

The social Responsibility of the auditor

A Basic Theory on the Auditor's Function
by Professor Theodore Limperg (1879-1961) of
the University of Amsterdam,
with some recent comments.

Published by:
Limperg Instituut
Inter-university institute for accountancy
Mensinge 2
1083 HA Amsterdam, The Netherlands

april 1985

Deze uitgave is verkrijgbaar bij de afdeling boekhandel van het NIVRA, Mensinge 2, 1083 HA Amsterdam, door overmaking van f 25,- op girorekening 62915 t.n.v. het NIVRA, Amsterdam, onder vermelding van "Social Responsibility of the Auditor".

© Copyright 1985, Limperg Institute, The Netherlands

All rights reserved. No part of this book may be reproduced, in any form or by any means, without permission in writing from the publisher.
Printed in The Netherlands.

PREFACE

Limperg Institute's Scientific Board offers in this booklet a translation in English of Professor Theodore Limperg's essays, exposing his general Theory of Inspired Confidence. These essays on the social responsibility of the auditor were published in 1932 and 1933 in the "Maandblad voor Accountancy en Bedrijfshuishoud- kunde" (Accountancy and Business Economics Monthly).

During his lifetime (1879-1961), Professor Limperg developed a comprehensive theory of business economics. He exposed this theory in lecturing to his students. It was only after his death that his theory was published, based on his personal manuscripts. He presented only a few articles and papers during his lifetime. His most lengthy publication is his essay on the Theory of Inspired Confidence.

Within the framework of his theory of business economics Limperg developed a theory of current value, which has deeply influenced academic thoughts as well as practice in the Netherlands. Based on the science of business economics Limperg also developed his Theory of Inspired Confidence, which is still considered fundamental for the education and the practice of Dutch auditors.

As with the theory of current value, requiring adaptation of business values to changed circumstances, the Theory of Inspired Confidence can be characterized as a dynamic theory. It connects the community's needs for reliability of financial information to the ability of audit techniques to meet these needs, and it stresses the development of the needs of the community and the techniques of auditing in the course of time. According to this theory changes in the needs of the community and changes in the auditing techniques result in changes in the auditor's function.

While the auditor's profession is growing more and more as a profession practised on an international basis, and while the discussion on auditing problems and standards is enacted more and more in an international forum, it seems appropriate to convey the original thoughts of Professor Limperg to that forum, together with the comments of Professor David Flint and Professor Gijs Bak.

The Scientific Board of the Limperg Institute wishes to thank the translators of Limperg's essays Messrs. R.A. Schmid F.C.A. and J.M.L. Beek as well as the commentators Professor David Flint and Professor Gijs Bak. Thanks to their valuable contributions, it hopes to have made accessible to an international public the inspiring thoughts of Professor Limperg, which have been proven fruitful to the development of the Dutch auditing profession.

Professor drs J. W. Schoonderbeek
Professor of Auditing, Free University, Amsterdam

April 1985

Table of contents

| | Page |
|---|------|
| The function of the accountant and the Theory of Inspired Confidence - by Th. Limperg Jr., Professor of Managerial and Business Economics and of Accountancy (from 1922 until 1949), University of Amsterdam | 5 |
| Professor Limperg's Audit Philosophy - The Theory of Inspired Confidence - by David Flint, Professor of Accountancy, University of Glasgow (U.K.) | 35 |
| A Comment by Gijs G.M. Bak, Professor of Accountancy, Catholic University Tilburg, The Netherlands, Chairman of the International Auditing Practices Committee (IAPC) of IFAC | 41 |

THE FUNCTION OF THE ACCOUNTANT AND THE THEORY OF INSPIRED CONFIDENCE

by Prof. Th. Limperg Jr.

Part I. (February 1932)

In my paper¹ for the 1926 Accountants' Congress, I tried to lay down the basic principles for the public accountant's function, for his task and especially his responsibility, on which the theory as well as the practice of the profession could logically be built. The thought developed in that paper has, in educational jargon and in the exchange of views in professional circles, gradually come to be referred to as the "Theory of Inspired Confidence" (a rather clumsy-sounding English translation of the Dutch "leer van het gewekte vertrouwen"). Though it may be said that this theory has been accepted by many in our country, it seems that there are also still many with objections.

It is therefore worth the trouble to develop my thoughts a little further. Besides, it appears that, in many respects, misunderstanding exists as to the standard rules which, with regard to the practice of auditing, particularly with regard to the extent of the audit and its relationship to internal control, I have derived from that general theory. This misunderstanding about my opinion of the practical problems of auditing theory has in the past already come to my attention, but my experience has been that practice in itself, and notably the work of those who agreed with my ideas, sufficiently checked the adverse consequences of this misunderstanding. Since it has now reached the point where, according to Belle's dissertation², an entire 'School' threatens to be fed from this misunderstanding, I feel called upon to explain once again how, in my opinion, the 'Theory of Inspired Confidence' essentially works in practice.

It is my intention to work out my ideas in a number of articles. I will start with an examination of the captioned subject in order to deal at a later stage with the application of the general principles developed in this and in a subsequent article. I shall only exceptionally dispute the opinions of certain people; generally I shall be content, when criticizing other opinions, to discuss the most propagated opinions and then only those which could be of influence on the practice. Any other approach would take too much time and would also be less appropriate for the reader.

If we ever wish to arrive at a common principle for the practice of the public accountant's profession, then it is above all essential that agreement be reached on the terminology used and the concepts represented thereby.

¹ The Accountant's Certificate in connection with the Accountant's Responsibility, Congresspaper International Congress of Accountants, 1926, Amsterdam.

² Dr. L.H. Belle, Grondslagen der Accountancy (Foundations of Accountancy), dissertation Economic University Rotterdam (1931).

