely to result in detection of such a crime as has been committed, nor is it deemed relevant that to have taken all the unlikely steps, one of which, as it turns out, would have resulted in discovery, would have necessitated the employment of men and time to an extent far beyond his resources. He is left to bear with what equanimity he can command the tolerant superiority of the amateur and the more open scorn of the minor characters in the story.

The feelings aroused in readers of such tales vary—some are lost in admiration of the achievements of the brilliant amateur, others feel a certain sympathy with the criminal whose well-laid plans have been frustrated by the combination of a seemingly inconsequential error and the uncanny intuition of his Nemesis; few waste any sympathy upon the discomfited inspector. But among those few (if it be true that a fellow feeling makes us wondrous kind) should be found those readers who happen to be professional auditors of accounts. For if they have been so fortunate as to enjoy a considerable practice, they are almost certain to be reminded of occasions on which they have vainly attempted to explain the fact that a defalcation undiscovered by them has been perpetrated in connexion with accounts which have been subjected to their audit. At such a time the sufferer from the defalcation is apt to be unable to see anything except the one fact that an apparently simple step involving perhaps no greater amount of work would have led to the detection of the fraud. Patiently, but with small hopes of success, the auditor explains that the steps which he did take would in ninety-nine out of a hundred cases be more likely to prove effective, and that if he had done all the many things that might possibly have unearthed the defalcation, the scope and extent of the audit would have been extended beyond all reason; delicately he points out things which the client himself or his staff might have done which would have made such a defalcation impossible or resulted in its discovery.

The analogy is not perfect. In the mystery story it is not suggested that the unsuccessful inspector should be cast in pecuniary damages for his failure or even that he should lose his position. The auditor is lucky if he is not confronted with both these suggestions.

In justice to one's clients let me say that many of them, when satisfied that the auditor has served them loyally and carried out his duties conscientiously, are willing to take a reasonable view of such a case. There are, however, exceptions, particularly in those cases where to absolve the auditor from blame is to imply that the directors themselves were negligent, or where the fraudulent employee has been the subject of a fidelity bond and the insurer refuses to accept liability until it has been proved that the auditor has not been negligent. The professional auditor is then at a distinct disadvantage and the case is made more delicate and difficult for him by the fact that his principal asset is his reputation and that resistance to the claim may result in damage to that reputation whether or not it results in a pecuniary liability.

Now, the lawyers may tell us that his is wholly a matter of contract, express or implied, and that it is for the accountant to see that the respective rights and obligations of his clients, the insurers and himself, are defined to his satisfaction. I think that in cases in which the auditor is retained expressly to make an internal audit it is possible at the time of making the contract to define his position in the unfortunate event of a defalcation taking place and escaping detection by him. And, in passing, may I say that he should not accept a contractual relationship under which he may be held pecuniarily liable if he fails to live up to the standards of effectiveness set by the heroes of detective fiction.

For the present, however, I should like to direct your attention to the narrower question which is presented when the auditor is appointed under the Companies Acts and assumes purely statutory obligations. Since the question has not been settled by legal decisions, and since I am not a lawyer, I am not going to undertake to define the legal position. I am going to put before you only the view suggested by my knowledge, inherited or acquired, of the history of the law, and by my experience in the field of business as well as in that of auditing.

The protection of a company against risks of fraud by its employees, the detection of frauds which occur and the recovery of whatever reparation can be obtained, are obviously purely administrative functions. The problem of safeguarding transactions is always a matter of weighing the risks of loss against the costs of protection, and, therefore, a matter lying wholly in the field of business judgment. The detection of frauds is usually most likely to be accomplished by continuous supervision which, unless the volume of business is small, can best be given by persons regularly employed for that purpose. Indeed, modern developments, and particularly the increased use of mechanical devices, while resulting in greater economy, accuracy and expedition in the field of book-keeping, have undoubtedly made the detailed audit which is not continuous and practically contemporaneous with the transactions audited extremely difficult and expensive.

It cannot, therefore, be questioned that, apart from the statute, the work of detecting fraud falls on the directors and on those whom they employ. Nor is there, I think, the slightest ground for a suggestion that the audit provisions of the Companies Acts have in any degree changed this position.

The provisions of the Companies Acts relating to the duties of auditors are, of course, familiar to you, but it may be desirable here to recall the precise language in which they are expressed in Section 134 (1) of the Act of 1929,[1] as follows—

> "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 sole objective of the auditor's work which is indicated is the formulation by the auditor of an informed opinion on the question whether the balance sheet of the company exhibits a true and correct view of the state of the company's affairs. This is a far less onerous task than for the auditors to satisfy themselves as far as possible (the litmiation is inescapable) whether all the transactions of the company have been faithfully recorded and all funds honestly administered.

Attempts are sometimes made to impose the more onerous responsibility on the auditor by inference. The auditor must see that the balance sheet is exactly correct (so runs the argument) and it cannot be correct unless all the transactions are correctly reflected therein; therefore the auditor must do everything in his power to satisfy himself that all the transactions

[1] Now replaced by the Companies Act, 1948, Section 162 (1) and Ninth Schedule, see page 23.

are honestly and properly recorded. This argument not only overstates in its premise the express requirements of the Act, but in its conclusion violates the principles which govern the construction of statutes.

If Parliament had intended to impose the more onerous duty on auditors, it would have done so in express terms; it would not have defined the minor obligation and left the major obligation a matter of inference. The contrast in this respect between the general Companies Acts and Acts such as the Building Societies Act of 1874 or the Friendly Societies Act, 1896, is striking and significant. Section 27 of the latter Act reads in part as follows—

> Section 27: "Every registered society and branch shall once in every year . . . send to the Registrar a return . . . of the receipts and expenditure, funds and effects of the society or branch as audited."
>
> Section 26: "The auditors shall have access to all the books and accounts of the society or branch, and shall examine the annual return mentioned in this Act, and verify the annual return with the accounts and vouchers relating thereto, and shall either sign the annual return as found by them to be correct, duly vouched and in accordance with law, or specially report to the society or branch in what respects they find it incorrect, unvouched, or not in accordance with law."

It would have been easy to embody similar language in the general company law, but this has never been done, no doubt for the simple reason that it was not necessary to the accomplishment of the purpose which Parliament had in contemplation, viz. a reasonable measure of protection for members against deception or other wrongful acts on the part of directors and officers. It was no part of this purpose to assign to the members and the auditor appointed by them duties which properly belong to the directors.

The origin and development of the audit imposed by Section 134 (1) of the Act of 1929, which perhaps for the sake of brevity I may allude to hereafter as the "official" audit, is fairly summarized in Spicer & Pegler's *Practical Auditing*, 3rd edition, page 13, as follows—

> "The fact that the whole control of the company was vested in the directors, rendered it necessary that some means should be utilized of enabling the shareholders to be assured that the accounts presented to them by the Board correctly represented the state of affairs of the company and that the directors had not utilized their position for the purpose of misappropriating the funds of the company or using them for their private gain. It was impracticable, however, for every individual shareholder to satisfy himself on these points, for as a rule he was not possessed of the requisite technical knowledge and the right of inspection and inquiry could not be given to one shareholder without it being granted to all. Consequently, it became usual for shareholders to appoint one or more of their number to act as Auditor or Auditors of the company and to report to the shareholders on their examination of the Balance Sheet and Accounts. Subsequently it was found inadvisable to confine this function to individual shareholders who might not be possessed of the requisite qualifications, and it became usual to appoint Professional Auditors to act on behalf of the shareholders generally."

In discussions of this subject a statement by the late Professor Dicksee is sometimes quoted to the effect that the object or scope of an audit may be defined as threefold—

1. Detection of fraud.
2. Detection of technical errors.
3. Detection of errors of principle.

This language, however, occurs in the course of a discussion on auditing in its broadest sense, and when an accountant is specifically employed to make a complete internal audit it is, I think, applicable. It is, however, I suggest, wholly inappropriate in relation to audits under the Companies Acts. Indeed, Professor Dicksee goes on to say quite correctly: "The extent of an auditor's duties depends entirely upon the express or implied contract between himself and his client."

I suggest that the scope of the official audit is rather—

(1) To ascertain whether any balance sheets or other accounts submitted to members are in accord with the books of accounts from which they would ordinarily be made up;

(2) To reach by examination and inquiry a reasonably informed opinion on the question whether the books are so kept that a true and correct view of the state of the company's affairs can be obtained therefrom;

(3) To determine whether the directors and officers of the company in preparing from the books the balance sheets or other accounts and submitting them to members have dealt fairly and honestly with the members.

The duties imposed on the auditors by Section 134 (1) in respect of accounts other than balance sheets are quite indefinite. The auditors are not expressly required to examine any other accounts—if they do so they must report on them; but the nature of the report to be made is not indicated as it is in the case of the balance sheet. Where, however, accounts are so closely related to the balance sheet as to constitute a part of the information given to members in relation to the state of the company's affairs, the auditor will be wise to regard them for this purpose as a part of the balance sheet.

The auditor must not form his opinion lightly, but he is not required to know everything that there is to be known about a company before he does so.

The duty imposed on the auditor has remained substantially unchanged from the enactment of the Companies Act of 1862 (Table A) to the present time; there is nothing to indicate that in the intervening seventy years the conception of the role of the members' auditor has been materially changed. It may be noted, however, that changes such as the substitution of the word "report" for the word "certify" do not suggest any enlargement of the auditor's obligation.[1]

No one would propose that in the case of large undertakings the auditors, as an incident to the determination of the state of the company's affairs, should undertake to duplicate the work done by the internal auditing department of the company. The law makes no distinction between large and small companies, and the only interpretation of the Act capable of general application is that it leaves the responsibility for the internal audit to the directors and their appointees.

It is quite true that in the case of small companies the maintenance of an elaborate organization such as would afford adequate internal checks might involve undue expense, and it is doubtless generally true that in such cases economy and efficiency can best be combined by arranging for continuous or frequent checks of the accounts by professional accountants. Moreover, the most convenient and economical course for the directors to adopt will usually be to retain for such a purpose the professional accountants who act as statutory auditors of the company. But I submit that there is a clear distinction between the work done by the accountants upon the instructions of the directors, practically as a part of the internal machinery of the company, and the work which falls to them as statutory

[1] This position has been altered by the Companies Act, 1948.

auditors. If in such a case a defalcation occurs and escapes detection, questions may arise concerning the liability of the auditors. The first will be whether there is any liability in respect of their position as statutory auditors, or whether the liability, if any, arises from their employment by the directors.

In my view, the question of defalcations arises in connexion with the official audit only incidentally in cases where one effect of the defalcation is that the balance sheet (or an account so related thereto as to come within the scope of the auditors' report) is incorrect to a material extent, as, for instance, where debts carried as assets have in fact been collected and the proceeds appropriated by the defaulter.

In considering the position of a statutory auditor in relation to a defalcation the vital question would seem to be whether a reasonable inquiry into the state of the company's affairs would have disclosed the over-statement and consequently the defalcation. If so, the auditor will no doubt be liable for the consequence of his failure to detect the over-statement of assets, but the question will still remain how far the fact that if he had done so further defalcations might have been prevented can properly be taken into account in assessing damages against him.

It is difficult to see how any claim could be asserted where the defalcations have been covered up in charges to expenses accounts so that the assets are not overstated and where the profit and loss account shows a single figure of profit "after deduction of all losses and expenses."

The extent of the auditors' liability arising out of employment by the directors will turn on the nature of their contract.

A number of cases in which claims against auditors for non-discovery of defalcations were based on their contract of employment have been before the Courts, but I know of no case in which such a liability has been asserted against an auditor in respect of his purely statutory duties under the Companies Act.

We are all familiar with the language in the decisions in the *London and General Bank* case and the *Kingston Cotton Mills* case. In those cases the auditors had been misled into making reports in which, as subsequently appeared, the assets were grossly overstated—a matter upon which they were required by the express terms of the Act to report. When it is recalled that even upon this issue the Court used such language as—

> "He is justified in believing tried servants of the company in whom confidence is placed by the company."
>
> "He is entitled to assume that they are honest and to rely upon their representations provided he takes reasonable care."
>
> "Auditors must not be made liable for not tracking down ingenious and carefully laid schemes of fraud when there is nothing to arouse their suspicion and when these frauds are perpetrated by tried servants of the company and are undetected for years by the directors."
>
> "Where there is nothing to excite suspicion very little inquiry will be reasonable and sufficient, and in practice I believe business men select a few cases haphazard, see that they are right, and assume that others like them are correct also."

it would seem safe to assume that the Court would not hold an auditor to a higher standard of responsibility in respect of duties which are not mentioned in the Act, and the assertion of which is an attempt greatly to extend by inference the express requirements of the Act, and to transfer to the appointees of the members duties and obligations which naturally and logically attach to the directors and those appointed by them.

I should not like it to be thought for a moment that in my view a

statutory auditor need feel no concern as to the degree of efficiency of the protection afforded by the company's methods against defalcations by employees, or that he should take no steps to satisfy himself that the system is being carried out in practice. On the contrary an auditor, even if undertaking nothing more than the official audit, should always examine the methods of control and test their working before he accepts the books as a basis for a balance sheet which he proposes in his report to approve as exhibiting a true and correct view of the state of the company's affairs. An auditor, who had signed a balance sheet which had been proved to be substantially incorrect and sought to defend himself on the ground that the balance sheet was in accordance with the information and explanations secured by him and was as shown by the books of the company, would find his defence gravely compromised if it were demonstrated that the accounting methods and control of the company were so lax and inadequate that no reliance could properly be placed upon the books.

Not only so, but while the auditor may properly refuse to accept a pecuniary responsibility which does not justly attach to his work, he has (if, as is now customary, he is a professional accountant) an obligation to make his work as valuable to his clients as possible within the limits of his appointment. His expert survey of the methods employed and the moral effect of intelligent tests of the working of the system, restricted though those tests may be, will exercise a valuable deterrent influence. I believe that the purpose of the modern criminal law is to act as a deterrent, the punishment of the individual being regarded as necessary to this purpose rather than retributive. No one denies, just because crimes are still committed, that the law and the police have such an effect nor can the deterrent effect of audits be denied because defalcations still occur.

The correct view of the relation of the shareholders' audit to the question of defalcations by employees is, I suggest, that it has this, by no means inconsiderable, preventive value, but involves no sort of guarantee nor any undertaking to be responsible for the consequences if in a particular case such an audit neither prevents nor discloses a defalcation. It should not be relied on to disclose defalcations except in so far as discovery would be a natural result of any reasonably adequate inquiry into the state of the company's affairs. If the directors desire further protection in the form of supplementary service by the auditor, the extent of the protection and the corresponding liability become matters of contract.

In the United States I believe there is no official audit, but the question of the scope of an examination sufficient to warrant a report by auditors, somewhat similar to that called for by our statute, has received considerable attention in recent years. As early as 1917, the question what examination was sufficient to justify a balance sheet being certified for credit purposes was considered by the Federal Trade Commission (a body somewhat analogous to the Board of Trade) and by the Federal Reserve Board (which supervises the federal banking system), and a pamphlet was issued by the latter body in that year and was revised in 1929. During the current year the New York Stock Exchange had indicated that it regards the scheme of examination outlined in that pamphlet as justifying certification of the balance sheet for submission to shareholders. It is interesting to note that in the first paragraph of this pamphlet it is stated that the procedure outlined "will not necessarily disclose defalcations," so that apparently the view in America is that an examination which is not sufficiently extensive to ensure the disclosure of defalcations may be entirely adequate as a basis for reporting to shareholders whether a given balance sheet exhibits a correct view of the financial position of the company. Anyone who has read the pamphlet will, I am sure, share that view.

What, then, should be the nature of the contract between the company and the auditor? Obviously, there must be a wide range in the scope of usefulness of the professional auditor in varying circumstances. The principal determining factors are, perhaps, the size and number of individual transactions and the extent of the internal audit. A company with a small staff entering into a relatively small number of important transactions may prudently instruct the auditor to make the most complete verification possible. Conversely, a company with a large staff, entering into a large number of relatively small transactions should rely mainly on a proper subdivision of work and internal audit, and ask the auditor to do no more than to satisfy himself thoroughly of the theoretical effectiveness of the internal system and make such tests of its practical working as will convince him that it is being made effective in practice. Between these limits varying degrees of completeness in the work of the auditor may be appropriate.

Naturally the fee and the degree of responsibility assumed must both vary as the audit is more or less extensive. And on this point I should like to say a word of caution to the practising accountant, and especially to those beginning practice.

We sometimes hear complaints that after a defalcation has been discovered clients take a view of the extent of the work which the auditor should have performed which is far more comprehensive than that which they took when instructing him and arranging the fee. The auditor should avoid the corresponding unfairness of leading his client to expect a greater degree of protection than the procedure he proposes to adopt will in reality afford. To-day the value of the work of auditors is too highly appreciated for it to be excusable for the auditor to emulate the share-pusher and attribute to his work a value greater than it can be expected to possess.

However extensive his work, an auditor should not be expected to agree to assume a pecuniary responsibility for losses which might have been avoided had he discovered a defalcation which for a time escapes detection, without regard to the amount of the loss, or to the ingenuity of the methods employed by the defaulter or to the fact that the directors or employees of the company may by their acts or negligence have contributed to the successful concealment of the irregularities.

This is essentially a risk to be covered by an insurance, the amount of which is predetermined and the cost or premium commensurate with that amount. The audit should greatly reduce the risk, and, therefore, the necessary premium, but it should not be regarded as in the nature of insurance or reinsurance.

It is an entirely mistaken notion which is, however, held by some people, that an auditor is legally liable for the amount of any defalcation which occurs after the date of an audit at which he might have discovered that one was being perpetrated, without regard to the difficulties of detection or to the extent to which the directors may have contributed to the loss by their acts or negligence. No cases involving this question have, I believe, reached the higher courts, but in the *London Oil Storage Co.* case (1904) it was considered very carefully. That case was tried by Lord Alverstone, and Mr. Rufus Isaacs (afterwards Lord Reading) was counsel for the auditor. The neglect complained of was failure at any time to verify a petty cash balance which over a period of years had increased from about £100 to nearly £800. It was thus a step which might be regarded as incidental to a determination of the state of the company's affairs. The auditor was appointed under the articles of association, which were rather more stringent than the provisions of the present statute. In his charge to the jury, the Lord Chief Justice said—

"The conduct of the directors is no answer to any breach of duty by

the defendant, but it is a circumstance you must take into consideration, because if you are of opinion that the loss was occasioned by a man stealing the money in consequence of there being a want of proper control over him, then the fact of there being a breach of duty by the auditor is what we lawyers call a *causa causans* which contributed to, but would not be the cause of, the loss. I do not know that I ever remember a question the solution of which was more difficult in the concrete. It is easy to put it in general terms: Was he guilty of breach of duty, and if so, what loss was occasioned to this company by that breach of duty? You must not put upon him the loss by reason of theft occurring afterwards or before, but you must put upon him such damages as you consider in your opinion were really caused by his not having fulfilled his duty as auditor of the company."

The jury found that there was a breach of duty extending over four years, but they assessed the damages at only five guineas, adding that they considered the directors to have been guilty of gross negligence. In the course of the subsequent discussion of the judgment to be entered, the Lord Chief Justice said—

"It was not a case in which Mr. Hasluck had said (as he might have said quite honourably, I think): 'My clerk was careless but the directors so acted that it caused the company no damage.' If that had been the way the case had been fought, I think Mr. Isaacs's contention would have been unanswerable, and that the action ought not to have been brought."

In one of the decisions of our Court of Appeal which I have already quoted the following sentence occurs—

"If there is anything calculated to arouse suspicion he should probe it to the bottom, but in the absence of anything of that kind he is only bound to be reasonably cautious and careful."

I have been surprised to find this language interpreted as meaning that when once an auditor's suspicions are aroused he must as a part of his statutory duty and without special compensation continue his investigations until he has found the truth, however deeply it may be buried.

I do not think that many clients would take such a view; most of them would, I feel sure, be appreciative of the vigilance of the auditor which had resulted in discovering the defalcation and be content themselves to bear the expense of investigating its extent and its effect on the state of the company's affairs. In any case it is satisfactory to find that Lord Alverstone lent no support to the exaggerated view of the auditor's duty for, after quoting the language above cited, he said—

"And apart from the circumstances of this case, I think Mr. Hasluck made an answer which shows that he appreciated his duty when he said, 'Had I any reason to think that the amount of cash retained at the city office was too much, I should have gone to the directors and asked for an explanation: that would have been my duty.' and so far as I may express an opinion, I think that is a true view of what his duty would have been under the statute and the articles. He ought, if his suspicion was aroused by anything that was called to his attention, to have gone to the directors and asked for an explanation."

Some years ago an interesting American case was reported in *The Accountant*. The auditors of a New York stockbroker's firm receiving an annual fee of not more than $2,000 were sued for damages and at the end of the trial the judge finally left to the jury two questions—

(1) Were the defendants negligent in the performance of their agreement, and (2) if so, what damages to the plaintiffs resulted directly and

proximately from such negligence? The first question was answered in the affirmative, and to the second the jury answered " $1,177,805·26."

Afterwards, however, the Court set aside the answer to the second question and directed a verdict in favour of the plaintiffs in the amount of $2,000. Upon appeal the Appellate Division of the State of New York, by a majority of three to one, sustained the decision of the lower court, and in doing so, said with regard to the damages of $1,177,805—

> "We think the damages cannot be said to flow naturally or directly from defendants' negligence or breach of contract. Plaintiffs should not be allowed to recover for losses which they could have avoided by the exercise of reasonable care."

The Court of Appeals of New York, a court which I believe possesses an authority in America only less than the Supreme Court of the United States, unanimously confirmed the decision of the Appellate Court.

Quite recently, the Court of Appeals of Manitoba gave a decision in an extremely interesting case (*International Laboratories Ltd.* v. *Dewar et al*, [1932] 3 W.W.R. 174; revsd. [1933] 2 W.W.R. 529). In the Court of First Instance the judge made a number of decisions adverse to the auditors which, if they had been sustained, would, I think, have made a complete reconsideration of the legal position of auditors inevitable.

The company was a subsidiary with no stockholders except the holding company, and the audit arrangements had been made by correspondence with the officers of the holding company and confirmed by those of the subsidiary. The auditors had undertaken a restricted audit, after warning their clients of the risks such restriction entailed. The loss was covered by insurance, and it was admitted that the suit was brought in the interest of insurers. The defalcations were ultimately discovered by the auditors, who were instructed by the company to investigate the records and determine the amount stolen.

The trial judge, that is the judge of the Court of First Instance, dismissed the correspondence from consideration, holding that it was ineffectual to relieve the auditors of a duty which was imposed on them by the statute, the proper performance of which would, in his view, have resulted in the prompt discovery of the defalcations in the first year in which they occurred; that the auditors were consequently liable for the amount of all subsequent defalcations, and that the insurers were entitled to recover upon the principle of subrogation. How extreme were his views on the responsibility of auditors may be judged from a single sentence quoted from his decision—

> "When the defendants assumed their duties and continued to carry them out from year to year, the necessity for special vigilance by the plaintiff as against its employees was removed."

Fortunately for the profession, and as I think, for the business world also, the Appeal Court disagreed with the trial judge on his law as well as on his interpretation of the evidence. With one dissentient out of five judges, that Court completely reversed the decision of the court below and decided the issues in favour of the auditors, both on the claim and the counter-claim for services investigating the thefts. The dissenting judge would have found for the plaintiff on certain items constituting about one-third of the total claim.

All of the judges found their decisions on the contract created by the correspondence. With the exception noted, all agreed that there was no breach of duty under that contract. Since this conclusion disposed of the

case, all further observations are in the nature of *obiter dicta*. Nevertheless, it seems worth while to quote the two following excerpts—

> "The liability sought to be imposed on the defendants is, in this view, based on the failure of the defendants to protect the plaintiff from its own negligence." (Trueman, J.A.)
>
> "There is a certain minimum of control which every firm is bound to exercise over the operations in its office and which the auditors will properly assume to have been exercised." (Prendergast, C.J.)

I do not think that the burden placed on the auditor is unreasonable, in theory, even under a contract express or implied that requires from him far more than the official audit. He is required to display only reasonable skill and reasonable diligence: he is not liable merely because he fails to discover a most ingenious fraud, and if the primary cause of the loss is negligent administration, his liability will, in law, be relatively small. What, then, are the reasons that make the question of liability a serious one.

The first is that, as stated by Lord Alverstone in the passage which I have already quoted, it is easier to define the auditor's liability in general terms than to deal with the question concretely. Consequently, the auditor is in the hands of a jury, and unless their decision is quite unreasonable it will not be interfered with. The second is that the question whether a fraud might have been discovered by reasonable skill and diligence is apt to take on a very different colour when the fraud has, in fact, been discovered and the means by which it might have been unearthed earlier have become apparent. It is too much to expect of jurymen that they should be able to put themselves back into the position of the auditor before the discovery had been made. In the third place, the question what constitutes reasonable skill and diligence is always a difficult one. The courts have indicated that such a question can best be answered by ascertaining whether other skilled persons would have regarded the procedure actually followed as adequate or whether they would have done something more which would have prevented or reduced the loss. It is easy to be wise after the event, and an expert may be prone to think that he would have done what as it turns out would have been effective; or, on the other hand, he may find it embarrassing to say that he would have done something which another expert, whom he regards as equally competent, did not do. Answers to hypothetical questions after the event are not a very satisfactory basis on which to have to depend for a decision whether a loss which may be disastrous is to fall upon an auditor.

Undoubtedly, however, the consideration which adds most to the seriousness of the question of the liability of an auditor is that he has so much more to lose than the person asserting the claim against him, and that claimants cannot fail to be aware of this fact. The mere fact that a suit for negligence is brought against him is apt to prove injurious whatever the outcome may be; and if he loses, the damages and costs may be out of all proportion to any compensation he has ever received. There is no doubt that recognition of these facts has led to claims being made and paid that could scarcely have survived scrutiny in a court of law.

It follows, I think, from the foregoing that the remedy for unsatisfactory conditions lies not in changes of the law but mainly in ourselves. If we are careful what contracts, express or implied, we enter into; if we do our work with reasonable competence and diligence; if we make up our minds to face the trouble and annoyance which resistance to unfounded claims will sometimes entail, we have little to fear.

I think, however, that the organized bodies of the profession should do

something to place the relations between clients, insurers and auditors on a more satisfactory footing. In the *Manitoba* case which I have mentioned Mr. Justice Robson said—

> "Much has been said about subrogation and suggestion that the insurers now have a right through plaintiff against defendants. I fail to see anything of the sort in the relationship of the parties."

If this is not the legal position in England steps should be taken to make it so, and I should suppose that this could readily be accomplished by appropriate wording in contracts of insurance.

CHAPTER XII

THE APPOINTMENT, REMUNERATION, RIGHTS AND DUTIES, AND RESPONSIBILITIES OF AUDITORS, AND LEGAL PRONOUNCEMENTS RELATING THERETO

In the case of companies governed by the Companies Act, 1948, the appointment and remuneration of Auditors are regulated by Sections 159 to 162 of that Act, which effects a number of changes in the provisions hitherto applying under the Act of 1929. In general it may be said that although greater responsibilities are imposed on the Auditor, his position is made a little more secure. He is automatically reappointed at an annual general meeting, without a resolution to that effect, unless

(*a*) he is not qualified for reappointment, or

(*b*) a resolution has been passed at the meeting that he shall not be reappointed or appointing someone else, or

(*c*) he has written to the company that he does not wish to be reappointed.

The steps to be taken before someone else can be proposed for appointment, instead of the existing Auditor, are considerable and more far-reaching than under the 1929 Act (Companies Act, 1948, Section 160). The existing Auditor, besides having the right to attend and speak at the general meeting, is now given the opportunity of making representations to the company in writing, which, if reasonable in length and received in time, must be sent to every member who receives a notice of the meeting. The Act, besides controlling the length of the representations, also provides for control of the contents, so that the facility will not be abused nor made the opportunity for defamation. If a copy is not sent to the members, because of receipt too late or default by the company, the Auditor may require the representations to be read at the meeting, without prejudice to his right also to speak.

As a matter of professional etiquette a person, before agreeing to accept nomination in place of an existing Auditor, should communicate with him to inquire whether he has any objection or knows of any reason why the proposed nomination should not be accepted. If there is an objection, the proposed nominee must then consider whether it is of such a nature that he should decline the invitation.

The sections of the Companies Act, 1948, dealing with the appointment of Auditors are as follows—

159.—(1) Every company shall at each annual general meeting appoint

an auditor or auditors to hold office from the conclusion of that, until the conclusion of the next, annual general meeting.

(2) At any annual general meeting a retiring auditor, however appointed, shall be reappointed without any resolution being passed unless —

(*a*) he is not qualified for reappointment; or

(*b*) a resolution has been passed at that meeting appointing somebody instead of him or providing expressly that he shall not be reappointed; or

(*c*) he has given the company notice in writing of his unwillingness to be reappointed:

Provided that where notice is given of an intended resolution to appoint some person or persons in place of a retiring auditor, and by reason of the death, incapacity or disqualification of that person or of all those persons, as the case may be, the resolution cannot be proceeded with, the retiring auditor shall not be automatically reappointed by virtue of this subsection.

(3) Where at an annual general meeting no auditors are appointed or reappointed, the Board of Trade may appoint a person to fill the vacancy.

(4) The company shall, within one week of the Board's power under the last foregoing subsection becoming exercisable, give them notice of that fact, and, if a company fails to give notice as required by this subsection, the company and every officer of the company who is in default shall be liable to a default fine.

(5) Subject as hereinafter provided, the first auditors of a company may be appointed by the directors at any time before the first annual general meeting, and auditors so appointed shall hold office until the conclusion of that meeting:

Provided that—

(*a*) the company may at a general meeting remove any such auditors and appoint in their place any other persons who have been nominated for appointment by any member of the company and of whose nomination notice has been given to the members of the company not less than fourteen days before the date of the meeting; and

(*b*) if the directors fail to exercise their powers under this subsection, the company in general meeting may appoint the first auditors, and thereupon the said powers of the directors shall cease.

(6) The directors may fill any casual vacancy in the office of auditor, but while any such vacancy continues, the surviving or continuing auditor or auditors, if any, may act.

(7) The remuneration of the auditors of a company—

(*a*) in the case of an auditor appointed by the directors or by the Board of Trade, may be fixed by the directors or by the Board, as the case may be;

(*b*) subject to the foregoing paragraph, shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

For the purposes of this subsection, any sums paid by the company in respect of the auditors' expenses shall be deemed to be included in the expression "remuneration."

160.—(1) Special notice shall be required for a resolution at a company's annual general meeting appointing as auditor a person other than a retiring auditor or providing expressly that a retiring auditor shall not be reappointed.

(2) On receipt of notice of such an intended resolution as aforesaid, the company shall forthwith send a copy thereof to the retiring auditor (if any).

(3) Where notice is given of such an intended resolution as aforesaid and the retiring auditor makes with respect to the intended resolution representations in writing to the company (not exceeding a reasonable length) and requests their notification to members of the company, the company shall, unless the representations are received by it too late for it to do so,—

(*a*) in any notice of the resolution given to members of the company, state the fact of the representations having been made; and

(*b*) send a copy of the representations to every member of the company to whom notice of the meeting is sent (whether before or after receipt of the representations by the company);

and if a copy of the representations is not sent as aforesaid because received too late or because of the company's default, the auditor may (without prejudice to his right to be heard orally) require that the representations shall be read out at the meeting:

Provided that copies of the representations need not be sent out and the representations need not be read out at the meeting if, on the application either of the company or of any other person who claims to be aggrieved, the court is satisfied that the rights conferred by this section are being abused to secure needless publicity for defamatory matter; and the court may order the company's costs on an application under this section to be paid in whole or in part by the auditor, notwithstanding that he is not a party to the application.

(4) The last foregoing subsection shall apply to a resolution to remove the first auditors by virtue of subsection (5) of the last foregoing section as it applies in relation to a resolution that a retiring auditor shall not be reappointed.

Eligibility for appointment as Auditor is determined by Section 161. The section deals in the main with those persons who are *not* qualified to be appointed, but in such a manner that persons who are qualified may readily be ascertained. A sound professional qualification is exacted and, except in the case of an exempt private company (see Schedule 7), or a case under Sect. 161 (1) (*b*) *infra*, the proposed Auditor must be a member of a body of accountants established in the United Kingdom and for the time being recognized for the purposes of Section 161 by the Board of Trade. To date these bodies are the following—

The Institute of Chartered Accountants in England and Wales.
The Society of Incorporated Accountants and Auditors.
The Association of Certified and Corporate Accountants.
The Society of Accountants in Edinburgh.
The Institute of Accountants and Actuaries in Glasgow.
The Society of Accountants in Aberdeen.
The Institute of Chartered Accountants in Ireland.

The section further imposes ineligibility for appointment as Auditor upon officers and servants of the company and their partners and employees, and on a body corporate. The exemption from this restriction for a person who is a partner of or in the employment of an officer or servant of the company which under the 1929 Act applied in the case of all private companies, now

applies only in the case of an exempt private company. (Companies Act, 1948, Section 161 (2) .) The term "officer" or "servant" does not, for the purposes of the sub-section, include an Auditor.

The Section is as follows—

161.—(1) A person shall not be qualified for appointment as auditor of a company unless either—

(*a*) he is a member of a body of accountants established in the United Kingdom and for the time being recognized for the purposes of this provision by the Board of Trade; or

(*b*) he is for the time being authorized by the Board of Trade to be so appointed either as having similar qualifications obtained outside the United Kingdom or as having obtained adequate knowledge and experience in the course of his employment by a member of a body of accountants recognized for the purposes of the foregoing paragraph or as having before the sixth day of August, nineteen hundred and forty-seven, practised in Great Britain as an accountant:

Provided that this subsection shall not apply in the case of a private company which at the time of the auditor's appointment is an exempt private company.

(2) None of the following persons shall be qualified for appointment as auditor of a company—

(*a*) an officer or servant of the company;

(*b*) a person who is a partner of or in the employment of an officer or servant of the company;

(*c*) a body corporate:

Provided that paragraph (*b*) of this subsection shall not apply in the case of a private company which at the time of the auditor's appointment is an exempt private company.

References in this subsection to an officer or servant shall be construed as not including references to an auditor.

(3) A person shall also not be qualified for appointment as auditor of a company if he is, by virtue of the last foregoing subsection, disqualified for appointment as auditor of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be so disqualified if the body corporate were a company.

(4) Notwithstanding anything in the foregoing provisions of this section, a Scottish firm shall be qualified for appointment as auditor of a company if, but only if, all the partners are qualified for appointment as auditor thereof.

(5) Any body corporate which acts as auditor of a company shall be liable to a fine not exceeding one hundred pounds

Doubts have arisen in the minds of accountants as to whether, through undertaking certain duties, or acting in certain well-recognized capacities, for companies, they may have made themselves, their partners or their firms ineligible to act also as Auditors. Such duties, for example, are those of a registrar, financial adviser or consulting accountant. The opinion of Counsel on this matter

has been taken by the Institute of Chartered Accountants, the purport of the advice received being that in general the test to apply is whether the contract is "for services" or "for service"; whether or not the company has the right to control his activities. Control would in effect make the accountant a servant of the company, and would render him, and his partners and employees ineligible to act as Auditors. But a contract "for services," implying professional independence, would carry no such disability.

Counsel further advised—

(*a*) That appointment as liquidator or receiver (except in the case of a Receiver and Manager) would not carry the above mentioned disability.

(*b*) That there is nothing to prevent an accountant whose employee acts as Director, Secretary or otherwise as an officer of the company, from acting as Auditor of the Company.

Questions have arisen in the past as to whether an Auditor is an officer of the company, and the matter is of special interest by reason of the penalties which under Section 333 of the Companies Act, 1948, can be imposed on delinquent officers. In Section 161 (2) of the Act it is provided that an officer is not qualified to act as Auditor of a company, but later the subsection specifically excludes an Auditor in references to an officer. An Auditor is not included in the definition of "officer" in the interpretation Section 455. But in the Fourth Schedule dealing with the reports to be set out in a prospectus, it is stated in paragraph 30 "for the purposes of this paragraph the expression 'Officer' shall include a proposed Director but not an Auditor." Section 124 provides that the expressions "Director" and "Officer" shall include any person in accordance with whose directions or instructions the Directors of a company are accustomed to act.

The remuneration of an Auditor is fixed in accordance with the provisions of Section 159 (7) of Companies Act, 1948, *supra*. If the remuneration is not fixed by the company in general meeting, the amount thereof shall be shown under a separate heading in the Profit and Loss Account (Eighth Schedule, Part I, paragraph 13). For the purposes of this paragraph, any sums paid by the company in respect of the Auditor's expenses shall be deemed to be included in the expression "remuneration."

This is a new provision, for hitherto, although it was not uncommon where a fee inclusive of expenses was charged to show the inclusive fee as an audit fee, in cases where expenses were paid specifically by the client such expenses were not as a rule shown as a part of the fee. It is recommended for the future that where Auditors, besides carrying out an audit, perform other duties for the client, such as the preparation of the final accounts,

work on taxation computations, secretarial or similar matters apart from the audit, they should separate their charges for these items so that the company may include them as a general expense. The amount to be shown separately in the accounts will then be limited to the fee for the audit required by the Act.

If, at the time of completing the accounts, the exact remuneration and expenses cannot be ascertained, a proper estimate should be made and such amount included in the accounts, any subsequent adjustment, if material, being shown in the accounts of the next period.

The company known as the "Exempt" private company is a creation of the Companies Act, 1948. Broadly it may be said to conform to the pattern which was no doubt intended originally for the private company, a class of company designed to confer on individuals, who had previously carried on business in partnership, the benefits of limited liability and other advantages of incorporation. Over a period of forty years these companies have grown in size and importance and in many cases they have lost the individual or family association which inspired their creation. Some of them were subsidiaries of large public companies. The intention to deal with this development is clearly discernible in the 1948 Act, which deprives the private company, unless it is an exempt private company, of privileges with regard to the non-filing of accounts, and in other respects, and of the exemption from disqualification for appointment as Auditors of persons who are in the position defined in Section 161 (2) (*b*) *supra*.

To be an exempt private company a private company must satisfy conditions laid down in Section 129 and in the Eighth Schedule to the Companies Act, 1948, namely—

(i) That the number of persons holding debentures of the company is not more than fifty (joint holders being treated as a single person).

(ii) That no body corporate is a Director of the company and neither the company nor any of the Directors is party or privy to any arrangement whereby the policy of the company is capable of being determined by persons other than the directors, members and debenture holders or trustees for debenture holders.

(iii) The conditions contained in the Seventh Schedule to the Act.

The Seventh Schedule provides *inter alia* that, subject to certain exceptions given in the Schedule, if the company is to be an exempt private company,

(i) No body corporate shall be the holder of any of the shares or debentures.

(ii) No person other than the holder shall have any interest in any of the shares or debentures.

The legal duties and rights of Auditors are set out in Sections 162 and 163 as follows --

162.—(1) The auditors shall make a report to the members on the accounts examined by them, and on every balance sheet, every profit and loss account and all group accounts laid before the company in general meeting during their tenure of office, and the report shall contain statements as to the matters mentioned in the Ninth Schedule to this Act.

(2) The auditors' report shall be read before the company in general meeting and shall be open to inspection by any member.

(3) Every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, and shall be entitled to require from the officers of the company such information and explanation as he thinks necessary for the performance of the duties of the auditors.

(4) The auditors of a company shall be entitled to attend any general meeting of the company and to receive all notices of and other communications relating to any general meeting which any member of the company is entitled to receive and to be heard at any general meeting which they attend on any part of the business of the meeting which concerns them as auditors.

163. References in this Act to a document annexed or required to be annexed to a company's accounts or any of them shall not include the directors' report or the auditors' report:

Provided that any information which is required by this Act to be given in accounts, and is thereby allowed to be given in a statement annexed, may be given in the directors' report instead of in the accounts and, if any such information is so given, the report shall be annexed to the accounts and this Act shall apply in relation thereto accordingly, except that the auditors shall report thereon only so far as it gives the said information.

It will be observed that Section 162 (3) gives a right of access at all times to the books. This places the Auditor in a strong position. Normally the Auditor will attend by arrangement with his clients, though there may be occasions on which he will attend without notice, and the Directors, for their part, may desire that he should do so. If he suspects fraud he will probably consider it necessary. (See Cuff's case, page 204, *post*, where in special circumstances the Auditors were denied access to the books.)

An additional duty is now imposed on the Auditor of reporting that proper books are kept (Ninth Schedule).

PARLIAMENTARY COMPANIES

II. In the case of Parliamentary Companies (Companies incorporated under a special Act of Parliament) the appointment is made in the first instance by the Directors and the remuneration fixed by them.

PUBLIC AUDITS

III. In the case of Public Audits comprising Societies registered under the Industrial and Provident Societies Acts, 1893 to 1929,

Friendly Societies Acts, 1896 to 1929, and Industrial Assurance Acts, 1923 to 1929, the following provisions apply—

Sections 13, 14 and 72 of the Industrial and Provident Societies Act, 1893, are as follows—

13. (2) The Auditors shall have access to all the books, deeds, documents and accounts of the society, and shall examine the Balance Sheets showing the receipts and expenditure, funds and effects of the society, and verify the same with the books, deeds, documents, accounts, and vouchers relating thereto, and shall either sign the same as found by them, to be correct, duly vouched and in accordance with law, or specially report to the society in what respects they find them incorrect, unvouched, or not in accordance with law.

14. (1) Every registered society shall once in every year, not later than the thirty-first day of March, send to the registrar an annual return of the receipts and expenditure, funds and effects, of the society as audited.

(2) The annual return—

(*a*) Shall be signed by the Auditor or Auditors; and

(*b*) Shall show separately the expenditure in respect of the several objects of the society; and

(*c*) Shall be made up from the date of its registration or last annual return to that of its last published Balance Sheet, unless the last-mentioned date is more than four months before or more than one month after the thirty-first day of December, in which case it shall be made up to the said thirty-first day of December inclusive; and (*amended by Act of* 1913)

(*d*) Shall state whether the audit has been conducted by a Public Auditor appointed as by this Act is provided and by whom.

A registered society shall, together with the annual return, send to the Registrar a copy of the report of the Auditors and a copy of each Balance Sheet made during the period included in the return. (*Added by Act of* 1913.)