Therefore I will in this first article pay considerable attention to the definition of the concepts with which we are concerned in relation to the problem of the accountant's task. I say this in advance as a warning to readers, among whom there will certainly be some, who do not like such theorizing. I promise to make amends in subsequent articles, but I am taking the opportunity to plead that such theorizing is necessary in order to come to a common principle for the practice of auditing.

What do we mean by common principle? I am intentionally not speaking of a 'theoretical' or 'scientific' principle, because in these articles I do not only wish to convince the theorist, but also, and even especially, the man in practice. And yet, the common principle is none other than the theoretical one and, if one succeeds in laying the basic principle in such a way that it follows logically and is therefore explained from the point of view of the accountant's function, we can then even speak of a scientific principle. But, for the man in practice, we need not go that far. For him, therefore, I am only seeking a common principle for his task. Why? Because without that principle he is like a ship without a rudder when taking the decisions which he has to take regarding what to do or not to do in a specific case. There must be a guideline for all these special cases, a line of action which makes it possible to keep one's course in the infinite variety of specific instances arising in practice. It is impossible with such variation in circumstances to lay down rules for every special case. It is therefore necessary to establish principles that have a general value and whose application leads to a consistent solution for all the cases differing in detail from one another. No book of recipes, which is still asked for now and then when the directions for the performance of the audit provide no answer as to what may and what may not be omitted in a particular case, but a general principle on which the accountant himself, as an expert, can base the plan for his work.

To make a start with the actual subject, let us now define which function the accountant fulfils in our society.

From the start the term *function* now needs to be defined; what are we to understand by the function of the accountant? The word function is used with different meanings. If we leave out its use in mathematics, it has the meaning of an operation or group of connected operations and, as a derivative, that of office or position in everyday life. In science, the word has a somewhat more restricted meaning; here it is not the concrete operation, action or activity, but the theoretically reasoned operation which is brought about by means of concrete action or by a structure of concrete actions.

So, for example, we can speak of the merchant's function as distinct from his activity. The latter consists of the buying and selling, the storage and transport of goods; the function can for example be seen as the widening of the market, or also as the bridging of distance or time, or as the elimination of unevennesses between demand and supply among successive branches of trade.

When we now speak in the sense as set out above of the function of a person or business or of any other manifestation, then we always assume, explicitly or tacitly, a certain viewpoint from which the person's concrete actions, the concrete object, etc. are observed. The same action can, functionally, have a number of meanings; and the same applies to an object, a person, etc.

Let us once again take an example. A dwelling house fulfils various functions. Considered from a physical viewpoint in relation to the human being, we can say that it fulfils the function of protector against the influences of the atmosphere, of the cold, the heat, the rain, etc. Considered from an ethical viewpoint, we can for example say that the dwelling house fulfils a function related to family life.

From an architecturally technical point of view, we may speak of the function of its shape and of the encapsulation of space, and from an architecturally aesthetic point of view, we can refer to the function of a certain house in relation to the town scene, for example as closing off a street or square. Thus it shows how, speaking about the same house, its function can be observed very differently. And the same can be said of every concrete manifestation and also of the accountant. We shall therefore have to agree on the viewpoint from which we wish to observe the accountant.

On what does the choice of the viewpoint now depend? It depends on the problems which we want to solve. The theorist primarily determines his point of view in relation to the objective of his science; the practical person determines it in relation to the purpose for which the solution of the problem is destined.

Unbreakably linked to the concept of the function, in the sense in which the word is used here, is evidently the supposition of a purpose attuned to the function's fulfilment, of a target at which the function is aimed or of a result which the function brings about. The function cannot be thought of independently from its objective and its result; in each of the above examples, it can be seen that the function derives its sense and meaning with a certain cohesion from its aim and its result. That cohesion is governed by the problem and by the set of manifestations wherein the function is conceived. In that way we were able to establish earlier how the function of the same concrete manifestation varied according to the objective or the result one had in mind.

In our case, we are concerned with economic problems. One could, for example, also turn the ethical function of the accountant into an object of investigation, but I do not believe that there is any difference of opinion about my statement that the problem of the manner in which the accountant should exercise his profession is, in the first instance, an economic problem. It is a problem, is it not, of the profession's efficiency and of the accountant's work as resources to achieve the satisfaction of needs.

Thus we want to investigate the *economic* function of the accountant. In particular we shall investigate the accountant in The Netherlands in the present state of the accountants' profession in this country. There is a strict need for limiting our objective because the accountant - as indeed do all other officials - holds a

position in society which differs with the country where he works and with the state of development of his profession in that country. That does not mean that our analysis could not be of significance for the accountants' profession in other countries; the contrary is true. If we succeed in arriving at common guidelines for the accountants' work in The Netherlands, then these must on the whole also apply to accountants in other countries. But, one has to accept that there is a difference between accountants in The Netherlands and those in Germany, in England, in the United States, as indeed the latter again differ among themselves. There is a difference in knowledge, in professional technique, in the views of principals and the expectations of society. In other words, the term accountant is represented by different definitions in the various countries and at different times.

Meanwhile, the ultimate aim of our analysis is not the investigation into the function of the accountant; we are looking for the substance of the 'task' of the accountant, for the factors which determine that task, i.e. his *work task*. In this sense, the task is thus distinct from the function; the former is the complex of concrete actions, the work which the accountant must perform in order to fulfil his function. We want to know that the accountant has to do and has to omit in order to perform efficiently and effectively his economic function in society for the purpose of satisfying needs and for the benefit of production.

Taking this investigation in hand, we can establish that the Dutch accountant performs various economic functions, which means that the function of the accountant is made up of different functions. As a rule, a distinction is thus made between the advisory and the auditing function; a distinction which, its correctness notwithstanding, is for the time being of no significance for our subject.

As we shall see, these two functions cannot in reality be separated. A much more important distinction can be made, important because it affects the foundation of our problems; the function of the accountant is split up into the *auditing (and advisory) body of management and the auditing (and advisory) body of the community* (consisting of investors, bankers, suppliers, workers, etc. = the public interest). The importance of this distinction will be evident from the following.