72. The Treasury may appoint Public Auditors for the purposes of this Act, and may determine the rates of remuneration to be paid by registered societies for the services of such Auditors.

Section 2 of the Industrial and Provident Societies (Amendment) Act, 1913, is as follows—

Every registered society shall once in every year submit its accounts for audit to one or more of the Public Auditors appointed under the provisions of the principal Act. An Auditor shall not hold any other office in connexion with the Society. (*This is substituted for sec.* 13 (1) *of the* 1893 *Act.*)

The following is an official statement of the conditions including remuneration under which Public Auditors hold their appointments—

INDUSTRIAL AND PROVIDENT SOCIETIES ACTS, 1893 TO 1928

FRIENDLY SOCIETIES ACTS, 1896 TO 1929

AND

INDUSTRIAL ASSURANCE ACTS, 1923 TO 1929

Conditions under which Public Auditors hold their Appointments

1. Public Auditors hold their appointments from year to year as from the 1st January. Any change of address should be communicated immediately to the Registrar of Friendly Societies.

2. A Public Auditor may describe himself as a "Public Auditor under the Friendly Societies Acts and the Industrial and Provident Societies Acts," but must not by reason of his appointment use any other description.

3. Public Auditors are expected to make themselves acquainted with the provisions of the Industrial and Provident Societies Acts, 1893 to 1928, the Friendly Societies Acts, 1896 to 1929, and the Industrial Assurance Acts, 1923 to 1929, and with the rules of the societies whose accounts are submitted to them for audit.

4. No Public Auditor may audit the accounts, balance sheet or Annual Return of any society or branch in which he holds any other office. Subject to this he must not refuse to audit the accounts of any society or branch which is registered under either the Friendly Societies Acts or the Industrial and Provident Societies Acts, unless he obtains the authority of the Registrar.

5. The Auditor must verify the Annual Return with the accounts and vouchers relating thereto, and must have regard to the rules of the society, and either sign the Annual Return as found by him to be correct, duly vouched, and in accordance with law, or specially report to the society in what respects he finds it incorrect, unvouched, or not in accordance with law. Where a special report is made, the Auditor should see that the certificate to the Annual Return is altered accordingly. He must initial any alterations required in the Annual Return.

6. The maximum fees allowed to be charged for auditing are stipulated. These do not include travelling expenses, and additional fees may be charged, by arrangement with the society, for work which is outside the scope of audit.

7. Every Public Auditor must send a return of his audits, in the prescribed form, to the Registrar of Friendly Societies not later than 31st January. For the purposes of this return, the Auditor should keep a record of the registered names and numbers of societies, classified as in paragraph 6 above, their receipts and payments, and the audit fees and additional charges (if any).

8. A Public Auditor who solicits audits by advertisement, circular, or otherwise, or by offering commission or other inducement to any person, or who acts as Auditor at the request of a person who has been appointed as Auditor but is not qualified to act, will be struck off the list of Public Auditors.

Note. The *Guide Book of the Registry of Friendly Societies* by the Chief Registrar of Friendly Societies and Industrial Assurance Commissioners should be read by all Public Auditors.

IV. PARTNERSHIPS. The Auditor is appointed by the partners and remuneration fixed by them. (As to his duties, see under PARTNERSHIPS, page 248.)

The Limited Partnerships Act, 1907, Section 6, Subsection 1. gives power to a limited partner to employ an Auditor to inspect, as his agent, the books of a firm in which he is a limited partner, and examine into the state and prospects of the partnership business. The remuneration is a matter of arrangement.

COUNTY COUNCILS, CORPORATIONS, ETC. The appointment of an Auditor is usually made and the remuneration fixed by the Council.

AUDITORS OF COMPANIES

The Auditor should make himself fully conversant, as the case may be, with—

1. The special Acts of Parliament incorporating the company.
2. Memorandum and Articles of Association of a limited liability company registered under the Companies Acts.
3. The rules and regulations of Friendly Societies and similar bodies.

The following legal cases relating to the matters discussed in this chapter should be carefully studied.

CASES

An Auditor had prepared the private accounts of income an expenditure of a baronet for thirteen years, and was paid for some years an annual fee of fifty guineas, and subsequently an annual fee of thirty-five guineas. On 22nd May he was informed the engagement would terminate on 30th June, but he contended the notice was insufficient. For the defence it was contended that the engagement was not a yearly one, although the amount was paid annually, and defendant was not entitled to notice. £18 7s. 6d. was paid into Court. It was held by Rentoul, J., sitting as Judge of the City of London Court, that judgment must be for the plaintiff for the full amount claimed, with costs.—*Homan* v. *Quilter*, 1908, Acct. L.R. 25.

A claim for compensation by the Auditors of a building society for damages owing to the loss of their appointments through the suspension of the society was referred by the Judge to Chambers. The parties subsequently agreed, subject to the Judge's sanction, for the Auditors to receive each an agreed sum by way of compensation and the costs of the proceedings.—*Re The Birkbeck Permanent Benefit Building Society*, 48 Acct. L.R. 41.

In *Litchfield & Sons* v. *Markus* (reported in *The Accountant*, Vol. XII, p. 676) the plaintiffs agreed, in December, 1885, to audit the defendant's books for £50 a year. They completed the audit for the year ending 31st December, 1885, in the following March, and claimed their fee. The defendant contended that the £50 claimed was for a year's work, and was not due until a year from the date of the contract. His Honour Judge Coventry ruled that the contract meant £50 for a year's services, and that the action had been brought too soon.

Section 91 of the Companies Clauses Consolidation Act, 1845, provides that the remuneration of the Auditors shall, unless otherwise provided by the special Act of Parliament, be settled by a general meeting of the company, and it has been decided that

Auditors appointed under this Section cannot recover any other remuneration than that fixed upon at a general meeting of the company.—*Page and Bishop* v. *Eastern and Midlands Railway Co.* (1884), 1 Cab. & El. 280.

Opinion of Counsel on Table A, Clause 83, *scheduled in the Companies Act*, 1862

The name or style under which a firm carries on business is merely a conventional name applicable to those persons only who are members of the firm on each occasion when the name is used. If, therefore, one person, Smith, is trading under the firm of "Smith, Jones & Co," he will be one Auditor within the meaning of Clause 83, Table A, of the Act of 1862. If two persons, Smith and Jones, are carrying on business under that style, they will be "more Auditors" within the meaning of the clause.

Such resolution as referred to would include Robinson and Brown, if they were members of the firm at the time the resolution was passed. It could always be shown in evidence that they were at that time partners in the firm of "Smith, Jones & Co."—*Carruthers* v. *Sheldon* (1815), 6 Taunt. 15; *Bass* v. *Clive* (1815), 4 M. & S. 13.

Newton v. *Birmingham Small Arms Co., Ltd.*, [1906] 2 Ch. 378, 22 T.L.R. 664

In this case it was held that Articles of Association which would limit the powers of the Auditor of the company are *ultra vires*.

Buckley, J., in his judgment, said—

In February last this company passed special resolutions the short substance of which is that the Directors may, under defined circumstances, set aside (without disclosing the fact) out of the profits sums to form an "internal reserve fund"—a sort of secret service fund—and that this fund need not be shown in or disclosed by the Balance Sheet, and no information need be given to the shareholders as to its amount, investment or application; that the Directors may invest it as they think fit without being liable for loss in consequence of such investments; that they may apply it for any purposes which they consider will advance the interests of the company; and that, while the particulars as to this fund are to be disclosed to the Auditors, it is to be the Auditors' duty not to disclose any information with regard to it to the shareholders or otherwise.

If the Balance Sheet be so worded as to show there is an undisclosed asset, the existence of which makes the financial position better than shown, such a Balance Sheet will not, in my judgment, be necessarily inconsistent with the Act of Parliament. Assets are often, by reason of prudence, estimated, and stated to be estimated, at less than their probably real value. The purpose of the Balance Sheet is primarily to show that the financial position of the company is at least as good as there stated, not to show that it is not or may not be better. The provision as to not disclosing the internal reserve fund in the Balance Sheet is not, I think, necessarily fatal to the special resolutions.

A principal question in this case, I think, is whether it is a compliance with the words of the Companies Act that the Auditors shall report that they have examined the accounts as to the internal reserve fund, that they are satisfied with them, and that the funds have been employed in manner authorized by the company's regulations, or whether there will be default in complying with the Act if they do not go on to say how the fund has been employed. In my judgment such a report would be a sufficient report within the Act if the Auditor is *bona fide* satisfied that in making this report, and nothing further, he is truly reporting as to "the true and correct view of the state of the company's affairs."

But the special resolutions do not stop there. They provide that it shall be the duty of the Auditor not to disclose any information with regard to this fund to the shareholders or otherwise. It is, I think, inconsistent with the Act of Parliament that the Auditor should be bound, even when he thinks that the true state of the company's affairs is affected by facts relating to the internal reserve fund, to withhold all information with regard to the same from the shareholders. If, for instance, the Directors had invested the internal reserve fund upon investments which might involve the company under certain circumstances in enormous loss, the Act, I think, requires that the Auditor shall be at liberty and be bound to report that fact.

Any regulations which preclude the Auditors from availing themselves of all the information to which under the Act they are entitled as material for the report which under the Act they are to make as to the true and correct state of the company's affairs are, I think, inconsistent with the Act.

His Lordship granted an injunction to restrain the company from acting on the special resolution, and ordered the company to pay the costs.

But see Chapter XIX as to the present position in regard to internal reserves.

Taylor and Others v. *Eustace Miles Foods* (1921) *Ltd. and Others* (1932), 76 Acct. L.R. 19

The plaintiffs sought an injunction to restrain the defendants from laying before the adjourned annual general meeting of the defendant company any Balance Sheet or Profit and Loss Account other than those audited by the plaintiffs with their report attached thereto, and further to restrain the defendants from excluding the plaintiffs from the adjourned meeting. The plaintiffs considered it to be their duty, having audited the accounts of the company and made a report, to insist that the Balance Sheet with their report should be laid before the company at the general meeting. The defendants wished to submit a revised Balance Sheet, audited by another firm.

Eve, J., said—

No court could say it was the Directors' duty to put forward a Balance Sheet which it was now admitted could not be justified and that they should be prevented from submitting a Balance Sheet showing the true position. The most any court could do would be to say the Directors must explain the position to the shareholders and make a complete and full disclosure of all the circumstances. In the long run an honest disclosure was far more profitable than a partial disclosure.

On the defendants' undertaking that the old Auditors should have the opportunity of attending and making a statement to the Adjourned Meeting, the court did not see its way to make any order on the motion.

Note. This case may be compared with *re Allen Craig & Co. (London) Ltd.*, [1934] Ch. 483 (see page 158).

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

The Secretary of the company having been guilty of defalcations, by which loss was occasioned to the company, the Directors alleged that the company's Auditors had by negligence in the performance of their duties conduced to these defalcations and refused to give them access to the company's books for the purpose of audit. The Auditors thereupon brought an action against the company and the Directors, claiming a declaration that they, as Auditors, were entitled at all times to access to the company's books, and an order for access thereto. The time having arrived when, in the ordinary course, the audit of the company's accounts by the plaintiffs should be proceeding for the purposes of the next annual general meeting, the plaintiffs made an interlocutory application in the action for an order that the defendants should give them access to the books, and Eve, J., made a mandatory order to that effect on the ground that the Auditors had a statutory right of access to the books.

Held by the Court of Appeal, that it was a question for the judicial discretion of the Court whether the right of access to the books claimed by the plaintiffs should be enforced by a mandatory order, and that such an order ought not, under the circumstances of the case to have been made upon an interlocutory application, and without any steps to ascertain whether the company were desirous that the plaintiffs should continue to act as Auditors or not, and therefore the appeal must be allowed.

COPYRIGHT IN AN ACCOUNTANT'S REPORT

Chantrey, Chantrey & Co. v. *T. H. Dey* (1912), Acct. L.R. 9

It appears that the plaintiffs had been employed by a third party to make an examination of the defendant's securities. After doing so they issued a report to their clients. At a later date the plaintiffs were registered as the proprietors of the copyright in the report. In the meantime the defendant had published an advertisement in which he included the plaintiffs' report to the third party. Mr. Justice Warrington in the course of his judgment said that it was contended on behalf of the defendant that the plaintiffs were employed to write this report as a portion of a periodical called *The Looking Glass*, and that they had been

paid for it on the terms that the copyright should belong to the proprietor, and that they had been paid by the proprietor for that portion of the article, and that accordingly the copyright was vested in the third party, and that, therefore, the plaintiffs were not in a position to sue the defendant, who admittedly had infringed the copyright.

His Lordship, after referring to the provisions of the Copyright Act, 1842, and the authorities, said that he had come to the conclusion that the sole and exclusive liberty of publishing and multiplying the report had passed to the third party and that the plaintiffs had not reserved to themselves the right of separate publication and therefore that the action failed and must be dismissed with costs.

AUDITORS' AND ACCOUNTANTS' REMUNERATION. LIEN ON BOOKS FOR AUDITORS' CHARGES

A distinction is drawn between the rights of accountants when acting in an accounting capacity and when acting as Auditors. An Auditor cannot have a lien over the statutory books of a limited company. An accountant may have a lien but not always a very effective one. The following case defines the distinction and also the limit of a lien.

Herbert Alfred Burleigh v. *Ingram Clark, Ltd.*
(1901), 27 Acct. L.R. 65

In this case the Auditor of the defendant company was asked to hand over the account books of the company which were in his custody, as a matter of convenience, to the Receiver appointed in a debenture-holder's action. Mr. Justice Joyce said—

> Apart from other matters, it was clear the Auditor had no right to keep the Shareholders' Register, as that was a book which the company must keep for public inspection, and he must therefore give it up. That was not an account book. As to the Articles of Association, he could not see that the Article relating to the Auditors gave him any lien whatever on the books. At present he was of opinion no book of the company ought to leave the company's office.

Mr. Justice Joyce asked whether, if the Auditor would return the books at once, the receiver would be willing to give the Auditor a personal undertaking to pay whatever it might be found he was entitled to. Of course, he did not say that the Auditor was entitled to a lien.

His Lordship said that the affidavits filed showed that the respondent claimed a lien, not as Auditor, but as Accountant. In his opinion the question of an Auditor's lien did not arise, and, had it done so, he considered that an Auditor had no such lien; but that

point he did not now decide. In respect of the Share Register, the Accountant had no possible lien on that, but he held that he was entitled to a lien on such books only as he had actually worked upon, in respect of his proper remuneration for work upon those books only. If the parties did not agree upon the sum, there must be an inquiry. Each side would pay its own costs.

CHAPTER XIII

INVESTIGATIONS

INVESTIGATIONS form a considerable part of a professional Accountant's practice, and it is appropriate to consider the subject in a work on auditing. Investigations arise chiefly in the circumstances outlined in this chapter and a summary is given of the main points which require attention.

I. *Investigation for the purpose of certification of past profits for prospectuses or other statements issued by public companies, or of past profits of a business of which a company contemplates the purchase.*

This class of investigation is one in which the Accountant undertakes a very special responsibility, for the investing public will have regard to his report in determining whether or not to invest their money in the issue. Further, the accountant may be dealing with directors who, by reason of their own faith in the business for which the money is required, or by reason of their anxiety that the issue should not fail, are apt to desire that the most hopeful interpretation should be placed on past results. Again, the directors may be acting fraudulently, or with a disregard of their duties and obligations to the public and their shareholders.

The accountant therefore must not fail to exercise the greatest care in his examination of the accounts, nor should he respond to any pressure to work to an impossible schedule of time, nor accept any suggestion that delay arising from excessive care will jeopardize the issue. Persons who leave things to the last minute are apt to impose on others the responsibility for making up the lost time, and many an accountant has had to produce his report under this pressure. Cases in the Courts have called public attention to the importance of prospectuses, and show very clearly how great is the responsibility which the accountant undertakes.

The Fourth Schedule to the Companies Act, 1948, deals with matters to be specified in a prospectus. Sections of Parts II and III of the Schedule deal with reports of the Auditors, the relevant paragraphs being as follows—

PART II

REPORTS TO BE SET OUT

19.—(1) A report by the auditors of the company with respect to—

(*a*) profits and losses and assets and liabilities, in accordance with sub-paragraph (2) or (3) of this paragraph, as the case requires; and

(*b*) the rates of the dividends, if any, paid by the company in respect of each class of shares in the company in respect of each of the five financial years immediately preceding the issue of the prospectus, giving particulars of each such class of shares on which such dividends have been paid and particulars of the cases in which no dividends have been paid in respect of any class of shares in respect of any of those years;

and, if no accounts have been made up in respect of any part of the period of five years ending on a date three months before the issue of the prospectus, containing a statement of that fact.

(2) If the company has no subsidiaries, the report shall—

(*a*) so far as regards profits and losses, deal with the profits or losses of the company in respect of each of the five financial years immediately preceding the issue of the prospectus; and

(*b*) so far as regards assets and liabilities, deal with the assets and liabilities of the company at the last date to which the accounts of the company were made up.

(3) If the company has subsidiaries, the report shall—

(*a*) so far as regards profits and losses, deal separately with the company's profits or losses as provided by the last foregoing sub-paragraph, and in addition, deal either—

(i) as a whole with the combined profits or losses of its subsidiaries, so far as they concern members of the company; or

(ii) individually with the profits or losses of each subsidiary, so far as they concern members of the company;

or, instead of dealing separately with the company's profits or losses, deal as a whole with the profits or losses of the company and, so far as they concern members of the company, with the combined profits or losses of its subsidiaries; and

(*b*) so far as regards assets and liabilities, deal separately with the company's assets and liabilities as provided by the last foregoing sub-paragraph and, in addition, deal either—

(i) as a whole with the combined assets and liabilities of its subsidiaries, with or without the company's assets and liabilities; or

(ii) individually with the assets and liabilities of each subsidiary;

and shall indicate as respects the assets and liabilities of the subsidiaries the allowance to be made for persons other than members of the company.

20. If the proceeds, or any part of the proceeds, of the issue of the shares or debentures are or is to be applied directly or indirectly in the purchase of any business, a report made by accountants (who shall be named in the prospectus) upon—

(*a*) the profits or losses of the business in respect of each of the five financial years immediately preceding the issue of the prospectus; and

(*b*) the assets and liabilities of the business at the last date to which the accounts of the business were made up

21.—(1) If—

(*a*) the proceeds, or any part of the proceeds, of the issue of the shares or debentures are or is to be applied directly or indirectly in any manner resulting in the acquisition by the company of shares in any other body corporate; and

(*b*) by reason of that acquisition or anything to be done in consequence thereof of in connexion therewith that body corporate will become a subsidiary of the company;

a report made by accountants (who shall be named in the prospectus) upon—

(i) the profits or losses of the other body corporate in respect of each of the five financial years immediately preceding the issue of the prospectus; and

(ii) the assets and liabilities of the other body corporate at the last date to which the accounts of the body corporate were made up.

(2) The said report shall—

(*a*) indicate how the profits or losses of the other body corporate dealt with by the report would, in respect of the shares to be acquired, have concerned members of the company and what allowance would have fallen to be made, in relation to assets and liabilities so dealt with, for holders of other shares, if the company had at all material times held the shares to be acquired; and

(*b*) where the other body corporate has subsidiaries, deal with the profits or losses and the assets and liabilities of the body corporate and its subsidiaries in the manner provided by sub-paragraph (3) of paragraph 19 of this Schedule in relation to the company and its subsidiaries.

PART III

27. If in the case of a company which has been carrying on business, or of a business which has been carried on for less than five years, the accounts of the company or business have only been made up in respect of four years, three years, two years or one year, Part II of this Schedule shall have effect as if references to four years, three years, two years or one year, as the case may be, were substituted for references to five years.

28. The expression "financial year" in Part II of this Schedule means the year in respect of which the accounts of the company or of the business, as the case may be, are made up, and where by reason of any alteration of the date on which the financial year of the company or business terminates the accounts of the company or business have been made up for a period greater or less than a year, that greater or less period shall for the purpose of that Part of this Schedule be deemed to be a financial year.

29. Any report required by Part II of this Schedule shall either indicate by way of note any adjustments as respects the figures of any profits or losses or assets and liabilities dealt with by the report which appear to the persons making the report necessary or shall make those adjustments and indicate that adjustments have been made.

30. Any report by accountants required by Part II of this Schedule shall be made by accountants qualified under this Act for appointment as auditors of a company which is not an exempt private company and shall not be made by any accountant who is an officer or servant, or a partner of or in the employment of an officer or servant, of the company or of the company's subsidiary or holding company or of a subsidiary of the company's holding company; and for the purposes of this paragraph the expression "officer" shall include a proposed director but not an auditor.

See also Section 38 of the Act.

The Accountant should make an examination of the Balance Sheets and Profit and Loss Accounts for the requisite number of years, and in particular should ascertain from the Profit and Loss Accounts—

(i) Whether there are any profits or losses of an exceptional or non-recurring character, or of a Capital nature. It is usual,

and in most cases necessary, to adjust the profits by deleting these exceptional items.

(ii) Interest received or paid. The basis of finance of the company will probably be altered by the subscription to the issue, in which case interest paid or received in the past will be no guide to the corresponding items in the future. Such items are not normal and would not be taken into account in computing goodwill. If the proceeds of an issue of capital are to be applied to pay off loans, interest on the latter would cease to be payable.

(iii) The amount of income tax debited. Income tax is not deemed to be a charge on, but an appropriation of the profits. The amount payable, year by year, varies and, since income tax is not ordinarily assessed on the profits of the actual year, it is not directly related to the profits. Income tax is deducted from dividends paid and this deduction goes to the credit of the Income Tax Account. Apart from these variations there is the change which is made from time to time in the rate of tax. For these reasons it is usual to state profits before charging income tax.

(iv) Depreciation charged. This may have been excessive, or too little. In any case the amount of depreciation to be written off in the future may be greater or less according to the values placed upon the assets to be acquired as set out in the prospectus.

(v) The amount of the Directors' fees. This figure should include income tax if the fees are paid free of tax. (As to payment of directors' fees free of tax see Companies Act, 1948, Section 189, and Chapter IV, page 54.) The prospectus sets out the fees which it is proposed to pay in the future, and these may differ from those paid in the past. Fees charged in the accounts may, therefore, be added back.

As stated above (paragraph 29) these adjustments if not made must be referred to by way of a note indicating that they appear to the person making the report to be necessary; if they have been made the fact should be stated. The purpose of this notification is to enable the intending investor to know on what basis the profits or losses quoted have been or should be computed. The further details furnished in the prospectus itself will enable him to ascertain what adjustments to make for future charges and other items so disclosed. The purpose of the report is to enable the investor to judge by past results what, *mutatis mutandis*, the company may be expected to do in the future. He should therefore be put in possession of evidence to enable him to do so, and for this reason items arising in the past which will not recur should not be included, and the prospectus should furnish such information as will enable him to take into account items which will arise in the future but have not arisen in the past. It is not the duty of

the Accountant, in his report, to give a forecast of the likely profits which the company will earn, nor is it proper for him to do so. He deals with facts as shown by the accounts of the company in respect of its past trading. He should not give averages without giving in detail the figures from which the average is computed.

Statements in this book as to the work to be performed at an audit apply with equal force in the case of an examination of accounts for prospectus purposes. In the case of a report under Part II (19) (1) of the fourth Schedule (*supra*) the investigating Accountant will himself have audited the accounts, but this may not be the case under Part II (20). If he has audited them his work will be simplified, but in any case he should make a particularly careful examination of the accounts of the last period to ensure that there has been no "window-dressing" with the prospectus in view, more especially by the omission of liabilities, by an unduly optimistic view of assets and items of profit, or by a too liberal valuation of stock. Again, it should be seen that the later years do not show unduly good results because earlier years have been burdened with excessive, though at the time prudent, provision for future contingent losses.

The requirements of the Council of the Stock Exchange which include reports by Auditors or Accountants are wider than those of the Act, and the Accountant should familiarize himself with them. He will find that where the accounts for at least ten years are available, he has to give a report in respect of the ten completed financial years preceding the issue of the prospectus instead of five years required by the Act. By the courtesy of the Council of the Stock Exchange, we are permitted to quote from their published Regulations (known as Appendix 34). These, so far as the duties of the Auditor or Accountant are concerned, are given in Appendix I to this volume (page 341).

The chief provisions of the Companies Act, 1948, with regard to prospectuses and their contents are given in Sections 37–46 thereof and in the Fourth Schedule. Section 40 deals with the consent required from an expert—the definition of which term includes an Accountant and any other person whose profession gives authority to a statement made by him—to the issue of a prospectus containing a statement which he has purported to make. A prospectus must not be issued unless he has given, and has not before delivery of a copy of the prospectus for registration withdrawn, his written consent to the issue thereof with the statement included in the form and context in which it is included. Further, a statement that he has given and has not withdrawn his consent must appear in the prospectus.

The Auditor should see a proof of the prospectus or advertised

statement which it is proposed to publish, and in his own interests should check very carefully not only his own report, but all other matter. If there is anything in the document with which he does not agree he should inform the company, and he may have to refuse to allow his report or his name to appear in the document, if it includes anything material with which he is not in agreement. Although incorrect statements may not be identified with him in the prospectus or advertised statement, his name will appear on it, and whether he has any legal liability or not he may be associated by the reader with anything that appears, as to which he might be expected to have knowledge.

The civil liability of persons for misstatements in prospectuses is covered very fully by Section 43 of the Act and attaches to Directors, promoters, and every person who has authorized the issue of the prospectus. A person shall not be deemed for this purpose to have authorized the issue of a prospectus by reason only of his having given the consent required by Section 40 of the Act (*supra*) to the inclusion therein of a statement purporting to be made by him as an expert; nor does the term "promoter" for this purpose include any person by reason of his acting in a professional capacity for persons engaged in procuring the formation of the company.

It will be noted that Section 40 refers to the form and context in which the statement is included. The method of presentation or even the position occupied by the report in a prospectus may involve an interpretation by the reader which the Accountant did not intend. He should therefore require that it is presented as he would approve it, and in such a position that it cannot be connected with reports or statements of others so as to identify him with their conclusions, for which he is not responsible. He should also do his best to ensure that unjustifiable inferences will not be drawn from his figures and statements.

II. *The valuation of Stocks, Shares or Debentures as between a willing buyer and seller, or for Probate.*

The Accountant or Auditor is frequently instructed to make a valuation of this kind and to report. He should have submitted to him accounts for a number of past years, so that he may judge the trends of the business and ascertain the causes of fluctuations. At the present time it is particularly desirable, if possible, that the review should include some years before the outbreak of war in 1939. The special effect of the war on accounts of businesses was sometimes favourable, sometimes adverse, and taxation played a disturbing part. Any attempt to ascertain the prospects of the business and the likely course of profits will be influenced by an inquiry into past results.

The two main ingredients in the valuation of shares are (i) surplus of assets, (ii) profit earning capacity. To ascertain (i) the Balance Sheets for past years should be constructed as far as possible on the basis of conventional and real values. The current Balance Sheet should also be prepared on these lines and a separate account should be prepared showing the actual current value of the assets, where there are up-to-date valuations by expert valuers (e.g. in the case of buildings, plant, and machinery), so that the value of the net assets may be ascertained. From this must be deducted debentures and shares carrying priority rights. The value per share purely on the net asset basis (often referred to as a break-up value) can then be computed.

The second ingredient, profit earning capacity, should be determined from the Profit and Loss Accounts adjusted, as far as possible, to normality or to the circumstances which will obtain in the future if any major variation is contemplated. If assets have been revalued the charge for depreciation should be based on the new values. The Accountant will decide, from the nature and circumstances of the business, what rate of dividend an investor would expect on such a share. Any surplus will be an element in the calculation of goodwill, which should be added to the assets and will increase the value of the shares *pro tanto*. The amount of the goodwill is usually taken as a given number of years' purchase of the excess of profits over the amount which the investor would normally expect. This excess is usually referred to as super profits. The goodwill, when added to the net assets, gives a total which enables the shares to be valued, subject to special conditions, which may have a material bearing on the value in the market or to a purchaser.

The first of these conditions is actual dividend yield. Although the net value of the assets is not disregarded, there is a natural inclination to relate values to dividend. In the past, when a conservative policy in regard to dividends was pursued and substantial reserves were created out of profits, this policy was frequently reflected, though not fully reflected, in the price of the shares on the market. But it is different where, as at present, dividends are in effect controlled, although the control is not statutory. In such circumstances prices may be more closely related to yield.

The second condition, in the case of a private company, is any restriction which there may be on the right of transfer of shares, or in the inherent limitation in the opportunity of dealing in the shares. This will tend to reduce the valuation.

The third condition is any special circumstance affecting the business, such as fashion, competition, special hazards, or possible nationalization.

The fourth condition is the extent of the interest which is being

acquired. If it is a controlling interest the purchaser will expect to pay a somewhat higher price than for a minority interest.

There are many other special conditions which may influence the value of shares which cannot be dealt with in detail here, but will emerge as the investigation proceeds.

In a valuation of debentures and preference shares similar conditions will affect the calculation. In the case of debentures, the first consideration is security, and it is important to review the assets comprised in the charge to ensure that the margin of cover is adequate. Next there should be an adequate margin for payment of interest and provision of sinking fund, the latter of which will be out of taxed profits. But as there is priority in all respects over shares, debentures should receive less interest. If the rate of interest is higher than current trends, the debentures may be worth more than par, particularly if they are not due for early redemption. But the date and price of redemption must be borne in mind in a valuation.

In the case of preference shares similar considerations to those affecting debentures arise. They come after debentures but before ordinary shares. The margin of profit required is not so great, therefore, as for the latter. If the rate of dividend is fixed, and the capital cover is adequate the valuation can be considered in relation to current yields of similar shares. If the shares carry a participation in profits beyond the fixed yield, some increase in value will arise if participation is shown by the profit record to be likely.

The Articles of Association should be studied and any special provisions affecting the shares considered. If they are to be redeemed, or will be paid off at a given price on a winding-up, the shares will not as a rule be considered worth more or much more than that price.

As will be expected, valuations for probate will tend to be on a lower basis than for a vendor. Valuation cannot be exact, and there are upper and lower limits of value which must apply in most cases. It is to be expected that the lower will be sought for probate purposes. This is not unreasonable, for there must always be an element of hazard or hope in the value of a share which will induce a willing purchaser to pay a little more. No such consideration should affect valuation for probate. But the Estate Duty authorites are entitled to put a value on goodwill which the accounts and history of the company and current conditions justify.

III. *Claims under an insurance policy covering consequential loss.*

As this is a question of account, a professional Accountant is usually appointed either as sole arbitrator, or one of two arbitrators with an umpire, to determine the amount of the claim.

The purpose of the insurance is to cover the loss of profits arising as a result of a fire. The extent of loss of profits varies naturally with the magnitude of the fire but also with the nature of the business. Loss will arise not only by reason of damage to premises and consequent interruption of business but also by reason of loss of stock, ready or being prepared for sale, which will have to be replaced. Apart from loss of the stock, there will probably be a certain loss of trade through stock not being available when required. Again a certain increase in working expenses may be caused, or on the contrary there may be some saving owing to the interruption of work.

The insurance, which is usually taken out for a specific period—probably year by year—indemnifies the insured against—

(*a*) loss of turnover,

(*b*) increase in cost of working,

during a period defined in the policy and known as the period of indemnity.

The amount of the insurance is stated in the policy and no claim can exceed this. If the amount of the loss is greater, the principles of average are applied and only a percentage falls upon the underwriters, the insured bearing the rest. It is important, therefore, to insure for an adequate amount.

Attached to the policy is a schedule setting out the particulars of the insurance. There are also special conditions, in common form, printed on the policy which have to be observed in determining the amount of the claim. The usual conditions are as follows—

1. In this policy the following words and expressions shall have the meanings hereunder attached to them respectively, viz.—

NET PROFIT. The Profit arising from the trading of the Insured in respect of the Business in the Premises after proper provision has been made for

(*a*) All fixed and other Charges.

(*b*) All Capital Receipts and Accretions and all Outlay properly chargeable to Capital, and

(*c*) Depreciation.

FINANCIAL YEAR. The year ending on the day to which in the ordinary course the yearly accounts of the Business are made up.

2. This Policy does not cover

(*a*) Loss occasioned by or happening through

(i) Earthquake, Subterranean Fire, Riot, Civil Commotion, Foreign Enemy, Military or Usurped Power, or Explosion (whether the explosion be occasioned by fire or otherwise).

(ii) The destruction of or damage to property through its undergoing any process involving the application of heat or through its own spontaneous fermentation, heating or combustion other than of Coal and (at Gas Works) of other materials used in the production of gas.

(iii) The destruction of or damage to any dynamo, motor or other

electrical machine or apparatus through its own over-running, excessive pressure, short-circuiting or self-heating.

(*b*) Fines or Damages for late completion or non-completion of orders or other breach of Contract or Penalties,

except in so far as any of such Contingencies or Matters may be specially mentioned in and expressed to be insured by the Policy.

3. The Policy shall be voidable

(*a*) In the event of misrepresentation, misdescription or non-disclosure in any material particular.

(*b*) If Insurance against Fire be not maintained upon the property of the Insured at the Premises.

(*c*) In any of the following cases unless in every such case the assent or sanction of the Company be signified by memorandum signed by or on behalf of the Company, viz.—

(i) If the Insured effect any additional Insurance to cover the subject matter of this Policy or any part of it.

(ii) If, after the risk has been undertaken, the danger of loss be increased from any cause whatsoever; or if the rate for the ordinary Fire Insurance risk be increased and notice thereof be not given to the Company.

(iii) If the Interest in the Business pass wholly or in part from the Insured otherwise than by Will or operation of Law, or

(iv) If the Business shall be liquidated or discontinued after the occurrence of the Fire otherwise than temporarily pending reoccupation of the Premises.

4. On the occurrence of a Fire in consequence of which a claim is or may be made under this Policy the Insured shall forthwith give notice thereof in writing to the Company and shall use due diligence and do and concur in doing and permit to be done all things which may be practicable to minimize any interruption of or interference with the Business and to avoid or diminish the loss. The Insured shall at his own expense deliver to the Company a claim in writing for the loss calculated in accordance with the terms and conditions of this Policy, and shall produce and give to the Company such properly audited balance sheets, account books, vouchers, plans, specifications and such other detailed particulars, proofs and explanations as may be from time to time reasonably required, together with, if demanded, a statutory declaration in support thereof. No indemnity under this Policy shall be payable unless and until the Company or Companies insuring the property of the Insured at the Premises against Fire shall have paid for or admitted liability in respect of the destruction of or damage to the said property.

5. If at the time of any loss under this Policy there shall be any other insurance covering the same subject matter or any part of it the Company shall not be liable for more than its rateable proportion thereof.

6. If the claim be in any respect fraudulent or if any fraudulent means or devices be used by the Insured or anyone acting on his behalf to obtain any benefit under this Policy or if any loss be occasioned by the wilful act or with the connivance of the Insured all benefit under this Policy shall be forfeited.

7. Any claimant under this Policy shall at the request and at the expense of the Company do and concur in doing and permit to be done all such acts and things as may be necessary or reasonably required by the Company for the purpose of enforcing any rights and remedies or of obtaining relief or indemnity from other parties to which the Company shall be or would become entitled or subrogated upon its paying any loss under this Policy,

whether such acts and things shall be or become necessary or required before or after his indemnification by the Company.

8. In adjusting a claim account shall be taken of any variations in the Business and allowance made for any additions or deductions in respect of Turnover Output or other Standard employed in the Policy which having regard to any extraordinary circumstances ought to be made.

9. In the event of the earnings of the Business for the financial year next preceding the Fire or other period specified in the Policy being insufficient to meet fully the amount of Standing Charges relating to such period the Insurance shall only apply to the extent to which the Standing Charges shall or would have been met by such earnings.

10. All differences arising out of this Policy shall be referred to the decision of an Arbitrator to be appointed in writing by the parties in difference or if they cannot agree upon a single Arbitrator to the decision of two Arbitrators, one to be appointed in writing by each of the parties within one calendar month after having been required in writing so to do by either of the parties, or, in case the Arbitrators do not agree, of an Umpire appointed in writing by the Arbitrators before entering upon the reference. The Umpire shall sit with the Arbitrators and preside at their meetings, and the making of an Award shall be a condition precedent to any right of action against the Company. After the expiration of twelve months from the termination of the period in respect of which indemnity is expressed to be recoverable the Company shall not be liable in respect of the relative claim unless it shall in the meantime have been referred to arbitration.

It is necessary to deduce the profits and the standing charges by reference to the books and in accordance with the schedule and special conditions.

CASE

By a policy of insurance against fire on business premises an insurance company agreed to pay to the insured, in the event of damage by fire to their property on account of annual net profit, an agreed percentage on the amount by which the turnover in each month after the fire should in consequence of the fire be less than the turnover for the corresponding month of the year preceding the fire. The policy further provided that the amount of all losses under the policy should be assessed by the insured's Auditors. During the currency of the policy property of the insured was damaged by fire. The Auditors gave certificates stating the difference between the turnover for the months after, and the corresponding months in the year before the fire, and the percentage payable. An arbitration was held to determine the amount payable under the policy. The Auditors' certificates were put in evidence, and a member of the firm of Auditors was called as a witness by the insured and stated that when he gave the certificates he was satisfied that the losses of turnover stated therein were in fact sustained in consequence of the fire.

Held, that the assessments of the Auditor were conclusive evidence of the amount of the loss recoverable under the policy,

unless it were shown that the Auditor had misdirected himself in point of law or had omitted to take into consideration some material fact; and that the Auditor might be cross-examined, and the insurance company might call direct evidence, to show that the Auditor had omitted to take into consideration the fact that the losses of turnover were wholly or in part due to other causes than the fire, but not to show that the Auditor's conclusions of fact were erroneous.—*Recher & Co.* v. *North British and Mercantile Insurance Co.*, [1915] 3 K.B. 277.

IV. *The proposed acquisition of a share in a business, whether as a partner or sleeping partner, or shares in an established company, or a proposed advance by a bank or other body or by an individual.*

In addition to ascertaining the assets and liabilities and profits as disclosed by the books, the Investigator should consider the following points—

(1) The conditions of the agreement proposed to be made between the respective parties.

(2) The nature of the business, the outlook so far as it can be gauged (including the possibility of supersession in, for example, a business working a patent or a secret process), and the prospect of keen competition in the future.

(3) The total capital, including borrowed capital, in the business.

(4) Whether there is a lease of the premises occupied, and the terms and conditions of the lease.

(5) The financial position and what additional capital is sufficient to keep the business liquid.

(6) What books are kept, and whether they are audited.

(7) How many persons connected with the business have a technical knowledge of the business and are qualified to carry on in case of need.

(8) What contracts are running for purchases and sales and whether they appear to be beneficial.

(9) Whether the sales include only trading sales in the ordinary course of business.

(10) Whether the debts are paid up promptly, and orders repeated, and whether all bad debts have been written off.

(11) Whether goods bought have been paid for promptly and the usual trade and cash discounts secured.

(12) What bills payable are outstanding and when they are due.

(13) How the stock is taken and valued, and whether there is an independent check on the stocktaking.

(14) What rate of depreciation is written off leases, plant and machinery, and whether this is adequate.

(15) What provision has been made in the accounts for outstanding rents, rates, and income tax. Who has prepared the income tax returns and whether there is any possibility of a claim by the Revenue for back duty, or, conversely, if a reclaim can be made.

(16) The percentage of gross and net profits on sales from year to year, over a number of years, noting whether the sales are progressive.

(17) How often the stock is turned over each year.

(18) What agreements exist with employees and the conditions attached thereto.

(19) Whether any part of the assets is mortgaged or pledged in any way.

(20) How the value of work in progress has been computed.

(21) The total wages paid and fixed charges, and the percentage of fixed charges to wages from year to year. The number of hands employed and the average wage.

In the case of companies—

(1) Obtain a copy of the Memorandum and Articles of Association. Ascertain the rights of preference and ordinary shareholders, who the holders are, and what are their respective voting powers.

(2) Ascertain what debentures are outstanding and the date of redemption.

(3) Obtain a list of the Directors, ascertain their powers and their remuneration, the provisions as to qualification shares and conditions as to re-election of Directors.

(4) Ascertain the company's borrowing powers, and how far they have been exercised.

(5) Inspect the Register of Mortgages and if thought necessary the Register of Charges at the Companies Registry.

(6) Examine the minutes of the meetings of Directors.

Where the books have been examined and the accounts reported upon by responsible Auditors, the Investigator may assume that the books and accounts are correct, and confine his attention to questions of principle and prospects, but he should make it clear that he has done so.

V. *Investigations in the case of fraud whether discovered or suspected.*

The Investigator may have to go back to the original records such as advice notes, delivery notes, stock records and invoices.

(1) He should examine closely the cash receipts and payments, verifying the additions, and comparing the receipts and payments with the Bank Pass Book or Statement, and eventually agreeing the balance shown in the Cash Book with the balance shown in the

banker's Pass Book or Statement and certified by the bankers to the investigator. He should examine carefully the constitution of the payments into bank as shown by the Paying-in Book, and primary records of cash received. He should vouch the payments. He should examine the petty cash, agreeing the amounts advanced to petty cash with the amounts appearing in the principal Cash Book from which the petty cash is fed, and he should ascertain how far the amounts advanced to petty cash are necessary to meet the expenditure.

(2) He should examine the statements of the various debtors and creditors and compare them with the relative Ledger balances.

(3) From the advice notes and delivery notes and invoices and stock records he should ascertain whether all sales and purchases have been recorded in the books, and whether the purchases are genuine and relate to the business. How far this procedure can be carried out depends upon the way in which the books and records have been kept, but the statements from the debtors and creditors will usually give a key to what is missing. He should examine the Goods Inwards and Goods Outwards Books.

(4) The original records of Cash Sales, if available, should be examined and the amounts of the sales agreed with the cash received.

(5) All expenses charged should be examined to show whether they are genuine or not.

(6) Drawings by partners and sums paid to Directors should be confirmed by the recipients.

(7) Counterfoil receipts should be checked. They may be of use, provided the receipts are not made out by the recipient of the cash; but if they have been made out by him they may have been manipulated, and they are not, therefore, conclusive evidence.

(8) The Bills Receivable and Bills Payable Books should be examined to verify that the bills receivable have been encashed or are on hand, and that the bills payable relate to the business and have been duly charged up to the respective creditors. An endorsed cheque should not be accepted as verification of payment without conclusive evidence as to the nature of the payment.

(9) The Wages Book should be verified with the assistance of someone who knows the facts as to the actual employees so that fictitious names and amounts may be identified.

The Investigator should so marshal his conclusions that if called upon to give evidence against a defaulting party, he may be able to do so in a clear and decisive manner.

VI. *Alleged negligence or lack of skill by Auditors.*

From time to time proceedings have been brought against Auditors, not on questions of principle, but on allegations that

owing to negligence or lack of skill they have failed to detect frauds by employees, which, owing to the absence of adequate control, had escaped the attention of the Directors or managers.

Professional Accountants are frequently asked to give evidence in such cases for one side or the other. As the reported cases show, very diverse views have been put forward in evidence for the plaintiff or defendant, and there is a natural tendency on the part of some witnesses to view the issue in the light of a close investigation made after the frauds have been discovered, and not to take sufficiently into account the position of the Auditor carrying out his duties at the time, in good faith, without any grounds for suspicion.

There is often a reluctance by many Accountants to give evidence in claims against their professional brethren, except on debatable matters of principle, because they realize the difficulty of determining how far, in the light of circumstances existing at the time, another Accountant may have been negligent in the performance of his work or because he left work undone. On the other hand, the public are entitled to protection and to have the opportunity of calling expert evidence to establish their case, and the accountancy profession should not adopt an attitude which has the effect of depriving them of this opportunity provided the claim is of a reasonable and fair character. (See also Chapter XIV, FRAUD IN ACCOUNTS.)

CASES

Short & Compton v. *Brackett* (1904), Acct. L.R. 85

The plaintiffs sued the defendant for payment of their fees for the preparation of accounts of a business to show the amount of profit and goodwill. The defendant counterclaimed for damages for alleged negligence on the part of the plaintiffs. A clerk had been defrauding the defendant and he thought the plaintiffs should have discovered the fraud. The clerk had made out the wages for a larger sum than was in fact payable and put the difference in his own pocket.

The plaintiffs pleaded that they were not responsible for the entries in the books; their duty was to arrive at the result as shown by the books and that the defalcations were due to the careless way in which the defendant kept his accounts.

His Honour Judge Tindal Atkinson held that, having regard to the object for which they were employed, the plaintiffs were entitled to assume that the figures appearing in the defendant's books as paid for wages were correct, and in view of the fact that at the time there was no suspicion of any defalcations by the defendant's clerk alluded to, he thought there was no negligence on their part. Therefore judgment would be for plaintiffs on the

claim with costs, and the counterclaim would be dismissed with costs.

Colmer v. *Merrett, Son and Street* (1914), 50 Acct. L.R. 21

This action was brought by the plaintiff claiming damages for alleged negligence of the defendants who had investigated a business and reported favourably upon it. The plaintiff had invested money in the Company, most of which he lost.

Lush, J., said—

Negligence meant in law breach of duty which one person owed to another who paid him to render certain services by not bringing to bear that reasonable skill and care which a professional man impliedly undertook that he would use.

The burden was upon the plaintiff to prove that the work the defendants did in the preparation of the October Balance Sheet was negligent. The defendant did not suggest that he undertook a full audit, while the plaintiff said in substance that he did. One of the first questions for the jury, therefore, was what was the real duty the defendant undertook. There was, of course, no charge of fraud against him. The report furnished by the defendant was of the greatest importance in the case, and, it seemed to him, actually set out what was undertaken to be done. That was never demurred to. The plaintiff's solicitor did not write back and say that was not what the defendant agreed to do. The plaintiff said he had taken the figures as supplied by the Managing Director, and that again was not objected to either by the plaintiff of his solicitor. The plaintiff, also, must have known from the report of the shortness of time in which the statement was prepared. It was begun on Saturday and finished on Tuesday, and as to that the defendant had stated that a full audit would have taken three weeks. This question of time seemed very important, and if the Auditor was employed to check the Managing Director and to make a full audit, then two or three days did not seem a long time to do it in. But if the jury were of opinion that the defendant undertook to act as a check upon the Managing Director and advise the plaintiff what the position of the company was as an Auditor did when he made a full audit, they might properly think that the duty had not been fulfilled and there had been a breach of it. It was very unfortunate that a gentleman who was going to invest a considerable sum in a business should have been content with having the result of two or three days' work from an Auditor authorized to accept from the Managing Director his own view of what the stock was worth, instead of having the thing done with full care.

The jury returned a verdict for the plaintiff and assessed the damages at £250. Judgment was entered accordingly.

CHAPTER XIV

FRAUD IN ACCOUNTS

FRAUD by employees is, in practice, a relatively unusual occurrence. None the less, occasions arise from time to time when frauds are perpetrated, and it is important that Auditors should be vigilant, for the detection of errors comes within the scope of their duties, and if fraud occurs and failure on their part to discover it can be proved to be due to negligence they may incur liability in damages. There is a natural inclination on the part of clients to feel that if a fraud has occurred, particularly where it has continued over a long period, blame attaches to the Auditor.

Fraud which continues for a long time is often perpetrated by a method which is sufficiently well designed to present difficulty of discovery. (In many cases lack of control by Directors or principals has made the fraud easier.) The Auditor is entitled to expect from his clients and their managers that all reasonable steps will be taken to make the perpetration of fraud difficult or impossible, and they, in their turn, are entitled to expect that he will give skilled advice as to organization of their accounting system, and that he will carry out an expert examination which will minimize the opportunity for fraud and lead to its early discovery if it occurs. Some frauds, however, are of so complicated a character that an Auditor could not reasonably be held negligent for failing to detect them. Many frauds are discovered by the merest chance. This must necessarily be so where only a limited amount of checking is carried out in the audit, and internal control fails.

As regards employees, frauds may be divided into two main classes—

(1) Falsification of the books to mask misappropriations of cash.

(2) Fraudulent dealings in stock, by misappropriation combined with falsification of records.

Certain features are common to the more elementary frauds, and discovery usually happens, either because early success induces the fraudulent clerk to continue his frauds on a progressively larger scale, more difficult to conceal, or quite simply when a certain amount of cash has unexpectedly to be produced and the defaulter cannot produce it. (A common practice in the case of misappropriation of cash is for the cashier to utilize the collections of the following day or days to make up a shortage in the payment into the bank of a preceding day. Payment into bank a day late may be easily and reasonably explained; but

where the delay grows, as inevitably it will, the cashier faces greater difficulties and, to cover his tracks, he will probably have to adjust subsequent payments into bank so that the defalcations may be hidden. This form of fraud is usually known as "teeming and lading," "log-rolling," or "cumulative abstraction." The second and third of these terms are self-explanatory.

The origin of the term "Teeming and lading" is uncertain. "Teeming" is probably the correct spelling although "teaming" is found in North Country dialect. One meaning of the phrase is emptying and loading, and this is what happens in the sort of transaction whereby a cashier steals cash received from customer "A" and, at a later date, uses a payment by customer "B" to provide the credit to "A."

On the other hand, one meaning of the word "lade" is "dip out," as with a ladle, which suggests another agreeable line of thought when dealing with fraudulent cashiers.

The English Dialect Dictionary gives "lading and teeming" as meaning living from hand to mouth, or saving in little things in order to make both ends meet.

Directors should arrange, where possible, for a distribution of the routine work which will make fraud difficult. For example, the cashier should not be in a position to tamper with the ledger accounts and, if possible, an independent record of cash as it is received should be made, and agreed by someone other than the cashier, with the amount paid in.

Some protection against misappropriation of petty cash is afforded if it is kept on the imprest system. (See VOUCHING AND VERIFYING THE CASH, Chapter V.) The Auditor should see that the amount of the petty cash in the cashier's hands bears a reasonable relation to the expenditure. If the cashier's balance is always largely in excess of the expenditure, he has an opportunity for misappropriating the surplus. This may only be discovered when the cash is counted and it is possible that the balance will be made up largely of IOU's. (*See London Oil Storage Co. Ltd.* v. *Seear, Hasluck & Co.*, page 170, *ante.*)

Misappropriation of the cash can take many forms and an employee who contemplates it will probably study the system of record and the method of dealing with the cash. The Auditor should acquaint himself with the system for dealing with cash from the time of its arrival at his client's office, whether by post or across the counter, until it is paid in to the bank. He should also examine the system under which amounts are withdrawn from the bank, for fraud may arise not only through failure to pay in but from wrongful withdrawal.

Unless the post is always dealt with by a principal, more than one person should be present when it is opened and a record

should be made in a book, not necessarily a book which forms part of the accounting system, of any money contained therein. The record should be agreed with the amount handed to the cashier's department for banking. It is a useful check for the Auditor to examine this rough book from time to time and compare it with the Paying-in Book or with the Cash Book. He should also examine the Paying-in Book by way of test to compare it with the Cash Book and ensure that the individual amounts shown in the Paying-in Book correspond as items. If teeming and lading is being practised, it will probably be found that individual items in the Paying-in Book do not correspond with the entries in the Cash Book because the cashier is using takings of another day to make up his total. The dates of the entries in the Cash Book should also be compared with the bank statement and with dates in the Ledgers. A discrepancy in dates may often indicate that payments into bank are late.

The system for the signature of cheques and withdrawal from the bank should be examined to ensure that only authorized cheques are drawn, and the receipts given by the payees should be examined both as to date and the nature of the items covered to ensure that the payments are genuine. In one case it was found that a cashier who was sent to a company's office to pay an account picked up off the counter a number of blank invoices of the customer, and took them away with him. From time to time he made out the invoices for fictitious purchases and amounts and obtained cheques from his employers for the payment of the amounts shown. The fraud came to light because it was perpetrated too often, and it was found that there was no trace of the company having received the goods mentioned on these fictitious invoices.

The system of payment of income tax under the P.A.Y.E. system opens the door to fraud unless a proper method of dealing with it is adopted. If a cheque is drawn for the gross total of the wages and the cashier is allowed to deduct the tax payable by each employee and to retain it until the monthly accounting date, he may make improper use of the money which he holds in hand, and even delay accounting to the Collector for some of the money for a protracted time. The Collector is unaware until the end of the fiscal year exactly how much should have been paid to him each month, and the check may therefore be long delayed. Cheques drawn for wages and salaries should be for the net amount payable to the employees, and the accounting to the Collector of Taxes each month should be by a cheque in favour of the Commissioners of Inland Revenue and crossed in accordance with the instructions on the collecting card.

Taxes, National Insurance contributions and other deductions are a fruitful source of fraud, and the Auditor should make a

point of carrying out an examination at uncertain intervals, and up to date, of the records of these items, including the cards. (As to investigations into fraud, see Chapter XIII, *ante*.)

Manipulation of stock is a not uncommon source of fraud. The question of pilfering of stock can be dealt with by internal control. A falsification of stock may, however, be carried out for the purpose of inflating or deflating profits. This can only be done at the expense of the following year or years, for the closing stock of one year is the opening stock of the next, and a wrongful valuation only switches the profits or losses from one year to another. The falsification cannot last indefinitely owing to the interlacing relation between sales and stock.

A rough check can be made by the Auditor when the Trading Account is prepared, by calculating the percentage relationship of the various items, including gross profit, to sales. Large variations between one year and another should be inquired into.

In one case, at the end of the first year of a new company, the whole of the stock was taken at selling prices with the result that the year appeared to be phenomenally successful, and additional capital was issued at a premium. In the following year, the results were very different and on inquiry the cause was traced to the previous valuation of stock. The Directors realized that no profits could be made in the current year on sales of stock which had been valued at selling prices (as if sold), and that the cost of selling that stock would be a charge on the profits of the current year. Although as regards stock, an Auditor must usually rely very largely on certificates by responsible officials, it is obvious that a blunder of this kind, which was due to ignorance on the part of the Directors and Secretary, should have been detected.

It may sometimes happen that the Balance Sheet and Profit and Loss Account are falsified by the Directors for the purpose of misleading the shareholders and the public. This, while not involving direct and immediate misappropriation, is usually done to enable the payment of unjustifiable dividends, and it may be to facilitate the sale of shares at an enhanced and artificial price, or perhaps to induce the public to subscribe to a new issue of shares. This, however, is uncommon nowadays, for professional practice in the art of auditing and investigation has become more incisive.

Falsification of the accounts for the purpose of misleading shareholders and the public is a large question which does not admit of detailed treatment in this volume. It may be carried out by the more simple method of omissions of liabilities, overvaluation of assets, or falsification of the stock. On the other hand, the method employed may be more subtle and deep-seated, and the Auditor will require to exercise all his skill and caution to

discover it. In some cases the presentation of the accounts though not actually involving falsification may violate accountancy and commercial principles and be misleading. This will probably involve a qualification in the Auditor's report though in all such cases the Auditor should endeavour to persuade the Directors to act in accordance with his view, rather than qualify his report. As mentioned in Chapter II, qualification of the report should be regarded as a last resort.

It should be borne in mind that errors, whether by way of omission or commission, do not always involve fraud, and may be genuine mistakes.

EXAMPLES

(1) The practice of counting cash in hand regularly on the last day of the year is not so effective as a surprise inspection at irregular dates. A very old instance is that of a toll-keeper who was allowed to retain a substantial sum in silver for the purpose of giving change. He had, however, misappropriated the money. In order to satisfy the Auditor at the end of the year, it was his practice to borrow the silver from a neighbouring publican. This practice continued for many years until the publican inconveniently died the day before the audit, when the fraud came to light.

(2) An invoice clerk received an invoice for £10, and in due course a statement for the same amount net. He altered the £10 on the invoice to £16, and procured a cheque from the cashier for £16 by producing the invoice, saying that he was calling at the payee's office, and would hand him the cheque. At the payee's office he produced the statement for £10 with the cheque for £16, explained that a mistake had been made by the cashier, got the statement receipted, also £6 in cash to pay into "Petty Cash" to square matters. He then destroyed both the invoice and the statement, and pocketed the cash. On asking for a receipt, the Auditor was shown a cheque properly drawn and regularly endorsed by the payee and cleared through the payee's bank. He, however, asked for the corresponding invoice, but there was none. On his pushing inquiries further, the whole story came out, and proved to be the first of a series of similar frauds, to which a lack of systematic control had opened the door.

This illustrates the danger of accepting an endorsed cheque, however regular on the face of it, as a voucher without supporting evidence.

(3) At the request of the Inland Revenue Authorities a professional Accountant was asked to prepare the accounts of a partnership for taxation purposes. The books consisted of a Cash Book and a Sales Ledger. The only way to arrive at the

purchases was to make a total of the payments to creditors, deducting the amount owing at the beginning of the year and adding the amount owing at the close of the year.

The Auditor took the precaution of comparing the payments in the Cash Book with the Bank Pass-book and found that many of the names in the Cash Book were false. The cheques drawn for the payments to alleged creditors were in fact made out in the names of the partners and cashed by them.

This emphasizes the value of the names of the payees and not simply the numbers of the cheques being given in the Bank Pass-book or Statement.

(4) The Secretary of a company with many branches received daily considerable sums of cash which he was supposed to pay in daily to the bank. He misappropriated part of the cash, making up the discrepancy by using the remittances from the branches to fill up the gap. The delay which arose in crediting the remittances from the branches aroused suspicion and the fraud was detected, but the money had gone. Adequate supervision by the Managing Director would have rendered this form of fraud impossible. In a well-organized business the branch remittances would be made direct to the Bankers of the company at the head office or paid in to the credit of the company at a local branch for transmission to the bank of the head office.

CHAPTER XV

THE ACCOUNTS OF EXECUTORS AND TRUSTEES

THE audit of Trust Accounts requires a close knowledge of the law relating to trusts.

Section 22 (4) of the Trustee Act, 1925, provides that the trustees may have the accounts of the trust audited once in three years unless special dealings in the trust property make a more frequent audit advisable. The Auditors' fees are payable out of income or capital or are to be apportioned between income and capital at the discretion of the trustees.

A beneficiary or a trustee may apply to the Court for an audit to be carried out under Section 13 (1) of the Public Trustee Act, 1906. The Court will appoint a solicitor, a public accountant or the Public Trustee (or some person appointed by him) to carry out the audit, and the applicant may be required to provide security for the costs of such audit.

By a study of the Acts and cases, the Auditor should acquire a thorough knowledge of the rules and decisions relating to the distinction between capital and income, which must be strictly followed, including the apportionment between capital and income of rents and profits, dividends, receipts from timber, minerals, proceeds of sales, and interest accrued due or accruing at the date of death and of income tax, whether deducted at the source or levied under Schedules A, B, or D, also of the various outgoings including rates and taxes, rents, fire insurance, repairs, upkeep of mines, improvements, costs and expenses, and items which arise in exceptional cases.

The Auditor having mastered the facts as to any particular trust should ascertain which of the statutes and rules apply to the trust and see that effect is given to them in the accounts. The provisions of a trust may, however, be altered with the consent of the beneficiaries if all are of full age.

In the interests of both trustees and beneficiaries, it is most important that all trusts should be held to a strict audit. At the first audit, the assets and liabilities should be traced to the books from the Estate Duty Affidavit and Corrective Affidavits, if any, so as to ensure that the assets have all been accounted for and the liabilities settled. A summary should be made of the testator's will and codicils thereto, if any, and care taken that the provisions of the will are observed. The rules of law as to capital and income must be followed, except where expressly excluded by the will. Gains or losses arising on realization of capital must

be added to or deducted from the corpus of the estate. In the case of obscurely worded wills, or where there are wasting assets as to which the procedure is not governed by any legal precedent, the Court is usually asked for directions, and the Auditor should be provided with a copy.

The Auditor should see that the trustees have received all the dividends and interest on investments, rents and other income that ought to have been received and should check the dividend counterfoils with the books. He should examine brokers' contract notes as to realization of stocks and shares and re-investments, and should see vouchers for all payments.

It is advisable occasionally to see that the trustees have obtained an acknowledgment from an annuitant or a life tenant of the receipt of income paid direct to a banking account under a banker's order.

The Auditor should satisfy himself that all duties payable have been ascertained and paid, or brought into account. In these matters he will have the guidance of the Solicitor to the trust.

The Auditor should satisfy himself on the following matters.

INVESTMENTS

He should see that they are all authorized either by the will or other instrument creating the trust or by law. Bearer securities which if in registered or inscribed form would be authorized investments may be held by trustees under Section 7 of the Trustee Act, 1925 (unless the instrument prohibits the holding of bearer bonds), on the condition that the bonds are deposited with a banker or banking company for safe custody. At the first audit it is advisable to inspect the bonds, but on subsequent occasions the certificate of the bailee can usually be accepted.

INCOME TAX

The Auditor should see that the testator had the full allowances for the year in which he died, and also that provision is made for any increased assessment that may arise in respect of the preceding year. If sur-tax is payable it should be seen that the last assessment has been made on the correct basis.

If there are any "free of tax" annuities he should see that the trustees obtain their share, under the rule in *Lefevre* v. *Pettit*, [1922] 2 Ch. 765, of any tax repayment that an annuitant obtains.

The Auditor should see that any Post-war Credits to which the testator was entitled are claimed. If the testator, though entitled by age, did not make a claim during his lifetime, the date of ultimate payment will depend on the respective ages of the beneficiaries to whom they are apportioned, and whether they are persons. A beneficiary cannot claim payment until he or she

has attained the age at which payment is made under the Finance Acts, 1946 and 1947, to holders.

LEGACIES

The Auditor should see, in cases where a legacy is not free of duty, that the duty is deducted, or in the case of specific legacies, recovered from the legatee. If on a free of legacy duty annuity payable out of the income of the estate, the duty is paid in advance under discount instead of by four annual instalments, this discount should be credited to income. On the death of an annuitant within five years, when the duty has been paid in advance under discount, a proportion of this duty can be recovered from the Inland Revenue and must be handed over to the annuitant's executors if the duty was originally paid by or recovered from him.

In the case of annuities, or other annual payments, created by an instrument effected before 3rd September, 1939, and not varied on or after that date and expressed to be payable free of income tax, the amounts to be paid are only twenty twenty-ninths of the amounts of the annuities, while the standard rate of income tax was ten shillings in the pound (Finance Act, 1941, Section 25), and twenty-two twenty-ninths of the amounts of the annuities while the standard rate of income tax is nine shillings in the pound (Finance (No. 2) Act, 1945, Section 20). Provision is made in the latter Act for proportionate reductions of all annual free of tax payments while the standard rate of income tax is in excess of five shillings and sixpence in the pound.

The effect of these provisions is to pass on to the recipient of the annuity or other annual payment the increased burden of taxation imposed since the rate reached the high level occasioned by the outbreak of war in 1939.

It is also necessary to ensure that, where annuities are payable free of legacy duty and income tax, the legacy duty on the freedom from income tax is accounted for to the revenue.

Legacy and Succession Duties are abolished in the case of legacies derived from persons dying after the passing of the Finance Act, 1949, and in the case of successions conferred after that date (Finance Act, 1949).

MARRIAGE SETTLEMENTS

Where one of the assets of a testator is a reversionary interest in his own marriage settlement which falls into the residue of his own estate on his death under a power of appointment or otherwise, the Settlement Deed and also the Estate Duty Account of the Marriage Settlement Trustees on Form No. C1 should be examined to see that all the assets have been included. If the

settled property comprises two or more funds the Auditor should see that each fund has borne its own death duties.

In the case of marriage settlements containing what is known as the "After Acquired Property" Clause, the Auditor should obtain a statement from the parties to the settlement that any after acquired property has been brought in.

This clause is frequently overlooked, leading to serious complications; as, for example, where one of the parties has bequeathed by will property which is in fact caught by the settlement.

PAYMENT OF DEBTS

After payment of the funeral and testamentary expenses, the payment of the debts is subject to the following rules of priority—

1. Debts due to the Crown.
2. Debts having priority by Statute.
3. Debts of record, e.g. judgments and recognizances.
4. Specialty and simple contract debts.
5. Voluntary bonds.

When the estate does not suffice to pay all the debts and legacies it must be applied in the following order, which is described as "marshalling" the assets—

1. Personalty not bequeathed, or only bequeathed by way of residue.
2. A real fund, created specifically for payment of debts.
3. Real estate devised for payment of debts.
4. Real estate not specifically devised.
5. Real or personal estate devised or bequeathed subject to payment of debts.
6. General pecuniary legacies.
7. Real or personal estate specifically devised or bequeathed.
8. Real or personal estate which the Testator had power to appoint, and which he appointed by his Will.

The principal statutes relating to Executorship Law, capital and income are as follows—

Land Clauses Act, 1845.
Apportionment Act, 1870.
Settled Land Act, 1882 (repealed 1925, except Section 30).
Settled Land Act, 1890 (repealed 1925).
Trustee Act, 1893 (repealed 1925).
Finance Act, 1894.
Judicial Trustees Act, 1896. (Section 3 repealed and replaced by Trustee Act, 1925, Section 61.)
Public Trustee Act, 1906.

Law of Property Act, 1922 (repealed 1925).
Agricultural Holdings Act, 1923.
Settled Land Act, 1925.
Trustee Act, 1925.
Law of Property Act, 1925.
Administration of Estates Act, 1925.
Judicature Act, 1925.
Landlord and Tenant Act, 1927.

The Auditor should, if necessary, make a detailed report on the Trust accounts. It is well to attach to the account a schedule distinguishing between securities in respect of which income has been received during the trust year, and those in respect of which no income has been received, thus bringing the facts before the executors or trustees.

In Scotland, a special form of account, known as "Account Charge and Discharge," is raised in the case of trust estates, and appears to be more easily followed than the ordinary Balance Sheet.

The conflicting interests of life owner and remainderman have been a fruitful subject of litigation. There are at least 140 reported cases by which the statutes have been elucidated. Among the rules in this connexion requiring careful consideration may be mentioned the rule in *Allhusen* v. *Whittell* (1867), L.R. 4 Eq. 295; followed and developed in *Lambert* v. *Lambert* (1874), L.R. 16 Eq. 322; *McEuen* v. *Phelps*, [1913] 2 Ch. 704; and *Wills* v. *Hamilton*, [1915] 1 Ch. 769; also the rule in *Howe* v. *Lord Dartmouth* (1802), 7 Ves. 137, which is more general in its application. The rule in *re Fawcett, Public Trustee* v. *Dugdale*, [1940] Ch. 402, deals in detail with the question of income from unauthorized investments.

One of the most important duties of an Auditor is to ascertain that proper adjustments have been made between capital and income, and to this end he must bear in mind the sections of the Apportionment Act, 1870.

It is impossible here to refer to all the cases which have been decided in the Courts, but the following may be perused with interest.

A testator who died in December, 1913, bequeathed his residuary estate to trustees upon trust to pay the dividends and income thereof to his wife for life, and after her death to stand possessed of the residuary estate in trust for his nephews and nieces. The widow died on 24th July, 1915. Part of the residuary estate consisted of stocks in three railway companies. In September, 1915, each of these railway companies declared a dividend, payable about a month afterwards, for the half-years ending on the preceding 30th June, 1915.

Held, that the Apportionment Act, 1870, applied, and the estate of the tenant for life was entitled to the whole of these dividends. "A provision in the Articles of Association of the company that a dividend shall be deemed to accrue and fall due on the day on which it is declared and not before does not exclude the Apportionment Act, 1870." In *Re Oppenheimer*, [1907] 1 Ch. 399 followed.

Stock in a public company forming part of a testator's residuary estate was settled upon trust for *A* for life, and after her death "to pay, transfer, and assign my residuary estate, and the stocks, funds, and securities upon which the same shall be invested unto and amongst" certain beneficiaries. After the death of the tenant for life the stock was sold "cum dividend" under an order of the Court for the purpose of distribution. This order was made in the absence of the legal personal representatives of the tenant for life. After the sale a dividend was declared and received by the purchaser in respect of profits, a portion of which had been earned prior to the death of the tenant for life.

Held, that the estate of the tenant for life was not entitled under the Apportionment Act, 1870, to be paid out of the purchase money of the stock anything in respect of the dividend; but, inasmuch as if the trust had been strictly carried out in accordance with the terms of the will, by transferring the investments to the beneficiaries, the representatives of the tenant for life would have been in a position, either directly or through the trustees, to obtain payment of an apportioned part of the dividend, their claim ought under the special circumstances of the case to be acceded to.—*Bulkeley* v. *Stephens*, [1896] 2 Ch. 241.

Whenever there are periodical payments accruing when the event calling for apportionment occurs, the Act is at once brought into operation and must be applied, and when, subsequently, the accruing payments become due and payable they must be distributed in accordance with the Act as applied on the occurrence of the event which brought it into operation. Dividends declared after the life-tenant's death in respect of a period commencing and ending in his life-time belong entirely to his estate.—*Re Muirhead*; *Muirhead* v. *Hill*, [1916] 2 Ch. 181.

Shares in a company were settled upon trust to pay *A* during her life "the interest, dividends, share of profits or annual proceeds," and after her death in trust for her children. The deed of settlement of the company provided that, by the vote of the majority, out of the half-yearly profits a dividend might be declared, and a sum reserved for such contingencies as the Directors should specify. During *A's* lifetime an addition of three new fully paid-up shares to those already held in trust for her was made, pursuant to a resolution passed at a general meeting of the

company to apply a portion of "the net earnings during the half-year" to necessary works, and issue new shares to represent the money so applied, a dividend being declared out of the remaining portion of the earnings.

It was held that these new shares were capital, and not income, as between tenant for life and those entitled to the remainder.—*Re Ezekiel Barton's Trust* (1868), L.R. 5 Eq. 244. This applies when a company resolves to capitalize its current profits.

The capital of a company was divided into 10,000 shares of £10 each, of which 3728 shares only had been issued and were fully paid-up. The company was very prosperous, and the market value of its shares was £30 each. In February, 1912, the Reserve Fund of the company exceeded £50,000, and the Directors proposed a scheme for distributing part of the Reserve Fund, representing accumulated undivided profits, amongst the shareholders, so that every shareholder would get a bonus of one new fully-paid £10 share for every existing share held by him. Accordingly, resolutions were passed by the company (*a*) empowering the Directors to declare a bonus dividend out of the Reserve Fund, and (*b*) sanctioning the distribution of a bonus dividend of £10 per share out of the Reserve Fund, authorizing the further issue of 3728 shares of £10 each out of the unissued capital of the company to be allotted *pro rata* amongst the existing shareholders, and directing that such new shares be paid up in full forthwith. The Directors then sent a circular letter to every shareholder with a warrant for the bonus dividend on his shares, informing him of an allotment to him of his proportion of the new shares and giving him an option to accept or refuse the allotment, and stating that if he accepted the allotment he was to endorse and return the dividend warrant to the company to be applied in payment of the new shares. The trustees of a testator's will held 200 shares of the company and, on receipt of the circular letter, accepted their allotment of 200 new shares, endorsed and returned their bonus dividend warrant for £2000 and afterwards sold the new shares at a profit. The question then arose whether, as between the tenants for life and the remaindermen under the will, the bonus dividend was capital or income.

Held, on the evidence, that the company intended to capitalize the Reserve Fund and not to distribute it as a bonus dividend, and therefore that the whole of the bonus dividend was capital of the testator's estate. The principle of *Bouch* v. *Sproule* (1887), 12 App. Cas. 385, applied.—*Re Evans*, *Jones* v. *Evans*, [1913] 1 Ch. 23.

The Directors of a company resolved to distribute accumulated profits as a bonus dividend of 50 per cent on the capital paid up, the dividend to be payable on the 6th of September, 1890. The

dividend was, at the option of the shareholders, payable in cash, or applicable to the payment of the amount then due in respect of new shares or of calls. The old shares were £10 shares, some fully paid up and some £7 10s. paid up, and the distribution was made in the proportion of one new share for every two old shares fully paid up, and one new share for every eight old shares with £7 10s. paid up. A call of £2 10s. per share was to be made at the same time on such of the shares as were not fully paid up. The trustee of a will who held 150 old shares fully paid up (the tenant for life consenting, without prejudice to his rights to treat the dividend as income) accepted seventy-five new shares in lieu of the £750 bonus dividend on the 150 shares. The shares were sold for £1363. The tenant for life claimed £750 out of the purchase money on the ground that it was income; he did not dispute that the balance was capital.

It was held that the £750 was income, on the ground that the declaration of the bonus dividend and the issue of the new shares were two distinct transactions and not one transaction, as in *Bouch* v. *Sproule* (1887), 12 App. Cas. 385, the shareholders having the option of taking the dividend in cash without taking up the new shares.—*Re Northage, Ellis* v. *Barfield* (1891), 60 L.J. Ch. 488.

In a case where a testator bequeathed his residuary personal estate to his executor in trust for the testator's wife for her life, and after her death to his executor, part of the residuary estate consisted of shares in a company whose Directors had power before recommending a dividend, to set apart out of the profits such sum as they thought proper as a Reserve Fund for meeting contingencies, etc. After the testator's death the Directors of the company distributed certain accumulated profits (which had been temporarily capitalized) as a bonus dividend, allotted new shares (partly paid up) to each shareholder, and applied the bonus dividend in part payment of the new shares. It was held by the House of Lords that, looking at all the circumstances, the real nature of the transactions was that the company did not pay or intend to pay any sum as dividend, but intended to and did appropriate the undivided profits as an increase of the capital stock; that the bonus dividend was therefore capital of the testator's estate, and that the life tenant was not entitled to the bonus or the new shares.—*Bouch* v. *Sproule* (1887), 12 App. Cas. 405.

Note. If a company gives a *clear* option to take the profits, either as a cash dividend or in the form of new shares the cash would be income. But the terms of the offer are vital to the question.

A testator bequeathed three annuities charged upon the income and corpus of his residuary estate. The whole of his estate was settled in strict settlement upon his son and grandson. The income

was insufficient to keep down the annuities, and £19 4s. 7d. was raised out of capital to satisfy the annuity of the first annuitant, who died in 1911. Sums amounting to £32 3s. 10d. had also been paid out of capital to the two surviving annuitants. It was now anticipated that there would be a surplus income in the hands of the tenant for life after satisfying the annuities. On a summons by the trustees of the will to ascertain whether this income should be applied in recouping to capital those sums raised thereout, or either of them—

Held that, having regard to the decision in *Prince* v. *Cooper* (1853), 17 Beav. 187, and to the fact that the annuities were charged upon capital as well as income, the tenant for life could not be called upon to replace the deficiency raised out of capital.—*Re Croxon, Ferrers* v. *Croxon*, [1915] 2 Ch. 290.

The Auditor in certain cases has to ascertain that the tenant for life of a testator's residuary personal estate should only receive the income of the true residue. In other words, he must be careful to ascertain that the life tenant does not receive the income of capital to which he is not entitled and which is legally required to pay the debts of the testator, legacies, and certain other payments. For this purpose he must make himself acquainted with what is known as the rule in *Allhusen* v. *Whittell* and see that it has been followed. The rule is to the following effect. It must first be ascertained what is the amount of capital of the testator at the date of his death plus the gross income, including income accrued, of the first year succeeding the testator's death. This will practically form the total fund which, when ascertained, is available for the payment of debts, legacies, and other deductions. Secondly, there must be ascertained the amount that may be required to pay such deductions (which do not form any part of what may be described as the true residue to which the tenant for life is entitled). The proportion of the income of the first year attributable to the secondly ascertained amount will be according to the ratio the sum required to pay debts, legacies, etc., bears to the total fund available for the payment thereof. In other words, the life tenant of residual personal estate is not entitled to any income from the portion of the estate which is required for the payment of the testator's debts, funeral, testamentary expenses, and immediate legacies.

The following cases bear on this rule—

The Rule laid down in *Allhusen* v. *Whittell* (1867), L.R. 4 Eq. 295, was that in adjusting the accounts between the tenant for life of the residuary estate of a testator and the remaindermen the executors must be taken to have paid the debts and legacies not out of capital only or out of income only, but with such portion of the capital as, together with the income of that portion for

one year from the testator's death, was sufficient for the purpose. Although it worked perfectly in that case and works equally well in any case where the capital subtracted from the gross estate before the ascertainment of residue is not subtracted before the end of the first year from the testator's death, it is not to be slavishly followed in every administration where residue is settled, and is inapplicable in hard and fast terms to a case where the subtractions from the estate occur at periods substantially anterior to the close of the first year.

A testator died on 6th February, 1911, having by his will given legacies to be paid free of all duty, and given his residuary estate as to each of four fifths thereof in trust for one of certain persons for life, with remainder to his or her children. The executors paid the estate duty, legacy duty, legacies and debts at various dates during the year immediately succeeding the testator's death, for instance, over £47,000 for estate duty on 1st April, 1911, legacy duty of £1370 on 1st July, 1911, legacies of about £14,000 in June and July, and debts and funeral expenses amounting to nearly £600 in May, 1911.

Held, (1) that the equitable book-keeping or mode of adjustment to be adopted, on taking the account of the share of income during the year succeeding the testator's death due to the tenants for life, was that there should be charged against them, in respect of the payment for estate duty, debts, funeral and testamentary expenses, and duty on legacies given free of duty, interest upon the capital sum which would, with such interest, make up the sums paid in respect of estate duty, etc., such interest being calculated only during the respective periods from the death of the testator until the respective times when the sums paid for estate duty, etc., were in fact paid; and (2) that the method of adjustment adopted in this particular case was not the only method available, and that extremely elaborate and minute calculations need not be gone through, in every case.—*Re McEuen, McEuen* v. *Phelps*, [1913] 2 Ch. 704. The rate of interest to be used should be agreed between all the interested parties and income tax should be taken into consideration in fixing the rate.

A testator, by his will, gave his real and personal estate not thereby otherwise disposed of, therein called his residuary estate, to his trustees in trust to sell, and out of the proceeds pay or provide for debts, funeral and testamentary expenses, legacies and annuities, and duties, and to divide the residue into nine equal shares, and to invest and pay the income of one-ninth share to each of his three daughters during her life with remainders over, and (by Clause 15) the testator empowered his trustees to postpone the sale and conversion of all or any part of his real and personal estate as long as they should think proper, and directed that the income

from his estate however invested should, after his death, be treated as income, and no part thereof should be added to capital. Testator died in 1909 leaving an estate of great value. The payments required to be made out of his residuary estate in respect of debts, legacies, duties, etc., were not concluded till the expiration of five years from the date of the testator's death. The average rate of interest earned by the estate in each of these five years varied considerably. On an originating summons raising the question how the accounts ought to be adjusted between the tenants for life and the remaindermen of the daughters' settled shares of residue:

Held, that the direction contained in Clause 15 of the will did not displace the rule in *Allhusen* v. *Whittell* (1867), L.R. 4 Eq., 295, and *Re McEuen*, [1913] 2 Ch. 704.

Held, also, that the true principle was to deprive the tenant for life of the income of such a sum as together with interest thereon from the date of the testator's death down to the date of payment, was sufficient to satisfy the liabilities.

Held, also, that the principle was not limited to the payments made during the first year from the testator's death, but applied equally to payments made during the subsequent years.

Held, also, that the average rate of interest earned by the estate in each year ought to be adopted for the purpose of this calculation.

Held, also, that as regards estate duty the total amount paid for duty and interest thereon ought to be treated as the debt or liability to be paid or discharged.—*In re Wills, Wills* v. *Hamilton*, [1915] 1 Ch. 769.

Note. A well advised testator will exclude the Rule in *Allhusen* v. *Whittell* from his will for it is difficult and costly to apply.

By his will a testator empowered his trustees to invest any part of the trust estate in "the debentures or debenture stock, or preference stock of any railway or other company in the United Kingdom."

Held, that inasmuch as there was a distinction, although a minute one, between the two classes of investments described as preference stock and preference shares, it was not within the power of the trustees to invest any part of the trust estate in the fully-paid preference shares of any joint stock company.—*Spencer* v. *Wills*, [1911] 2 Ch. 563.

The life tenant of the residue is not, in the absence of any special provision in the will, entitled to the income produced by unauthorized investments. The rule is that such investments must be sold and the proceeds invested in consols or other authorized investments of a permanent character.—*Howe* v. *Lord Dartmouth* (1802), 7 Ves. 137. By the Law of Property Act, 1925, Section 28, subsection 2, leaseholds held upon trust for sale have been taken

out of the rule as from 1st January, 1926, unless there is a direction in the will to the contrary (*Re Brooker*, [1926] W.N. 93), and it seems that this rule does not now apply to any leaseholds.

The Rule does not apply to real estates.

The application of the rule in cases where conversion does not immediately take place is as follows—

(i) The life tenant is entitled to interest at four per cent per annum, less income tax, on the aggregate market value of the unauthorized investments still held at the end of the executor's year, and at the end of each succeeding year, and to interest at the same rate on the net proceeds of sale of the unauthorized investments sold, calculated for the part of the year from death, or the last anniversary thereof before sale.

(ii) Where the actual income from the unauthorized investments is more than sufficient to pay to the life tenant the amount due to him under (i) the surplus must be invested in authorized investments.

(iii) Where the actual income from the unauthorized investments is not sufficient to pay to the life tenant the amount due to him under (i) the deficiency must be made up out of future excess income from unauthorized investments or the net proceeds of future sales of such investments.

(iv) No statutory apportionments either at the death or any other date are to take place in connexion with the actual income received from the unauthorized investments.

(v) The life tenant will receive the full income from all the authorized investments in the normal way.—*Re Fawcett, Public Trustee* v. *Dugdale*, [1940] Ch. 402.

Attention should also be paid to the rule in *re the Earl of Chesterfield's Trusts* (1883), 24 Ch.D. 643, where part of a settled estate consists of outstanding personal estate which is not realized on the death of the settlor. In such a case capital must be credited with such a sum as, had it been invested on the death of the settlor at four per cent per annum less income tax, calculated at compound interest with yearly rests, would have produced the sum actually received by the Trustees on the date they realized the outstanding personal estate or it fell into possession. The life tenant will then receive the balance, which is the notional interest, calculated as above, on the capital sum.

The expression "testamentary expenses" in a will includes the estate duty in respect of the personal property of which the testator or other person whose "testamentary expenses" are referred to was competent to dispose at his death.

A direction for the payment of "testamentary expenses" may extend to the expenses of administration under the intestacy of some other person.

A testator by his will gave his residuary estate to trustees upon trust to convert and to invest the net proceeds and pay the income to his wife during her life; and after her decease he directed his trustees, after paying his widow's funeral and "testamentary expenses" and debts, to apply his residuary estate as therein mentioned. The testator's wife survived him, and signed a document which purported to be her will. After her death the plaintiff and her brother, who were in the same relationship to the widow and were her next-of-kin, disputed the will, and the brother brought an action in the Probate Division to have a grant of administration to the estate of the widow made to him. The Court pronounced against the alleged will, but made no order as to costs. Letters of administration to the widow's estate were subsequently granted to the plaintiff with the assent of her brother.

Held, that the direction for payment of the "testamentary expenses" of the testator's widow extended to (1) the costs and expenses of the plaintiff in obtaining the letters of administration, and in connexion with the administration of the estate of the widow; (2) the costs of the brother of the action in the Probate Division; and (3) the estate duty payable on the death of the widow in respect of her personal property.—*Re Clemow, Yeo* v. *Clemow*, [1900], 2 Ch. 182.

Where a testator empowers the trustees of his will to invest moneys in (amongst other things) the "stocks, funds and securities (not payable to bearer) of any corporation or company, municipal, commercial or otherwise," the clause does not confine the trustees to the stocks, funds and securities of corporations and companies formed or registered in the United Kingdom.—*Re Stanley, Tennant* v. *Stanley*, [1906] 1 Ch. 131.

The plaintiff's costs of an unsuccessful action impeaching the validity of a will, though ordered by the Judge of the Probate Division to be paid out of the testator's estate, are not testamentary expenses.—*Re Prince, Godwin* v. *Prince*, [1898] 2 Ch. 225.

Settlement estate duty on personalty is not a testamentary expense, although the executor is accountable for it. It is, therefore, payable out of the settled property under the Finance Act, 1896, Section 19, Subsection (1), notwithstanding a direction in the will to pay testamentary expenses out of residue.—*Re King, Travers* v. *Kelly*, [1904] 1 Ch. 363.

Estate duty payable in respect of real estate is not a "testamentary expense" within the meaning of a direction contained in the will of a testator who died after the Land Transfer Act, 1897, for payment of his debts, funeral and testamentary expenses, out of his personal estate.—*Re Sharman, Wright* v. *Sharman*, [1901] 2 Ch. 280.