Let us first consider the function of the accountant as a *body of management*. I must here allow myself a small digression into the field of Organizational Theory, which is required for a good understanding of the accountant's relationship vis-à-vis the enterprise.

As soon as the enterprise expands beyond the status of a one man operation and, in consequence, a hierarchical division of labour (i.e. a division of labour where sections are put in a vertical order on top of each other) is applied, a manager-operator relationship is brought about between the various sections. If we consider the organization as a pyramid or a cone, then at the top we can imagine the upper management as the central managing body on whose instructions all other

sections will, as operating units, participate in the production.

If the upper management is to be effective, it will have to penetrate into all the sections; thus it will have to flow from the top through to all the sections. And, because upper management cannot reach all sections directly, the managing function is passed on from section to section. Thus in each section, there again develops a manager-operator relationship because each section is the managing body for the subsequent sections, while each section is, in its turn, an operating unit, not only as regards the upper management but also as regards the immediately preceding section. Eventually, only operators are found in the bottom section. Thus a differentiation in management develops.

Effective management calls for control as well as for management as such (viz. giving operational directions). Without control over operations, the manager has no certainty that performance takes place in accordance with his instructions. Mind you, here I am speaking of control in general, thus not only of accounting controls or of an examination by the accountant. Control is therefore a strictly essential element in the managing function.

With the increase in the size of operations, the pyramid also expands. The gravity exercised by the mass of the labour body always leads to an increase in the number of sections; the distance between upper management and the bottom section is for ever increasing and with it not only the need for control but also the extent of the control measures.

If this growth is allowed to occur freely as a result of the gravity of the labour body's increasing mass, it will be seen that a differentiation occurs in the control and with it in the management. Management sections also become control sections; the managing body again and again serves the controlling function at the same time not only for its own management work, but also on behalf of upper management.

This natural development of control brings with it many disadvantages; combining the management and control functions time and again in the same person soon becomes economically irrational. In the first place, because both functions require very different qualities and capabilities; this eventually becomes apparent in the form of a cost advantage arising from the splitting-up of the functions. With such a split, the operations manager can be relieved of the control duty which is onerous to his personality, while the control function can be allocated to persons who are particularly qualified for that function. In the second place, because the techniques of management and of control are very different, the splitting-up of the functions enables the technique of control to be perfected. And, in the third place, because managing bodies are *unsatisfactory* control tools for upper management, in that in their control they not only include the performance of operating units under their leadership, but at the same time also

the results of their own management activities. Upper management fails to find the necessary guarantees of objectivity and impartiality in the managing bodies' communications about performance that a controlling body ought to give. In other words, with the combination of functions discussed here, there is a need again for the control to be controlled.

This leads to the need for a separate control organization, a body which specializes in control and performs its control function around and outside the sections of management. Schematically, this can be represented in such way that, apart from the aforementioned management pyramid, a control column or pyramid develops which, with its observations from the side, penetrates into the sections of the first pyramid and, as a controlling body, is independent of the managing bodies subordinated to upper management and has a direct link with that upper management. In this way, in the enterprise the specialized function of auditor came into being.

This function - the first of the two functions distinguished above - is now for the greater part appropriately vested in the accountant. As an expert in the field of accounting control and a skilled business economist, he is the right man for this function. Accordingly, we see the accountant in our country - as indeed we also do abroad, especially in England and the United States - fulfil this function as manager in charge of the control staff. Mind you, I am not yet speaking here about the distinction between the public accountant and the internal auditor; I am still speaking solely about the function, regardless of the formal or legal relationship between upper management and the accountant.

But this much should already be stated; this function is one that is in fact from an hierarchy point of view subordinate to that of the central upper management and only exists in order to support the latter in its function.

We now come to the function of *auditing body of the community*. It is this function in particular which calls for our attention; it is in relation to this function that the actual problems arise. However, we shall let these problems rest for the time being and start with an analysis of the function.

Society severed long ago the old relationships pertaining to the financing of production. In the past, it was the owner of the business who not only managed operations, but who also financed them with his own resources, out of his own savings built up from income generated by the business. The classic figure of the individual entrepreneur, who was dependent on no one and not accountable to anyone, has for the greater part served its purpose regarding the output of the combined factors of production. Bank overdrafts, suppliers' credit, direct credits from savers in the form of deposits and debenture loans, and lastly the savers' participation in the limited liability companies, have radically changed the financing of a large part of the production. Without that change, production could not have developed as strongly as it has done in the last hundred years.

But with that change, the relationship between the enterprise and the community has also totally changed. The financial structure of production has become dependent on society's participation in its financing and, in exchange, the community demands that producers account to it for the savings entrusted to them and for their management. That accountability is formally given in the annual report of the limited liability company, in the statements of banks, in the issue prospectus and in other publications; in addition, in the information given to lenders, banks, etc.

It is clear that the community at large cannot in the end be satisfied with accountability and data provided by the person who requests the money and manages the capital. It is rational that the community will seek information from persons other than the interested parties; in other words, that it desires verification of the information presented by these interested parties to the community. Initially, the financial community was content with the institution of Supervisory Directors. The supervisory director acts as confidential agent of the shareholders and of some other groups of savers - for example as supervisory director of policy-holders with life assurance companies - and the community beyond these groups of interested parties also benefits from the verification by this functionary, until one experiences such verification as providing insufficient guarantees. The supervisory director who, as an amateur auditor, does not have the time to carry out the extensive examination work and who also lacks the expertise to carry out an efficient audit in the complex organization of modern enterprise, himself asks for help and support from the professional auditor.

At this point, the public accountant appears on the societal scene as a *confidential agent of the community at large*, particularly as confidential agent for the financing of production. Besides, he is also confidential agent for numerous special interests, the interests of his principals. But the great significance of his office is derived from his function of confidential agent of the impersonal community of savers and other interested parties *who are not his principals*. That function of confidential agent for the community at large is the accountant's most important function by far. It provides his office with its principal substance, and in the main also determines his economic role in the community.