A testatrix having directed the executors and trustees of her will to pay her testamentary expenses, bequeathed (*inter alia*) certain specific personalty, over which she had a general power of appointment, to her trustees upon trust for certain specific legatees. She devised and bequeathed her residuary real and personal estate to her trustees upon trust for sale and conversion, the net proceeds to be paid to certain residuary legatees.

It was held by Swinfen Eady, J., that the appointed fund had passed to the executors "as such" within the meaning of the Finance Act, 1894, Section 9, Subsection (1), so that the estate duty was payable out of residue. *Held, also*, that the will itself imposed this duty on the residue, the residuary estate being what remained after satisfying the previous dispositions of the will, including the direction to pay testamentary expenses, which covered estate duty.—*Re Fearnsides, Baines* v. *Chadwick*, [1903] 1 Ch. 250.

A testatrix by will settled certain real property upon several persons in succession, and directed her trustees to stand possessed of her residuary personal estate upon trust to pay (amongst other things) the estate duty on the whole of the real and personal estate devised and bequeathed by her will. It was held that "estate duty" included "settlement estate duty."—*Re Leveridge, Spain* v. *Lejoindre*, [1901] 2 Ch. 830.

A testatrix, after giving a specific legacy on trust by way of settlement, directed that her debts, funeral and testamentary expenses, "including all duties payable by law" out of her estate, and including the duties on certain annuities given by her will, and on all legacies bequeathed by her duty free, should be paid out of funds which she designated. She then directed certain legacies to be paid out of these funds free of duty. It was held that the special direction in the will for payment of duties payable by law out of the testatrix's estate referred to duties which by law were payable out of the general residuary estate of the testatrix, and not to duties which by law were made payable out of specific property, and that therefore the direction did not amount to such an express provision as was required by Section 19 of the Finance Act, 1896, in order to make the settlement estate duty payable, otherwise than out of the settled legacy. *Held* accordingly, that the settlement estate duty payable in respect of the settled legacy must be paid thereout.—*Re Lewis, Lewis* v. *Smith*, [1900] 2 Ch. 176.

Where a general power of appointment over a fund is exercised by will, the appointed fund does not pass to the executor as such; consequently, the estate duty in respect thereof (in the absence of any direction in the will to the contrary) is payable out of the fund; but such estate duty falls within the description of testamentary expenses; consequently, where the will contains a

direction to pay testamentary expenses out of the residue, the estate duty in respect of the fund is payable out of the residue.—*Re Treasure, Wild* v. *Stanham*, [1900] 2 Ch. 648.

This decision of Kekewich, J., was not followed by Buckley, J., *Re Moore, Moore* v. *Moore*, [1901] 1 Ch. 696, but was followed by Byrne, J., *Re Power, Re Stone, Acworth* v. *Stone*, [1901] 2 Ch. 659. It was referred to by Kekewich, J., in *Re Sharman, Wright* v. *Sharman*, [1901] 2 Ch. 280, and followed by him in *Re Maddock, Llewelyn* v. *Washington*, [1901] 2 Ch. 372.

When pecuniary legacies or shares of the residue of a testator's personal estate are settled by his will, no part of either the estate duty or the settlement estate duty imposed by the Finance Act, 1894, is to be borne by the settled legacies or shares, but the whole of those duties must be borne by the general residue.—*Re Webber. Gribble* v. *Webber*, [1896] 1 Ch. 914.

Simple contract debts cannot be paid in preference to specialty debts in the case of an insolvent estate.—*Re Hankey, Cunliffe Smith* v. *Hankey*, [1899] 1 Ch. 541.

The commission charged by an estate agent for procuring a building lease of settled land for a tenant for life under the Settled Land Act, 1882, is payable out of capital money arising under the Act.—*Re Maryon-Wilson's Settled Estates*, [1901] 1 Ch. 934. But not his charges for letting for a short term.—*Re Leveson-Gower*, [1905] 2 Ch. 95.

The income fee payable to the Public Trustee in respect of life annuities bequeathed by a will is payable out of those annuities and not out of residue.—*Re Bentley, Public Trustee* v. *Bentley*, [1914] 2 Ch. 456.

A bequest of "moneys owing to me at the time of my decease" has been held to include moneys on deposit at a testator's bank, whether notice of withdrawal is or is not required in respect of the same.—*Re Derbyshire, Webb* v. *Derbyshire*, [1906] 1 Ch. 135.

A bequest of "moneys at the bank" did not include an unused letter of credit held by the testator, according to an opinion given by counsel.

A testatrix specifically bequeathed all the "stocks, shares, debentures, debenture stock, and all other securities which shall be standing in my name at my decease." At her decease the testatrix was possessed of foreign Government Bonds to bearer, which, together with certain stock certificates, were kept by her bankers in an envelope, marked outside with her name and also with a reference to the page of a safe custody register kept by the bankers on which the securities were entered under the heading of her name—

Held, that the bonds to bearer were not included in the specific bequest.—*Re Mayne, Stoneham* v. *Woods*, [1914] 2 Ch. 115.

Interest on advances made by the trustees under a will which has to be brought into hotchpot must be calculated at the rate of 4 per cent per annum.—*Re Davy, Hollingsworth* v. *Davy*, [1908] 1 Ch. 61.

When a testator empowers the trustees of his will to invest in the stocks, funds, and securities of "any corporation or company, municipal, commercial, or otherwise," the words "corporation or company" mean an incorporated body or unincorporated body which is "municipal, commercial or otherwise," and which is of such a kind as not to be what is commonly called "a firm." The word "company" has no strictly technical meaning. It involves two ideas, namely: first, that the association is of persons so numerous as not to be aptly described as a firm; and, secondly, that the consent of all the other members is not required to the transfer of a member's interest.—*Re Stanley, Tennant* v. *Stanley*, [1906] 1 Ch. 131.

When trustees hold shares of a company belonging to the trust, and they are appointed Directors of the company in respect of such holding, and there is no provision in the will enabling them to retain their remuneration as such Directors for their own benefit, they must account for such remuneration to the trust, and the remuneration is to be treated as capital, and will go to the remaindermen as an accretion to their shares.—*Re Francis* (1905), 92 L.T. 77; but the decision in *Re Dover Coalfield*, [1908] 1 Ch. 65 suggests that the fees do not belong to the trust.

A testator directed payment out of the income of his estate of £200 per annum "free of all duties" to a solicitor-trustee for his trouble in acting as a trustee of his will, so long as he should continue to act as such trustee, and also in addition gave him power to charge and be paid for professional and other charges.

Held, affirming the decision of Neville, J., that the sum of £200 was to be paid subject to and not free of income tax.—*Re Saillard, Pratt* v. *Gamble*, [1917] 2 Ch. 401.

On the death of a testator carrying on a business, accounts would normally be made up to the date of death. On the death of a partner in a firm the capital of the deceased would be ascertained in a similar manner or in accordance with the provisions of the partnership deed, and in both cases no difficulty should arise in apportioning the receipts between capital and income.

On the death of a life tenant entitled to the profits of a business or a share thereof, however, as between his estate and the subsequent life tenant or the remainderman, the Apportionment Act, 1870, does not apply and the profits belong to the person entitled to the income at the end of the period for which the profits are declared.—*Browne* v. *Collins* (1871), L.R. 12 Eq. 586. For example, if a life tenant dies in February and on 1st May following

the trustees receive an amount on account of the profits of the business in respect of the year ended 31st December preceding, such sum would belong to the life tenant's estate, but if in respect of the year ended 31st March, to the subsequent life tenant or to the remainderman.

A partner, on retiring from his firm, left his capital in the business under an agreement with the continuing partners that it should be a debt due from them to him, and bearing interest until repayment. The agreement contained a stipulation that the outgoing partner should have free access to the books at all times, and various provisions intended to satisfy the outgoing partner from time to time of the solvency of the business; upon breach of any one of these provisions he was to be at liberty to call in his capital. The outgoing partner subsequently died, having by his will bequeathed his residuary estate, which included his capital in the business, to a trustee, upon trusts for one for life and for others in remainder.

It was held by the Court of Appeal that the trustee was at liberty to employ professional accountants and valuers for an audit and stocktaking once a year, if desired, or oftener if special circumstances so required, and that the expenses of these audits were costs, charges, and expenses incurred by the trustee in the execution of the trusts of the will for the benefit of the whole estate, and were therefore payable out of capital, and not out of income.—*Re Bennett, Jones* v. *Bennett*, [1896] 1 Ch. 778.

Note. In an unreported case the Court directed that the Auditor's fees should be charged to capital. See also Section 22 (4) of the Trustee Act, 1925, referred to earlier in this chapter, regarding the apportionment of Auditors' charges.

A bequest of shares in a limited company, coupled with a declaration that the shares so bequeathed shall carry the dividend accruing thereon at the testator's death, operates as an exclusion of the Apportionment Act.

A testator bequeathed certain shares in a limited company to trustees upon trust to sell, with a power of postponement, and stand possessed of the proceeds and the shares remaining unsold upon trust to receive the annual produce thereof and hold the same in trust for the testator's children and remoter issue in succession, and declared that every share bequeathed by his will should carry the dividend accruing thereon at his death. The dividends were payable annually. It was held by the Court of Appeal that the trustees should take the whole of the dividend for the year in which the testator died without apportionment, and that such dividend was payable as income to the tenants for life under the will.—*Re Lysaght, Lysaght* v. *Lysaght*, [1898] 1 Ch. 115.

A testator directed that the whole of the income of stocks, out of which his wife was entitled to an annuity, should be paid to her during widowhood. It was held that he had expressly stipulated, within the meaning of Section 7 of the Apportionment Act, 1870, that that Act should not apply.—*Re Meredith, Stone* v. *Meredith,* [1898] W.N. 48.

The Apportionment Act, 1870, is not excluded by a power to postpone a trust for sale coupled with a direction that pending sale "the whole of the income of property actually producing income" shall be applied as from the testator's death as income.—*Re Edwards, Newbury* v. *Edwards,* [1918] 1 Ch. 142.

The word "dividends" in the Apportionment Act of 1870, Section 2, includes payments by way of bonus or surplus profits to the shareholders of a public company, even though such payments may be only occasional and not strictly periodical, but "dividend" does not include payments by way of a return of capital.—*Re Griffith, Carr* v. *Griffith* (1871), L.R. 12 Eq. 655.

Executors and trustees are bound to keep accounts, and to give a satisfactory statement of the state of a testator's assets.—*Ottley* v. *Gilby* (1846), 8 Beav. 692.

In a case where proceedings for administration are rendered necessary by the gross and indefensible neglect of trustees to deliver accounts, the defaulting trustees may be ordered to pay all the costs, including the costs of taking and vouching the accounts. Such an order may be made in proceedings commenced by originating summons.—*Re Skinner, Cooper* v. *Skinner,* [1904] 1 Ch. 289.

The Court will not as a rule control a trustee's discretion as to investments.—*Lee* v. *Young* (1843), 2 Y. & C.Ch.Cas. 532. The Trustee Act, 1925, lays down what are authorized trustee securities and contains important provisions as to the power of trustees and the care to be exercised by them.

When a testator gives power to his trustees to appoint a factor to the estate, who may be one of themselves, but at the same time guards that provision with this further one: that the other trustees shall at least once in every year, within one month from the termination of the year, examine and audit the whole of the last year's accounts, require vouchers, and see that the accounts had been properly kept, and that the money had been properly received and properly applied, the trustees are guilty of *culpa lata* if they fail to call for annual accounts.—*Carruthers* v. *Carruthers,* [1896] A.C. 659.

A trustee, who was himself one of the beneficiaries, had inadvertently overpaid the other beneficiaries their share of income, and died before any adjustment had been made. It was held that the executors of the deceased trustee were not entitled to

, ecover from the other beneficiaries the amounts so overpaid, or to have accrued, or future income impounded till the shares were equalized, by reason of the fact that their testator himself was the person responsible for the mistake that had been made.—*Re Horne, Wilson* v. *Cox Sinclair,* [1905] 1 Ch. 76.

It is a breach of trust for trustees, having the ordinary power to invest on "real securities," to invest on a contributory mortgage in the absence of an express authority.—*Webb* v. *James* (1888), 39 Ch.D. 660.

Trustees are not justified in advancing trust moneys on a second mortgage (*Drosier* v. *Nelson,* [1876] W.N. 225) or on mortgages of leaseholds (*Re Chennell* (1877), 8 Ch.D. 492).

Trustees who lend a larger sum than is authorized on security of property will not be chargeable with breach of trust if in making the loan they acted on a report of a person whom they believed to be a competent valuer (Section 8 of the Trustee Act, 1925), but the valuer should be employed by the trustees themselves.—*Conn* v. *Wilson* (1888), 39 Ch.D. 39.

This Section, which replaces and extends Section 5 of the Trustee Act, 1888, will not, however, help trustees who take hazardous securities.—*Blyth* v. *Fladgate,* [1891] 1 Ch. 337.

Re Crabtree, Thomas v. *Crabtree* (1912), 106 L.T. 49

Under the will of the testator, the trustees were given power to carry on his business during the lifetime of his wife, the profits arising from the business to be paid to her.

In arriving at the profits, depreciation at the rate of 7½ per cent was written off machinery on its original cost, as well as repairs. The life tenant objected and brought an action to have the depreciation disallowed. The Court of Appeal decided that the depreciation was a proper charge.

Cozens Hardy, M.R., said—

> In the ordinary course of ascertaining the profits of a business where there is power machinery and trade machinery, which is necessary in order to perform the work of the business, it is, in my opinion, essential that, in addition to all sums actually expended in repairing the machinery, or in renewing parts, there should be also written off a proper sum for depreciation, and that sum ought to be written off before you can arrive at the net profits of the business, or at the profits of the business, and it is not profit until a proper sum, varying with the class of machinery, with the nature of the business, and the life of the machinery, has been written off for depreciation.

All payments and receipts on account of War Damage (including War Damage Contribution) are, by the War Damage Acts, capital. Auditors of accounts of Executors and Trustees should verify that a proper distinction has been made between repairs to properties to make good war damage and normal day-to-day repairs.

CHAPTER XVI

PARTNERSHIPS

As far as partnership accounts are concerned, a complete audit is required sometimes by the active partners themselves, sometimes by a sleeping partner, by a retired partner whose interests have not been liquidated, or it may be by trustees or others interested in the partnership business. More frequently, however, a professional Accountant is employed simply to prepare a true and correct Balance Sheet for all parties, an arrangement which is often loosely referred to as an audit. The Accountant should take care that there is no misunderstanding as to the actual duties he has undertaken. It is desirable in every case to have a clear arrangement reduced to writing, otherwise the Accountant may assume a responsibility which he at least had never contemplated. For example, in an action for damages for negligence, it has been held that an accountant employed to check books and prepare a Balance Sheet should agree the Cash Book with the Bank Pass-book, or inform his client he has not done so, though, as every Auditor knows, a Bank Pass-book is not conclusive evidence without the banker's certificate as to the balance, since the Bank Book itself is capable of being manipulated. Many private limited companies, which are the conversion of partnerships into companies in which the partners become the sole directors and shareholders, retain all the business characteristics of a partnership, and on the ground of expense the director-shareholders frequently seek only a partial audit. But in such cases the Auditor must perform the full duties required by statute.

A summary should be made of the conditions laid down in the partnership deed as to partners' salaries, Capital Accounts, Drawings Accounts, Loan Accounts, interest on capital and loans, interest on drawings, and any other material points, particularly those of a financial character. If there be any points as to accounting in the agreement which are obscure, they should be cleared up by means of a supplementary agreement.

The method of dealing with the annual results varies with different firms. If separate Drawings Accounts are kept for the respective partners, it is usual to credit each partner with his share of the profits and interest on his capital, debit his drawings, with interest thereon if chargeable, and to carry forward the balance or credit it to his Capital Account. Or the whole of the entries may be made in the Capital Account. If the latter method is adopted, each partner's capital will vary from year to year, and this practice should not be followed unless it is in accordance with

the partnership deed. It may be that any surplus over the amount of capital for which the deed stipulates should be treated as a loan to the partnership, ranking as between the partners before the stipulated amount of capital, and carrying interest at a different rate, or there may be no provision at all to meet the case. Where a Partner's Capital Account shows a deficiency, it is also a common practice to charge interest on the amount of the deficiency regardless of the fact that this charge may not be stipulated in the partnership deed. Any departure such as this from the terms of the deed should be brought to the notice of each partner.

The Auditor should see that any borrowings of the firm's money by a partner, or any moneys due by a partner to the firm for goods supplied by the firm to him are not included among Sundry Debtors, but clearly set out in the accounts. He should also see that all the partners sign the amounts as correct.

Income tax paid by the firm should be treated as a drawing, and charged to the partners' individual accounts according to their individual liability, which is based upon the partner's salary, interest on capital less interest on drawings, and his share of the profits after deducting these items and taking into account any claims for relief.

Interest on drawings should be charged where the drawings are unequal as to date and amount. Each partner should be asked to agree the amount of his drawings. Where partners are lax as to control of drawings, a dishonest cashier has been known to appropriate money and enter it as partners' drawings, and—an extreme case—the drawings of a deceased partner have been known to continue (according to the books) for some time after his demise. If there are any agreements with third parties restricting drawings, see that the agreements are complied with.

The most satisfactory method of dealing with partners' drawings is for the partners to draw agreed amounts at regular intervals in partnership proportions, and to make specific drawings of any excess from time to time by agreement. It is preferable that drawings of a private nature, not connected with the business, should be dealt with by partners through their private bank accounts, except for items of a minor character.

Clauses in the partnership agreement as to computing goodwill in the event of a partner dying or retiring are not always clear, especially as to what is to be considered to be a net profit. The Auditor should study these clauses carefully, and, if necessary, have them amended. If any third party has a right to share in the profits, the Auditor should see that the method by which the share is to be calculated is clearly set out in the agreement relating thereto, and that the correct amount is duly charged in the Profit and Loss Account.

Care should be taken to see that any loans either to or by the partnership have been approved by the whole of the partners, and any borrowing or lending contrary to the Partnership Articles should be reported to them, especially any loans made to any individual partner.

In the case of an incoming or outgoing partner the apportionment of the receipts and expenses should be verified and care taken that the assets and liabilities are correctly adjusted as between the parties.

In the case of a shipping partnership, where an exceptional partnership agreement provided that partners should share profits equally but that loss of capital should be borne as to two-thirds by the senior partner and one-third by the junior partner, a ship which had not been adequately insured was lost at sea. The loss was ruled by an arbitrator to be a loss of capital. The neglect to insure adequately was admitted to be attributable to the senior partner, otherwise a nice question as to partnership liabilities *inter se* might have arisen.

The Auditor should be familiar with the Partnership Act of 1890, and the Limited Partnerships Act, 1907. Partnerships under the Limited Partnerships Act must be registered as such in accordance with the provisions of the Act, and must consist of one or more persons called general partners and one or more persons called limited partners. The limited partners, besides having the benefit of limited liability, have also limited functions and rights. An Auditor appointed by a limited partner, under Section 6 of the Act, to inspect the books, should satisfy himself as to his duties and rights.

Registration under the Limited Partnerships Act is very rare having regard to opportunities of securing similar benefits by registration of a private company under the Companies Act. It is not proposed therefore to consider the provisions in detail in this volume.

The Auditor will find a *Digest of the Law of Partnership and an Appendix on the Limited Partnerships Act*, 1907 (Pollock) a valuable work of reference.

CASES

In a case decided by the House of Lords, taken on appeal from a judgment by the First Division of the Court of Session, Scotland, the appellant had advanced £15,000 to the respondent, to be used in the business of the respondent for five years. In return for the advance, the appellant was to receive interest and 37½ per cent of the profits of the respondent's business. The contract stipulated that there should be an annual audit of the respondent's business by a firm of Chartered Accountants, and that their certificate as to the profits should be binding on both parties. For four years

the respondent's books were audited by a member of the firm of Chartered Accountants. Subsequently the appellant raised this action against the respondent for a Judicial Account, on the ground that the audits had not been in terms of the agreement, in respect that the Auditor did not know that his estimate of the profits was to be binding on the appellant and respondent. The Auditor stated in his evidence that he did not know of this Agreement, and that, if he had, he would have made out the account in a somewhat different form. The House of Lords held that a new account must be taken, the Auditor being unaware that his audit was to be final between the parties.—*Teacher* v. *Calder*, [1899] A.C. 451.

In the absence of any agreement to the contrary partners are liable to share losses equally.—*Saffery* v. *Mayer*, [1901] 1 K.B. 11.

Every partner has a right to have accurate accounts kept and to have free access to them.—*Rowe* v. *Wood* (1822), 2 Jac. & W. 558; *Goodman* v. *Whitcomb* (1814), 3 V. & B. 36.

A partner cannot insist on the production of documents to an improper person.—*Dadswell* v. *Jacobs* (1887), 34 Ch.D. 278.

In ascertaining the "profits" of a partnership (solicitors) in the absence of special agreement to the contrary, the net profits of each year must be ascertained on the footing of the moneys actually received and paid in that year without reference to when the work is done in respect of which the moneys are received.—*Badham* v. *Williams* (1902), 86 L.T. 191.

G, M, and W went into partnership under a parole agreement that the capital of the business should be contributed by them in certain unequal shares, but that profits should be divided equally. Upon a dissolution, after satisfying all liabilities to creditors, and the advances of two of the partners, the assets were insufficient to make good the capital. A considerably larger sum was due in respect of capital to G than to M.

Held that the true principle of division of assets was for each partner to be treated as liable to contribute an equal third share of the deficiency, and then to apply the assets in paying to each partner rateably what was due to him in respect of capital.—*Garner* v. *Murray*, [1904] 1 Ch. 57.

Every partner is entitled by the Partnership Act, 1890, Section 24 (9), to have access to and to inspect and copy the books of the partnership, and is entitled to have the books and accounts examined on his behalf by a Chartered Accountant or by an agent appointed by him for the purpose, provided that the agent is a person to whom no reasonable objection can be taken by the other partners, the agent undertaking not to make use of the information which he should thus acquire, except for the purpose of confidentially advising his principal.—*Bevan* v. *Webb*, [1901] 2 Ch. 59.

CHAPTER XVII

VARIOUS CLASSES OF AUDITS

PARTICULARS in this chapter should be read in relation to the routine set out in previous chapters.

BANKS

The great joint stock banks are so well organized as to be able to publish their accounts duly audited within about ten days from the close of the year. A continuous internal supervision is exercised over the transactions from day to day. The Auditor may, therefore, accept the vast mass of detail as correct (it would be impracticable to do otherwise), and devote himself to a close consideration of the Balance Sheet, involving a scrutiny of the various Ledger Accounts and balances, and the verification of the assets. He should satisfy himself to the best of his judgment that the loans made are adequately covered, that all known liabilities are brought into account, the assets correctly valued, and losses provided for. The principal work to be done is as follows.

Cash. Attend a little before or immediately after the close of business on the last day of the year. Have the cash brought out of the tills and safes, and count or weigh it. For convenience in counting, notes should be arranged according to their amounts. A memorandum should be made of the respective amounts of notes, silver and copper produced. The current cash should be agreed with the Effects Book, also with the Day Book, adding, if necessary, the cheques payable at other banks not collected, which may or may not be treated as cash. See that the Day Book is balanced, and the figures inked in and carried forward to the next day. Trace also cheques which the bank has not been able to present for payment (if they are not included in the cash). Procure certificates for cash at the Bank of England and other banks. Officials of the bank should be present during the counting of the cash and securities, and take charge of them at the close of the inspection.

Securities Deposited Against Loans, Overdrafts, and Acceptances. See a sufficient number of the securities as in the Customers Securities Book. Examine Loan Accounts in Loan Ledger, and see whether the margin of cover appears adequate, having regard to the value of the security. In case of loans against produce, see valuation by a broker. Look at date of warrants, and see that produce is not old and possibly unsaleable. Note the general tenor of the account, and whether shipments cleared off satisfactorily

or not. Note whether there is any contingent liability for uncalled capital in respect of any of the securities in the name of the bank or the bank's nominees. See that interest is not being charged in respect of accounts which appear to be doubtful. Note any exceptionally large loans and scrutinize closely.

Bank's Investments. See the securities for the bank's investments as in the Investment Ledger and check the valuation, and ascertain whether adequately depreciated. Note whether any are hypothecated for any special purpose requiring disclosure in Balance Sheet.

Investments held for Safe Custody and Collection of Dividends. See a sufficient number of the securities as in the register, and trace payment of a certain number of the dividends.

Bills Discounted. Examine bills with list of bills on hand. See that bills are not overdue. Agree with the Bills Account. See whether any exceptionally large amounts relate to individual firms, and make inquiries. See that a rebate is made in respect of discount on bills not matured, as the practice is to carry the whole of the discount to the credit of Interest and Discount Account when bills are discounted. Note at what rate the rebate is calculated, and whether it is a fixed rate, or the rate at which the bills were discounted, or the rate at which they could be rediscounted. See that the same principle is followed from year to year.

Deposits and Current Accounts. The list of balances on Deposit and Current Account should be examined with the Ledgers. Any overdrawn Current Accounts should be satisfactorily explained. The overdrawn amounts should not be deducted from the total liabilities on Current Account. See that Interest on Deposit Accounts is duly provided for up to date. A number of Pass-books, if Pass-books are used, may also be compared with the Ledger Accounts.

General Ledger. The Balance Sheet should be compared with the General Ledger balances, and the General Ledger balances agreed with the respective totals of the balances of the subsidiary Ledgers.

Branches. Examine the Branch Accounts and see that they are satisfactorily incorporated in the Head Office Accounts.

Section 433 of Companies Act, 1948 and the Thirteenth Schedule dealing with periodical publication, should be studied.

Balance Sheet. A distinction should be made between (1) Coin and Bank Notes, and Balances with the Bank of England and other banks, (2) Money at Call and Short Notice, (3) Bills Discounted, (4) Short Loans, and (5) Loans of a permanent character (if any), such as mortgages. Investments should be classified, and the liability on Deposit and Current Accounts distinguished from other liabilities.

The accounts must conform to the requirements of the Eighth Schedule of the Companies Act, as modified in regard to banking companies by Part III of that schedule. The form of Auditors' Report has been considered in Chapter II, page 25 *ante*.

The amount of liabilities on account of acceptances and engagements on account of customers (on which there is a contingent liability) is usually stated on both sides of the Balance Sheet, or is sometimes mentioned in a footnote.

It is a common practice to write down or even write off bank premises, investments, etc., the amounts so written off being mentioned in the annual report, and thereafter becoming Internal Reserves. As values may fluctuate widely over a term of years, the conservative practice adopted by the great banks is essentially sound from a financial point of view, and adds to the liquidity of the Balance Sheet.

The system of internal control to-day is usually so effective that much of the work considered necessary in the past may safely be dispensed with. More particularly is this the case since the introduction of mechanical systems of record.

BREWERIES

The accounts of breweries present many special features. The Brewing Account sets out the total quantities of hops, malt, and other brewing ingredients used (which are agreed with the quantities purchased after allowing for stocks), also the wages, expenses, and other costs of brewing on the debit side, thus establishing the total cost of the beer brewed and racked, and the cost per barrel. Any wastage in the process of brewing is also brought out. The Beer Account, which is charged with the cost of the beer racked, as shown by the Brewing Account sets out in classified totals the number of barrels sold, the total money, the average selling price per barrel of each class of beer, and the average profit per barrel. The barrels sold, after allowing for beer bottled, is agreed with the total production. The business done, in barrels and money, with each tied house is also shown, set out in schedules, together with the rent receivable, rent payable, and loans (if any) to the publican, also the amount owing in respect of rent and for beer, wines, and spirits.

To enable accounts to be raised in this way the books are usually kept on the columnar system in considerable detail. The Auditor has no difficulty in testing the accuracy of the accounts and schedules by reference to the books and vouchers. The beer brewed, quantities of ingredients used, cost, etc., may be compared with the Brewers' Book, and a certificate may be obtained from the Excise Officer as to the gross number of barrels brewed from which racking losses and losses in cellar should be deducted.

In examining the book debts, note how much is due on account of beer, wines and spirits, and rent, also the length of the lease or agreement under which the house is held, also keep an eye on discounts, which are exceptionally heavy and variable. Note how casks, cases, etc., are charged out to customers, and see that they are not included both as book debts and stock.

Where there are managed houses, see that there is a sufficient check on the accounts submitted. The stocks of these houses are usually taken at selling price, and in bringing them into the annual accounts the usual discounts must therefore be deducted. See that payments on account of Compensation Fund are all charged to income. Where licences are cancelled, any amount received in excess of the book value of the house should be regarded as a reserve. Should there be a deficiency, the deficiency might, technically speaking, be looked upon as a loss of capital, but it is sounder to write the deficiency off to Profit and Loss Account, or against reserve, and that is usually done.

See that sufficient depreciation is written off casks, jars and cases charged to customers (and returnable), as well as off those in hand. See that only actual improvements are capitalized, and that repairs are all charged to profits. See that sufficient provision is made for depreciation of leaseholds. If any houses be sold at a profit, the profit should be carried to a reserve, out of which any losses should be written off. Failing such a reserve, losses should be written off against profits.

Inquire as to forward contracts for hops, etc. If markets have fallen sufficient reserves should be made. See that sales of grains are duly accounted for. In weight they should be rather more than the malt used. Certificates should be procured for stocks of hops in cold storage or in hands of hop factors. See that the outstanding liability for duty on beer is brought into account.

BUILDERS, CONTRACTORS, ETC.

Balance Sheets. The special features are contracts and jobbing in progress, builders' plant, which is moved from one job to another, advances against contracts in progress (whether on Surveyors' Certificates or otherwise), loans secured on leases and on buildings in course of erection, etc. Inspect the various leases, building agreements, and contracts, note the conditions, and see that all charges and liabilities arising thereunder are taken into account or disclosed. See that proper records are kept as to the transfer of plant from one job to another, also that the plant is freely written down, and is scheduled and valued from time to time for the purpose of comparison with the values in the books.

Wages may be payable at many different places, and wages sheets, certified by the foreman and the pay clerk, should be

produced in respect of each pay. An occasional surprise wages audit at the different points is recommended.

The book-keeping of many builders and of the smaller contractors is frequently defective, making it difficult to gauge the position as regards the apportionment of establishment charges to the contracts, the value of the work in progress, and the estimated cost to complete contracts. In the case of incorporated companies carrying on the business of builders or contractors, see whether the Articles of Association contain any provisions as to the way in which work in progress is to be dealt with in the accounts. As to cases where interest on capital during construction is being charged, see page 75.

BUILDING SOCIETIES

The constitution and conduct of building societies are governed by the Building Societies Acts, 1874 to 1940. The Chief Registrar of Friendly Societies, in conformity with Section 2 of the 1894 Act, has prescribed the form of Annual Account and Statement (known as form AR 11) and from time to time gives his opinion on its interpretation. This section contains also a statement of the matters upon which the Auditor must report, and Section 3 requires that one at least of the Auditors be a person who publicly carries on the business of an Accountant. Reference should be made to *Wurtzburg's Building Society Law* which explains the somewhat complicated provisions of the various Acts. The Building Societies Association, supported by the majority of societies, issues to its members advice on building society practice in relation to matters of account and other matters.

The greater part of the audit of a building society follows common procedure as regards vouching of transactions and the verification of assets and liabilities. but particular attention should be given to the following matters —

(1) All transactions must be in conformity with law and with the society's own rules, such rules, or alterations thereto being invalid unless registered with the Registrar of Friendly Societies. The Auditor should call for certificates of registration.

(2) Since the Auditor is obliged to report that he has at each audit actually inspected all the mortgage deeds, provision must be made for a speedy check at the end of the year or a continuous physical check and control during the year.

(3) The systems of accounting, all procedure, and all internal check and internal audit should be inquired into, particularly with reference to—

(*a*) The control and issue of pass-books, receipts, share certificates, etc.

(*b*) The chain of authority for advances to mortgagors.

(*c*) The method of dealing with subscriptions in arrear or paid in advance, and with dormant credit balances of borrowers, investors or depositors. These may offer opportunities for misappropriation.

(*d*) The regular sending of notices to depositors, shareholders, and borrowers of the balances of their accounts.

(*e*) The instructions to cashiers as to the receipt and payment of cash, the giving and obtaining of receipts, and the making of cash entries.

(*f*) The examination of the register of Fire Policies to ensure that the insurance of all properties in mortgage to the society is maintained.

(*g*) The control and inspection of any branches.

(4) In large societies it may be necessary for the Auditor to attend monthly or weekly to verify advances on mortgages as they are made. He should make tests of the title deeds in addition to inspecting the mortgage deed itself. He cannot be expected to take responsibility for the soundness of the title, but he should see that some properly qualified person has done so. Further, he should inspect, by test, the valuations of properties, bearing in mind the prohibition imposed by the Act of 1939 upon the taking of additional security from non-members, and should remember the distinction between mortgages from members and those from non-members in connexion with the limitation of a society's borrowing powers under Section 15 of the 1874 Act and Section 14 of the 1894 Act.

Section 15 of the 1874 Act provides that the amount received by a permanent society on deposit or loan and not repaid by the society shall not at any time exceed two-thirds of the amount for the time being secured to the society by mortgages from its members. Section 14 of the 1894 Act provides that for this purpose there shall be disregarded (*a*) the amount secured on properties the payments in respect of which were upwards of twelve months in arrear at the date of the society's last preceding annual account and statement, and (*b*) the amount secured on properties of which the society has been twelve months in possession at the date of such account and statement.

The Auditor should satisfy himself that any investment of surplus funds is in accordance with the provisions of Section 25 of the 1874 Act as extended by Section 17 of the 1894 Act.

(5) For the purposes of Part III of the Schedule to the Accounts, care should be taken to ensure the inclusion of all cases where the repayments of principal are upwards of twelve months in arrear, and that any notes as to additional security are correct.

It will be noted that the Schedule refers to "repayments" whereas the reference in paragraph 4 *supra* is to "payments." It is considered that "repayments" must include an element of principal, and that cases in which the arrears of upwards of twelve months are of interest only should not be included in Part III; but they must be excluded for the purpose of ascertaining the limit of borrowing power. A revised form of account which was introduced in 1948 deals with this distinction and provides for a reference note (A) to appear on the Balance Sheet against the total of the balance due on mortgages from members, and for a note at the end of Part III of the Schedule in the following terms—

The amount shown in the Balance Sheet against "Total (A)" includes £—— outstanding on mortgages where the payments of interest but not the payments of principal are upwards of twelve months in arrear.

This facilitates the computation of the limit of borrowing power.

(6) The liability of a society to taxation is under an extra-statutory arrangement with the Inland Revenue, and from time to time details of this arrangement, which is open to review each year both as to continuance and the amount of the composite rate, are published.

A specimen Auditors' report reads as follows—

We, the undersigned, having examined the foregoing Annual Account and Statement, hereby certify that it is correct, duly vouched and in accordance with law. We further certify that we have at this audit actually inspected the Mortgage Deeds in respect of each of the properties in mortgage to the society and the other securities belonging to the society, referred to in the foregoing Account and Statement, with the exception of . . . mortgage deeds relating to mortgages redeemed subsequently to . . . in which cases we have seen that the society has received the redemption moneys, . . . mortgage deeds held in Land Registries for registration and . . . mortgage deeds held by approved solicitors in the normal course of business.

CHARITIES

The Balance Sheet, if there be one, is usually but a statement showing accumulations of income and any special capital funds on the one side, and investments, cash, etc., on the other, though these details are sometimes woven into the Income and Expenditure Account. The Auditor should ascertain what conditions attach to the various funds, and see that they are complied with so far as the accounts are concerned. He should ascertain the constitution of the charity, who are responsible for the management of the funds and empowered to make regulations, whether they have made any, and if so what they are. If by chance incorporated under the Companies Act as a company limited by guarantee, see that the Memorandum and Articles are complied with, and make a report as required by the principal Act.

If there be a printed list of subscriptions and donations, the amounts should be totalled up and agreed with the totals shown in the accounts. See under what system counterfoil receipts are issued, and compare them sufficiently with the cash receipts. Miscellaneous receipts may be verified by reference to correspondence, memoranda, etc. Vouchers may not always be available, especially as regards remittances abroad, for example, to missionaries or others. The method of remittance should be ascertained, and vouchers produced at a later date.

If any income tax has been paid or deducted at the source from investment income, see that it is duly recovered. Payments under Schedule A on property owned by a charity, but not in its occupation, should also be repaid, or arrangements can be made to have the assessments cancelled. In the case of property in the occupation of a charity, exemption or repayment of tax paid under Schedule A may, subject to certain exceptions, be claimed. (As to which see any standard book on income tax practice.) Land Tax may also be saved in certain cases.

Before accepting an appointment as Auditor to a charity, the Auditor will do well to satisfy himself that proper books are being kept, counterfoil receipts issued in a businesslike way, vouchers properly filed, and expenditure controlled.

CHURCHES AND CHAPELS

The Balance Sheets (if any) are, as a rule, simply accounts showing various Trust Funds and accumulations of income (if any) on the *Dr.* side, and investments and cash, and possibly a deficit, on the *Cr.* side. Sometimes also the fabric itself may be included in the Balance Sheet, and any debt outstanding in respect thereof. The Auditor should ascertain the constitution of the church or chapel, and who is charged with the administration of the funds, and see the trust deed (if any) regulating the administration of the funds and effects as a whole, or any of the special funds, and satisfy himself that the payments are in accordance therewith. The emoluments, salaries, etc., should be verified and vouched in the usual way by reference to agreements, minutes and vouchers. If there be any invested funds representing endowments, legacies, etc., they should be verified. If income-tax has been paid or suffered by way of deduction from income on investments, see that it is duly recovered. (See also under CHARITIES.) Where pew rents are charged, a summary showing the total letting capacity, the rents and total rental, should be prepared, and the total rental worked out and agreed with the receipts, after allowing for unlet sittings. If counterfoil receipts are given for the pew rents, they should be sufficiently examined. Sometimes Church officials attend on stated occasions to receive the rents, one officer

receiving the money and entering the amount in the Cash Book, while the other credits the amounts in the Pew Rent Ledger, no receipts being given. The Cash Book and Ledger should be compared and agreed. The offertories should be entered in a suitable book, and the total initialed by two responsible officers of the church or chapel. Any special collections or receipts from special sources should be similarly recorded and authenticated. Depreciation of church fittings, books, etc., should be provided for.

CINEMAS

Balance Sheets. The special feature is the unexhausted value of films purchased, more especially if to be shown at a number of houses, and also sublet. Questions at once arise how quickly to write down the cost, leaving a balance as the unexhausted value of the films, and what should be charged to each house. How to spread the hire of films to be shown at a number of associated houses is another point to be settled.

The answer to these questions depends on the conditions in each case, and the agreements for the purchase or hire, or hire-purchase, of films should be closely scrutinized, as the conditions are variable. Fixtures and fittings, including the sitting accommodation, are also a considerable item, depreciation requiring to be carefully considered. The sound financial plan is to write down the cost of films as quickly as possible. As regards checking the receipts (including tax) and payments arising in connexion with the house, the procedure does not differ from that which obtains in the case of theatres. (See under THEATRES.)

There should be an adequate system for recording sales of refreshments, chocolates, ices, etc.

CINEMA FILM PRODUCTIONS

The special duty of the Auditor in these matters is to study all the agreements for sales of films, whether for sales outright or hire-purchase, or simply hire. The conditions are very varied, but the majority of films should be written down over a short period.

CLUBS

Balance Sheet. The principal items are usually the lease of the premises, the furniture and fittings and catering equipment, all of which should be adequately depreciated. Subscriptions received in advance, rents, rates, and taxes accrued, but not due, should be brought into account, and a due proportion of any payments which relate to the succeeding year should be carried forward. If, as is unusual, the accounts are not prepared at the end of the club year, the subscriptions should be apportioned. Entrance fees

are usually treated as income, sometimes described as "Extraordinary Income," and, subject to any provision in the rules of the club, there seems to be no object in treating entrance fees as capital, for the fees are not returnable and are not a liability.

To facilitate the book-keeping and the audit, the cash receipts should be in columnar form, the entrance fees and each class of subscription being distinguished, so that the total received in respect of each class of member is shown separately at the close of the year. A classified summary of the members should be compiled, setting out the members at the beginning of the year, the additions to the membership and resignations during the year as shown by the minutes of the committee or the governing body. The classified receipts, as shown by the cash receipts, should be agreed with this summary. As an additional precaution, the counterfoil receipts for entrance fees and subscriptions should be sufficiently tested. The fees and subscriptions should be paid direct to the club bankers. A list of subscriptions in arrear should be prepared and submitted to the committee. The conditions of membership should be noted, and care taken that any special sums besides entrance fees, payable on election, are duly accounted for. The check on the catering receipts and payments, bedrooms, baths, cards, billiard room, etc., follows that adopted in the case of hotels. (See HOTELS.)

See Chapter XXIII for example of use of cards for club records.

If any part of the stock of wines or cigars is not the property of the club, but of merchants supplying the club, care should be taken that the stock is not included among the club's assets. In the case of golf clubs, the locker rents received should be agreed with the number of lockers actually let. Green fees should be checked with the Visitors Book, in which the green fees should be totalled up daily, and the daily total agreed with the amount entered in the Cash Book. Caddie fees should be agreed with the caddie master's register. There should be additional columns in the columnar Cash Book for green fees and locker rents. If it be a condition of membership of the club that the member take up a share in a company running the club, see that the numbers of entrance fees and of shares taken up agree.

A gauger should be employed to check the bar receipts, and his statements should be produced to the Auditor.

COLLIERIES

The nationalization of collieries and their control by the National Coal Board renders a description in this volume of audit procedure in the case of collieries unnecessary. The Auditors of the Accounts of the National Coal Board are appointed by the Minister of Fuel and Power. The audited accounts and a copy of

the Auditors' Report are sent to the Minister to be laid before each House of Parliament. The first Auditors were appointed by the Minister for the period from the 12th July, 1946, to the 31st December, 1947. The National Coal Board have organized an internal audit staff which was settled in conjunction with the outside Auditors of the collieries. There is an internal audit staff for each area which has been formed by the Coal Board from persons already engaged on internal work in the coal industry, and new appointments have been made from the staffs of firms of Accountants, mainly those with large practices in the coal industry, and from other staffs with extensive knowledge of coal industry accounts. The Board propose to develop accounting systems which will provide their own checks without reference to audit, and then the work of the internal Auditors will apply mainly in seeing that the systems of internal check operate satisfactorily.

The annual report and statement of accounts of the National Coal Board are available to the public through His Majesty's Stationery Office.

No doubt similar circumstances will apply in the case of other nationalized undertakings, and the special features of electricity, gas, and railway audits are not therefore dealt with in this chapter.

COLONIAL BANKS

The chief receipts of the branch in England of a Colonial bank are money received from depositors. These amounts should be checked with the counterfoils of the Deposit Receipt Books.

Deposits paid off during the period should be checked with the surrendered deposit receipts.

The balances should occasionally be checked with the Deposit Ledgers.

When the bank lends money to stockbrokers from settlement to settlement, the Auditor should attend before any variation takes place in the securities deposited, and examine them with the borrowing notes, and also ascertain that the advances are made on sufficient margin.

The Cash Book should be checked with the Loan Ledger, and the balances in the Loan Ledger should be checked with the list of loans agreeing with the General Ledger. Bills receivable should be examined with the bills themselves as entered in the Bills Receivable Book. The Bills Payable Book and Bills Receivable Book and the Bills Negotiable Book should be checked into the Head Office Account, for the purpose of ascertaining that the head office has been properly debited and credited with the amounts paid or received.

The books containing the drafts issued on the head office and

letters of credit should also be checked with the Head Office Account.

The balance of the Head Office Account should be agreed with the balance appearing in the head office books according to the statement sent over from the head office for that purpose.

A number of Customers' Pass-books if available should be checked with the Ledger.

CONTINENTAL AUDITS

Book-keeping is on a uniform system throughout most of the Continent, and is based on the Journal, the use of which is compulsory in most countries. The Auditor should procure a translation of that part of the commercial code in each country which relates to the books which traders must keep, from which it will appear that, if the Code Napoléon is in force, in addition to the Journal the trader has to keep—

(1) An Inventory Book (like the English Balance Sheet Book) which must contain each year a Balance Sheet and Profit and Loss Account, an inventory of his real and other property, stocks, debts, and credits, all made up to the same date, and signed by him.

(2) A record of the letters and telegrams received by him.

(3) Copies, in a copy book, of the letters and telegrams sent by him.

In addition to these books, companies must keep a Share Register, a Minute Book of directors' meetings, and a Minute Book of shareholders' meetings The books have to be kept in order of date. There must be no blank spaces, and no writing between the lines or in the margin. No erasures may be made, and if any alteration be necessary, it must be made in such a way that what has been altered is quite legible. Before the Journal can be used, each folio must have been numbered and signed by a Judge of the Tribunal of Commerce, or by a magistrate in the domicile of the trader or some official appointed for the purpose. A certificate is inserted on the last page of the books, certifying the number of folios therein, to which certificate the Magistrate or Judge or official must add the date and his signature. The form of the certificate is usually as under—

This book of 40 pages of the Company A. B. C. has been checked by the undersigned.

date

A Judge of the Court

Signature

The Journal has to be presented to the Court or to the Magistrate once a year for certification, which must be made under the last entry. The trader is compelled to keep the books for a prescribed

term of years. The official visé and certificate prove the books to be authentic, thus making the production of false books very unlikely. The entries in the books must be tested by the Auditor in the usual way, the official control not extending to the entries. The Journal is not necessarily a daily detailed record of transactions, but may be a monthly record of sales and purchases, cash receipts and payments, bills accepted and endorsed, with the usual adjusting and closing entries. The details are given in subsidiary books, or, in some countries, in subsidiary Journals, which may also require to be viséd, stamped, and officially controlled. The Journal may be in columnar form, only the annual totals being posted to the principal Ledger, or in common form, in which case the contents are posted to the Ledgers in detail. The balances of the accounts in the principal Ledger should be agreed with the total of the balances of the subsidiary Ledgers, which are posted from the subsidiary Journals or books referred to above. This is similar to the English method of raising Bought and Sold Ledger Accounts in the Private or Impersonal Ledgers, and agreeing the balances with the personal balances in the Bought and Sold Ledgers. The Auditor can conveniently vouch the Journal by reference to the Day Books and Cash Books, and can test these books as far as may be necessary by reference to invoices, vouchers, correspondence, etc. In foreign accountancy, great care is also taken to furnish reliable detailed information by means of subsidiary columnar books used for costing and statistical purposes. The Ledgers are sometimes sub-divided, one being kept for capital items, another for Trading and Profit and Loss items, debtors and creditors having separate Ledgers. Loose-leaf books would probably not be accepted in most foreign Courts, and can, therefore, be used only for the purpose of subsidiary records.

In the case of a company, the Auditor should procure a translation of the Articles of Association so far as they affect the accounts.

CO-OPERATIVE STORES

Some of the invoices for purchases should be compared with the Receiving Sheets and Invoice Journal, for the purpose of ascertaining that the goods paid for have been actually received, and have been charged to the Purchases Accounts of the various departments. This will also prevent goods received being sold or taken into stock before the Department has been charged with the purchase; it will also be a check on the Departmental purchases (if any) in cases where a separate book is not kept for the purpose.

As regards sales, certain of the duplicates of the bills handed to customers should be compared with the Abstract prepared by each salesman, and the totals of the Abstracts should be traced in

the "Dissecting" Journal, and thence to the Cash Book. Should there be any credit sales, some of the duplicates should be checked with the Journal reserved for each Sales Ledger.

The special provisions in the Income Tax Acts relating to co-operative societies should be studied.

DISCOUNT HOUSES

The bills on hand should be checked with the Bill Books for the day previous to the audit, the additions of the books checked, and the amounts compared with the entries in the Bill Balance Book.

The securities belonging to the House should be compared with the Security List, and those appearing on the List as being in the hands of the depositors or the bank for safe custody should be checked with the receipts given by the holders of such securities. The securities held against loans should be verified with the entries in the Contract Lists, and the amount of loan and security checked into the Summary.

The prices on the list should be checked with the Stock Exchange Official List of the day, to ascertain that the loans are fully covered.

The balances of the following Ledgers should be checked—

"Deposits without Security" Ledger, including interest unpaid, constituting a liability in the Balance Sheet.

"Deposits against Security" Ledger, including interest unpaid, and constituting a liability in the Balance Sheet, the hypothecated securities, consisting of bills discounted and companies' securities, appearing *per contra* among the general assets.

"Loans" Ledger, being the balances of amounts advanced by the House, including interest unpaid and covered by security.

"Security" Ledgers. These show the amount of security including bills discounted in the hands of depositors against their deposits with the House.

The "Calendars" should also be checked, as they show the bills due on each date and the amount rediscounted. They also furnish the particulars required for the Rebate Account, which shows the amount debited to the Profit and Loss Account, on account of discount on bills discounted, which will mature in a later period. In the Statement for Rebate the daily amounts of bills falling due are entered, and the balances due after deducting the bills rediscounted, the number of days from the date of the Balance Sheet to maturity, and the amount written back as rebate, calculated on the average rate of the discount agreed upon.

As regards the bills discounted, the balances in the Ledger may be checked as follows: with the bills on hand, with bills held for collection, and bills out for collection, with the bills deposited

as security, and with the bills rediscounted as in the Ledger balance.

ESTATE ACCOUNTS

Balance Sheet. The principal item is the value of the estate and properties, which should be taken at cost, less any necessary depreciation. Profits or losses arising on sales of any part of the estate or properties should be added to or deducted from capital in the case of individual owners. If owned by a company, one of whose objects is to buy and sell estates, the profits and losses come into revenue unless the Articles otherwise provide.

Transactions. At the first audit the terrier of the estate should be produced, and the rent rolls checked with it, also with the respective leases and agreements. The collections at the rent audits, together with property tax deducted, allowances, etc., and allowance for arrears, should be agreed with the total rental as shown by the rent roll. Arrears should be traced from one quarter to another until accounted for. Any allowances, reductions, or concessions made should be as authorized in writing by the owner or the directors, as the case may be. Royalties receivable should be compared with the royalty agreements, also with the mining surveyor's certificate, if the owner is represented by a surveyor. See that salaries and commissions are as provided under agreements or authorized in writing.

Sales of timber, and such like, should be vouched by Accounts Sales, or correspondence may be available. In the case of a private owner, the question of taxation should be carefully gone into, for tax is deducted at the full rate from rents under Schedule A, and there may also be Schedule B assessments on property owned and occupied. The Auditor should see that any claims for allowances, reliefs, etc., including insurance premiums paid, are duly submitted.

FARMERS' ACCOUNTS

Many farmers live in the patriarchal manner, each member of the family living on the farm and taking part in the work of the farm, including the book-keeping. The books consist of a Bank Pass-book, some Note Books, and possibly a Debtors' Ledger of sorts. Private expenditure is usually intermingled with farming outlays. Private payments made by cheque can be distinguished, but frequently cash receipts or cheques cashed for wages are applied to private purposes without any adequate record, making it impossible to prepare precise accounts. Although expert accounting is seldom possible, the Auditor can at least arrange to have full details of all receipts entered in the Bank Paying-in

Book, including, for the purpose of checking live stock, the number of horses, cows, calves, sheep, pigs, etc., sold. Full details of payments should be entered on the counterfoils of the cheque books, also giving particulars as to live stock purchased. A Wages and a Petty Cash Book with a few suitable columns should be introduced, and a systematic filing of vouchers. From these sources columnar Cash Books of receipts and payments can be written up, and with lists of outstanding debtors and creditors duly classified, and a summary of stocks at the close of the year, and of plant, machinery and implements, sufficiently satisfactory accounts can be raised.

Accounts in this form will be accepted by the taxing authorities, a point of importance to all farmers. The accounts should be raised at the end of March, when stocks, as well as growing crops, are at their lowest, that also being a convenient date for taxation purposes. The live stock on hand should be valued at average cost price, and the net profit or loss on sales written off. In the case of dairy farmers, dry cows are frequently being sold and replaced, and the loss on sales is a constant feature in the accounts. As regards horses, if the risk of loss by accident or disease is covered by insurance, provision for depreciation need not be excessive. In some cases horses are valued from year to year. The value of the natural increment of live stock is also a question to be taken into account if of sufficient importance. In sheep farming the increment is usually brought in at some more or less arbitrary value, the average cost being a nominal one which costing purists might find it hard to determine.

Where farming is on a large scale, and expert accounts are prepared, the following points require to be more carefully considered and brought into account with more precision—

(1) The value of growing crops, cost of seeds, etc.
(2) Unexhausted cost of manures.
(3) Stocks of farm produce on hand.
(4) Crops and produce not realized.
(5) Depreciation of plant, machinery and implements.
(6) Valuation of live stock—

(*a*) for breeding purposes,
(*b*) for use on farm,
(*c*) for sale.

(*a*) and (*b*) should be valued at average cost, any profit or loss on sales being duly carried to Profit and Loss Account; (*c*) should be taken at a careful and conservative valuation so as not to anticipate profits. As regards profits, it is true the law of averages should correct any under-valuation or over-valuation over a

period of years, unless stock is continually increasing, but for Balance Sheet purposes a prudent valuation is the only sound one.

Some of the income tax conditions attaching to farmers are exceptional, and should be mastered by the Auditor. Care should be taken to see that the assessments under Schedule A all relate to the property occupied by his client and do not overlap. The special provisions of the Finance Acts, 1947 and 1948, in regard to the assessment of farming profits should be studied. All farming is dealt with for income tax purposes under Schedule D from and including the year 1949–50. The farmer should be aware of the choices available to him under Section 67 and the Tenth Schedule of the Finance Act, 1947, so that he may keep appropriate records.

FINANCIAL HOUSES

So far as the accounts relate to dealing in stocks and shares, the books and accounts should be modelled on those of stockbrokers. The Register of Contracts, which should be in columnar form, is vouched by reference to brokers' contract notes. As regards underwriting transactions, the Auditor should see the underwriting agreements. Underwriting commissions received should not be included in profits earned without taking into account possible losses on shares with which the house may have been left, as a result of the underwriting transactions.

FRIENDLY SOCIETIES

These societies are governed by the provisions of the Friendly Societies Acts, which provide for a special form of Audited accounts, also for a quinquennial valuation.

There is a vast amount of detail in the books, and the student cannot do better than read the volume on "Friendly Societies" in *The Accountant's* Library Series, both as to the books and as to the conducting of an audit.

GOLD MINING COMPANIES

The Auditor at the head office depends upon the returns received from the mines, which, whether summarized or in detail, should distinguish between Development Account, Erection of New Works and Working Account. If possible, copies in detail of the Mines Cash Account (with duplicate vouchers and certificate as to the balances on hand), and of the Bought Day Book and Sales Day Book, should be available. Shipments of gold or sales of gold or of stores to local banks should be recorded in the Sales Day Book. Copies of the Mines Journal and closing entries should

also be sent, and a periodically agreed list of Ledger balances. A duplicate set of Mining Accounts can then be raised at head office, and examined by the Auditor. The head office remittances in cash or kind should be agreed with the corresponding items in the Mines Cash Book, allowing for what is in transit. Certified inventories of the stores, works, buildings, and fixed plant, movable plant, live stock, stock of ore on hand, should also be produced.

The consulting engineer should certify as to the additions to plant and buildings during the year, that it is all chargeable against capital expenditure, that there has been no exceptional depreciation of the company's property, or any loss or damage thereto, and that the provision for ordinary depreciation is sufficient. The Development Account, including expenditure on shafting, should be gradually written off by a tonnage charge against ore raised. The Auditor should see what provision is made for redemption of capital according to the estimated life of the mine. For gold sold, the Bullion Brokers' Accounts Sales should be seen.

HOTELS

Balance Sheet. The principal items are leases, furniture and fittings, linen, plant and catering equipment, stores, wine, tobacco and cigars, visitors' accounts, also outlays on painting, papering and decorating, which may sometimes be spread over a period of years.

Transactions. In a well organized hotel control clerks check the Tabular Ledgers from day to day with the returns from the office as to rooms let, waiters' returns as to meals, liquor, etc., chambermaids' returns as to baths, fires, and other extras. The Auditor may also test the Ledger by occasional visits while the returns are still available. He should also check to some extent the casts and carry forwards in the Ledgers, and check the cash received to the Cash Book. With a well devised columnar Cash Book, the cash may be agreed in total by extracting the Ledger totals for a period. The wages should be checked with the totals of the certified Wages Book. The wines sold should be checked with the Cellar Returns, and the stores with the Store Returns, Billiard Room receipts by the Billiard Room Book, and the bar receipts by the Bar Attendants' Returns as checked by a gauger from time to time.

The Register of Invoices (in columnar form) should be examined to see that nothing is charged to capital which should be charged to revenue. The Servants' Keep Cost Book should also be examined. The stocks as taken should be compared with the corresponding Ledger Accounts, and any difference looked into.

An important point is to see that sufficient depreciation is

written off, repairs and renewals being taken into account in settling the rates.

INSURANCE COMPANIES

Balance Sheet. The Balance Sheets of all insurance companies present similar features, i.e. loans, investments, reversions, outstanding premiums on the one side, and on the other side the various funds, claims admitted or intimated but not paid, annuities due and unpaid, surrender values, unclaimed expenses and commission outstanding. The investments should be dealt with in the manner already described. (See page 111.)

The Auditor should be conversant with the Assurance Companies Act, 1909, applicable to Life, Fire, Accident, Employers' Liability, and Bond Investment Companies, with some special provisions as to Accident Insurance Companies. The Act provides, *inter alia*, that separate accounts be kept for each class of insurance transacted, and to it are scheduled forms of Balance Sheet, Revenue Account and Profit and Loss Account. Provision is also made for the deposit of the accounts with the Board of Trade.

Transactions. The total premium income can be computed by reference to the Registers of Policies, Renewals, Lapsed Policies, etc., and agreed with the receipts after allowing for arrears. The Agent's Accounts should be compared with the Ledgers to a reasonable extent. Agent's expenses and commission should be vouched in the ordinary way, the Auditor seeing that they are in accordance with the agreed terms. For claims paid, cancelled policies will be produced, and claims intimated may be compared with the Claims Book. For surrender values, policies should be available, and receipts for the money paid. The Re-Insurance Account should be carefully examined. In the case of Life Companies, the Act provides for a quinquennial valuation, the result of which should be given effect to in the accounts. In the case of other companies, the provision for unexpired risks is usually based on a proportion of the premiums.

The Balance Sheet must state how the values of the Stock Exchange securities are arrived at, and a certificate must be appended, signed by the persons who sign the Balance Sheet, to the effect that in their belief the assets set forth in the Balance Sheet are in the aggregate fully of the value stated therein, less any Investment Reserve Fund taken into account. In the case of a company transacting life assurance business or bond investment business, this certificate is to be given on the occasions only when a statement respecting valuation under the Fourth Schedule is made pursuant to Section 5 of the 1909 Act.

The Auditor should also be conversant with the Insurance Companies Act, 1946.

Marine Insurance. The account for each year is kept open for three years before being finally closed, the claims being charged to the year in which the premiums are received.

Fire Insurance. There is no rule of law that, in assessing a fire insurance company to income tax, the total premiums receipt for the year, after deducting the losses and disbursements for the same period, are to be taken as the profits of the company, without making any allowance for unexpired risks on policies outstanding at the end of the year; but where it becomes necessary to have recourse to some form of estimate, that method will be adopted which approximates most nearly to the truth.

Where, therefore, it was proved, on an appeal by a fire insurance company against an assessment, that it was the practice of the company, in making up its annual accounts for the purpose of ascertaining the profits for distribution among its shareholders, to carry forward to the succeeding year a certain percentage of its premium receipts as an allowance to meet unexpired risks on outstanding policies, and that this percentage was a fair and reasonable allowance for that purpose, and the figures, on the triennial average then prescribed by the Income Tax Acts, showed a large increase in the amount of such allowance for the year of assessment:

Held, that in the circumstances it was competent to the company to make an allowance in respect of unexpired risks and that the increase in the allowance formed no part of the profits or gains of the year.—*Sun Insurance Company* v. *Clarke*, [1912] A.C. 443.

JUDICIAL TRUSTEES

In auditing the accounts of Judicial Trustees, the Auditor should peruse the following documents, which, in accordance with No. 4 of the Rules under the Judicial Trustees Act, 1896, have to be supplied by the applicant for the use of the Court when making the application for the appointment of a Judicial Trustee.

A short description of the trust.

Short particulars of the trust property, with an approximate estimate of its income and capital value.

Short particulars of the encumbrances (if any) affecting the trust property; also the complete statement of the trust property, accompanied by an approximate estimate of the income and capital value of each item, as required by Rule 8 to be furnished by the Judicial Trustee to the Court.

LOCAL AUTHORITIES

The Auditor of the accounts of local authorities should be familiar with the various Acts relating to local authorities

generally, also any special Acts relating to a particular authority. The more important Acts are as follows—

Municipal Corporation Act, 1882 (Borough Fund Act).
Public Health Act, 1875 (Sanitary Authorities Act).
Local Government Act, 1888 (County Council Act).
Local Government Act, 1894 (Parish Council Act).
Local Government Act, 1899 (District Council Act).

The important points are the exercise of borrowing powers, Sinking Fund arrangements, and the class of expenditure made, which must be strictly in accordance with the powers conferred on the various authorities. The Auditor will, therefore, have to vouch and examine the expenditure carefully, also the borrowing powers and the exercise of such powers.

The receipts are usually controlled by a thorough system of internal control, and the Auditor need, therefore, only test the figures sufficiently. With regard to these matters, and also to certain activities undertaken by local authorities, such as tramways, etc., the student should read *An Internal Municipal Audit*, *The Accounts of Local Authorities* (Collins), in which the system of control is lucidly set out, and Whitehead's *Municipal Audit Programmes* and *Municipal Accounting Systems*.

MOTOR BUSES AND TRAMWAYS

Motor Buses. Balance Sheet. The special item is the "fleet" of buses. The Auditor should ascertain the terms on which they have been acquired, and if under hire-purchase agreements, see that the facts are set out in the accounts, and capital and interest duly distinguished. Depreciation written off should be of an ample character.

Tramways. Balance Sheet. The special items are the permanent way, electrical equipment of the line, power stations, cars and equipment. Depreciation in relation to repairs and maintenance is an important factor, having regard to the risk of obsolescence.

Transactions. As regards both buses and trams, the system by which receipts are controlled is manifest to the passenger. The traffic receipts may be tested by the Auditor to a reasonable extent, and the expenditure vouched with an eye to the allocation between capital and revenue. Receipts from advertising is a substantial item usually let out to contractors whose accounts are available for vouching purposes.

NEWSPAPERS, PUBLISHERS, ETC.

Balance Sheet. The special items are goodwill, copyright, printing machinery, type, unexpired subscriptions and advertisements, contributors' accounts, and stocks of books and paper.

Printing machinery should be depreciated at from 7½ to 15 per cent, cost of new machines and renewals being added to capital. There are many styles of type in use for newspapers and magazines, and the type should be depreciated heavily up to 33⅓ per cent if in constant use. Sales of old type should be brought into account and deducted from the Type Account. The Auditor should see that the goodwill and copyright are not swollen by diverting to capital what should be charged to income.

Copyright is sometimes valued from year to year, and written down according to circumstances. Writing-up is a dangerous practice, and unsound financially, since it adds to profits what has not been realized, but is locked up in capital.

Subscriptions and advertisement receipts should be carefully apportioned, unexpired subscriptions and advertisements paid in advance being carried forward. Stock of books should be certified as to quantities and value, which may be tested to some extent by reference to sales and selling prices. The value should not exceed cost, and in many cases should be written down quite quickly.

Transactions. There is much detail in newspaper and publishing accounts, and a well organized system of accounting and control, as in the case of all large undertakings, is the only effective safeguard against irregularities.

Only a continuous daily audit would enable all the transactions to be overhauled thoroughly.

As regards advertisements, a marked copy of the paper may be checked with the Advertising Day Book at intervals by the Auditor, but this check should be carried out continuously by a control clerk as part of the internal organization. Sales may be tested by reference to the Distribution Register. Sales of waste paper, type, etc., should be certified to by a responsible official. The Subscription Ledger may be tested by reference to the subscription list. Expenditure on stamps should be controlled by internal organization. Stocks of paper may be compared with the Paper Stock Book. The money paid to contributors is vouched in the usual way. Authors' agreements should be examined, so as to see that royalties are duly provided for.

OIL COMPANIES

The oil industry includes—

Production.
Transportation and storage.
Refining.
Marketing.

In the case of producing companies, the outstanding feature is the amount to be written off the wells for amortization and the depreciation to be written off those assets whose usefulness will terminate with the life of the wells. The amount to be written off depends upon the estimated life of the wells and is computed under expert advice. Otherwise the general features in the accounts of oil companies are covered by the usual auditing procedure.

PARLIAMENTARY COMPANIES

Parliamentary companies are companies incorporated by special Acts of Parliament. These Acts form part of the law of the country, and must be strictly observed. As a matter of convenience, the special Acts usually incorporate in whole or in part what are known as the "Clauses Acts," including the Companies Clauses Act, 1863 and 1869, as amended by the Companies Clauses Consolidation Acts, 1888 and 1889, respectively, also the Land Clauses Acts including—

Lands Clauses Consolidation Act, 1845.
Lands Clauses Consolidation Acts Amendment Act, 1860.
Lands Clauses Consolidation Act, 1869.
Lands Clauses (Umpire) Act, 1883.

There used to be special Acts relating to Railways, Harbours, Docks, and Piers, but these undertakings have in almost every case been nationalized.

The Insurance Companies Act of 1909 applies to all insurance companies, whether they be Parliamentary Companies or not.

The Auditor must, therefore, be conversant, not only with the special Act, but with the Acts incorporated (which are specified in the special Act under the heading "Incorporation of Acts"), also with all the general Acts. Special Acts govern the procedure of the company, including the raising of capital, issue of stocks and shares, limitation of dividends, calls, forfeiture and surrender of shares, borrowing powers, and all the other matters usually provided for in the Memorandum and Articles of Association of a company registered under the Companies Act.

RUBBER COMPANIES

Balance Sheet. The special feature of importance is the cost of the estate and the expenditure thereon and on development, an essential question being whether the division between capital and revenue is on sound lines. The Estate Manager's monthly report, which includes a Cash Account and a summary of transactions in Journal or other form, should distinguish between capital outlay

on extensions, upkeep of immature areas, buildings and manufacture, upkeep of rubber in bearing, general charges, etc. Outlay on the thinning down of trees, which is considered essential to good cultivation, should usually be charged to revenue. A percentage of the general charges, and sometimes also of the London administration charges, is frequently charged to the Estate Account, by reference either to the trees tapped and the total trees on the estate, or to acreage in bearing and in course of development and total acreage. This addition to capital is quite justifiable, but in order to keep down capital some companies write off the whole of the charges to revenue, and even apply premiums on shares to writing down the cost of the estate. The productive life of rubber trees, though not definitely determined, is considered to be about forty years. If the trees are thinned out, and trees which have become unproductive for any cause are replaced out of revenue, there would appear to be no object in writing down the cost, as the value of the estate is being maintained, but successful companies frequently do so for financial reasons, and to build up reserves.

Transactions. Remittances from head office to the local agents and by the local agents to the estate manager or managers can all be agreed by reference to the Cash Accounts of the respective parties. The Managers' and Agents' Accounts set out any local sales of rubber or of catch crops, such as coffee. Shipments of rubber are advised by cable (confirmed by mail) as soon as the rubber is packed in cases for shipment. Cases in common use contain about 280 lb. of sheet, or 180 lb. of crêpe rubber. The decoded cables and advices should be available, if required, for production to the Auditors, also the Accounts Sales of the local agents and the London selling brokers, enabling the whole crop to be traced and sales verified. Stock in transit may be verified by the advices or by the subsequent Accounts Sales when the stock has been disposed of. Stock on the estate is certified to by the manager or local agents, stock at the port by the agents there. The value of stock unsold is usually estimated by the Directors or the Managers, and the amount disclosed as a separate item in the accounts. The whole of the crop may, however, be sold under forward contracts at an agreed price. Any difference in exchange should be adjusted in the usual way. The Manager's report also contains a statement of the acreage, the trees on the estate which are being tapped, specified according to girth, so that the rubber produced per tree or per acre can be deduced from year to year. The production varies, but it is said that an average of 4 lb. per tree or 400 lb. per acre is a fair result, though trees have been known to yield 100 lb. per annum.

The title to the rubber estates may be vested in a local company,

whose shares are held by an English company, which finds the capital, direction, and management. Strictly speaking the actual assets of the English company are the shares in the local company, together with any sums advanced and laid out on the estates.

SAVINGS BANKS

The extracted list of balances should be checked independently of the office staff. The balances shown in the Deposit Ledgers should be marked off consecutively, the Auditor's assistant taking the list of balances as prepared by the staff and calling out the amounts entered therein. The total of this list should be checked and compared with the total liability shown by the account "Depositors" in the General Ledger, and the list should be certified by the Auditor to be correct.

The interest credited to depositors should be tested by certain accounts taken at random.

The balance at the close of the half-year or other period fixed for audit should be verified both as to cash in hand and as to the Treasurer's balance, or preferably the Secretary or Actuary should pay into the Treasurer's account all cash in hand at the close of each period. A reference to the Bank Pass-book should not be regarded as sufficient evidence of the balance in hand, but a formal certificate from the Treasurer or banker should be called for.

No audit of Savings Bank Accounts can be considered complete unless it includes an independent examination of Depositors' pass-books as presented at the bank and their comparison with the Deposit Ledgers. For this purpose the Auditors should attend frequently and carry out the comparisons to ensure the examination of at least 10 per cent of the Pass-books.

The frequency of the audit is fixed by the Trustee Savings Bank Act, 1863, at a minimum of once each half-year, but it should, if possible, be continuous as to examination of Pass-books, and the assets and liabilities should be examined in total each quarter. The periodical meetings of Trustees and Managers (or Committee of Management) should coincide with the periodical audits, and the Auditor should report direct to them.

The Auditor should examine the accounts of the National Debt Commissioners for transfers, purchases, sales of stock, interest, etc.; he should also ascertain that the statutory limits of yearly (£500) and total deposits (£2000) are not exceeded for individuals, or such larger amounts for Societies and other organizations as the National Debt Commissioners may sanction.

In the case of banks making special investments unerd Section 16 of the Act of 1863, the Auditor should verify the securities held by the Bank for moneys advanced from the funds

of the Special Investment Department, and should state in his report the manner in which this has been done.

SHIPPING ACCOUNTS

Balance Sheet. The special items are the fleet of steamships, motor-vessels and sailing vessels, the uncompleted Voyage Accounts, outstanding freights and agents' balances, and the Insurance Fund where companies undertake their own underwriting. The ships should be valued at cost, less depreciation.

It is important to see that in addition to ordinary depreciation the shipping company provides sufficient depreciation to write off all capital additions over the ship's life. During times of depression in the shipping trade when freight rates are low, it may be found that the company has made inadequate provision, or none, for depreciation of their tonnage, and this matter should be investigated.

Profits on ships sold may be divisible as revenue if it be one of the objects of the company to buy and sell ships, and there is nothing to the contrary in the Articles of Association. The profits are, however, usually applied to writing down the cost of the fleet. Any losses on ships sold will be a charge to revenue.

Transactions. There is usually a complete system of internal control, and the Auditor will, therefore, deal mainly with certified summaries of freights and passage money, testing them as far as he thinks necessary. In companies with a large fleet a separate Ledger is kept for each ship, and a separate account for each voyage, which can be checked by reference to the captain's or purser's Cash Book, the agent's accounts, and the usual tradesmen's bills. The Cash Book should show the moneys supplied to the ship, either from the head office, or by the agents at the various ports. Cash in hand should be carried forward from one Voyage Account to another. The Auditor should see that any wines, slops or stores on hand at the end of a voyage are carried forward to the next Voyage Account. The Allotments Book should be examined here and there, also the portage bills. Passage money can be verified by reference to the agents' accounts. The separate manifests or copies of bills of lading for outward and homeward cargo are always available for inspection. The Disbursements Book contains the analysed accounts of the agents, including port charges and other outlays, at the various ports of call which may be vouched by reference to the agents' accounts, and supporting vouchers. The principal expenditure accounts, viz. Provisions, Wines, Slops, Stores, Repairs, Reconditioning, etc., should be scrutinized.

The Unclaimed Wage Account should be looked into, and a voucher seen for all payments on this account. The Auditor

should also look into the Unclaimed Passage Money Account, returns of insurance premiums where shipping is laid up, and should note how the foreign exchanges are handled. The sufficiency of the Insurance Fund and the investments relating to it should be inquired into, as to which the Auditor may require expert advice. The overhauling of the ship is sometimes a serious item, which may reasonably be spread over a number of voyages.

Shipowners working regular routes will very probably have an arrangement to return a proportion of freight to shippers in the form of deferred rebates. The Auditor should see that the provision for the liability is adequate.

In the case of passenger ships the company may issue orders for return passages available by their own vessels or by those of other associated lines. It is important to see that there is a reserve sufficient to meet liabilities in this connexion. Considerable passage money usually remains unearned at the end of the accounting period through deferred and return bookings not completed. The Passage Money Register should disclose this.

Debit balances may include considerable sums recoverable from underwriters under general or particular average claims. These can be verified by referring to the company's average adjusters.

Fuel is probably the largest item carried forward from voyage to voyage, and fuel and wages the largest items of expenditure in the Voyage Accounts.

The Auditor should look into and test the system of verifying receipts from sales of wines and tobacco in the case of passenger steamers.

Passage money and number of passengers carried can be verified from the Purser's Waybill and printed list of passengers carried. Rates can be checked with printed schedules.

The apportionment of annual charges such as vessels' insurances, Mutual Club calls, etc., should be tested.

Wages and allowances to officers and crew can be vouched with the voyage portage bills. When the personnel is paid off at the end of a voyage, this is done in the presence of a Board of Trade official whose certified statement can be seen at the Board of Trade if necessary.

Ordinary repairs and cost of undergoing periodical surveys are important items of expenditure on a vessel and a separate Repairs Account is frequently kept by the larger Shipping Companies.

In the case of single ship companies the Articles of Association and Agreements with Managing Owner, Captain, etc., should be perused and notes made of any matter affecting the accounts.

The Auditor should ascertain that no expenditure is added to "Purchase of Ship" Account when the final payment has been made to the vendor.

The Voyage Account should contain all payments made for outfit, disbursements at each port of call, expenses at loading and discharging ports, Captain's emoluments and the Managing Owners' commission. Vouchers for the Outfit Account and the agents' accounts from the various ports should be produced. The vouching is a very important part of the audit, as vouchers may come from several sources, such as the Managing Owners, the Captain, the home agents, the foreign agents, and the underwriters or Insurance Companies. There may also be sundry other receipts. The correctness of the foreign exchange and the calculations should be ascertained.

The Voyage Account should be credited with outward freights, freights received abroad, homewards freights, forfeited wages from the Portage Bill, sales of stores, port charges refunded, etc.

The accounts for the whole period under audit should be examined to ascertain whether the freight of every voyage has been included from the date of the last Account. For this purpose the Auditor should ask for the production of a record of the movements of the vessel, while the rates of freight can be ascertained from the manifests or charter-parties. Demurrage of dispatch money can be verified from the agents' Time Sheets.

The Captain's (or Purser's) Account should be charged with advances to the crew, their wages, cash to himself, and payments on account of his outfit. On the other hand, it should be credited with the Portage Bill, after deduction of forfeited wages, his disbursements, and his remuneration which should be in accordance with his agreement.

By an examination of the policies of insurance and special clauses therein, it can be ascertained if the ships have been fully protected, and that returns for risks not incurred (as when a ship is laid up) and unexpired time have been credited.

No profit should be taken to credit in respect of an uncompleted voyage.

The Auditor should search the Customs Registry Office to ascertain if there is any mortgage on the ship.

When several companies are in one office, the office expenses should be divided on an equitable basis.

In the case of shipping companies registered under the Companies Act, 1948, and owning many ships and having issued debentures with a floating charge on the assets of the company, it is necessary to register these debentures at the port of registry, otherwise prior lien on the vessels is sacrified. It is sometimes the *practice to register the whole amount against each vessel.* A charge on

a ship or any share in a ship must be registered with the Registrar of Companies. (Companies Act, 1948, Section 95 (2) (*h*) .)

Each ship must be registered separately at the port of registry.

The shares in a ship are always divided into sixty-fourths. Nowadays, however, it is most usual for 64/64ths to be owned by an individual or a company.

Single ship companies must be registered under the Companies Act like any other company.

To register a new ship it is necessary to produce to the Registrar at the port of intended registry, evidence of title to the vessel, viz. Builder's Certificate and any intermediate bills of sale proving a sequence of title. Application to the Board of Trade is then made on a form provided by the Registrar for permission to call the vessel by the name chosen. In the case of a new ship application must then be made to the Board of Trade Surveyors to measure the ship. The Surveyor's Certificate will be forwarded to the Registrar when completed. When this is received and title proved a Declaration of Ownership will be required. This is made out on a special form and must be attested by the Registrar of Shipping. Registration fees are payable in accordance with gross tonnage of the vessel.

As mentioned above the shares in all cases are sixty-fourths. In the case of a single owner 64/64ths are in his name.

A ship may be owned by an individual or by bodies corporate or by joint owners. In the last-mentioned case one person must be appointed as managing owner. A firm which is not a limited company cannot itself be registered as owner of a ship, but the individual partners may be registered as joint owners appointing a managing owner.

The owner of one sixty-fourth share can transfer it to a limited company, but it would not avoid the liability attaching to such share. The liability is limited by statute to £8 per gross register ton of the vessel, for damage to property, and £15 for loss of life.

The Register of a ship is not signed by buyer or seller but by the Registrar. Transfers of shares in a ship are made by bill of sale.

A mortgage not registered at the port of registry would not be invalid but loses its priority of claim if not so recorded.

For a consideration of the form of the Auditor's report see Chapter II.

SOLICITORS' ACCOUNTS

Balance Sheet. The amount included as costs should distinguish between costs delivered, but not paid, and costs not delivered (as shown by the draft bills) and estimates of costs outstanding.

Many solicitors only bring into account costs delivered and paid from year to year, a sound practice from a financial point of view. In the case, however, of changes in a partnership, this practice would not always work out fairly, and adjustments are necessary. Moneys held on account of clients must be shown separately and kept in a separate Banking Account. Any fees due to counsel, as shown by the bills of costs, should be brought in as a liability. Premiums received on account of articled clerks should be apportioned, and a proportionate amount carried forward.

Transactions. Two Cash Books should be kept, one for clients' moneys and one for the solicitor's moneys, and the Auditor should see that a proper distinction is made. Disbursements appear in the Cash Book, Petty Cash Book, and, where one is kept, a Disbursements Journal. To facilitate the audit, these books should be ruled on the columnar principle so as to distinguish disbursements on account of clients from the solicitor's own expenses. Disbursements should be carefully scrutinized, and the solicitor asked to examine them personally, as it is here that irregularities may occur.

A Register of Bills delivered should be kept, showing which have been paid, and the solicitor should be asked to go through this periodically.

By reference to the solicitor's diary, the Auditor may satisfy himself that all matters are being duly charged out in the books and accounted for.

The Auditor should be familiar with the Solicitors Acts, 1933 and 1941, the Solicitors' Accounts Rules, 1945, the Solicitors' Trust Accounts Rules, 1945, and the Accountant's Certificate Rules, 1946. He should also study the explanatory memorandum of 1946 issued by the Law Society in regard to Solicitors' Accounts.

The following quotations from this memorandum are made with the consent of the Council of the Law Society—

THE ACCOUNTANT'S CERTIFICATE RULES

(*a*) *General Principles.* The underlying object of Section I of the Solicitors Act, 1941, and of the Accountant's Certificate Rules, 1946, is that every solicitor who handles client's money shall produce annually a certificate by a duly qualified accountant that the solicitor has complied with the Solicitors' Accounts Rules.

The section requires every solicitor to produce an accountant's certificate except where—

(i) he satisfies the Council that owing to the circumstances of his case the delivery of an accountant's certificate is unnecessary, or

(ii) he is a "public officer" (as defined) who does not take out a practising certificate.

These exceptions are discussed at (*e*) below.

The accountant's certificate has to be delivered once during each practice year (i.e. between the 16th November and the following 15th November,

both dates inclusive). The delivery of an accountant's certificate is accordingly a matter entirely separate from the issue to a solicitor of his annual practising certificate.

(*b*) *Qualification of accountant.* An accountant competent to give an accountant's certificate—

(i) must be a member of one of the professional bodies prescribed by Rule 3 (1) (*a*); and

(ii) must not be a partner, clerk or servant of the solicitor; and

(iii) must not have been specially disqualified by the Council.

(*c*) *Nature of the accountant's examination.* It is important to realize that neither the Act nor the Accountant's Certificate Rules require a complete audit of the solicitor's accounts nor do they require the preparation of profit and loss accounts or balance sheets. A complete audit would normally be impracticable in connexion with a solicitor's practice, because, for example, it is impossible—or at all events impossible without extreme difficulty—to vouch the payment of stamp duty on original deeds handed to clients. Accordingly provision is made for a test examination—and not a complete audit—of the solicitor's accounts.

The nature of this examination is prescribed by Rule 4 of the Accountant's Certificate Rules. The intention of this provision is that the accountant, when called in to make his examination, should first make a general survey of the books of account and bank statements relating to the solicitor's practice, so that the accountant may satisfy himself that a separate bank account for client's money has been kept, that a reasonable system of book-keeping is in use and that the books are kept up to date, and may form a general opinion as to the standard of book-keeping efficiency which obtains. The accountant is not in the normal case required to check and vouch each and every item in the books and bank statements.

The accountant should then select not fewer than two dates at random and make an examination of the solicitor's position regarding liabilities to clients as at each of those dates. He should ask for such information and explanations as he may require arising out of the general examination and detailed tests. Normally this will be sufficient to enable the accountant to satisfy himself whether or not the solicitor has complied with the Solicitors' Accounts Rules. The question of expense must not be ignored and the Council have no intention of saddling solicitors whose books have been properly kept with the additional costs of a prolonged and detailed investigation by the accountant.

If, however, the general examination and detailed tests disclose evidence that the Rules have not been complied with, the accountant is required to pursue a more detailed investigation.

It is emphasized, however, that normally the general survey of the books and bank statements and the tests to which reference has been made should be sufficient to enable the accountant to give the certificate.

(*d*) *Form of accountant's certificate.* The form of accountant's certificate prescribed in the Schedule to the Accountant's Certificate Rules[1] is such that the certificate will relate to an individual solicitor, whether or not he be a member of a firm of solicitors. Accordingly, in the case of a firm where there are several partners the accountant will examine the books of the firm and then render a separate certificate in respect of each partner; each certificate will thus be in substantially the same form, unless there have been changes in the constitution of the firm during the accounting period in question. It will not be sufficient to give a single certificate in respect of the firm.

[1] See Appendix II, page 347

(*e*) *Cases in which the delivery of an accountant's certificate is unnecessary.* As indicated above, there is a general obligation on every solicitor to deliver an accountant's certificate. Rule 6 of the Accountant's Certificate Rules prescribes the cases in which the Council will be satisfied that the delivery of an accountant's certificate is unnecessary. These cases are discussed in detail in the note to that Rule, but the broad basis is that no certificate is ordinarily required in the case of a solicitor who—

(i) does not take out a practising certificate, or

(ii) takes out a practising certificate but has not held client's money, or

(iii) has not been holding client's money long enough to justify requiring a certificate before the end of the current practice year, or

(iv) has retired from practice and has ceased to hold client's money, or

(v) takes out a practising certificate but, being employed by a public body, does not engage in private practice.

It should be noted that in certain cases exemption from liability to deliver an accountant's certificate depends upon the form of the declaration lodged by the solicitor to lead to his current practising certificate.

The form of this declaration is prescribed in the Second Schedule to the Solicitors Act, 1941, and requires the solicitor to state, *inter alia*—

(i) "I have to the best of my knowledge and belief complied with the Solicitors' Accounts Rules for the time being in force"; or

(ii) "I am exempt from complying with the Solicitors' Accounts Rules on the following ground . . ."; or

(iii) "I have not complied with the Solicitors' Accounts Rules in the following respects . . ."