The nature of this function is not new. I have already said that, before him, the supervisory director fulfilled a similar function; and still the supervisory director is, next to the accountant, the confidential agent of the community and in respect of the same interests. This means that, at a later stage, we shall by putting them face to face have to determine and define the parameters of both their functions and therefore of both their tasks.

But from the foregoing a very important difference has already become evident. The supervisory director is but an amateur in the field of the accountant's task; expertise and professionalism are the elements that provide the public accountant's function with an entirely different significance when compared with the function of the supervisory director.

The function of the professionally efficient confidential agent of the community is meanwhile not new either. I may mention the chemical laboratory with its verification of and its certificates concerning the composition of foodstuffs, the veterinary surgeon with his verification of the quality and care of cattle on behalf of the consumers and particularly the actuary, who already fulfilled the important function of confidential agent of the community in the life assurance business prior to the public accountant.

However, none of these functions has been deserving a significance which is in any way comparable with that of the accountant who for a long time in England, later in the United States and in The Netherlands and very recently also in Germany, has become one of the most important factors in the financing of output.

Part II. (October 1932)

Let us now investigate in which relationship in both functions that we have come to know, the accountant must stand vis-à-vis the enterprise (I am ignoring, for reasons of space, the relationship to corporate bodies) to which he renders his services, in order to fulfil the function in an efficient way. We have principally the choice between two relationships; that of the accountant as an employee and that of public accountant; there are other possibilities but for the general analysis, to which I wish to restrict myself in these articles, they are of no importance.

Before defining the choice as regards both functions, it is meaningful to dwell on the economic significance of the profession in the work of the accountant. The development of the free profession has called into existence an independent branch of industry to which the work of the accountant - particularly the audit work - is allocated. This specialization is in fact not distinct economically from the numerous other specializations that we see being created in the production process, when autonomous industrial sectors are formed to execute a process or an action that was previously carried out in conjunction with other activities or actions in a joint industrial sector. We are dealing here with a manifestation of *differentiation*³).

To take a simple example, just as the shipping trade, which carries out transport by sea for the vast majority of other trades, has formed itself into a separate branch of trade, so has auditing recently become the speciality of *public accountants* who, as a free profession, have grouped themselves into business which carry out audit work for members of the other branches of industry.

³ With respect to production specialization, a distinction can be made between differentiation, i.e. specialization in the different processes and treatments which the same good must consecutively undergo in production, and specialization, i.e. specialization in product types and in requirements. This distinction, which is in general of great significance for an insight into the structure of the community's production, is also important for many problems relating to the accountancy profession.

A differentiation in community's production occurs as soon as a process can be more efficiently carried out in an autonomous branch than it can combined – *integrated* - with other processes. More often than not, it is the cost advantage in processing that brings about the differentiation, but sometimes there are other causes that make it efficient to carry out a process in an autonomous branch of industry.

Apart from those of a general nature, such a specific cause presents itself in connection with the work that the accountant does in his function of *confidential agent of the community*. For, in that function, the independence of the accountant is a condition for the effectiveness of the work of the office holder.

Independence, in the most absolute sense of the word, is what is required of the *confidential agent* before all other things. What that requirement entails for the accountant will still be investigated further in the course of my later observations; for the moment it is sufficient to ascertain that that requirement rules out a master and servant relationship between the confidential agent and the entity being audited.

If the community wants to be truly served by the function of the confidential agent, then it cannot be satisfied with an unqualified opinion of the enterprise's employee accountant. The community asks for an independent opinion on the accounts of the stewardship of the managers, and that can apparently not generally be expected of one who is in the service of that manager and who, organizationally speaking, has to dance to that manager's tune. Mind you, it is very well possible that a specific accountant in a specific case also maintains his independent opinion as an employee. However, the requirement of independence does not apply to the character of the accountant but to his functional status; independence is the logical condition for obtaining effective relationships as regards the audit. When we later object if an employee accountant signs a report to the published financial statements of an enterprise, that criticism will in principle not be aimed at the person in that particular case, but against a method which, no matter how well the audit may have been carried out and no matter how steadfast and independent of character the person concerned may be, is inappropriate and, as regards the function of the accountant in the community, also detrimental.

The community cannot and may not be content with a relationship which is irrational, economically speaking, and which does not provide the required guarantees for the confidential agent's effective functioning. Society needs the *public accountant's* certificate and, through the insistence of that need, the free profession and with it the differentiation, has consequently to come about.

Conversely, as soon as the differentiation is completed, the choice between the two relationships is now also made in favour of the function of the confidential agent. The function demands the choice of the public accountant.

Evidently this requirement need not be set for the function of the accountant as the

auditing body of management. Only independence of opinion is required here and to the extent that it is of service to upper management's enlightenment it is useful as well. Thus the employee accountant can wholly effectively fulfil the function in this respect. And yet it is remarkable that this function too reverts to the public accountant in the majority of enterprises. It is worth the trouble to indicate the causes of this state of affairs.

As we saw earlier, the function of the specialized auditing organization in the enterprise has arisen out of rational considerations. That organization can perform the audit work at less cost than the managing bodies and, in addition, the latter are from upper management's point of view less reliable auditing bodies. The aim to create a separate auditing body is therefore economically rational.

However, the laws of relationships⁴ set limits to the use of a specialized auditing organization. Only very large enterprises will make it economically possible to set up such a body at all. Evidently money is wasted so long as at least one person is not kept continuously engaged with the audit. But, even when one person is kept continuously engaged with the audit, it is proportionally speaking still much too disadvantageous. Only when the company is so large that an audit staff can be employed in which the same division of labour can be applied as is found in the business of the public accountant, does an economically rational basis for its own auditing organization exist; as long as that size has not been reached, the costs of the internal organization must, normally and in the long run, be higher than the use of the services of the public accountant; at least when the same high standards are demanded of the internal audit organization as of the public accountant.