A solicitor who takes out a practising certificate but desires exemption from the necessity of lodging an accountant's certificate on the grounds that he is employed by a public body should, in his declaration to lead to a practising certificate, complete the second alternative above by stating—

(i) which of the offices covered by Section 4, 5, 6 or 7 of the Solicitors Act, 1933 he holds; and

(ii) that he has not engaged in private practice.

A detailed note on the application of Section I of the Solicitors Act, 1941, to these solicitors will be found on page 24.[1]

A solicitor who takes out a practising certificate but desires exemption on the grounds that he does not practice on his own account either alone or in partnership, or hold or receive client's money (e.g. because he is employed as an admitted assistant with a firm of solicitors), should state in his declaration to lead to a practising certificate—

"I have not complied with the Solicitors' Accounts Rules in the following respects—

"The Solicitors' Accounts Rules do not apply to me because I have not practised on my own account either alone or in partnership or held or received client's money."

(*f*) *The accounting period.* The normal accounting period is prescribed by Section I (5) of the Solicitors Act, 1941. Such period must begin at the expiry of the last preceding accounting period, cover not less than twelve months, terminate not more than twelve months before the date of the delivery of the certificate to the Registrar, and, where possible, correspond to a period for which the accounts of the solicitor or his firm are ordinarily made up.

Clearly, however, the normal period will not be appropriate in every case. Thus, during the first year after the coming into operation of the

[1] Of the Law Society's Memorandum.

Rules special provisions are required because the accounting period cannot begin at the expiration of the last preceding accounting period; these special provisions are contained in Rule 7.

Furthermore, in subsequent years there will also be special cases, such as those of—

(i) a solicitor who delivers his first accountant's certificate after starting practice on his own account; or

(ii) a solicitor who was previously exempt from the necessity of delivering a certificate (e.g. because he was employed by a public body) but who ceases to be exempt (e.g. by engaging in private practice).

These and other special cases are dealt with in Rules 8 and 9.

It should perhaps be mentioned here that Rule 9 (2) deals specifically with the case of a solicitor who has two or more places of business. This may occur through the solicitor being a partner in two or more firms, or through the same firm having two or more branch offices where the accounts are kept separately in respect of each. In such a case it may be convenient for the solicitor to deliver separate accountants' certificates—possibly prepared by different accountants—in respect of each place of business. This course is permissible, but the solicitor must during each practice year deliver accountants' certificates covering all client's money held or received by him.

(*g*) *Offences.* Failure to comply with Section I of the Solicitors Act, 1941, or the Accountant's Certificate Rules, 1946, is an offence in respect of which disciplinary proceedings may be taken.

The exact terms of the Accountant's Certificate Rules, 1946, should be studied. These include an epitome of the duties imposed on the Accountant, which is as follows—

(*a*) To examine the general book-keeping system in the office, with particular reference to the questions whether proper ledger accounts for clients have been kept, whether these accounts show separately from any other transactions on behalf of each client, client's money received, held or paid on behalf of each client, and whether separate cash books or cash accounts have been kept in order to segregate client's money from any other money received, held or paid by the solicitor; and to make test checks or castings and postings of these books, and to "test vouch" the cash book.

(*b*) To ascertain whether a client account is kept at a bank.

(*c*) To reconcile the balances on the client account (bank account) with the cash book in which the solicitor records transactions on client account at the dates selected in (*d*) *infra*, and to test the daily lodgments with, and payments from, the bank with those shown in the cash book.

(*d*) To extract client ledger balances at selected dates and to agree these balances with cash held on client account.

(*e*) To inquire into and test check the system of recording costs and making transfers from client account to office account.

(*f*) To scrutinize the ledger accounts in order to ascertain that payments from client account have not been made on any individual account in excess of cash held on behalf of that client and to vouch a few accounts with that object.

(*g*) To scrutinize the office cash accounts and pass book with a view to ascertaining that client's money has not been paid in error into the wrong account.

Having satisfied himself on these points the accountant will, it is hoped, feel able in the straightforward case to give a certificate to the solicitor;

only where the accountant is faced at this stage with evidence that the Solicitors' Accounts Rules have not been complied with should he feel compelled to make any more detailed investigations. Such more detailed investigation (which may be called the second part of the accountant's duties) should not normally be necessary, but where it is necessary the Council consider that the accountant should have a free hand to sift the matter thoroughly before completing the accountant's certificate with or without qualification.

The comparisons which the accountant is required to make under Rule 4 (1) (*d*) must be *as at* not fewer than two dates selected by him, but it is entirely within his discretion whether the actual making of these comparisons is done at one visit or at more than one visit to the solicitor's office.

Where the accountant makes on the instructions of the solicitor a complete audit of the solicitor's accounts (in so far as a complete audit is practicable), he is entitled to give an accountant's certificate without making any of the specific "test checks" or "test vouchings" mentioned above, and in particular without complying with paragraph (*d*) of this epitome of duties.

The form of the Accountant's Certificate is given in Appendix II, *post*. It must be in this form or in a form to the like effect approved by the Council of the Law Society.

The Accountants qualified to give an Accountant's Certificate on behalf of a Solicitor are members of the following bodies—

(i) The Institute of Chartered Accountants in England and Wales, or
(ii) The Society of Incorporated Accountants and Auditors, or
(iii) The Association of Certified and Corporate Accountants, or
(iv) The Society of Accountants in Edinburgh, or
(v) The Institute of Accountants and Actuaries in Glasgow, or
(vi) The Society of Accountants in Aberdeen.

The information furnished by the Law Society is so full that amplification is unnecessary. It will be noted that in the case of firms an Accountant's Certificate must be furnished for every partner; a general certificate for the firm will not be accepted.

The Council of the Law Society recommend the following as the minimum books to be kept by a Solicitor in connexion with his practice—

(1) A Cash Book or books to record separately transactions on Client Account and on Office Account.
(2) A Ledger or Ledgers effecting a similar separation.
(3) A record clearly showing particulars of bills delivered and distinguishing between profit costs and disbursements.

STOCKBROKERS

Balance Sheet. The Balance Sheet is a comparatively simple one, consisting of balances due to or by jobbers and clients, balances at bankers, loans on security, securities on hand (which

are brought in at the market price at date of balancing), also names receivable and names payable, representing sums due on stocks to be delivered by or delivered to brokers, and of dividends to be collected or paid over.

Transactions. To those familiar with Stock Exchange practice, the checking of the whole of the transactions presents no difficulty, provided the books are written up in reasonable detail.

The following is the special work which the Auditor would normally be expected to carry out—

1. To check balances from the previous account.
2. To check the Clients' Ledgers from—
   (*a*) The debit side of the Bought Journal.
   (*b*) The credit side of the Sold Journal.
   (*c*) The Cash Book.
   (*d*) The Sundries Journal.
   (*e*) The Dividend Journal.
   (*f*) The Rights Journal.

STOCKJOBBERS

The Balance Sheet comprises moneys owing to and by brokers, and shares "open" where the jobber has not "evened" his book; also securities on hand, dividends to be collected or paid over. The checking of the transactions presents no difficulty in normal cases where the books are kept on an adequate system.

It is beyond the scope of this volume to describe Stock Exchange practice and book-keeping in detail, and an expert knowledge of both is essential to agreeing the books and raising correct accounts, or auditing them effectively.

The jobber is the market. He does not come into touch with the public at all, but deals only with brokers, covering the bargains he makes by, sooner or later, re-buying or re-selling. When called upon he makes two prices, the lower that at which he is ready to buy, the higher that at which he will sell.

He should keep the following books—

1. Jobbing Book.
2. Checking Book.
3. Journal.
4. List Book.
5. Names Receivable.
6. Names Payable.
7. Cash Book.
8. Jobbers Ledger.
9. Impersonal Ledger.
10. Private Ledger.
11. Stock "Take and Deliver" Ledger.

The following checking should be done—

1. Call balances brought over from previous account in Jobbers Ledgers, if any, and check any differences adjusted in subsequent accounts.

2. To check the Jobber's Ledger from—

(*a*) The credit side of the Bought Journal.
(*b*) The debit side of the Sold Journal.
(*c*) The Cash Book.
(*d*) The Sundries Journal.
(*e*) The Rights Journal. (The Rights Journal should be compared with the "Rights" List—that is, the Dividend List issued officially.)
(*f*) The Dividend Journal. (The Dividend List should be examined to ensure that dividends have been duly debited or credited.)

TEA COMPANIES

The outstanding feature is the provision to be made for replacements of buildings and machinery. It is also prudent, though not legally compulsory, to build up a reserve in respect of the properties some of which may under certain conditions go out of cultivation. The detail work does not require any special comment.

THEATRES, MUSIC HALLS, ETC.

Balance Sheet. The special items are scenery, wardrobe materials in store and in use, furniture and fittings, including seating accommodation, electric light fittings, etc., printed material, posters, etc. Some of the scenery is stock scenery, which may be depreciated slowly. Scenery for special productions not likely to be used again without substantial alterations should be written off quickly out of the earnings of the production. The Auditor should see that the wardrobe purchases are duly spread over new productions, renewals, running productions and tours, according to the facts, and are written down quickly. He should also see that all liabilities for advertising, including posters, etc., are brought into account.

Transactions. The Salaries Book may be compared with the Attendance Book kept at the stage door. Overtime charged should be authorized by the stage manager.

In a well-organized theatre or hall there is a complete check upon all receipts based upon counterfoil tickets in triplicate for reserved seats, roll tickets or check machines for unreserved seats, and the counters return. The receipts may be checked by reference to the House Receipts Book which is compiled from the house,

bar, and programme receipts. Programme receipts are verified by the number of programmes printed and given out, the programmes being fastened in a special way, so that they cannot be sold over again.

For cloak room fees, counterfoil Receipt Books should be available. Receipts from the bar are vouched by returns of sales made by the bar attendants (controlled by the bar manager), stock also being taken at intervals by a gauger as an additional check.

Advance bookings should be reserved for, and the amount reserved agreed with the amount received in advance, as shown by the House Receipts book. This figure can be verified by checking the tickets torn out of the Ticket Books in the box office at the date to which the audit relates. The Libraries Accounts should be agreed with the Libraries Book. The Tour Manager's Accounts, as certified, should be agreed with the Tour Book.

TRUST AND FINANCE COMPANIES

The Auditor should ascertain that the amounts carried to the credit of the Profit and Loss Account have been definitely earned and are not subject to any possible deductions on valuation, or require a reserve to be made. When the profits are represented by shares in other companies, either as the result of promoting or of underwriting, the Auditor should recommend that such profits be treated in a separate Profit and Loss Account, and that only the profits earned on realization of such shares be carried to the General Profit and Loss Account, which shows the profit available for dividend.

He should ascertain whether each investment (whether debentures or shares) and loan has yielded interest or dividend, as the investments of trust and finance companies are sometimes non-dividend paying. In the case of investments or loans not producing income, reasons should be required. Accrued interest on the debentures of unquestionable value may be taken credit for.

Especial care must be taken when considering the value taken credit for in the Balance Sheet in respect of the Investments.

Brokers' Notes should be compared with the prices stated to have been paid for stock or received on account of stock sold, and also for the purpose of ascertaining that dividends and interest accrued on stock have been accounted for.

Should there be any liability on shares held as investments, the fact must be shown on the face of the Balance Sheet. If this is not done a reference must be made in the Auditor's Certificate.

The essential distinction between trust companies and finance

companies should be borne in mind. In the case of a trust company the investments are of the nature of fixed assets purchased for the purpose of earning income. The investments may be stated at cost in the Balance Sheet even though this may exceed the market value at the date of the Balance Sheet; prudence, however, indicates the creation by degrees of a reserve to meet depreciation. In any case a note must appear on the Balance Sheet giving the market value at the date of the Balance Sheet. Profits on sales of investments should be utilized to write down the cost of remaining investments; it is not necessary to write off losses on sales to Profit and Loss Account.

The investments of a finance company are in the nature of stock-in-trade and should be brought into the account at the market value at the date of the accounts. It is usual to bring to credit of the Profit and Loss Account only realized profits on sales, and items of an income character such as dividends, underwriting commission, etc. Profits arising from increases in the market value of investments unsold should be held in suspense until realized. Frequently a special account is opened for this purpose.

It is usual for the articles of trust companies (as opposed to finance companies) to provide that profits on sales of investments shall not be distributed in dividend, the amounts distributable being limited to income of the class which would be paid to a life tenant. This would include bonus shares received by way of distribution of profit of a company in which the trust company held an investment, if such shares are sold.

WATER COMPANIES

The charge for water is either by meter, or based on rateable value, no charge being made in respect of empty houses, and the testing of the receipts is not, therefore, a complicated matter. Water rates are chargeable in advance, and should, therefore, be apportioned from year to year. The Auditor may test the figures by a comparison of the aggregate totals from year to year, looking into the cause of any striking variation.

WINE MERCHANTS

Balance Sheets. A special item is the stock, which, unlike most stocks, usually improves with age. The stock consists of stock in bond (on which duty has not been paid), stock in bins, in cases (as shipped), and in bulk (in vats or casks). For each of these classes of stock there should be a special Stock Book with which the particulars of the Stock Sheets may be compared, allowing for ullages and shorts (breakages, etc.), which should be written off in the Stock Books. In some cases it is the practice to add interest at 5 per cent to the stock every year, provided the wine

will bear it, that is to say, is considered to have improved sufficiently. In this way interest is treated as part of the cost. Unless the stock is increasing in quantity from year to year the effect of this addition will average out over a period of years, and is not unreasonable, but the sounder practice is that interest be added for the purpose of arriving at cost and fixing selling prices, but only be brought into account when the wine is sold. If the stock is increasing, and the profits, including interest, are divided, the financial position becomes unsound, unless capital is brought in equivalent to the interest added to the stock. Where interest is added, the facts should be set out on the face of the accounts.

Transactions. Discounts and allowances should be carefully scrutinized. Where clubs, hotels, etc., are supplied on sale or return, see that the supplies are not treated as sales until actually sold, but are brought into stock at cost. See also that jars and cases charged out to customers are not also included in the stock. Where there is a well-kept Cellar Book, the quantities received into and passing out of the cellar, returns, etc., may be effectively traced through the books.

CHAPTER XVIII

SHARE CAPITAL

THE amount of the share capital of a company is set out in the Memorandum and Articles of Association, as for example—

The capital of the company is £500,000 divided into 500,000 shares of £1 each, with power to divide the shares in the capital for the time being into several classes, and to attach thereto respectively any preferential, deferred, qualified or special rights, privileges or conditions.

The share capital may consist of any of the following classes—

Preference Shares (Non-cumulative).

Preference Shares (Cumulative).

Preference Shares (Cumulative or non-cumulative and Participating).

Redeemable Preference Shares (cumulative, non-cumulative or participating).

Ordinary Shares.

Deferred Shares (or Founders' Shares).

Particulars of the classes of shares are contained in the Memorandum and Articles of Association, and may be varied from time to time by the company in general meeting (Companies Act, 1948, Section 61), or by order of the Court under a scheme of reconstruction or for reduction of capital. As mentioned in Chapter III, page 29, the particulars and any variations thereof should be recorded in the Auditor's permanent note-book. In the case of a reconstruction the Auditor should satisfy himself that the new capital is in accordance with the agreements entered into relating to the reconstruction. If the alteration has been authorized by an Order of Court, an office copy of the Order should be produced to the Auditor.

Section 61 of the Companies Act, 1948, reads as follows—

61.—(1) A company limited by shares or a company limited by guarantee and having a share capital, if so authorized by its articles, may alter the conditions of its memorandum as follows, that is to say, it may—

(*a*) increase its share capital by new shares of such amount as it thinks expedient;

(*b*) consolidate and divide all or any of its share capital into shares of larger amount than its existing shares;

(*c*) convert all or any of its paid-up shares into stock, and reconvert that stock into paid-up shares of any denomination;

(*d*) subdivide its shares, or any of them, into shares of smaller amount than is fixed by the memorandum, so, however, that in the subdivision the proportion between the amount paid and the amount, if any, unpaid on each reduced share shall be the same as it was in the case of the share from which the reduced share is derived;

(*e*) cancel shares which, at the date of the passing of the resolution in that behalf, have not been taken or agreed to be taken by any person, and diminish the amount of its share capital by the amount of the shares so cancelled.

(2) The powers conferred by this section must be exercised by the company in general meeting.

(3) A cancellation of shares in pursuance of this section shall not be deemed to be a reduction of share capital within the meaning of this Act.

Non-cumulative Preference Shares entitle their holders to a preferential dividend, at a stipulated rate, out of the profits of the year only, before a dividend can be paid on other shares. If no profits are earned no dividend is payable.

Cumulative Preference Shares entitle their holders to payment of the preferential dividend, at the stipulated rate, out of the profits of the year, but in the event of the profits of any one year not being sufficient to provide for the stipulated dividend, the arrears must be paid out of the profits of future years, and the preference dividends paid up to date, before a dividend can be paid on other shares. Unless the contrary intention is expressed in defining the rights of preference shareholders, shares entitling their holders to a preference dividend at a given rate are *prima facie* cumulative.

The Companies Act, 1948, Eighth Schedule, Paragraph II (3), provides that there shall be shown on the Balance Sheet by way of note, or in a statement or report annexed, if not otherwise shown, the amount of arrears of fixed cumulative dividends, the period, and, where applicable, the class. The amount must be stated gross, or, in the case of tax free dividends, the amount free of tax with a statement that it is so shown.

Participating Preference Shares entitle their holders not only to a fixed dividend, but to an additional dividend after the ordinary shareholders have received a dividend at a stipulated rate.

If, as is usual, it rests with the Directors to declare the dividend on the preference shares, the dividend does not become payable and therefore not a liability of the company until it has been declared. Unless, therefore, there is a contrary provision in the Articles, arrears of undeclared preference dividends may not be a liability in a liquidation of the company and are not payable out of surplus assets.

Preference shares are not entitled to priority in a return of capital in a winding up unless the Articles so provide. In the absence of any contrary provision in the Articles, preference shares having this right of priority share rateably with ordinary shareholders in any surplus after the ordinary shareholders have been repaid.—*Re Espuela Land and Cattle Co.*, [1909] 2 Ch. 187; 78 L.J. Ch. 729.

SURRENDER OF SHARES

Surrender of shares is in fact a reduction of capital and should have the sanction of the Court. The Auditor is only concerned to see that the terms of surrender are duly given effect to in the books and accounts.

REDUCTION OF CAPITAL

Provisions as to reduction of capital are set out in Sections 66 to 70 of the Companies Act, 1948. Reduction, which requires the authority of the company's Articles, is effected by special resolution, and is subject to confirmation by the Court. The Auditor's duty is to see that the terms as set out under the arrangement approved by the Court are duly given effect to in the books and accounts.

CASES

A company's capital consisted of 5 per cent cumulative preference shares and ordinary shares, the preference shares having priority as to both capital and dividend, and the preferential dividend being payable before any profits could be carried to reserve.

The Articles provided that no dividend should be payable except out of profits, and that, in the event of the company being wound up, the surplus divisible assets for the time being remaining "after paying the liabilities of the company" should be applied first in repaying the preference capital, and "secondly in paying the arrears (if any) of the 5 per cent preferential dividends thereon to the commencement of the winding up." The remainder of the surplus assets was to belong to the ordinary shareholders.

No dividends were ever declared, but the profits accumulated until the company was wound up.—

Held, that the preference shareholders were entitled to their arrears of preferential dividends, though not declared, but only to the extent of the accumulated profits.—*Re W. J. Hall & Co., Ltd.*, [1909] 1 Ch. 521, but distinguish *re Crichton's Oil Co.*, [1901] 2 Ch. 184; [1902] 2 Ch. 86, in which it was held that where the shareholders were only entitled to dividends when declared by the directors, the shareholders, in the event of liquidation, could only claim for dividends so declared.

Where a company issues preference shares carrying dividend at 10 per cent per annum, payable half-yearly, and with no words restricting the holders of such shares to the profits of the current year, the deficiency in the profits of any one year to pay the 10 per cent in full was, as between the preference and ordinary shareholder, to be made good out of subsequent profits.—*Foster* v. *Coles and M. B. Foster & Sons, Ltd.*, [1906] W.N. 107.

In cases not within Sections 13 and 14 of the Companies Clauses Act, 1863, it has been held that preference shareholders are entitled to have arrears of interest made up out of the profits of subsequent years.—*Henry* v. *Great Northern Railway Co.* (1857), 1 De G. & J. 606; *Corry* v. *Londonderry, etc., Railway Co.* (1860), 29 Beav. 263; *Matthews* v. *Great Northern Railway Co.* (1860), 28 L.J. Ch. 375.

Preference shareholders who have allowed the surplus profits of one year to be applied in payment of ordinary shareholders, instead of in payment of arrears due to them, are not prevented from claiming such arrears against the profits of future years.—*Matthews* v. *Great Northern Railway Co.* (1860), 28 L.J. Ch. 375.

When the Memorandum of Association of a company incorporated under the Companies Act, 1862, stated that a portion of the shares were to have a right of receiving a dividend by preference to the other shares, resolutions passed by the company altering the priorities and payments of the net revenue as between the preference and ordinary shareholders were held to be not valid, and that no resolution of the company, special or otherwise, could alter the contract made between the company and all the shareholders, and that the revenue of the company available for dividend must be applied in the manner originally prescribed by the Memorandum of Association.—*Ashbury* v. *Watson* (1885), 28 Ch.D. 56 and 30 Ch.D. 376.

If the yearly profits are divisible among the holders of the ordinary shares, subject to the half-yearly dividend to the holders of the preference shares, the preference dividend is not cumulative.—*Adair* v. *Old Bushmills Distillery Co. Ltd.*, [1908] W.N. 24.

REDEEMABLE PREFERENCE SHARES

The issue of this class of shares was authorized for the first time by Section 46 of the Companies Act, 1929, now replaced by Section 58 of the Companies Act, 1948. Subject to the provisions of the latter Section a company limited by shares may, if so authorized by its Articles, issue preference shares which are, or at the option of the company are to be liable, to be redeemed: Provided that—

(*a*) no such shares shall be redeemed except out of profits of the company which would otherwise be available for dividend or out of the proceeds of a fresh issue of shares made for the purposes of the redemption;

(*b*) no such shares shall be redeemed unless they are fully paid;

(*c*) the premium, if any, payable on redemption, must have been provided for out of the profits of the company or out of the company's share premium account before the shares are redeemed.

(*d*) where any such shares are redeemed otherwise than out of the proceeds of a fresh issue, there shall out of profits which would otherwise

have been available for dividend be transferred to a reserve fund, to be called "the capital redemption reserve fund," a sum equal to the nominal amount of the shares redeemed, and the provisions of this Act relating to the reduction of the share capital of a company shall, except as provided in this Section, apply as if the capital redemption reserve fund were paid-up share capital of the company;

There shall be specified in every Balance Sheet of a company which has issued redeemable preference shares that part of the issued capital of the company consists of such shares and the earliest date on which the company has power to redeem those shares.—Schedule 8 (2) (*a*).

Subject to the provisions of this Section, the redemption of preference shares thereunder may be effected on such terms and in such manner as may be provided by the Articles of the company.

Where a company has redeemed or is about to redeem any preference shares, it shall have power to issue shares up to the nominal amount of the shares redeemed or to be redeemed as if those shares had never been issued, and there will be no liability for stamp duty on the issue if redemption of the old shares takes place within a month after the issue of the new shares, or if it takes place before such new issue.

The capital reserve fund may be applied, up to an amount equal to the nominal amount of the shares so issued, in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

ORDINARY SHARES

The holders of ordinary shares are entitled to the surplus profits subject to the payment of dividends to holders of shares giving preferential rights. Sometimes ordinary shares are divided into preferred and deferred ordinary shares, in which case the preferred are in the same position as preference shares in relation to dividend, being entitled to a fixed rate of dividend in priority to the deferred shares, which are entitled to the surplus profits.

DEFERRED OR FOUNDERS' SHARES

The holders of these shares are entitled to dividends after holders of other shares have received a prescribed dividend, and are as a rule entitled to the whole or a proportion of the remaining profits. Usually these shares are issued as fully paid to founders or promoters of a company in consideration of the services which they have rendered.

SHARES OF NO PAR VALUE

These cannot be issued in this country though they are common in the United States of America. It is not, therefore, proposed to consider their merits or demerits in this volume.

SHARES ISSUED AT A DISCOUNT

Companies were empowered by Section 47 of the Companies Act, 1929, and now by Section 57 of Companies Act, 1948, to issue at a discount shares of a class already issued. Provided that—

(*a*) The issue of the shares at a discount must be authorized by resolution passed in general meeting and must be sanctioned by the Court.

(*b*) The resolution must specify the maximum rate of discount at which the shares are to be issued.

(*c*) Not less than one year must, at the date of issue, have elapsed since the date on which the company was entitled to commence business.

(*d*) The shares to be issued at a discount must be issued within one month after the date on which the issue is sanctioned by the Court or within such extended time as the Court may allow.

Every prospectus relating to the issue of the shares and every Balance Sheet issued subsequently to the issue of the shares must contain particulars of the discount allowed on the issue of the shares, or of so much of the discount as has not been written off at the date of the issue of the Balance Sheet or Prospectus. (Companies Act, 1948, Section 57, and Eighth Schedule, Part III.)

PURCHASE BY COMPANY OF ITS OWN SHARES

A company may not, either directly or indirectly, or by means of a loan, guarantee, provision of security or otherwise, give any financial assistance to a person to purchase shares in the company. This does not apply to loans under a scheme for the purchase by trustees for the benefit of employees of the company or to enable employees to purchase fully paid shares.

The aggregate amount of loans made in accordance with these authorized exceptions must be shown separately in the Balance Sheet.

CASES

There is nothing in the Companies Acts expressly or by necessary implication prohibiting a limited company from mortgaging its unpaid capital; consequently, where power to mortgage future or unpaid-up capital is given by the Memorandum or Articles of Association, a mortgage of such is valid.—*Re Pyle Works* (1890), 44 Ch.D. 534. This decision was approved by the Judicial Committee of the Privy Council on an appeal from the Supreme Court of New South Wales, the Companies Act being for this purpose identical with the English Act of 1862, on the 6th March, 1895.—*Newton* v. *Debenture-holders, etc., of Anglo-Australian, etc., Company*, [1895] A.C. 244. The Companies Act, 1948, Section 95

(2) (*b*), implies that uncalled share capital can be mortgaged or charged. Such a charge must be registered with the Registrar of Companies.

A company has no power to create any charge on that portion of its capital which, in accordance with a resolution passed under this Section, can only be called up "in the event of and for the purposes of the company being wound up."—*Re Mayfair Property Co., Bartlett* v. *Mayfair Property Co.*, [1898] 2 Ch. 28; *Re Irish Club Co., Ltd.*, [1906] W.N. 127.

The capital of a limited company may not be diminished by a surrender to it by shareholders of partly-paid shares, as such is a transaction of purchase and sale, the company in effect purchasing the shares at the price of discharging the shareholders from their liability to calls, and such a transaction is bad under the decision in *Trevor* v. *Whitworth* (1888), 12 App. Cas. 409.—*Bellerby* v. *Rowland & Marwood's Steamship Co., Ltd.*, [1901] 2 Ch. 265.

In a case it appeared that the directors of the company had each surrendered shares to the company in order to write off an extraordinary loss which had arisen on the sale of one of the company's ships. Some years later, the company having made profits, it was proposed that special remuneration should be paid to the Directors by issuing to them the surrendered shares. The arrangement was contrary to the decision in *Trevor* v. *Whitworth* (12 App. Cas. 409) and the original surrender was illegal, so that the question of re-issuing the shares did not arise.—*Bellerby* v. *Rowland & Marwood's Steamship Co., Ltd.*, [1901] 2 Ch. 265.

A surrender of shares to a limited company, not involving any reduction of capital and not amounting to a purchase of its own shares by the company, is not necessarily *ultra vires*.

In 1896, pursuant to Articles of Association and special resolution, the holders of 6 per cent fully-paid preference shares surrendered them to the company in exchange for fully-paid 5 per cent preference shares, and a contract in writing was duly filed with the Registrar of Companies, pursuant to Section 25 of the Companies Act, 1867. The surrendered shares were not cancelled, but were subject to be reissued by the company.

Held, that the surrender not involving any reduction of capital was valid; that the transaction did not amount to a purchase by the company of its own shares; and that the new shares issued in exchange were fully paid up.—*Rowell* v. *John Rowell & Sons Ltd.*, [1912] 2 Ch. 610.

The power to reduce capital must be conferred by the Articles, and not by the Memorandum.—*Re Dexine Rubber Co.*, [1903] W.N. 82.

Payment on shares made by a fictitious proceeding under which a company never really receives the amount payable on the shares

at all is invalid.—*Aspinall's Case, Re The Eupion Fuel and Gas Co.* (1877), 36 L.T. 362; *Hay's Case, re Canadian Oilworks Corporation* (1875), 10 Ch.App. 593.

A company governed by the Companies Clauses Consolidation Act, 1845, and the Acts amending it, may issue fully paid-up original stock at a discount, and for payment either in cash, for land or labour, or other consideration, subject to the liability of the Directors for issuing the stock below its value without necessity.

Such companies may also issue debentures or debenture stock at a discount, if authorized to borrow money or raise money by mortgages or debentures.—*Webb* v. *Shropshire Railways Co.*, [1893] 3 Ch. 307.

A company governed by the same Acts may issue fully paid-up original shares at a sum less than their nominal amount in the same manner as new shares can under the authority of those Acts be issued.—*Statham* v. *Brighton Marine Palace and Pier Co.*, [1899] 1 Ch. 199.

As mentioned previously in this chapter, the Companies Act, 1929, Section 47, empowered companies, for the first time, to issue shares at a discount provided that they are of a class already issued. (Now Companies Act, 1948, Section 57.)

The subscribers of the Memorandum of a company shall be deemed to have agreed to become members of the company, and on its registration shall be entered as members in its Register of Members.

The agreement is satisfied by the allotment of a larger number of shares on a formal letter of application.—*Gilman's Case, re Crookes Mining and Smelting Co.* (1886), 31 Ch.D. 420.

Every other person who agrees to become a member of a company, and whose name is entered in its Register of Members, shall be a member of the company.

The Auditor must satisfy himself that all the shares applied for on the Memorandum of Association are included in the capital in the Balance Sheet, whether they have or have not been allotted, and if not paid for the amount unpaid, so far as it is called up on the other shares of like class, must be treated as "calls in arrear."

The register may consist of several books, which, by reference from one to the other, will supply all the information required.—*Weikersheim's Case re Land Credit Co. of Ireland* (1873), 8 Ch. App. 831, 836.

A company having a share capital, whose objects comprise the transaction of business in a Colony, may, if so authorized by its Articles of Association, cause to be kept in any Colony in which it transacts business a branch Register of Members resident in that Colony (Sections 34-36).

A contract between a company and one of its shareholders that

calls shall be set off against goods to be supplied by the shareholder instead of being paid for in money is *ultra vires.—Pellatt's Case re Richmond Hill Hotel Co.* (1867), 2 Ch.App. 527.

"Every year" means a year from 1st January to 31st December.—*Gibson* v. *Barton* (1875), L.R. 10 Q.B. 329; *Edmonds* v. *Foster* (1876), 33 L.T. 690.

The word "interest" does not mean "dividend." Interest upon moneys paid in advance is a legal debt, payable out of any assets of the company, including its capital.—*Lock* v. *Queensland Investment and Land Mortgage Company, Ltd.*, [1896] A.C. 461.

Forfeited shares may be re-issued as paid up to an amount not exceeding the amount paid by the previous holder, and may be so re-issued in consideration of a sum less than the sum credited as paid on them.—*Morrison* v. *Trustees, Executors, and Securities Insurance Corporation Ltd.*, [1898] W.N. 154.

The books containing these minutes are known as "Minute Books." In large companies it is the practice to keep separate "Minute Books" for meetings of the Directors, for meetings of committees of the Directors, and for meetings of shareholders respectively. These "Minute Books" are, it is conceived, open to the inspection of the Auditor should he, in the performance of his duties, consider such an inspection desirable.

A clause giving a right of inspection of "the books wherein the proceedings of the company are recorded" does not give a shareholder the right to inspect the books of minutes of the proceedings of the Directors.—*R.* v. *Mariquita Company* (1859), 1 E. & E. 289.

The bearer of a share warrant shall not be deemed to be the holder of the shares specified in the warrant for the purposes of director's qualification (Companies Act 1948, Section 182 (2)).

A loose-leaf record did not constitute a book within the meaning of Section 120 of the Companies Act, 1929, but this form of record is recognized by the Companies Act, 1948. The question whether a Minute Book in the form of a loose-leaf record was a book within the meaning of the Act was raised in a case which was summarized in *The Accountant* of 19th October, 1935, page 547. Bennett, J., said that the thing which Mr. Morton called a Minute Book consisted of a number of loose leaves fastened together between two covers in such a physical condition that at any moment anybody who pleased to do so could take out any number of leaves and substitute any number of other leaves. This was a thing which people, if they were minded to be dishonest, could readily and easily tamper with without anybody being able to see that it had been tampered with. What he had to decide was whether this thing was a book within the meaning of Section 120 of the Companies Act, 1929. So far as he knew there was no other authority on the question, but he would hold that it

was not a book as he thought it most undesirable that anything that could be added to or taken away from at any moment without anyone being the wiser should be put in as evidence under the Section. On that ground he found that what was tendered was not a book within Section 120 and he rejected the evidence.

Having regard to the increasing use of loose-leaf records and the fact that many banks had substituted loose-leaf records for Pass-books, it seemed likely that this decision would in due course be the subject of legislation. This has, in fact, happened and Section 436 of Companies Act, 1948, provides for entries in a bound book or by "some other means." But where the entries are not in a bound book, adequate precautions must be taken for guarding against falsification and for facilitating its discovery. There are penalties for default.

ROUTINE WORK OF AUDIT OF SHARE CAPITAL

At the first audit the issue of the share capital should be checked by reference to the Application and Allotment Sheets, which should be initialed or signed for identification by the chairman of the Board of Directors, and the minute of the Board authorizing the allotment should be seen. The Application and Allotment Sheets should be compared with the Application Letters and counterfoils of the Allotment Letters, or with the Allotment Letters themselves if they have been surrendered in exchange for Share Certificates. The moneys received in respect of the shares should be traced to the company's Banking Account. If there be calls in arrear the amount should appear as a deduction from the share capital on the face of the Balance Sheet. A list of the arrears as shown in the Share Ledgers should be made and the list agreed with the Ledger Balance "Calls in Arrear." The attention of the Directors should be drawn to the arrears, and correspondence with the shareholders who are in arrear inspected. As regards calls on shares, see the minute making the call, agree the amount received with the amount due on the shares in the Share Register, trace the moneys received to the bank, and report as to arrears as before. A separate Banking Account should be opened in respect of moneys received on application and allotment and for each call. Any subsequent issues of shares should be checked in the same way.

The Auditor should see that the total number of shares on the Register agrees with the Share Capital Account, and that the total capital issued does not exceed the authorized capital as originally fixed by the Memorandum of Association, or as subsequently increased. Each class of shares should have a separate account in the Ledger, and the balances be agreed with the aggregate of the balances appearing in the respective Share Registers.

The Auditor should see what conditions or rights attach to the various classes of shares, and that these conditions or rights have been duly complied with. The transfer of shares may be compared with the Transfer Register, the register called to the Share Register, the counterfoils of issued certificates examined, and cancelled certificates produced. This, however, is not so much a question of accounting as of record. The checking of the transactions is usually a matter of special arrangement, the work being done by the Auditors before each board meeting and a report made that the certificates to be signed are in order.

A record should be kept giving details of the certificates cancelled and the new certificates issued with an agreement of the respective totals. (See Chapter XX, as to verification of the transfer of shares, share certificates, etc.)

CHAPTER XIX

RESERVES AND PROVISIONS

RESERVES are amounts set aside, as a rule out of profits, for a general or a specific purpose. Until the passing of the Companies Acts, 1947 and 1948, a classification of reserves into general reserves and specific reserves was sufficient and appropriate. A specific reserve is a sum set aside to provide for some anticipated or possible loss in the value of an asset; to redeem debentures; to create a sinking fund; to provide for some exceptional future liability or for some similar object. The new classification of items of this character into capital reserves, revenue reserves, and provisions, is dealt with in the following pages.

A general reserve is set aside to strengthen the financial position by retaining in the business, profits which might otherwise be distributed in cash. In this way, resources are provided to meet contingencies and additional capital requirements. A general reserve, in effect, differs only in name from the "carry forward" or "surplus" as the balance remaining at the credit of Profit and Loss Account (after deducting dividends) is commonly called. The transfer of part of the profits to general reserve has the effect of setting aside a sum which thereupon ceases to be regarded as profit available for distribution under ordinary circumstances.

Examples of appropriations, whether in reserves or provisions, which have hitherto been regarded as specific, are reserves for obsolescence of plant and machinery, dilapidation of buildings, expiry of leases, doubtful debts, possible shrinkage in the value of investments, claims in dispute to the extent to which disputed, or liabilities which may arise under uncompleted contracts. In any of these cases, a definite loss may eventually arise, and if profits are set aside to meet such losses, the position can be met without the disturbance of the financial position which might arise if no such provision had been made.

The Auditor's views in relation to reserves are determined by an examination of the position disclosed by the books. He cannot insist on the creation of reserves which he may think are necessary. His duty, if he is dissatisfied, is to report his view to the shareholders who are in this way given the opportunity of determining whether they will accept the views of the Directors or those of the Auditor.

The manner in which reserves and provisions are shown in the Balance Sheet is governed by the Eighth Schedule to the Companies Act in Part 1, paragraphs 4 and 7, which are given in

detail in Chapter IX, page 132. The requirements relate broadly to—

(*a*) The classification under appropriate headings.

(*b*) The source of increases, except in the case of provisions for depreciation, renewals or diminution in value of assets.

(*c*) In the case of decreases, the application of the amounts derived from the decrease.

It should be noted that where there are sub-headings under a heading showing Reserves or Provisions, the foregoing applies to each of the separate amounts shown in the sub-headings and not to the aggregate.

Part IV of the Eighth Schedule, in paragraph 27, gives an interpretation of the expressions "Provision," "Reserve," "Capital Reserve," and deals also with items included under the heading of Liabilities.

Certain exceptions for special classes of company are provided in paragraphs 23–26 of the Schedule, these being banking companies, discount companies, assurance companies within the meaning of the Assurance Companies Acts, 1909–1946, and such other companies as the Board of Trade may prescribe.

The general basis of the distinction between reserves and provisions, and also the subdivision of reserves into capital reserves and revenue reserves is very important. In regard to reserves, the definition in the Act does not assist very much, but this is understandable, for it is a matter about which it is difficult to be exact. The general principle appears to be to keep reserves under control and to prevent their being created without the approval or even without the knowledge of shareholders. In this sense, the Act clearly intends that the term "provision" shall not cover anything which is of a general character, but should be used for amounts which, at some foreseeable time, will be required for a specific purpose. Anything in excess must be treated as a reserve and not as a provision.

In recent years, prior to the Companies Act, 1948, the term "provision" was used in cases where provision for a known liability was made if the amount could not be determined exactly though it might be estimated closely. It is now considered that, if the amount can be estimated closely, it should be included as a liability and not as a provision. Similarly, amounts set aside to meet deferred repairs, the execution of which is a contractual or statutory obligation, should be treated as liabilities if the amounts can be determined with substantial accuracy, and as provisions if the amounts cannot be so determined. Other amounts set aside to meet deferred repairs because they are regarded as charges necessary for the correct computation of profits, should be treated as provisions.

The term "reserve" can be said in a general way to be something more remote than a provision. It is used to apply to sums set aside which it is considered prudent or advisable to appropriate to provide for contingencies or for additional working capital, and generally to strengthen the business. Obvious examples are general reserves and reserves for contingencies. Any such appropriation, even though of a character which might suggest inclusion under the heading of a provision, should be treated as a reserve to the extent to which it exceeds the sum considered by the Directors to be reasonably necessary for the purpose. Thus, the Directors may decide that it would be useful to provide an additional sum for depreciation or for increased cost of replacement, and any such sum would not come within the definition of provision.

Whether a reserve is a capital reserve or a revenue reserve, depends in some cases upon its origin and purpose and in some cases upon intention. Thus, a general reserve may be a revenue reserve or a capital reserve, according to whether the intention is to make it available for distribution or to regard it as frozen. At some future time it may be decided that it is no longer required as a capital reserve and that it should become a revenue reserve. The inclusion of a reserve as a capital or a revenue reserve in one year does not mean that it cannot, in a future year, become the reverse, for the determining factor is whether it is regarded as free for distribution through the Profit and Loss Account or not. This is where the Act, quite rightly, ceases to be rigid and leaves the matter for determination by the Directors and the members.

It will be observed from the Eighth Schedule, paragraph 7, that besides providing for the headings under which reserves and provisions will be shown in the Balance Sheet, the Act also provides for movements of reserves and provisions to be shown. Thus, it must be made clear in the accounts, either on the Balance Sheet itself or in the Profit and Loss Account (if the Profit and Loss Account is involved) what changes there are and how they are effected, unless the amount involved is not material. If there has been an increase, the cause of the increase must be shown; if there has been a decrease, the application of the amount must be shown. This will mean that reserves and provisions cannot be augmented or used in the course of the year without disclosure of the fact to the members.

SECRET RESERVES

If the Companies Act, 1948, operates as is intended, secret reserves, except in the case of certain types of company which are exempted from the restrictions in regard thereto (namely, banking, discount, insurance, and similar companies) should become a thing of the past. None the less, it is appropriate in a work of this kind

to make reference to them, as the very full consideration which this subject received in 1931 in the case of *Rex* v. *Lord Kylsant and Morland,* better known as the Royal Mail case, undoubtedly influenced the Company Law Amendment Committee whose recommendations led to the Companies Act, 1948.

"Secret Reserves" or "Internal Reserves" could be created in various ways, as shown below, mainly by writing down stocks or other assets to an excessive degree, or over-estimating liabilities not capable of precise computation. As their name suggests, these reserves were not shown on the face of the Balance Sheet. Reserves of this type were more common in the days when limited companies were few in number and business was mainly in the hands of private traders. As reserves were of a precautionary nature, making for financial stability, they were not necessarily objectionable, when they were made in good faith.

The full report of the Royal Mail case is worthy of study, but the following extract from the summing up by the judge, which has been given earlier, may appropriately be re-quoted—

> We have heard a great deal about the keeping of secret reserves, and we have heard a great deal about the commercial troubles which may flow from that practice. We have heard a great deal about what is often done in practice, and, it may be, reasonably and properly done, but questions may arise some day, and possibly will arise, in some appropriate proceeding in order to find out and elucidate these very special matters. It was said by a very learned Judge on one occasion, by way of observation and not by judgment, that a company—that is to say, the shareholders—could not complain if the position of the finances of the company was better than the accounts disclosed. That has been quoted from time to time as a justification for this method of keeping reserves secret. But there may be very great evils if those who have the control and management of the company, and who control and manage companies for the benefit of the shareholders who entrust their moneys to companies, if very large portions of the company's assets are left to the secret disposition of the managing authority. It may work very well in many cases; no doubt it does. It is a practice which is being followed no doubt by many concerns of the highest standing. On the other hand, it may be the subject of almost intolerable abuse. Such a system may be used to cover up negligences, irregularities, and almost breaches of faith. It is said to be a matter of domestic concern between the company and the shareholders, but if shareholders do not know and cannot know what the position is, how can they form any view about it at all? How can they consider whether it is something which they are satisfied with or which they are not satisfied with?

The view had been expressed, and it gained emphasis from this case, that while the accumulation of secret reserves might in many cases be quite proper and not open to objection, the utilization at a later date of such reserves, or any part of them (if the amount were relatively large) to increase the profits, should be disclosed specifically in the accounts. It was, of course, recognized that such a procedure would in most cases defeat the purposes of secret

reserves. But it was very clear, that however justifiable the creation of secret reserves to strengthen the business might be, disclosure should be made or some indication given to the shareholders where the amount was relatively substantial, or where the practice of drawing on secret reserves continued year by year.

The object of an internal reserve is the creation of a fund which will enable the Directors to meet any unexpected claim or liability without having to draw upon the admitted or disclosed reserves. The guiding principle may be to protect the company against damage which might ensue if anxiety were caused amongst their own shareholders or the outside public, or if a loss were disclosed to a rival company. Some such consideration clearly applies in the case of a banking or discount company or an assurance company, and it has been recognized in the Companies Act by the exemption granted to such a company from certain requirements of the Eighth Schedule to the Act (Companies Act, 1948, Eighth Schedule, Part III). A banking or discount company is described in paragraph 23 (3) of the Schedule as any company which satisfies the Board of Trade that it should be treated for the purposes of the Schedule as a banking company or as a discount company. It should be noted from paragraph 23 referred to, that where in its Balance Sheet a company of the kind mentioned does not state separately capital reserves, revenue reserves or provisions (other than provisions for depreciation, renewals or diminution in value of assets), any heading stating an amount arrived at after taking into account such a reserve or provision shall be so framed or marked as to indicate that fact, and its Profit and Loss Account shall indicate by appropriate words the manner in which the amount stated for the company's profit or loss has been arrived at.

The following examples will show how secret reserves can be created —

(*a*) By inserting in the Balance Sheet of an insurance company, under the heading representing the amount reserved to meet claims in respect of policies in force, a larger amount than is considered necessary, based on the experience in the past.

(*b*) By reserving a larger amount for possible loss on the realization of book debts than it is expected will be ultimately sustained.

(*c*) By valuing the investments below their true value on an independent valuation and below the original cost.

(*d*) By under-valuing the prices of material in stock or taking off an excessive discount from the manufactured stock-in-trade.

(*e*) By writing down buildings, plant and machinery, furniture and fittings at an excessive rate.

An objection to the creation of internal reserves was that it might deprive those who happened to be shareholders, at the date of the creation or addition to such reserves, of the opportunity of

participating in a higher dividend than that which was declared, although the profit might have been earned while they were shareholders. Directors must, however, give primary consideration to the company and they cannot have regard to interests of individual shareholders which may be opposed to the interests of shareholders as a body, more particularly where the disposal of shareholdings is the consideration in question. It is their business to administer the affairs of the company to the best of their judgment and to maintain its current resources.

Consideration of the subject of secret reserves, while for the most part inconsistent with the requirements of current legislation, may, none the less, be worth while as explaining the circumstances which led thereto.

TAXATION

Provision must be made for the company's liability to taxation, and the basis on which the amount set aside is computed must be shown in the Balance Sheet (Companies Act, 1948, Eighth Schedule, paragraph 11 (10)). The manner of computation may vary as between different companies and the views of Boards of Directors as to what is appropriate. The minimum which should be provided for is the proportion of the assessment for the fiscal year in which the company's Balance Sheet falls, covering the period from the 6th April to that date. In this case, the remainder of the fiscal year will fall into the next accounting period; it should, however, be borne in mind that the payment is due on the 1st January although the year of assessment does not end until the following 5th April.

This is the minimum essential requirement so far as income tax is concerned. But in most cases a fuller provision is made and is desirable. Usually, the liability for a year of assessment is based on the results of the preceding year, but the actual profits of the year of assessment may be higher, with the consequence that that year will not have to bear tax which is directly related to its results. Further, the year in which the tax on these good results has to be borne may itself show a reduced profit and have to bear a burden which is relatively excessive, or which the profits may be inadequate to meet. With taxation at its present high level this may be crippling unless an appropriate provision has been made in anticipation.

With this position in mind, it has for many years been the practice to make provision not only for the minimum tax for the current year of assessment, or a proportion of it, but also for income tax which will fall due in the future, calculated by reference to profits of the current accounting period even though the assessment based on those profits will not arise earlier than nine months

later and can be as much as twenty-one months later, according to the closing date of the accounts. This is a policy of prudence, and in the early years of operation of an undertaking or when such an additional provision is first made, it may prove a heavy burden. Once the system is in operation, however, the charge can reasonably be met and the amount set aside each year is directly related to the profits of the year.

The Companies Act requires that the Balance Sheet should show the basis on which the amount, if any, set aside for United Kingdom tax is computed (Eighth Schedule, Part I, paragraph 11 (10)). A distinction should be made between the current liability for tax for the year of assessment in which the company's financial year ends and future income tax computed on the above-mentioned basis. The amount computed or estimated for the former should be shown as a provision whereas the latter should be shown as a reserve.

SINKING FUND

A Sinking Fund is a form of specific reserve set aside for the redemption of a long term debt or the replacement of a wasting or a depreciating asset. It is created by charging the requisite amount to the debit of Income or Profit and Loss Account. The use of the word "fund" implies investment outside the business, and in the case of a Sinking Fund there should be such an investment, the assets being specifically earmarked to represent the Fund. As the amount is written off to Profit and Loss Account, the correct way to bring the amount into the Balance Sheet is to raise two accounts, one on the assets side, setting out the investments, and one on the other side called Sinking Fund which corresponds with those investments. The interest earned on the investments is usually added to the Sinking Fund unless the conditions attaching to the Fund provide otherwise. The Fund should be used only for the purpose for which it has been provided unless the necessity for it lapses.

The effect of the setting aside of a Sinking Fund is to invest profits year by year. As a result, when the Sinking Fund has matured, there will be a sum at the credit of Sinking Fund Account which is in reality accumulated income.

If the fund is for the purpose of replacing an asset, no other provision will probably have been made for the depreciation of the asset. The procedure on the realization of the Sinking Fund will, therefore, be to write off the expired asset by a transfer from the Sinking Fund, and to use the proceeds, in cash, of the Sinking Fund for replacement of the expired asset, or for investment, or as may be dictated by circumstances. If the Fund is for the extinction of a liability, such as a debenture debt, the Sinking Fund

investments will be used to pay off the liability and the balance on the Sinking Fund Account itself will become a free reserve, having been raised out of profits year by year.

As an alternative to the purchase of investments, an endowment policy may be taken out payable on a given date for the amount which will ultimately be required. In this case the definite amount assured is available on the due date and no risk of capital depreciation will arise if the insurance company selected is one of repute. The risk of depreciation in investments is a disadvantage of the investment method which cannot be ignored. On the other hand investments may appreciate. The manner of setting aside is, however, a question of policy. The Auditor is only concerned to see that the facts are correctly set out.

If a policy is taken out—

(*a*) Profit and Loss Account should be debited with the amount of the annual premium.

(*b*) A Sinking Fund Policy Account should be debited each year with the amount of the premium and a Sinking Fund Account credited, the respective balances being included in the Balance Sheet.

In the earlier years the Sinking Fund policy will not be equal in value to the Sinking Fund Account, but the yearly addition of interest to the premiums by the insurance company gradually increases the value of the policy representing the Sinking Fund. It is not usual to credit the accumulating interest to Profit and Loss Account.

At maturity the value of the policy will therefore exceed the total of the Sinking Fund. The difference should be credited to the Sinking Fund Account, and the Policy Account will be extinguished by the receipt of the cash due on maturity. The cash, which represents saving out of income, will then be in the coffers of the business and available for the purpose for which it is required.

The interest *may* be added from year to year to the Sinking Fund premiums on the one side of the Balance Sheet and to the Fund on the other side. If this be done an allowance must be made for the expenses chargeable in respect of the policy which will usually amount to one year's premium.

A capital redemption reserve fund provided for the redemption of preference shares may be applied by the company in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares (Companies Act, 1948, Section 58 (5)).

RESERVES FOR REPLACEMENTS

The financing of replacements of fixed and current assets requires special attention at a time of increasing costs. So far as

certain fixed assets are concerned, a policy will probably have been followed of providing for depreciation and possibly obsolescence year by year, so that at the end of their estimated life the original cost will have been either written off or an equivalent reserve or fund provided, so that the financial equilibrium of the undertaking will not be disturbed when replacement takes place. Such provisions, however, are related to original cost, and it may well be that when the replacement comes to be made the cost will be very much higher, and unless this position has been anticipated replacement may be difficult. It may be said that major increases in these replacement costs should be met by the raising of new capital for it is clear that the capital is out of tune if increased levels of cost apply, as they will in such circumstances, to the assets generally. On the other hand, the rise may not be sufficient to warrant the raising of new capital and further the permanence of the high level of prices cannot be assured, and there may be a subsequent decline which will mean a pruning of the capital structure.

An alternative method of making the provision is to set aside a sum, either annually or from time to time, over and above the normal charge for depreciation, which will enable the undertaking to meet this additional burden. It can be done either by ascertaining, on the basis of current costs, the additional amount which it is estimated will be required and computing an annual charge to provide this amount at the required time; or round sums may be provided from time to time, particularly when substantial profits are available, for the purpose. Any such sums are best dealt with as transfers to reserve after the profit for the year has been ascertained, and the items should be appropriately described. As the sum is being provided for a specific capital purpose it should be shown as a capital reserve to provide for increased cost of replacement of assets.

The question of rising price levels in relation to accounts has been made the subject of a recent recommendation of the Council of the Institute of Chartered Accountants in England and Wales, for the guidance of its members.

CASES

The Directors of a company were empowered by the Articles of Association to create a Reserve Fund out of the profits of the company for such purposes as they should think conducive to the interests of the company, and to employ the Reserve Fund in the business of the company, without being bound to keep it separate from the other assets. The company had built up a Reserve composed partly of premiums received for leases, partly of premiums received on the issue of preference shares, and partly of

ordinary business profits. The Reserve was used in the company's business, and was not kept separately invested. The company had incurred a loss arising from the depreciation in the value of its public houses below the amount stated in the company's Balance Sheet. The company accordingly applied for the sanction of the Court to a scheme for reduction of capital, whereby the company, while retaining a small portion of the Reserve, attributed to the Reserve more than its rateable proportion, and to the Capital Account less than its rateable proportion of the loss.

Held, that the Reserve, having been properly created out of profits, in ascertaining the amount of capital lost, the loss of assets ought to be treated as rateably apportioned between the Reserve and the Capital Account, and that, in the absence of special circumstances, the company, in proposing a scheme for reduction of capital, was not bound to wipe out the whole of the Reserve, or to attribute to it more than its due proportion of the loss, though it might do so if it chose; and the Court sanctioned the scheme.—*Re Hoare & Co.*, [1904] 2 Ch. 208.

In a case where the Articles of Association of a company provided that the Directors might, in priority to any dividend, set aside out of "profits" any sum as a "Reserve Fund" for certain specified purposes, or "any other contingencies or purposes of the company," and might invest it; that any interest derived from such investment should be dealt with as profits; and that, subject thereto, "the entire net profits of each year" should belong to the shareholders, the Directors year by year carried part of the profits to three Reserve Funds, to meet (*a*) depreciation of steamers, (*b*) insurance, and (*c*) canal improvements; and the remaining profits, after providing for the preferential dividend, were distributed among the ordinary shareholders. These Reserve Funds were not represented by any separate or specific investments.

The company's undertaking was eventually sold by special Act of Parliament at a price which left a surplus in excess of the liabilities of the company and the capital paid up on the ordinary and preference shares. The sale was completed during the currency of a financial year. On the completion of the sale the company passed resolutions for a voluntary winding up. It had never been found necessary to resort to any of the Reserve Funds while the company was a going concern, and part of them had been in fact divided among the ordinary shareholders in the form of bonus; and at the date of the sale three funds representing these Reserve Funds were still standing in the company's books.

It was held by the Court of Appeal that all three Reserve Funds represented undrawn "profits" uncapitalized, and were, therefore, to be treated as income, to which, subject to the preferential

dividend for the broken financial year, the ordinary shareholders were exclusively entitled, and not as "capital" or "assets" distributable among both the ordinary and the preference shareholders; also, that in taking the accounts for the broken year, the value of the plant and book debts should be taken at the actual ascertained values as stated in the Stock Books, and not at the lower values at which the company had, according to their regular custom and from motives of prudence, estimated them in a previous annual Balance Sheet on which a dividend had been declared; and that the difference between the two values represented undrawn profits, to which, subject to preferential dividend, the ordinary shareholders were exclusively entitled.—*Re Bridgewater Navigation Company*, [1891] 2 Ch. 317.

The Directors of a company resolved to distribute accumulated profits as a bonus dividend of 50 per cent on the capital paid up in the proportion of one new share for every two old shares paid up, and one new share for every eight old shares with £7 10s. paid up, the dividend to be payable on the 6th of September, 1890. The dividend was, at the option of the shareholders, payable in cash, or applicable to the payment of the amount then due in respect of new shares or of calls. The old shares were £10 shares, some fully paid up or with £7 10s. paid up. A call of £2 10s. per share was to be made at the same time on such of the shares as were not fully paid. The trustee of a will who held 150 old shares fully paid up (the tenant for life consenting, without prejudice to his rights to treat the dividend as income) accepted seventy-five new shares in lieu of the £750 bonus dividend on the 150 shares. The shares were sold for £1363. The tenant for life claimed £750 out of the purchase money on the ground that it was income; he did not dispute that the balance was capital.

It was held that the £750 was income, on the ground that the declaration of the bonus dividend and the issue of the new shares were two distinct transactions and not one transaction, as in *Bouch* v. *Sproule* (1887), 12 App. Cas. 385, the shareholders having the option of taking the dividend in cash without taking up the new shares.—*Re Northage, Ellis* v. *Barfield* (1891), 60 L.J. Ch. 488.

A company had an issued capital of 40,000 preference shares of £5 each fully paid and 60,000 ordinary shares of £5 each, of which 6047 were fully paid, and the residue were paid to the extent of only £1 a share. By the Articles of Association dividends were paid upon the ordinary shares in proportion to the amount paid up on the shares. The company had paid dividends and had accumulated a very large reserve fund consisting of undivided profits. A special resolution was duly passed and confirmed "That out of the accumulated profits of the company the sum of £4

per share be paid to the holders of 6047 fully-paid ordinary shares of the company by way of reduction of capital pursuant to Section 40 of the Companies (Consolidation) Act, 1908."

Held, that that Section could not be construed as authorizing the return of capital to the whole class of shareholders among whom the accumulated profits were divisible, and therefore the resolution was not *ultra vires*.—*Neale* v. *City of Birmingham Tramways Co.*, [1910] 2 Ch. 464.

CHAPTER XX

VERIFICATION OF THE TRANSFER OF SHARES, OF SHARE CERTIFICATES, AND OTHER DOCUMENTS RELATING THERETO

THE Auditor is not concerned with the rights of individual shareholders, but is frequently employed at a special remuneration to check all the work relating to transfers and share certificates and to report to the Directors of the company that the share certificates are in order for signature. No accounting principles are involved in this routine work, but the Auditor should be versed in the technicalities of transfer work.

In the first place it is essential that there should be an exact understanding between the Directors and the Auditor as to the extent to which the latter is to check the share records.

Most companies adopt the usual common form of transfer, but the Auditor should refer to the Articles of Association in this respect, and note whether they contain any special provisions relating to transfers.

The transfer deeds should be scrutinized to ascertain—

1. Whether the name and address of the transferor and numbers and distinctive numbers of shares transferred correspond with the share certificate surrendered, which should be *cancelled by the Auditor* and agreed with the Register of Share Certificates Cancelled and New Certificates Issued. (See *infra.*)

2. Whether the stamp duty impressed is correct. Transfers for a nominal consideration should bear the Inland Revenue Marking Officer's stamp as an endorsement.

3. Whether the class of shares and name of the company are correctly stated, and whether there are any calls in arrear on the shares. If there are calls in arrear the Directors will probably desire to consider the circumstances before deciding whether to accept the transfer.

4. Whether the date is inserted and the signatures are duly witnessed. Regard should be paid to the regulations of the company as to the witnesses which may be accepted; e.g. some companies refuse to accept a wife as witness to her husband's signature. The signatures of parties abroad should be attested by a local consul or notary.

5. Whether the signatures of all the parties appear on the transfer and are in accord with the names set out in the deed.

6. Whether the signature of the transferor appears to correspond with previous signatures in the company's possession.

The Auditor is not necessarily an expert in handwriting and this form of verification is not always adopted unless by the express desire of the Directors.

7. Whether all alterations are duly initialed by all parties to the transfer.

It should be ascertained from the Share Register that the transferor is the registered holder of the shares transferred. This is *prima facie* evidence, but, unless every entry in the Share Register from the inception of the company has been checked by the Auditor, it would not be difficult for a fraudulent clerk or secretary to open a fictitious account in the name of a transferor in addition to forging a Share Certificate. If a "Register of Share Certificates Cancelled and New Certificates Issued" is kept (see *infra*), it would be necessary in a fraud of this kind, also to forge a certificate for cancellation and the Auditor's "marks" on the certificate.

It is the regular practice of most companies to notify transferors of the lodgment or certification of transfers purporting to be signed by the transferors, and the Auditor may ask to see the notices, and any objections which have been received. Unless the issue of the notices and the receipt of objections is carried out independently of the Registration Department of the company, this method of verification is not convincing, for the notices might not have been posted, or the objections might have been destroyed.

The new Certificates should be compared with the transfers in respect of the name and address of transferees, and numbers and distinctive numbers of shares transferred, and initialed or specially stamped if correct.

In cases where only part of a holding shown on a surrendered certificate is transferred, the new certificate for the unsold balance should be examined as to name and address, and numbers and distinctive numbers of shares.

The practice differs with various companies in the matter of balance certificates. Some only draw them on request, others draw them in every instance. The latter method, although involving more work by the company's staff, appears to afford a further check, provided a "Certificates Cancelled and Issued Book" is kept, showing on one side the shares represented by certificates surrendered for cancellation, and on the other those appearing on new certificates drawn, both sides agreeing in total. If such a book is kept the Auditor should examine it with the respective certificates, check the casts of the shares and agree the totals.

Where companies only draw balance certificates on request, the Auditor will require so to mark the certificates surrendered for cancellation (preferably by placing his initials against the entries endorsed thereon in respect of shares transferred), that he may

ascertain at any time how many shares remain untransferred and still held by the shareholder named thereon, or which may await further transfers by him not yet presented for registration. If balance receipts are issued they should be examined in the same way and the counterfoils of the balance receipts "marked."

The Auditor should ask for production of the company's "stop" list in respect of lost certificates, and notices of lien or distringas, and see that the transfers produced to him are not affected thereby.

If a Transfer Register is kept the entries therein should be compared with the transfers.

Before checking the postings to the Share Register the Auditor should examine the Directors' Minute Book to ascertain that the previous transfers checked have been duly passed by the Board for registration.

The amount received for transfer fees may be traced to the Cash Book, but this is usually part of the routine work of the audit of the company's accounts.

The audit of share transfers has made fraud much more difficult, even by means of forgery. The following cases are of interest, though they deal with administration rather than auditing.

1. It is a common practice to deposit with the lender blank transfers accompanied by a share certificate as security for a loan. The transfer is signed by the transferor, but particulars as to transferee and date of execution are not inserted. Until it is desired to lodge the transfer deed for registration the date should not be entered as the document must be stamped within thirty days of the date it bears.

The company is not concerned with a blank transfer, and will probably have no knowledge of it, but such a transfer may give a good equitable security in respect of the shares, whether the company requires transfers to be by deed or not.—*Société Générale* v. *Walker* (1886), 11 App. Cas. 20.

2. Should the transferor in blank execute another transfer, the transferee can establish a good title to the shares on registration of his transfer, and the blank transfer may be overridden.—*Peat* v. *Clayton*, [1906] 1 Ch. 659.

Share certificates almost without exception bear a note that no transfer will be registered without production of certificate. A company is usually prepared, however, to issue a duplicate certificate to replace a certificate which has been lost. In this case the shareholder to whom the duplicate is issued must furnish a letter of indemnity. Fraud is still possible, for a transferor who has signed a blank transfer and submitted his share certificate as security, can obtain a duplicate certificate from the company, though this would involve a fraudulent declaration in the letter

of indemnity that he had lost the original certificate. Having obtained the duplicate he could execute a fresh transfer, sell his shares, and submit the duplicate certificate. This emphasizes the importance of registering transfers as quickly as possible.

3. If a company is deceived by a forged transfer and registers the transferee and issues a certificate to him, and a third party acquires the shares from the transferee on the strength of the certificate, the company is liable to pay any loss which the purchaser may suffer when the shares are claimed by the real owner. —*Bahia* v. *San Francisco Railway Co.* (1868), L.R. 3 Q.B. 584.

4. If a Secretary fraudulently, without the authority of the Directors, affixes the seal of the company to share certificates, forging the signatures of the Directors, and issues such certificates, it has been held that the company is not liable to the holders of such certificates for valuable consideration.—*Ruben* v. *Great Fingall Consolidated Co.*, [1906] A.C. 439.

5. A person who presents a forged transfer in good faith and procures the issue of a fresh certificate is liable to indemnify the company.—*Sheffield Corporation* v. *Barclay*, [1905] A.C. 392.

6. No notice of any trust, expressed, implied, or constructive, shall be entered on the register, or be receivable by the registrar, in the case of companies registered in England. (Companies Act, 1948, Section 117.) But if the Directors have become aware that a transfer is being made in breach of trust or to defraud anyone having equitable rights in the shares, the Directors may become personally liable if they admit the transfer without having given notice to the person interested, but the company has no liability.— *Société Générale* v. *The Tramways Union* (1885), 14 Q.B.D. 424.

If a forged transfer is presented to and accepted by a company the transferee mentioned in the transfer does not obtain a good title. The true owner of the shares is, of course, entitled to demand that the shares remain registered in his name. If any dividends have in the meantime been paid to a person other than the true owner, the latter can claim payment from the company.

The certification by a company of a transfer shall be taken as a representation by the company to any person acting on the faith of the certification that there have been produced documents appearing to show a prima facie title to the shares or debentures, but not as a representation that the transferor has any title (Companies Act, 1948, Section 79).

CHAPTER XXI

AUDITING THE STATUTORY REPORT

SECTION 130, Subsections 1, 2, 3, and 4 of the Companies Act, 1948, reads as follows; the section does not apply to a private Company –

130.—(1) Every company limited by shares and every company limited by guarantee and having a share capital shall, within a period of not less than one month nor more than three months from the date at which the company is entitled to commence business, hold a general meeting of the members of the company, which shall be called "the statutory meeting."

(2) The directors shall, at least fourteen days before the day on which the meeting is held, forward a report (in this Act referred to as "the statutory report") to every member of the company:

Provided that if the statutory report is forwarded later than is required by this subsection, it shall, notwithstanding that fact, be deemed to have been duly forwarded if it is so agreed by all the members entitled to attend and vote at the meeting.

(3) The statutory report shall be certified by not less than two directors of the company and shall state—

(*a*) the total number of shares allotted, distinguishing shares allotted as fully or partly paid up otherwise than in cash, and stating in the case of shares partly paid up the extent to which they are so paid up, and in either case the consideration for which they have been allotted;

(*b*) the total amount of cash received by the company in respect of all the shares allotted, distinguished as aforesaid;

(*c*) an abstract of the receipts of the company and of the payments made thereout, up to a date within seven days of the date of the report, exhibiting under distinctive headings the receipts of the company from shares and debentures and other sources, the payments made thereout, and particulars concerning the balance remaining in hand, and an account or estimate of the preliminary expenses of the company;

(*d*) the names, addresses and descriptions of the directors, auditors, if any, managers, if any, and secretary of the company; and

(*e*) the particulars of any contract the modification of which is to be submitted to the meeting for its approval, together with the particulars of the modification or proposed modification.

(4) The statutory report shall, so far as it relates to the shares allotted by the company, and to the cash received in respect of such shares, and to the receipts and payments of the company on capital account, be certified as correct by the auditors, if any, of the company.

(5) The directors shall cause a copy of the statutory report, certified as required by this section, to be delivered to the registrar of companies for registration forthwith after the sending thereof to the members of the company.

On the issue of a prospectus, a columnar list or book of the applications received in respect of each class of share is prepared for submission to the Directors of the company, who then settle

the allotments to be made; it is completed by the insertion of particulars of the allotments. The list then contains the names and addresses of the applicants, the number of shares applied for, the money received on application, the shares allotted, the total amount payable on application and allotment, and finally the amount payable by the applicants on allotment or which may be repayable to those applicants who have not received an allotment in full. The list, after approval by the Board of Directors, is signed by the Chairman.

The Auditor should—

(1) Verify the list by reference to the applications and allotment letters and the Minutes, tracing the cash received and paid through the company's banking account. (In the case of debentures, the same procedure is followed.)

(2) Check the entries in the Share Ledger with the application and allotment lists or book.

(3) Check return of application money or a part thereof to persons to whom shares have not been allotted or who are entitled to a return of cash because a full allotment has not been made to them. Where a partial allotment is made, the excess application money is, in the first instance, utilized in paying the amount due on allotment, leaving a balance due to or by the applicant.

(4) Check the receipt of cash for calls on the shares and examine the minutes of the Board of Directors in regard thereto.

(5) Verify that the provisions of the Memorandum and Articles of Association have been complied with and the minimum subscription made.

(6) Check all commissions for underwriting or otherwise and verify that the provisions of Section 53 of the Companies Act, 1948, have been complied with.

In addition to the receipts and payments on capital account, the Statutory Report must exhibit the receipts from other sources and all payments made, though not necessarily of a capital nature. The Auditor, although for his own satisfaction he may vouch all cash transactions, has only to certify as to the shares allotted and to the cash received in respect of such shares and to the receipts and payments on capital account, which he will examine and vouch in the usual way. The usual form of audit certificate is as follows—

I certify that so much of the above report as relates to shares allotted by the company, to the cash received in respect of such shares, and to the receipts and payments of the company on capital account is correct.

CHAPTER XXII

HOLDING COMPANIES AND SUBSIDIARY COMPANIES

THE development in comparatively recent years of the subsidiary company has proved to be of great importance to accountancy and commerce. The practice involves the existence of a parent company—usually called a "holding company"—and one or more companies called "subsidiary companies" over which by virtue of a shareholding or otherwise the holding company exercises control. Control may arise by means of the possession of more than 50 per cent of the issued share capital of the subsidiary or of such an amount of the share capital as will entitle the holding company to more than 50 per cent of the voting power. Again, although the holding company may not possess the amount of share capital laid down by the Companies Act, 1948, it may exercise control of the subsidiary company by virtue of a right, directly or indirectly, to appoint the majority of the Directors of the other company (Companies Act, 1948, Section 154).

The existence of the holding company and the subsidiary company were recognized in the Companies Act, 1929, which contained definitions of those Companies and laid down regulations affecting their accounts. The Companies Act, 1948, as will be seen in the following pages, goes much farther. The relationship of holding company and subsidiary company may arise in several ways, of which the following may be cited—

(1) By the acquisition by a company (holding) of a controlling interest in an existing company by the acquisition of a majority of the shares or otherwise.

(2) By the formation by a company (holding) of a subsidiary company, by registration in the ordinary way, and the acquisition by purchase or otherwise of a controlling interest in the company. In this case it may be that the holding company (in its own name or the names of nominees) will acquire the whole of the shares, in which case the subsidiary company will become a "wholly-owned subsidiary."

(3) By the division of an existing company into two or more separate companies of which one becomes the holding company and the remainder subsidiary to it.

(4) By the formation of holding and subsidiary companies as above, and the further formation of companies subsidiary to existing subsidiary companies—known as sub-subsidiary companies. In this case grand-parental control is exercised over the

grandchildren by reason of the control of the grandchildren's parents.

The complications, both of accountancy and of direction, which the existence of subsidiary companies entails, are so numerous that it is of interest to examine the considerations which prompt and appear to justify their formation.

The first consideration, and a very practical one, is the desirability of maintaining the name and constitution of a business which has been acquired by another (holding) company. There may be some goodwill in the name, with which its products may be connected; or, the business may be self-contained and different from the business of the holding company and for this reason it may be better to keep it as a separate entity. It is therefore more convenient to deal with the acquisition by a purchase of shares than to liquidate the company and incorporate the business in that of the holding company.

A second consideration, applying particularly to foreign subsidiary companies, is the probable desirability or necessity of having a separate local legal entity. This is important where locally domiciled companies have rights or privileges not accorded to foreigners or where non-domiciled companies are subject to certain disabilities; this question is often material in relation to the incidence of taxation whether in the United Kingdom or in the country concerned.

A third consideration is the necessity in many cases for anonymity. It is frequently undesirable that the public and competitors should be aware, at any rate at first, of the acquisition of one company or business by another. Secrecy can be preserved to some extent by the maintenance of the acquired business as a subsidiary company, the shares being held by nominees of the holding company. In these days it is not easy to keep anything secret for long, but it may be possible by the use of nominees to conceal the exact extent of the holding company's interest.

A fourth consideration, probably less effective now than in the past, is the means which it may offer to secure the most favourable incidence, or even the avoidance, of taxation; to escape the effect of certain legislation, and to limit or control publicity as to the subsidiary company's activities.

Abuse of the subsidiary company has led in the past to a number of prosecutions of Directors, while certain uses not amounting to abuses have led to restrictive legislation. One example of legislation of this character is the Finance Act, 1936, Section 19 of which widened the net which catches for sur-tax assessment the undistributed income of certain companies.

A holding company in the more generally accepted sense of the term connotes a company which holds shares in one or more

subsidiary companies, and collects dividends from them and pays dividends, out of that income, to its own shareholders. The term has a wider application, however, and is also applied to a company which itself carries on a business, and in addition has a controlling interest in subsidiary companies. A company of this kind derives its income from its business operations and from the subsidiary companies.

The term "subsidiary company" is applied to a company in which the holding company has a controlling interest, as defined earlier in this chapter. This interest may be anything from a bare majority to complete ownership of the share capital, the latter creating what is usually called a "wholly-owned" subsidiary. A bare majority will enable a holding company to give an effective vote on most resolutions, though there are some resolutions for which a three-fourths majority is required.

The whole question of subsidiary companies was considered by the Company Law Amendment Committee which reported in 1926, and many of its recommendations were adopted and incorporated in the Companies Act, 1929. These provisions affected the form of presentation of accounts of companies where subsidiary companies were involved. Experience showed that the new requirements did not help very much, and the additional information which was required could be presented in so condensed a form as to be almost valueless. The Cohen Committee carried the matter much further, and the requirements of the Companies Act, 1948, which arise out of their report, are far-reaching. Accounts of holding and subsidiary companies are dealt with in Sections 150–154 of the Act, and there is now an obligation where there are holding and subsidiary companies, to lay group accounts before the holding company, and it is provided that where, at the end of its financial year, a company has subsidiaries, group accounts dealing with the state of affairs and profit or loss of the company and its subsidiaries shall, subject to certain dispensations, be laid before the company in general meeting when the company's own Balance Sheet and Profit and Loss Account are so laid. This means that the holding company will present not only its own accounts, but a form of group accounts dealing with the holding company and its subsidiaries (Companies Act, 1948, Section 150 (1)).

It will be recognized that, within a group, subsidiary companies may themselves be holding companies. The Act provides that group accounts shall not be required from such a holding company if at the end of its financial year it was the wholly-owned subsidiary of another company (Section 150 (2)).

There are also certain practical dispensations where it is recognized that group accounts would not serve the purpose intended,

and it might prove difficult to present a clear and informative picture. These dispensations are given in Section 150 (2) (*b*) as follows—

If the company's directors are of the opinion that—

(i) It is impracticable, or would be of no real value to members of the company, in view of the insignificant amounts involved, or would involve expense or delay out of proportion to the value to the members of the company; or

(ii) The result would be misleading, or harmful to the business of the company or any of its subsidiaries; or

(iii) The business of the holding company and that of the subsidiary are so different that they cannot reasonably be treated as a single undertaking;

and if the directors are of such opinion about each of the company's subsidiaries, group accounts shall not be required.

The approval of the Board of Trade is required if the reason for not dealing in group accounts with a subsidiary company is that the result would be harmful, or that the difference between the business of the holding company and that of the subsidiary makes it unreasonable to treat them as a single undertaking. Where group accounts are not submitted a statement, giving the information required by the Eighth Schedule, Part II para. 15 (4), *post*, shall be annexed to the Balance Sheet.

For the purposes of Section 150, a body corporate is deemed to be the wholly-owned subsidiary of another if it has no members except that other's wholly-owned subsidiaries and its or their nominees.

The form of group accounts is provided for in Section 151 where they are referred to as consolidated accounts, though departure from what has hitherto been recognized as the more usual form of consolidation is permitted. The section provides that group accounts shall be consolidated accounts comprising—

(*a*) A consolidated Balance Sheet dealing with the state of the affairs of the company and all the subsidiaries to be dealt with in group accounts.

(*b*) A consolidated Profit and Loss Account dealing with the profit or loss of the company and those subsidiaries.

If, however, the company's Directors are of the opinion that it is better for the purpose—

(*a*) of presenting the same or equivalent information about the state of affairs and profit or loss of the company and those subsidiaries; and

(*b*) of so presenting it that it may be readily appreciated by the company's members;

the group accounts may be prepared in a form other than the consolidation required by (*a*) and (*b*) above but they must be group

accounts. In particular, they may consist of more than one set of consolidated accounts dealing respectively with the company and one group of subsidiaries and with other groups of subsidiaries or of separate accounts dealing with each of the subsidiaries, or of statements expanding the information about the subsidiaries in the company's own accounts, or any combination of those forms.

The group accounts may be wholly or partly incorporated in the company's own Balance Sheet and Profit and Loss Account.

The contents of the group accounts are dealt with in Section 152 and there is a general requirement in sub-section (1) in similar terms to those applying to companies' own accounts under the Act, that they shall give a true and fair view of the state of affairs and profit or loss of the company and the subsidiaries dealt with thereby as a whole, so far as concerns members of the company.

There is recognition of the fact that the financial years of the companies involved in group accounts may not be coterminous, with the result that accounts of different periods, although of a year, may have to be merged; although in some cases this may not matter seriously, in other cases it will be of importance and it is provided in Section 152 (2) that where the financial year of a subsidiary does not coincide with that of the holding company, the group accounts shall deal with the subsidiary's state of affairs as at the end of its financial year ending with or last before that of the holding company and with the subsidiary's profit or loss for that financial year. But the holding company's Directors may apply to the Board of Trade for consent to vary this procedure, in which case the Board of Trade may give directions accordingly or may so direct with the consent of the holding company's Directors.

Section 152 (3) provides that, without prejudice to sub-section (1), the group accounts, if prepared as consolidated accounts, shall comply with the requirements of the Eighth Schedule to the Act, so far as applicable thereto, and if not so prepared shall give the same or equivalent information.

But it is provided that the Board of Trade may, on the application or with the consent of a company's Directors, modify the said requirements in relation to that company for the purpose of adapting them to the circumstances of the company.

Section 153 deals with the financial year of the holding company and the subsidiaries. Naturally, it will often happen that the financial years of the various companies will end on different dates. This presents a certain problem for the submission of consolidated accounts and the legislature have therefore thought it desirable that every effort should be made to have the accounts coterminous. In sub-section (1) of Section 153 it is provided that the Directors of a holding company shall secure that, except where in their

opinion there are good reasons against it, the financial year of each of its subsidiaries shall coincide with the company's own financial year. It is further recognized that if a company's financial year has to be extended to bring about this result, it may happen that the submission of the accounts to a general meeting may be moved into the following calendar year, with the result that there may be no annual general meeting in the year in which it would otherwise have been held. In such a case the Board of Trade may, on the application or with the consent of the Directors of the company in question, direct that the submission of accounts to a general meeting, the holding of an annual general meeting or the making of an annual return shall not be required in that calendar year.

There may be good reasons, as the Companies Act recognizes, why the year should not be changed. One of them may be that the preparation of accounts of a subsidiary may necessarily be delayed each year because information, whether because it comes from abroad or for some other reason, cannot be obtained with sufficient speed. If the accounts were to be coterminous this delay might affect the submission of the accounts of the whole of the companies of the group. An earlier closing date for the subsidiary might, therefore, enable the group accounts to be prepared more promptly.

The meaning of the terms "holding company" and "subsidiary company" is dealt with in Section 154. In sub-section (1) it is provided that a company shall be deemed to be a subsidiary of another if, and only if,

(*a*) that other either—

(i) is a member of it and controls the composition of its Board of Directors, or

(ii) holds more than half in nominal value of its equity share capital; or

(*b*) the first-mentioned company is a subsidiary of any company which is that other's subsidiary.

Later in the section the above requirements and the method by which they may be determined are defined.

A company shall be deemed to be another's holding company if, but only if, that other is its subsidiary. The expression "company" includes any body corporate, and the expression "equity share capital" means, in relation to a company, its issued share capital excluding any part thereof which, neither as respects dividends nor as respects capital, carries any right to participate beyond a specified amount in a distribution.

The Auditors' Report in relation to consolidated accounts has been dealt with elsewhere in this volume. The following may be given as a specimen, taking the date of the accounts of the holding company as 31st December, 1948. It can form an addition to the

report of the Auditors on the accounts of the holding company. It must be modified to suit the circumstances; specimen modifications are included in the example—

We have also examined the annexed consolidated Balance Sheet and consolidated Profit and Loss Account of the company and its subsidiaries dealt with thereby with the audited accounts of those companies. With the exception of the accounts of two subsidiary companies, none of the accounts of the subsidiaries has been audited by us. Subject to the foregoing, in our opinion such consolidated Balance Sheet and consolidated Profit and Loss Account have been properly prepared in accordance with the provisions of the Companies Act, 1948, so as to give a true and fair view respectively of the state of affairs and of the profit (loss) of the X.Y.Z. Co. Ltd., and its subsidiaries dealt with thereby so far as concerns members of the X.Y.Z. Co. Ltd., and so far as practicable having regard to the fact that the accounts of some of the subsidiary companies are made up to the 30th September, 1948, and cover their financial years ended on that date.

The following is a specimen of the Auditors' report in the case of group accounts—

We have also examined the annexed group accounts with the audited accounts of the companies dealt with thereby, certain of which have not been audited by us. Subject to the foregoing, in our opinion, the group accounts have been properly prepared in accordance with the provisions of the Companies Act, 1948, so as to give in conjunction with the Balance Sheet and Profit and Loss Account of X.Y.Z. Ltd. a true and fair view of the state of affairs and of the profits (loss) of X.Y.Z. Ltd. and its subsidiaries dealt with by such group accounts, so far as concerns members of X.Y.Z. Ltd., and so far as is practicable having regard to the fact that accounts of some of the subsidiaries are made up to different dates and cover different periods from those of X.Y.Z. Ltd.

The following are the special provisions laid down in the Companies Act, 1948, Eighth Schedule, Part II, where a company is a holding or a subsidiary company—

PART II

SPECIAL PROVISIONS WHERE THE COMPANY IS A HOLDING OR SUBSIDIARY COMPANY

Modifications of and Additions to Requirements as to Company's own Accounts

15.—(1) This paragraph shall apply where the company is a holding company, whether or not it is itself a subsidiary of another body corporate.

(2) The aggregate amount of assets consisting of shares in, or amounts owing (whether on account of a loan or otherwise) from, the company's subsidiaries, distinguishing shares from indebtedness, shall be set out in the balance sheet separately from all the other assets of the company, and the aggregate amount of indebtedness (whether on account of a loan or otherwise) to the company's subsidiaries shall be so set out separately from all its other liabilities and—

(*a*) the references in Part 1 of this Schedule to the company's investments[1] shall not include investments in its subsidiaries required by this paragraph to be separately set out; and

[1] p. 132 *ante*.

(*b*) paragraph 5, sub-paragraph (1) (*a*) of paragraph 12, and sub-paragraph (2) of paragraph 14 of this Schedule shall not apply in relation to fixed assets consisting of interests in the company's subsidiaries.[1]

(3) There shall be shown by way of note on the balance sheet or in a statement or report annexed thereto the number, description and amount of the shares in and debentures of the company held by its subsidiaries or their nominees, but excluding any of those shares or debentures in the case of which the subsidiary is concerned as personal representative or in the case of which it is concerned as trustee and neither the company nor any subsidiary thereof is beneficially interested under the trust, otherwise than by way of security only for the purposes of a transaction entered into by it in the ordinary course of a business which includes the lending of money.