In addition, there are two more factors which make the use of the public accountant's services preferable to those of the internal organization. In the first place, the variety in the nature of enterprises which the public accountant audits is in the long run an important component of his competence; the versatility of observations made in various enterprises increases that competence. And, in the second place, the independence of the public accountant's auditing organization benefits the technical effectivity of the audit carried out for the management. The public accountant's staff stand aside of the hierarchy of executive management and the operational work force of the enterprise. In this way, one avoids the many irrational relationships between the employee accountant and his staff and the other personnel, which inevitably stand in the way of the functioning of an internal audit staff.

All these factors together cause the function of management's auditing body also to be assigned on rational grounds to the public accountant. In those enterprises, too, where there is no need for an auditing body to serve the community, and for which - as we have seen - only the public accountant can be considered, the

⁴ The organization of production is ruled, both communally as within enterprises, by the laws of proportions. Among these proportions, quantitative ratios hold a significant position. It is, in fact, the laws of quantitative ratios which are introduced into the controversy.

services of the independent public accountants are enlisted. And in those companies where an auditing body is required on behalf of the community, it is moreover rational to combine both functions in one person. A large proportion of the audit work for both functions coincides, does it not, and it is obvious that, in order to save costs, this duplication in the task of both officials is avoided; as a rule, both functions are therefore entrusted to the same public accountant.

Thus, a combination of the two functions in the profession of public accountant arises and, moreover, a combination of the two functions in the same company in one person. These combinations are in many respects rational. But, however efficient they may be, particularly from the point of view of audit costs, they create some difficulties which we will investigate later.

It is clear that in our continued analysis we can now limit ourselves to the function and task of the public accountant. For the function of the employee accountant does not present any difficulties as regards the task which he has to carry out; at least not in connection with the problem that we are now investigating. That task is defined by upper management, for the benefit of whom he fulfils his function. The relationship between the employee accountant and that management is not different from that between any other employee and upper management; the latter determines each person's task. However, the capable manager will allow many an employee a certain degree of initiative and more so as he himself is less competent in the employee's profession but, in the end, he will still have to fix the parameters of each person's task and in effect he must therefore determine each person's work. Only in that way can one speak of management.

That does not mean that the employee accountant will have to be a malleable tool in the hands of upper management. I would not accept that of any employee. But that is quite a different problem, one of ethics, and I do not wish to discuss that. *Economically*, the employee accountant is an executive body of management and therefore subject to the rules that are fixed by upper management as regards the audit.

I am thus restricting myself to the public accountant. And, as a starting-point for my examination, I shall dwell upon his task in carrying out the function of auditing body of the community at large.

Up to now, we have spoken of this function in the sense of the social, the *general* function of the accountant-auditor, without thinking of specific work which he carries out or of specific cases in which he acts. If we take these into consideration, then the general function is made up of an infinite number of *special* or *specific* functions, directed at the special purposes for which the accountant-auditor is engaged. Thus there is the special function of the accountant-auditor in a particular enterprise, the function related to the verification of certain financial statements, to the investigation of an issue

prospectus and to many other special investigations which he is asked to carry out.

It is necessary to realize the way in which the general and the special functions are related to each other. The general function is made up of the special functions and, conversely, is the *raison d'être* of the specific functions through which it is given concrete form and is realized. While the latter are purposefully established by a certain action with a limited objective in mind, the general function is borne in the community at large, effectively but not purposefully, by a certain action: it develops from the specific functions. When we ask ourselves the question, what the work task is that results from the function of the accountant, then we are in the end concerned with the question as to what the accountant has to do in any *specific* function.

But the right answer to that question can only be found if we bear in mind the demands made by the *general* function, so that it may be appropriately carried out for the benefit of the community. No special function can come into its own without being supported by the general function and unless it in turn supports the general function to come into its own. It is the general function, with its general objective and the resultant standards demanded by the community, which governs all special functions. Therefore, we shall firstly have to investigate what standards are required from the work of the accountant-auditor in his general function as confidential agent of the community; those standards will also have to apply to all specific functions resulting from that function.

The objective of the general function is the starting-point for the *Theory of Inspired Confidence*; I will now go on to develop that Theory.

The auditor-confidential agent derives his general function in society from the need for expert and independent examination and the need for an expert and independent opinion based on that examination. The function is rooted in the confidence that society places in the effectiveness of the audit and in the opinion of the accountant. This confidence is therefore a condition for the existence of that function; if the confidence is betrayed, the function, too, is destroyed, since it becomes useless.

It is true that confidence plays a part in more or less every function in society; particularly confidence in the proper fulfilment of the function, in the honesty of the holder of the function, etc. But in relation to the function of confidential agent, the significance of the confidence is of a very special kind; it is the essence of the function itself. The function of the confidential agent arises, does it not, precisely because society has little or no confidence in the communication and the opinion of other officials. The confidence in the effectiveness of the audit and in the opinion of the accountant thus forms the *raison d'être* of his function.

In the same way that, for every function, the requirement must be set that it needs

to be fulfilled in such a manner as to achieve the objective, we may, as regards the function of the auditor, say that he must perform the work necessary to justify the confidence in his audit and in his opinion. If that work does not meet this requirement - particularly if the work is done in such a way, to such a limited extent, that confidence is betrayed in the end - then the function too loses its purport; it misses a real basis and has no *raison d'être*.

If the function is to achieve its objective, then no more confidence may be placed in its fulfilment than is justified by the work carried out and by the competence of the accountant, while, conversely, the function must be fulfilled in a manner that justifies the confidence placed in its fulfilment.