(4) Where group accounts are not submitted, there shall be annexed to the balance sheet a statement showing—

(*a*) the reasons why subsidiaries are not dealt with in group accounts;

(*b*) the net aggregate amount, so far as it concerns members of the holding company and is not dealt with in the company's accounts, of the subsidiaries' profits after deducting the subsidiaries' losses (or vice versa)—

(i) for the respective financial years of the subsidiaries ending with or during the financial year of the company; and

(ii) for their previous financial years since they respectively became the holding company's subsidiary;

(*c*) the net aggregate amount of the subsidiaries' profits after deducting the subsidiaries' losses (or vice versa)—

(i) for the respective financial years of the subsidiaries ending with or during the financial year of the company; and

(ii) for their other financial years since they respectively became the holding company's subsidiary;

so far as those profits are dealt with, or provision is made for those losses, in the company's accounts;

(*d*) any qualifications contained in the report of the auditors of the subsidiaries on their accounts for their respective financial years ending as aforesaid, and any note or saving contained in those accounts to call attention to a matter which, apart from the note or saving, would properly have been referred to in such a qualification, in so far as the matter which is the subject of the qualification or note is not covered by the company's own accounts and is material from the point of view of its members;

or, in so far as the information required by this sub-paragraph is not obtainable, a statement that it is not obtainable:

Provided that the Board of Trade may, on the application or with the consent of the company's directors, direct that in relation to any subsidiary this sub-paragraph shall not apply or shall apply only to such extent as may be provided by the direction.

(5) Paragraphs (*b*) and (*c*) of the last foregoing sub-paragraph shall apply only to profits and losses of a subsidiary which may properly be treated in the holding company's accounts as revenue profits or losses, and the profits or losses attributable to any shares in a subsidiary for the time being held by the holding company or any other of its subsidiaries shall not (for that or any other purpose) be treated as aforesaid so far as they are profits or losses for the period before the date on or as from which the shares

[1] pp. 125, 126, and 132 *ante*.

were acquired by the company or any of its subsidiaries, except that they may in a proper case be so treated where—

(*a*) the company is itself the subsidiary of another body corporate; and

(*b*) the shares were acquired from that body corporate or a subsidiary of it;

and for the purpose of determining whether any profits or losses are to be treated as profits or losses for the said period the profit or loss for any financial year of the subsidiary may, if it is not practicable to apportion it with reasonable accuracy by reference to the facts, be treated as accruing from day to day during that year and be apportioned accordingly.

(6) Where group accounts are not submitted, there shall be annexed to the balance sheet a statement showing in relation to the subsidiaries (if any) whose financial years did not end with that of the company—

(*a*) the reasons why the company's directors consider that the subsidiaries' financial years should not end with that of the company; and

(*b*) the dates on which the subsidiaries' financial years ending last before that of the company respectively ended or the earliest and latest of those dates.

16.—(1) The balance sheet of a company which is a subsidiary of another body corporate, whether or not it is itself a holding company, shall show the aggregate amount of its indebtedness to all bodies corporate of which it is a subsidiary or a fellow subsidiary and the aggregate amount of the indebtedness of all such bodies corporate to it, distinguishing in each case between indebtedness in respect of debentures and otherwise.

(2) For the purposes of this paragraph a company shall be deemed to be a fellow subsidiary of another body corporate if both are subsidiaries of the same body corporate but neither is the other's.

Consolidated Accounts of Holding Company and Subsidiaries

17. Subject to the following paragraphs of this Part of this Schedule, the consolidated balance sheet and profit and loss account shall combine the information contained in the separate balance sheets and profit and loss accounts of the holding company and of the subsidiaries dealt with by the consolidated accounts, but with such adjustments (if any) as the directors of the holding company think necessary.

18. Subject as aforesaid and to Part III of this Schedule, the consolidated accounts shall, in giving the said information, comply, so far as practicable, with the requirements of this Act as if they were the accounts of an actual company.

19. Sections one hundred and ninety-six, and one hundred and ninety-seven of this Act shall not, by virtue of the two last foregoing paragraphs, apply for the purpose of the consolidated accounts.

20. Paragraph 7 of this Schedule shall not apply for the purpose of any consolidated accounts laid before a company with the first balance sheet so laid after the commencement of this Act.

21. In relation to any subsidiaries of the holding company not dealt with by the consolidated accounts—

(*a*) sub-paragraphs (2) and (3) of paragraph 15 of this Schedule shall apply for the purpose of those accounts as if those accounts were the accounts of an actual company of which they were subsidiaries; and

(*b*) there shall be annexed the like statement as is required by sub-paragraph (4) of that paragraph where there are no group accounts, but as

if references therein to the holding company's accounts were references to the consolidated accounts.

22. In relation to any subsidiaries (whether or not dealt with by the consolidated accounts), whose financial years did not end with that of the company, there shall be annexed the like statement as is required by sub-paragraph (6) of paragraph 15 of this Schedule where there are no group accounts.

It is not practicable in a book on auditing to deal with many considerations affecting the preparation of consolidated accounts. The advantage claimed for them is that they show at a glance the whole of the assets and liabilities of the group of companies involved, and the members are thus able to tell the extent of the total assets and liabilities and so arrive at a proper valuation of their interests. Such a view cannot be formed when only the book value of shares in a subsidiary company is shown in the Balance Sheet of the holding company; and there is no guide as to its earning capacity where only the dividends received are shown as income. Shareholders are also enabled by consolidation of accounts to ascertain how the assets are spread as between fixed assets and current assets, and how much represents goodwill.

The amalgamation of assets and liabilities of a large number of companies can be a complicated matter, particularly if there is considerable variety in their nature. The advantage of having the same closing date for the accounts of the various companies, for the purposes of this amalgamation is evident, though there may be reasons, referred to earlier, why this may not prove practicable or desirable. But if the same dates do not rule throughout, adjustments will be necessary so that as exact a picture as possible of the position at the date of consolidation may be presented. Uniformity in the basis of valuation and presentation should also be ensured. This applies equally to the consolidated Profit and Loss Account.

In many cases the holding company owns only a part of the capital of a subsidiary, though sufficient to secure the relationship, either because the shares held represent a majority or they are held in such circumstances that the relationship of holding company and subsidiary company exists. The most practical way of dealing with this position in the consolidated Balance Sheet is to include the whole of the assets and the liabilities of the subsidiary company or companies in the consolidated Balance Sheet, and to show as a liability the interest of outside shareholders. This is a better method than reducing the totals of assets and liabilities by a proportionate amount relative to the interest of outside shareholders.

In the consolidated Profit and Loss Account there should be shown, as a deduction from the profit, the proportion attributable

to the interest of outside or minority shareholders. If any part of the profits or losses of subsidiaries, whose shares have been acquired during the accounting period, is applicable to a period prior to the date of acquisition, this sum should also be excluded as being of a capital nature and may be transferred to capital reserve or used to write down goodwill.

It will be seen that in a consolidation of accounts, closed at the same date, inter-company balances will be eliminated from the Balance Sheet, but if all the accounts are not coterminous inter-company balances may arise which will involve an item in the accounts usually shown as a net sum. If any companies of the group are not consolidated there may be similar balances.

The Auditor should examine carefully all inter-company transactions particularly to ensure that nothing of an artificial character is included. The inter-company profits on stock-in-trade unsold at the dates of the respective Balance Sheets should be eliminated and deducted from the aggregate amount of stock-in-trade. In the case of bank balances overdrafts should not normally be set-off against credit balances, except where they are with the same bank, and the bank would so treat the accounts by reason of some arrangement between the companies concerned and the bank.

CHAPTER XXIII

LOOSE-LEAF LEDGERS, CARDS, AND MECHANIZED ACCOUNTING

LOOSE-LEAF ledgers and cards as substitutes for ordinary books are extremely useful for accounting and statistical purposes and facilitate division of labour, so avoiding congestion and saving time. They are now found in such regular use, either as manuscript records or in conjunction with mechanized systems, that it is not surprising that they have received official sanction and recognition by Section 436 of the Companies Act, 1948. The wording of the section shows that it is felt there may be greater danger of falsification than in the case of bound books, for the section requires that precautions shall be taken for guarding against falsification and facilitating its discovery.

One of the first considerations of the Auditor will therefore be to see that the internal precautions are such as will prevent, or at least make very difficult, any unofficial removal of the leaves or cards.

A SIMPLE ILLUSTRATION OF THE USE OF CARDS

In the case of a club distinctive cards can be prepared for each class of member. Two drawers are provided for each class of member, one labelled "Subscriptions Paid" and the other "Subscriptions Unpaid." As the subscriptions are paid, the cards are transferred from the "Unpaid" drawer to the other one. As a result, a list of subscriptions outstanding can be taken out very quickly by reference to the "Unpaid" drawer. Where the terms of membership may vary, as, for example, when a town member becomes a country or foreign member at a reduced subscription, the cards need only be removed to the appropriate drawers. A register of any transfers of this nature should be kept, based upon the Minutes of the committee (which should record all additions to membership, resignations, and change of status). This provides for an effective check on the cards.

MECHANICAL ACCOUNTING SYSTEMS AND THEIR EFFECT ON AUDIT PROCEDURE

Mechanized accounting systems are now in use in many offices and the Auditor is therefore concerned with the effect of such mechanization on auditing methods. The introduction of book-keeping and punched-card machines does not in any way reduce the responsibilities of the Auditor, but it does enable him to

approach his duties somewhat differently by dispensing with considerable detailed checking and concentrating more on the wider aspects of the audit.

On his commencing a new audit where office machinery is in use, the Auditor's preliminary considerations will be—

1. *Machines.* He must learn about the machines. He should inquire from the Accountant in charge exactly what they are capable of doing and the uses to which they are put. He should follow through representative transactions, noting the particular operators responsible for each stage of the recording. Although machines used in different offices may be the same, their uses may vary and in consequence this preliminary examination of methods and uses should be carried out in each case.

2. *Operators.* The capabilities and experience of the operators are the next points for the Auditor's consideration. This inquiry is particularly important when the mechanized system is newly installed. An attempt to train existing staff to work machines instead of engaging expert operators frequently proves unsatisfactory unless a careful choice of employee is made. Where possible, expert operators should be employed, at any rate when the system is new, though it is useful also to train selected members of the existing staff.

The Auditor will now be in a position to analyse the results of his inquiries. He will be able to appreciate to what extent the machines are foolproof; he will realize where errors are likely to arise, and where there are still possibilities of mistakes in spite of mechanization, and he will see where fraudulent practices would be either possible or difficult. Great importance should be attached to this first analysis as it is on this that the audit procedure will be based. Further, the audit procedure should be kept constantly under review as systems and operators may be changed. It is useful for two members of the Auditor's staff to draw up separately their conclusions from the preliminary examination, as this will often serve to prevent important points being overlooked.

POSSIBLE ERRORS

It is usually claimed by the manufacturers of the various machines that, owing to the system of cross-checks with which those machines are provided, errors in mechanized accounting are infrequent. While this claim is to a great extent justified, the Auditor cannot place complete reliance on machine accuracy unless suitable internal checks are super-imposed on the system.

Errors common to any book-keeping system and fraudulent practices to aid embezzlement or hide the facts are still possible. There are, too, certain errors which arise through the use of the machines themselves. Mechanical failures with well-maintained

machines are rare. Some mistakes may occur through the employment of inexperienced operators with insufficient knowledge of the machines and the correct methods of operation. These errors will usually be indicated by independent internal checks.

On no account should operators be allowed to tamper with the internal mechanisms of their machines.

TYPES OF MACHINES

There are two main types of office recording machinery which are so different that it is necessary to consider the audit procedure separately in relation to each type. The types are —

(1) Book-keeping machines which are a combination of typewriter, adding and calculating machines, for use with loose leaves or cards.
(2) Punched-card machines.

In addition to the above there are the adding, adding-listing and calculating machines which, while not used in the actual recording processes, are of great assistance in casting and calculating, particularly for internal checks.

BENEFITS FROM INTRODUCTION OF MACHINERY

The principal reasons for the introduction of machinery to record business transactions may be summarized as follows—

(1) Saving of time.
(2) Division of labour.
(3) Economy of personnel.
(4) Reduction in the possibility of errors.
(5) Combining of stages of book-keeping.
(6) Rapid analysis of records for various purposes.

The Auditor will be most concerned with (4), (5), and (6).

The combining of the stages of book-keeping differs with the various types of machine and the offices using them. In the book-keeping machine the use of carbon paper enables two, three or even four stages of recording to be combined, depending on requirements and the internal checks in force. If the initial information is correctly recorded, the possibility of errors of posting will be reduced, and the amounts will be the same in each combined stage. There is still a possibility of posting to the wrong account.

The various systems, though they rely on double-entry principles, do not necessarily follow the methods of hand-written records. In some, certain stages may be dispensed with as unnecessary, and it is usual in every system for various analyses and

totals to be produced at the same time and in conjunction with the normal recording processes.

AUDIT CONSIDERATIONS AND PROCEDURE

Audit considerations must now be examined in more detail. Differing circumstances call for different treatment and it is not intended that the following details of procedure should be regarded as exhaustive. They are merely designed to indicate the lines of approach that may be adopted by the Auditor in conducting an audit of mechanized accounts. As previously stated, the two main types of machine recording must be considered separately.

Book-keeping Machines. The types of machinery which will be found most frequently in use are those which combine typewriter, adding and calculating machines for use with loose leaves or cards. The various stages in the recording of transactions will be followed through, and the checks, both internal and as applied by the Auditor, considered.

Sales

(i) *The Preparation of the Sales Invoice.* The Auditor should satisfy himself that the invoice corresponds with the goods issued and that this is covered by a satisfactory internal check. There should also be a check on the calculations. There may be a calculating machine check on a physical calculation, or independent calculations on two machines. Test checks by the Auditor will then be sufficient.

(ii) *Sales Journal or Day Book.* The Sales Journal will probably consist of carbon copies of the sales invoices. If the Auditor is satisfied with the preparation of the invoice, the details of the Journal should be in order, but any alterations should be scrutinized. Monthly totals will probably be obtained by means of an adding-listing machine and can be checked with periodical totals recorded on the summary sheets. Where internal checks such as this are considered satisfactory, the Auditor will be able to limit the casting checks, but they should not be eliminated altogether. Operators and machines producing the checking casts should be different from those responsible for the originals. The Auditor's checks should be more frequent when the adding machines used are of the non-listing variety.

(iii) *Sales Ledger.* Postings to the Sales Ledger may be done as part of the same operation as the preparation of the invoice, but it may be combined with the making out of the customer's statement. In posting the Sales Ledger the book-keeping machine must pick up the balance on the customer's account, enter the new sales transaction and carry out the ending balance. While this is done, running totals are being accumulated by the machine which can

be recorded ultimately on a summary sheet. This enables the total ending balances to be reconciled with the total new debits and the commencing balances. It will be seen that there are here two possibilities of undetected error—

(1) The Debit introduced into the machine may be incorrect.
(2) It may have been posted to the wrong account.

The first error can be disclosed by a control-listing or pre-listing of the invoices on an ordinary adding machine. The pre-listed total can be checked with the total debits shown on the summary sheet from the book-keeping machine. This forms a good method of internal check if the pre-listing is carried out by someone other than the Ledger posting operator.

Posting to the wrong account is more difficult to prevent. One method often used is for the operator always to note both the name and address at the top of the card or sheet to make sure that it refers to the correct customer before inserting it in the machine. Another method is to give each customer a code number which is recorded on the invoice and therefore on the copy and should be compared with the code number on the customer's sheet or card, where it is repeated with each entry.

The recording and posting of sales returns will be dealt with in the same manner as sales, copies of credit notes forming the book of prime entry.

Similar precautions must be taken with the postings from the Cash Book or the detailed records constituting it. As balances are struck after each posting to an account, no totals are shown in the personal account and casting checks can be dispensed with to a great extent. The items making up the balances should be noted so that any old unsettled items may be examined.

Some offices have dispensed with the Sales Ledger. The only customers' records available will be the filed copies of the paid and unpaid statements. These will normally be kept separately. In such cases the internal check must include frequent comparison of balances with the total accounts.

As with other systems, many concerns send out, either directly or through their Auditors, special audit statements to all customers showing the state of their accounts at the accounting date. By this means discrepancies should be brought to light.

Purchases

It is not proposed to go through the recording and posting of purchases in detail as the procedure is very similar to that recorded for sales. It is, however, important to ensure that purchases have been properly analysed as between capital and revenue expenditure. The Auditor should inquire as to the internal check in this

respect, but in any case he will probably find it necessary to carry out comprehensive tests. As part of the internal check invoices should be pre-listed and the totals compared with the totals of the analysis.

The Purchase Ledger may be dispensed with, the suppliers' statements being used for this record; in this case the unpaid statements may be filed separately from those paid to which the appropriate invoices are attached.

Cash Records

(i) *Payments.* Payments must be vouched in the normal manner. In mechanized systems the Cash Book may or may not contain all the details. If not, the details will be recorded on separate sheets, the casts of which must be tested and the totals compared with the credit entries of the Cash Book. This will, of course, apply to Wages Sheets. Where machines are in use for cheque and receipt writing the cheques are listed on a sheet at the same time as the cheques are written, the total of this sheet being transferred to the Cash Book.

(ii) *Receipts.* Receipt writing machines will also produce the receipts lists from which totals are transferred to the debit of the Cash Book. At the same time they will produce Bank Paying-in Slips. The totals of the receipts lists should be tested and the postings to the cash book checked. Cash Sales should always be the subject of a good internal check. Where cash registers are in use the cash receipt is thrown out for the customer while the machine automatically records a running total. The cashier should not have a key of the register. This should be in the possession of a responsible official who collects the cash from the self-locking till, removes the receipts list and checks the cash with the list. The total of the list will be transferred to the debit of the Cash Book.

It will often be found that the Cash Book itself is kept in manuscript, the above-mentioned mechanically produced lists being used to give the totals to be entered.

Posting from cash records to Purchases and Sales Ledgers will be from listed cheques and receipts. The same care is required here to see that postings are to the correct accounts and the Auditor should satisfy himself on any internal checks in use. He will then be able to decide how much testing of the postings is necessary.

Petty cash records may also be mechanically produced. Debits will normally be petty cash cheques posted from the Cash Book. All payments will be supported by vouchers which can be pre-listed as an internal check.

Nominal or Impersonal Ledger. The postings to the Nominal Ledger and the internal checks to ensure correct posting must

receive considerable attention from the Auditor. Capital and revenue items must be clearly distinguished, and the Auditor must ascertain what checks are in force to ensure posting to correct accounts. Individual checking of each posting by a responsible official is often considered necessary to make certain of this point. Control Account balances should be compared with listed balances from Personal Ledgers. The totals of analysed records produced for statistical and other purposes will often serve as additional checks of totals in financial records. All such checks will relieve the Auditor of a great deal of routine checking and casting. He will be able to concentrate more on a critical examination of the records to ensure that correct accounting principles have been followed and that the Balance Sheet and Profit and Loss Account are properly drafted.

It is quite usual to find the Nominal Ledger kept in manuscript form, though the other records are mechanically produced. This is found advisable as the work cannot be reduced to a routine so easily as in the case of the Personal Ledgers, and considerations of principle need special care.

Final Considerations. Finally, the Auditor should see that the whole of the book-keeping processes are suitably divided between the staff. Cashiers should not be responsible for posting cash records to Ledgers. Invoicing clerks and Ledger posting operators should have nothing to do with cash receipts and payments. Personal Ledger posting operators should not post the Nominal Ledger and vice versa. These are normal precautions and should be incorporated in any mechanical system.

In addition, as nearly all mechanized systems involve cards or loose leaves, special care must be taken to prevent unauthorized extraction or exchanging of leaves or cards.

All original documents from which postings are made should be numbered for easy reference and strict filing control enforced. It may be found that the method of filing does not always provide the Auditor with easy access to information which he requires. Although he cannot expect a change of system merely to suit his convenience, it is often found that some re-arrangement can be made which will assist the Auditor without loss of efficiency in the system.

Punched-card Systems. Punched-card accounting systems are gradually being introduced with considerable success and, where the volume of transactions is very large, they can be used with advantage. Formerly they were confined mainly to sorting and tabulating, but their uses have been greatly extended so that the information stored on the cards can be rapidly translated on to the ordinary Ledger card.

In punched-card systems, cards of a uniform size but of different

colours are used, the colours indicating different kinds of transactions such as purchases, sales, returns, cash receipts, cash payments, etc. A code is adopted and the cards are divided into a number of sections as required, each section containing all the necessary code numbers. In the case of sales, for instance, the various sections are used to indicate the customer, the date, class of goods, quantity, rate, value, traveller, and any information which may be needed. As these cards form the records on which the whole system is based, the utmost care must be taken to see that they are initially correct. In the case of a sale the Auditor must first satisfy himself that the invoice is in order and he will do this in the same manner as previously described. He must then be satisfied that the information is correctly transferred to the card. It is here that there must be a good internal check and the various punched-card systems invariably provide for this. Each card has usually to be punched by one operator and verified by another, using a different machine. The card is put in the punching machine by the first operator and the details of the invoice punched thereon according to the code in use. The second or verifying punch differs with the various systems. In one the first punching machine makes semi-circular holes whilst the second punches the other half of the circle; so that if, after the card has been through both machines, there are any half-circles, a mistake has been made. In another system the first machine punches the holes while in the second machine small plungers pass through the existing holes. If there is a mistake the plunger will not be able to pass as there is no hole and the machine will stop, indicating to the operator the necessity to check again.

In this manner every record will be made on cards of identical size, which are kept in trays. The greatest care must be taken to ensure that these are not lost or unofficially removed.

The next machine is the sorter. It will be seen that, according to the code in use, the cards can be sorted into many different classifications. When so sorted the cards are put through the third machine, the tabulator, which will produce typed or listed information. This machine will give lists of purchases, sales returns, cash records, and all the analyses within the limits of the code in use. It will also produce Ledger accounts, Personal and Nominal, and customers' statements.

When the Auditor has satisfied himself that the initial information on the cards is correct and covered by suitable internal checks he will probably find it advisable to put a number of cards through the tabulator to make a test. It is a wise precaution to ensure accuracy of totals, and it will reduce the Auditor's test checks if purchases and sales invoices are independently pre-listed on an adding machine so that this total can be compared with the

tabulator total, so providing an additional check that cards and invoices correspond. Tabulated totals will give the data for the Control Accounts.

With regard to Personal Ledgers, it will be necessary to have balance cards so that, combined with the current transactions, the correct ending balance will be shown each time.

From the foregoing it will be seen that there are three main points upon which the Auditor must satisfy himself—

(1) That every possible precaution is taken to ensure that the details of every transaction are punched on a card.

(2) That the cards are correctly punched.

(3) That there is sufficient guard against the extraction and substitution of cards.

Although, in the first place, additional work is necessary to punch the cards, the great advantage of the punched-card system is the rapidity with which the cards can be sorted and the information tabulated.

APPENDIX I

REGULATIONS OF THE COUNCIL OF THE STOCK EXCHANGE

THE following regulations relate to Prospectuses, Offers for Sale, and Advertised Statements, in so far as they affect the reports of Auditors, and are an extract from the Regulations of the Stock Exchange, Appendix XXXIV.

SCHEDULE II

PART 1

PROSPECTUS OR OFFER FOR SALE

The following information and requirements must be given or dealt with—

18. A report by the Auditors of the Company or qualified Accountants with respect to the profits and losses of the Company, and, where the proceeds or any part of the proceeds of the issue are to be applied directly or indirectly in the purchase of a business or of shares in a company which is or will by reason of such purchase become a subsidiary company, with respect to the profits and losses of such business or subsidiary, in respect of the 10 completed financial years preceding the issue of the prospectus or in respect of the years since the commencement of the business or the incorporation of the Company or the subsidiary if this occurred less than 10 years prior to such issue as the case may be. Such report shall include a statement of the aggregate emoluments paid to the Directors by the Company during the last period for which the accounts have been made up and the amount (if any) by which such emoluments would differ from the amounts payable under the arrangements in force at the date of the Prospectus.

SCHEDULE II

PART 2 (a)

ADVERTISED STATEMENTS

In the case of a company (a) no part of whose capital is already quoted on The Stock Exchange, and (b) whose annual accounts for at least two years have not been made up and audited, the statement required to be advertised must contain the following information giving all material particulars relating to the formation of the Company and to the flotation of the issue, including the following—

20. A report by the auditors of the Company—

(i) with respect to the profits or losses of the Company in respect of each of the years since the incorporation of the Company, and, if in respect of a period ending on a date earlier than three months before the publication of the Advertisement no accounts have been made up, a statement of that fact. In making such report the auditors shall make

such adjustments (if any) as are in their opinion necessary for the purposes of the Advertisement;

(ii) in the case of an issue by a holding company, in lieu of the report in (i), a like report with respect to the profits or losses of the Company and of its subsidiary companies, so far as such profits or losses are attributable to the interests of the holding company. For the purposes of this report the financial years of each company shall mean as regards that company the financial years immediately preceding the publication of the Advertisement;

(iii) with respect to the rates of the dividends, if any, paid by the Company in respect of each class of shares in the Company in respect of each of the said years giving particulars of each such class of shares on which such dividends have been paid and particulars of the cases in which no dividends have been paid in respect of any class of shares in respect of any of those years;

(iv) with respect to the assets and liabilities of the Company and in the case of an issue by a holding company, a like report with respect to the assets and liabilities of the Company and of its subsidiary companies so far as attributable to the interests of the Company. In making such reports the auditors shall make such adjustments as are in their opinion necessary for the purposes of the Advertisement;

(v) with respect to the aggregate emoluments paid to the Directors by the Company during the last period for which the accounts have been made up and the amount (if any) by which such emoluments would differ from the amounts payable under the arrangements in force at the date of the Advertisement.

21. If the proceeds, or any part of the proceeds, of the issue of the shares or debentures are or is to be applied directly or indirectly in the purchase of a business or of shares in a company which is, or will by reason of such purchase become, a subsidiary company of the Company, a report made by qualified accountants who shall be named in the Advertisement—

(i) with respect to the profits or losses of the business or to the profits or losses attributable to the interests acquired or being acquired by the Company in the subsidiary in respect of each of the 10 completed financial years preceding the publication of the Advertisement or in respect of each of the years since the commencement of the business or the incorporation of such subsidiary if this occurred less than 10 years prior to such Advertisement; and, if in respect of a period ending on a date earlier than three months before the publication of the Advertisement no accounts have been made up, a statement of that fact. In making such report the accountants shall make such adjustments (if any) as are in their opinion necessary for the purposes of the Advertisement:

Provided that where any such subsidiary is itself a holding company the report shall be extended to the profits or losses of that company and its subsidiary companies which shall be ascertained in the manner laid down in sub-paragraph (ii) of paragraph 20;

(ii) with respect to the assets and liabilities of the business or of the subsidiary and where such subsidiary is itself a holding company, the report shall be extended to the assets and liabilities of that company and of its subsidiary companies in the manner laid down in sub-paragraph (iv) of paragraph 20.

SCHEDULE II

PART 2 (b)

ADVERTISED STATEMENTS

In the case of a Company (a) no part of whose capital is already quoted on The Stock Exchange, and (b) whose annual accounts for at least two years have been made up and audited, the statement required to be advertised must contain the following information giving all material particulars relating to the formation of the Company and to the flotation of the issue, including the following—

20. A report by the auditors of the Company—

(i) with respect to the profits or losses of the Company in respect of each of the 10 completed financial years immediately preceding the publication of the Advertisement or in respect of each of the years since the incorporation of the Company, if this occurred less than 10 years prior to the publication of such Advertisement; and, if in respect of a period ending on a date earlier than three months before the publication of the Advertisement no accounts have been made up, a statement of that fact. In making such report the auditors shall make such adjustments (if any) as are in their opinion necessary for purposes of the Advertisement;

(ii) in the case of an issue by a holding company, in lieu of the report in (i) a like report with respect to the profits or losses of the Company and of its subsidiary companies, so far as such profits or losses are attributable to the interests of the holding company. For the purposes of this report the financial years of each company shall mean as regards that company the financial years immediately preceding the publication of the Advertisement;

(iii) with respect to the rates of the dividends, if any, paid by the Company in respect of each class of shares in the Company in respect of each of the said 10 years or shorter period as the case may be, giving particulars of each such class of shares on which such dividends have been paid and particulars of the cases in which no dividends have been paid in respect of any class of shares in respect of any of those years;

(iv) with respect to the assets and liabilities of the Company and in the case of an issue by a holding company, a like report with respect to the assets and liabilities of the Company, and of its subsidiary companies so far as attributable to the interests of the Company. In making such reports the auditors shall make such adjustments as are in their opinion necessary for the purposes of the Advertisement;

(v) with respect to the aggregate emoluments paid to the Directors by the Company during the last period for which the accounts have been made up and the amount (if any) by which such emoluments would differ from the amounts payable under the arrangements in force at the date of the Advertisement.

21. If the proceeds, or any part of the proceeds, of the issue of the shares or debentures are or is to be applied directly or indirectly in the purchase of a business or of shares in a company which is, or will by reason of such purchase become, a subsidiary company of the Company, a report made by qualified accountants who shall be named in the Advertisement—

(i) with respect to the profits or losses of the business or to the profits or losses attributable to the interests acquired or being acquired by the Company in the subsidiary in respect of each of the 10 completed financial years preceding the publication of the Advertisement or in respect of

each of the years since the commencement of the business or the incorporation of such subsidiary company if this occurred less than 10 years prior to such Advertisement; and, if in respect of a period ending on a date earlier than three months before the publication of the Advertisement no accounts have been made up, a statement of that fact. In making such report the accountants shall make such adjustments (if any) as are in their opinion necessary for purposes of the Advertisement:

Provided that where any such subsidiary is itself a holding company the report shall be extended to the profits or losses of that company and its subsidiary companies which shall be ascertained in the manner laid down in sub-paragraph (ii) of paragraph 20;

(ii) with respect to the assets and liabilities of the business or of the subsidiary and where such subsidiary is itself a holding company, the report shall be extended to the assets and liabilities of that company and of its subsidiary companies in the manner laid down in sub-paragraph (iv) of paragraph 20.

SCHEDULE II

PART 2 (c)

ADVERTISED STATEMENTS

In the case of a Company part of whose Capital is already quoted on The Stock Exchange, the statement required to be advertised must contain the following information—

16. A report by the auditors of the Company—

(i) with respect to the profits or losses of the Company in respect of each of the 10 completed financial years immediately preceding the publication of the Advertisement or in respect of each of the years since the incorporation of the Company, if this occurred less than 10 years prior to the publication of such Advertisement and, if in respect of a period ending on a date earlier than three months before the publication of the Advertisement no accounts have been made up, a statement of that fact. In making such report the auditors shall make such adjustments (if any) as are in their opinion necessary for purposes of the Advertisement;

(ii) in the case of an issue by a holding company, in lieu of the report in (i), a like report with respect to the profits or losses of the Company and of its subsidiary companies, so far as such profits or losses are attributable to the interests of the holding company. For the purposes of this report the financial years of each company shall mean as regards that company the financial years immediately preceding the publication of the Advertisement;

(iii) with respect to the rates of the dividends, if any, paid by the Company in respect of each class of shares in the Company in respect of each of the said 10 years or shorter period as the case may be, giving particulars of each such class of shares on which such dividends have been paid and particulars of the cases in which no dividends have been paid in respect of any class of shares in respect of any of those years;

(iv) with respect to the assets and liabilities of the Company and in the case of an issue by a holding company, a like report with respect to the assets and liabilities of the Company and of its subsidiary companies so far as attributable to the interests of the Company. In making such reports the auditors shall make such adjustments as are in their opinion necessary for the purposes of the Advertisement.

(v) with respect to the aggregate emoluments paid to the Directors by

the company during the last period for which the Accounts have been made up and the amount (if any) by which such emoluments would differ from the amounts payable under the arrangements in force at the date of the Advertisement.

17. If the proceeds, or any part of the proceeds, of the issue of the shares or debentures are or is to be applied directly or indirectly in the purchase of a business or of shares in a company which is, or will by reason of such purchase become, a subsidiary company of the Company, a report made by qualified accountants who shall be named in the Advertisement—

(i) with respect to the profits or losses of the business or to the profits or losses attributable to the interests acquired or being acquired by the Company in the subsidiary in respect of each of the 10 completed financial years preceding the publication of the Advertisement or in respect of each of the years since the commencement of the business or the incorporation of such subsidiary company if this occurred less than 10 years prior to such Advertisement; and, if in respect of a period ending on a date earlier than three months before publication of the Advertisement no accounts have been made up, a statement of that fact. In making such report the accountants shall make such adjustments (if any) as are in their opinion necessary for purposes of the Advertisement: Provided that where any such subsidiary is itself a holding company the report shall be extended to the profits or losses of that company and its subsidiary companies which shall be ascertained in the manner laid down in sub-paragraph (ii) of paragraph 16;

(ii) with respect to the assets and liabilities of the business or of the subsidiary and where such subsidiary is a holding company, the report shall be extended to the assets and liabilities of that company and of its subsidiary companies in the manner laid down in sub-paragraph (iv) of paragraph 16.

SCHEDULE II

PART 2 (d)

ADVERTISED STATEMENTS

In the case of Government and Municipal loans and issues by Statutory Bodies the statement required to be advertised must contain the following information—

10. In the case of a Company incorporated otherwise than under the Companies Acts, a copy of the last audited Balance Sheet and Profit and Loss or Income and Expenditure Account, with a copy of the Auditor's Certificate and any notes or observations in or on the Balance Sheet required to be published by any Act of Parliament relating to the Company.

11. The full names of Directors (if any) and Auditors (if any) stating professional qualification.

Advertised statements must contain the name, address, and professional qualification of the Auditors. The Auditors must have recognized professional qualification or special authority from the Board of Trade as in Section 161 of the Companies Act, 1948.

APPENDIX II

FORM OF ACCOUNTANT'S CERTIFICATE UNDER THE SOLICITORS ACT, 1941

1. In compliance with Section I of the Solicitors Act, 1941, and the Accountant's Certificate Rules, 1946, made thereunder, I (*a*)
, have examined the books, accounts and documents
of (*b*)
or his firm (*c*), in respect of his practice(s) (*c*)
(in partnership under the style of (*d*)
(alone under the style of (*d*)
at (*e*)
for the accounting period, beginning on the day of
19 , and ending on the day of 19 , (*f*)

2. I certify that from my examination of the books, accounts and documents relating to the above practice(s) produced to me and from the information and explanations given to me I am satisfied that—

(1) during the accounting period the said (*b*)
, has complied with the provisions of the Solicitors' Accounts Rules, except so far as concerns

(*g*) certain trivial breaches of the Solicitors' Accounts Rules, due to clerical errors or mistakes in book-keeping, all of which were rectified on discovery. I am satisfied that none of such breaches resulted in any loss to any client;

(*g*) the matters set out on the back hereof; and

(2) (*c*) having retired from active practice as a solicitor, the said (*b*) ceased to hold client's money on the day of
19 . (*h*)

Dated this day of 19

(Signature)

To The Registrar of Solicitors,
Law Society's Hall,
Chancery Lane,
W.C.2.

Notes. (*a*) State the full name, firm name (if any), the address and professional qualifications of the Accountant.

(*b*) State the full name of the Solicitor in respect of whom the certificate is given.

(*c*) Delete as necessary.

(*d*) State the firm name or names of the Solicitor.

(*e*) State the business address or addresses of the Solicitor to which the certificate refers.

(*f*) The accounting period to be covered by the certificate must comply

with sub-section (5) of Section I of the Solicitors Act, 1941, and with the Accountant's Certificate Rules, 1946.

(*g*) *One or other or both* of the alternative sub-paragraphs marked (*g*) must be deleted. If the second alternative is allowed to stand a detailed note of all breaches of the rules should be endorsed on the certificate.

(*h*) Where clause 2 (2) applies, this date must be the ending date of the accounting period as given at the end of clause 1.

APPENDIX III

RECOMMENDATION OF THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES ON THE VALUATION OF STOCK-IN-TRADE

No particular basis of valuation is suitable for all types of business but, whatever the basis adopted, it should be applied consistently, and the following considerations should be borne in mind—

(*a*) Stock-in-Trade is a current asset held for realization. In the balance sheet it is, therefore, usually shown at the lower of cost or market value.

(*b*) Profit or loss on trading is the difference between the amount for which goods are sold and their cost, including the cost of selling and delivery. The ultimate profit or loss on unsold goods is dependent upon prices ruling at the date of their disposal, but it is essential that provision should be made to cover anticipated losses.

(*c*) Inconsistency in method may have a very material effect on the valuation of a business based on earning capacity though not necessarily of importance in itself at any balance sheet date.

The following interpretations are placed on the terms "cost" and "market value."

"COST"

The elements making up cost are (i) the purchase price of goods, stores and, in the case of processed stock, materials used in manufacture; (ii) direct expenditure incurred in bringing stock-in-trade to its existing condition and location; and (iii) indirect or overhead expenditure incidental to the class of stock-in-trade concerned.

Whereas the cost of (i) and (ii) can be ascertained with substantial accuracy, (iii)—indirect or overhead expenditure—can only be a matter of calculation. If (iii) is expressed as a percentage of actual production, the amount added to the stock valuation will fluctuate from one period to another according to the volume produced. To avoid distortion of revenue results, in some cases indirect or overhead expenditure is eliminated as an element of cost when valuing stock-in-trade or, alternatively, only that part which represents fixed annual charges is excluded. In other cases, an amount is included which is based on the normal production of the unit concerned.

The following are bases usually adopted in practice for calculating cost—

(1) "*Unit*" *Cost.* Upon this basis, each article, batch or parcel is valued at its individual cost.

In certain cases, such as bulk stocks, this method is not always capable of application and records, including the allocation of expenses, may become unduly complicated. Further, it may not be practicable to apply the method to partly processed stocks or finished products where the individual units lose their identity.

(2) "*First in, first out.*" This basis assumes that goods sold or consumed were those which had been longest on hand and that the quantity held in stock represents the latest purchases.

It has the effect of valuing unsold stock in a reasonably close relation to replacement price. In certain manufacturing or producing businesses, however, it is difficult to apply accurately through the various stages of manufacture or production.

(3) "*Average*" *Cost.* This basis entails averaging the book value of stock at the commencement of a period with the cost of goods added during the period after deducting consumption at the average price, the periodical rests for calculating the average being as frequent as possible having regard to the nature of the business.

It has the effect of smoothing out distortion of results arising from excessive, and often fortuitous, fluctuations in purchase price and production costs and is particularly suitable to manufacturing businesses where several processes are involved.

The bases referred to above are founded on the principle that "cost" is an historical fact. In some cases, however, their application is unsuitable or impracticable owing to the nature of the business and stock-in-trade is taken at a cost estimated by one of the following methods:

(4) "*Standard*" *Cost.* This basis entails valuing stock at a predetermined or budgeted cost per unit. It is coming more into use, particularly in manufacturing or processing industries where several operations are involved or where goods are produced on mass production lines.

(5) "*Adjusted Selling Price.*" On this basis, an estimated cost is obtained by pricing stock at current selling prices and deducting an amount equivalent to the normal profit margin and the estimated cost of disposal.

Other methods of stock valuation are the "base stock" method, which retains permanently certain basic stock at a fixed price not exceeding its original cost, and that known as "last in, first out" which is based on the principle that profit or loss on trading is the difference between the price at which goods are sold and their replacement cost. There is, however, only limited application of either of these methods in this country.

"MARKET VALUE"

The expression "market value" is commonly interpreted as either—

(i) The price at which it is estimated that the stock can be realized either in its existing condition or as incorporated in the product normally sold after allowing for all expenditure to be incurred before disposal; or

(ii) the cost of replacing the stock at the accounting date.

In considering the merits of these alternative methods, regard must be had to the purpose for which stock-in-trade is held, namely, to sell either in its existing condition or as incorporated in a manufactured product. The fact that at the time of valuation the goods could have been acquired at a sum less than their cost only indicates that the expected profit is less than it might have been had it been possible to acquire them at the accounting date—a possibility which often does not exist in view of the quantity held and of the fact that in many cases purchases have to be made for later delivery; the circumstance has not caused a trading loss but only indicates that the ultimate results under other conditions might have been better.

On the other hand, if at the time of the valuation it is clear that selling prices will not cover cost and expenses yet to be incurred before the goods are disposed of, provision is necessary to meet the anticipated loss.

When estimating the amount of the provision required to cover excess of cost over market value, the method employed may be either (i) to consider each article in stock separately, (ii) to group articles in categories having regard to their similarity or interchangeability or, (iii) to consider the aggregate cost of the total stock-in-trade in relation to its aggregate market value.

RECOMMENDATION

It is therefore recommended that—

(1) The basis of valuation for stock-in-trade should normally be the lower of cost or market value, calculated as in (2) and (3) below.

In certain businesses, such as tea or rubber-producing companies and some mining companies, there is a general custom to value stocks of products at the price subsequently realized less only selling costs if this basis is adopted, the fact should be clearly indicated in the accounts.

In the case of long-term contracts, the value placed on work-in-progress should have regard to the terms and duration of the contracts. If, after providing for all known contingencies, credit is taken for part of the ultimate profit, this fact should be indicated.

(2) Cost should be calculated on such a basis as will show a fair view of the trend of results of the particular type of business concerned. Indirect or overhead expenditure, if included as part of the cost of partly processed or finished products, should be restricted to such expenditure as has been incurred in bringing the stock-in-trade to its existing condition and location.

Stocks of by-products, the cost of which is unascertainable, should be valued at current selling price (or contracted sale price where applicable) after deducting expenses to be incurred before disposal. The cost of the main product should be reduced accordingly.

(3) Market value should be calculated by reference to the price at which it is estimated that the stock-in-trade can be realized, either in its existing condition or as incorporated in the product normally sold, after allowing for expenditure to be incurred before disposal. In estimating this price, regard should be had to abnormal and obsolete stocks, the trend of the market and the prospects of disposal.

If the value of stock-in-trade is calculated by reference to replacement cost, it should be described in the balance sheet as being "at the lower of cost or replacement value," but in no case should it exceed market value as described above.

(4) For the purpose of estimating the amount of the provision required to reduce stock-in-trade below cost, it may properly be valued on the basis of the lower of its aggregate cost or of its aggregate market value. On the other hand, a more prudent and equally proper course is to take each item of stock (or each category group) and value it on the basis of the lower of its own cost or market value.

(5) Where goods have been purchased forward and are not covered by forward sales, provision should be made for the excess, if any, of the purchase price over the market value and should be shown as such in the accounts.

Note. Where goods have been sold forward and are not covered by stocks and forward purchases, provision should be made for the excess, if any, of the anticipated cost over sales value.

(6) Whatever basis is adopted for ascertaining cost or calculating market value, it should be such as will not distort the view of the real trend of trading results and should be applied consistently regardless of the amount of profits available or losses sustained. Any reduction in stock values which exceeds the provisions embodied in the above recommendations is a reserve and should be shown as such in the accounts.

15th June, 1945.

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