There are two alternatives in the event of confidence placed and the manner of fulfilment not covering each other; there can be an *exaggerated* confidence and a *shortcoming* in the fulfilment of the function. Initially this distinction seems perhaps to have little sense. For, if there is a shortcoming in the fulfilment of the function, then there is at the same time an 'exaggerated' confidence, i.e. an expectation about the result of the work of the accountant that goes beyond what is justified by the manner in which the function is fulfilled. And, conversely, if there is an exaggerated expectation then also the work done falls short of the confidence placed in it. The effect of the accountant's work on the community will thus be the same with both assumptions; in both cases, the function has not been fulfilled. But the distinction serves a purpose in that it enables us to indicate the *causes* which have nullified the function; in the first case, the cause lies with the community or with the individual, whose expectations were excessive, while in the second case, the cause lies with the holder of the function who betrayed a legitimate confidence. Only in the latter case is the accountant to blame.

When, in a specific instance, one has to judge whether or not the accountant is to blame, then it is important to ask oneself whether he whose confidence in the accountant was disappointed did not set his expectations at too high a level. For the purpose of our analysis, it is merely necessary to investigate whether, in general, the accountant is threatened by the danger that the community's expectations will be exceeding those that would be reasonably warranted by careful and able fulfilment of the function.

That holding unreasonably high expectations indeed forms a danger, not only for the individual accountant but also for the profession in general, needs no further argument; it must unavoidably lead to disappointments, for which the accountant is then unjustly blamed with the ultimate result that the general confidence in the accountant's function is shaken. And if his danger really existed, it would then be the task of the accountants to fight against such unreasonable expectations. But can it seriously be said that there is a danger in that direction?

This is not the case at all. Undoubtedly it could in general be said that the inexperience of the people, for whom the accountant frequently is the confidential

agent - particularly the 'general public' - leads to exaggerated expectations. And there are opponents of the Theory of Inspired Confidence, who, with predilection, wield the argument that that Theory puts the accountant at the mercy of the unpredictable expectations of the *man in the street*. But this argument is, for two reasons, not correct.

In the first place because this argument is belied by the facts. Experience teaches that in general there is no question of unreasonably high expectations. I do not deny that, in certain cases, efforts are now and then made to unreasonably saddle the accountant with the blame for a disappointment experienced; but of ten the disappointed party is then not acting in good faith and the 'expectation' is construed afterwards. But generally, alas, it is noticeable that expectations are placed *lower* than is necessary, given the level of ability and technical possibilities of the Dutch accountant, who is recognized as competent in professional circles. I say *alas*, for disadvantageous as the entertainment of generally exaggerated expectations might be for the profession, excessively low expectations are detrimental to the significance of the function of accountants. It is the more remarkable that there are accountants who systematically try to force down those expectations. Under the pretence of combating self-assertion and conceit in the endeavours of colleagues, who are attempting as much as possible to raise the standard of expectations and hence of confidence of the community, these accountants play to third parties and among themselves the role of the modest man. They are the ones who create for themselves the danger of 'exaggerated' expectations, because in the fulfilment of the function they fall behind with that which is reasonably possible and with that which is being done by those colleagues. But the community is intelligent and reasonable; it does not set standards of confidence which are higher than the competent and cautiously working accountant is able to satisfy.

It is that standard which, according to the Theory of Inspired Confidence, defines the purport of that confidence. The expectation we are speaking of is therefore not - see here the second error that is concealed in the argument- some arbitrary standard set by some dumb or irresponsible individual, but a standard of confidence evolved by the needs of the community which the sensible layman builds into the function of the accountant.

Part III. (October 1933)

The normative core of the *Theory of Inspired Confidence* is therefore this: the accountant is obliged to carry out his work in such way that he does not betray the expectations which he evokes in the sensible layman; and, conversely, the accountant may not arouse greater expectations than can be justified by the work done. This simple maxim applies independently of the tenor of the expectations; whether these are extensive or modest, the community may never be disappointed in its expectations. In its normative core, the Theory does not lay down definite

rules about what the accountant has to do in each particular case; that decision it leaves to him as a professional. But, as a guide for that decision, it gives him this general prescription, based on the consideration that the effective tenor of the function, thus its operation in the community, is determined by the confidence it inspires. In consequence, the Theory expects from the accountant that in each special case he ascertains what expectations he arouses; that he realizes the tenor of the confidence that he inspires with the fulfilment of each specific function. To that end, it is necessary that he has an insight into the factors that determine the substance of that confidence.

Therefore we shall now proceed to investigate those factors.

We have already come to know the most important factor; it is *the community's need*. The services of the accountant are used in order to meet a need of the community and thus it is expected that the accountant will meet that need in an efficient manner. The need gives rise to the function and the accountant is bound to fulfil that function efficiently; his task is thus primarily determined by the need. And that need asserts itself in a standard in which the expectations are restricted in a reasonable way to what the accountant is technically able to do with careful and competent fulfilment of the function.

With this limitation we have named a second factor: *the ability of audit techniques to meet the community's needs*.

If we investigate these two factors somewhat further, then it is immediately apparent that they do not provide the function of the accountant with a firm import in the sense that that import would be the same everywhere and in the course of time. The needs of the community are not everywhere the same, and also change in the course of time; on the other hand, the techniques of auditing also change.

I do not here wish to elaborate on the local differences that can thus arise in connection with the import of the function; as I have already said in the first part of this paper, I am concentrating on the function of the accountant in The Netherlands, and it is of no fundamental interest to investigate how the function of the accountant relates to the Theory in countries where the circumstances differ from those in our country. But I must pay some more attention to the changes which the function undergoes in the course of time, since in that respect there are some fundamental points to be noted.

Taken together, we may consider the changes which the function undergoes in the course of time as the growth of the function. Wherever the primary cause for the changes lies, whether with the development of the community or with that of auditing techniques - I am not thinking here of techniques in a narrower sense, but also of the *method* of auditing - that growth always has a gradual character. And this means that as regards the practice and the application of the Theory, a period of uncertainty arises about the import of the function and of the confidence; an

uncertainty, which is still enhanced, because initially there rarely or never is any consensus in professional circles about the usefulness of certain methods of working and about the desirability of expanding the function. What, in these circumstances, is the standard of confidence applicable to the function of the accountant?

Before answering this question, I would like to make a remark about the nature of the influence, which is generally exercised by the accountant himself on the import of the confidence inspired by him, and on the way in which that influence makes itself felt. For this purpose we must distinguish between the influence that is exercised by the accountant individually in the fulfilment of each specific function, and the influence that is exercised by accountants collectively.

As regards the latter influence, it can be said that the import of the general function, the place that accountants occupy in the community, and the import of the confidence inspired by them, are the *result* of the needs of the community on the one hand and of the manner in which accountants meet those needs on the other. The standard of confidence springs from the interaction of both these factors; a standard of confidence that meets society's demands cannot arise as long as accountants do not appear in sufficient numbers to be able and willing to fulfil their function in accordance with those demands and to carry out the task necessary for that purpose.

The way in which accountants comprehend and accomplish their function is thus undoubtedly an important constituent factor of the confidence inspired by their general function.

But, for the application of the Theory, what is at stake in the end is the substance of the confidence inspired by the *individual* accountant in each *specific* function. What was just now the *result* of the interaction between the performance of accountants collectively and the needs of the community, becomes the basis for the actions of the individual accountant; the standard, grown out of this interaction in the community, becomes the *starting-point* to determine the task in the special function of each accountant individually. Consequently, the subject of my further reflections is going to be an analysis of the individual accountant's relationship, in the specific function, to this result of the interaction between performance and performance ability of accountants on the one hand and the demands of the community, which are being presented to him as a criterion for his task, on the other. In that analysis, it will at the same time be ascertained how far the individual accountant still exercises influence on the confidence inspired by him personally.

In that connection, I will firstly deal with the above-mentioned relationship in the development period during which the result of the intended interaction, and therefore the criterion, undergo changes.

The development of the community's needs does not in itself create difficulties. A new need gives rise to a new function provided it can be efficiently fulfilled by the accountant, the accountant's function can then grow in accordance with that need. Once the new function has been firmly established in the community and its purpose has thus also become generally known, then it is that new purpose or the broader purpose which determines the extent of the confidence inspired by the accomplishment of that function. But, as already said, before the new function has captured that place in society, there is a period of uncertainty and it is that uncertainty which creates a problem.

It is important now to establish from the very start that all prevailing standards find on the one hand a firm *basis* in the rational demands of the community as derived from the needs of that community and, on the other hand, in the demands of audit techniques, which must meet those needs. Those demands are entirely fixed in every case; they can be indicated logically and with certainty.

As the engineer creates the right tool for the exact technical demands of manufacture, heating, etc., so the accountant designs the effective audit for the demands logically determined by the needs of the community.

When, for example, the attestation of the accountant is asked for the financial statements, then it is firmly established that society has a need for a perfect assurance concerning the correctness of that publication. That need therefore forms the starting-point for defining the function and task of each and everyone involved with that publication. For the accountant, that need consequently applies as a basis for his function and as objective, at which his task is directed; in that way that task too has been definitively defined.

However, a closer investigation will make it evident all the same that we are not here concerned with *absolute* standards; the prevailing standards always more or less recede from that fixed basis. In the first place, no body can provide *perfect* assurance; "human ability" creates a first barrier. Furthermore, rational action requires that the community surrenders as much from that perfect assurance as will make the result worth the cost. In addition, a rational constraint arises from the division of functions; for the assurance sought, the *accountant* is required only to care for and guarantee the correctness of the financial statements, in so far as this lies within the boundaries of his expertise. And so, in the end, standards are agreed upon which are no longer the absolute standards uninfluenced by personal opinions. All prevailing standards, however positive and however generally accepted they may be, leave some scope for personal variations in the special case, in the specific function, to which they are applied. But that scope is limited; for it does not arise from a difference in opinion about the substance of the function and thus about the objective of the audit. *Only the technical views of the accountant as expert can play a role here.* The Theory happens to exclude his considerations *as a businessman!*

The variations that are possible in the periods of development are of a completely different nature. In the transitional periods, when new demands from the community develop, *uncertainty arises concerning the import of the function*; an uncertainty that does not exist individually, but that exists for all professional colleagues. It is not possible to ascertain definitely what confidence the accountant inspires in his specific function, because the various individuals who take note of his certificate will have different expectations of it; no general standard has yet been formed.

Does this now mean that the Theory of Inspired Confidence is inadequate or has become unsteady? It does not mean that at all. As always, the accountant will in the first place have to decide for himself what confidence he inspires. In the absence of a generally applicable standard, a stronger appeal is now made to his own view than otherwise; and the personality of the accountant will thus play a greater role here than in the normal cases. Not only technical insight now determines his behaviour - let us for simplicity's sake assume that the accountant as expert has already accepted as essential the new needs of the community - but also other factors, particularly his character. If he is progressive, he would sooner wish to meet that need *within* his own function than he would be if he is indolent; and the more conscientious he is, the more he will take into account the possibility that his certificate is seen by somebody who has already geared his expectations to the new needs.

In this case, therefore, when the accountant determines the extent of the inspired confidence, there is a personal element, partly even of a subjective nature, which in the application of the Theory raises a problem that would not have arisen but for the lack of a fixed standard. But one should take good note that the objective basis is not abandoned. The scope for subjectivity in the accountant's opinion will increase in proportion to a decline in the emphasis of the standard, but, in accordance with the Theory, the basis on which the opinion is formed remains objective in all cases; the logical analysis of the rational demands remains to the end, and in all circumstances, the basis for function and task. The vagueness in a transition period is unavoidable and cannot be removed by any hypothesis or Theory. That vagueness is not a weak spot in the Theory, because it is an existing and unavoidable manifestation of a community in the course of development.

Neither does that vagueness render the Theory any less efficient in its applications; on the contrary, the Theory fits in completely and unrestrainedly with the development process of the community. As long as the accountant's estimate of the extent of the confidence inspired by him as regards his work is still reasonable, no blame will attach to him. Only gradually does the developing community compel the accountant to adapt his estimate to the new needs.

My above argumentation as regards the development of the community's needs, as such equally applies in principle to the development of the function attributable to the growth in audit techniques. Neither does the circumstance whereby

accountants can play an active role in that development cause any change in the principle.

Also in this respect, - and even more than in the cases just discussed - a personal and a subjective element will temporarily be observed in the decision of the individual accountant. But again the Theory is not thereby affected, either in its fundamental propositions or in its applications. More than in the case discussed above, the indolent accountant, the accountant who, from a competence point of view or because of personal considerations lags behind in the exercise of the profession, and also the accountant who does not act wholly in good faith, have the chance to escape a *sanction*, which is placed upon the inadequate exercise of the profession, by appealing to the lack of a definite standard. But the essence of the relationship is not thereby affected; there may be uncertainty about the substance of the inspired confidence, but that uncertainty does not remove the influence of that confidence. The new techniques, the improved methods, become by a variety of means common property in an ever broader circle of colleagues.

The press, education and practical application spread them and make them known, also in the community, which gradually incorporates them in its expectations. The general function grows thanks to the new opportunities opened up by the improved technique, until the community demands its application as a necessary element of the task to be carried out; the more comprehensive confidence, deriving from the growth of the general function, creates a new standard for the specific function.

If we want to be able to speak with same confidence about the substance of the accountants' task, we must then take good note of a certain phase of development of the profession. The most rational starting point for a fundamental treatment is evidently that of the fully grown profession; only after the stage of development has been reached in which the accountant fully fulfils his function as the confidential agent of society and only after auditing has developed to the point where it has reached a perfectly balanced technical system, is it possible to provide the confidence, inspired in the specific function, with fixed parameters. The substance of the general function is then entirely determined by the effectiveness with which the function is fulfilled; the problem has in each special case been solved, if we establish what the community needs and in which need the community must provide, wants and is also able technically to provide by employing the services of an accountant.

In the meantime, we must then for each particular case still know which specific function has been assigned to and is intended for the accountant.

I pointed out earlier that the specific function is established by a purposeful action; though based on the general function, it still has its own existence to the extent that it can only be brought about by a certain action.

This means that it is not only dependent on the impersonal demands of the community, but also on the wish of a certain person or group of persons, who create the special function.

The accountant himself cannot bring that specific function about; he fulfils it by virtue of his general, his social function but also by virtue of the *engagement* given to him. Thus the question arises as to how far that engagement and, more generally, the wish and the objective of the *principal*, have influence on the import of the special function, for the fulfilment of which we have to define the task.

To what extent is the substance of the engagement a constituent factor of the task, in addition to the factors which we have come to know until now?

This question is particularly important, because for the most part, special functions are not established and the audit engagement is not therefore given by those, whose confidential agent the accountant is.

The problem is most fundamentally put in those instances where the services of the accountant are enlisted for the benefit of the community at large; in those instances, therefore, in which the function is directed at satisfying the needs of people who cannot or are scarcely able to exercise any influence, least of all any direct influence on the substance of the engagement. Last but not least; in these instances, the engagement is of ten given, and thus the function established, by those facing the community as the interested parties, whose actions and communications are subjected to the supervision and the opinion of the accountant. Managing directors of a limited liability company appoint the accountant; he is generally also their confidential agent. But, besides and on top of this, he is the confidential agent of the community, of the unknown saver, the anonymous interested party outside the organization.

With that we have, in relation to the issue we are dealing with, also defined the position of the "engagement". The engagement establishes the function, it sets it up *legally*, but from the moment that the function exists, the principal has no further say in the manner in which it must be accomplished. From that moment onwards, it is the function itself to which the principal and even the accountant are subjected. Even the latter is no longer free in the choice of the means which he uses to fulfil the function; his task is objectively determined by the rational technical demands that arise from the confidence which the community attributes to that function. As an expert, the accountant has to decide what he has to do in order to respond to that confidence, not to betray it.

No other considerations can apply and, in particular, it is not possible to restrict the task to below the limits which the technique of the audit sets for the effective fulfilment of the function. No wish whatever of the principal may thereby be brought into the discussion.

The engagement is the mould in which the agreement between the accountant and his principal is cast. That agreement is necessary for the creation of the function; principal and agent must agree on the import of the function- The *conventional*

element is therefore present with the creation of the function; and it goes without saying that the accountant is legally bound to the substance of the engagement accepted by him. But the legal aspects are now beside the point; the accountant is bound to refuse an engagement which could legally constrain him within limits which he as expert would have to exceed.

However, this all applies from the moment the function exists, and the engagement is given. But, as we have seen, that engagement does establish the function and in consequence it will also have to give an indication regarding the substance of the function; without that indication, the function would be undefined, not distinguished from all other specific functions. A brief indication can in many cases be sufficient; thus the function can be fully defined when the accountant is engaged to audit the limited liability company 'X'. But the indication of the function is not always so simply achieved. The engagement has been seen to take the form of a description of the task to be carried out. The question therefore arises whether, in that instance, the function is after all not derived from that task indicated by the principal, and whether in that instance the function is not defined by the task and it in turn is defined by the engagement. And the question also arises whether, in this manner, the way is after all not logically opened up for the introduction of a limitation in the task as desired by the principal.

Here, we have reached an important point in the problem. There is a widely held opinion that such a limitation may be accepted without objection, provided this is clearly disclosed in the certificate. If this latter condition is met, then it appears that even the Theory of Inspired Confidence has been satisfactorily applied.

For the time being, I shall leave that clear disclosure and its significance for the problem and wish to investigate first how far it is possible to define the import of the specific function by describing the task of the accountant in the engagement given to him.

An indication in the engagement is indispensable for the definition of the specific function. But what kind of indication is necessary? Not of the *task* or the *work* which the accountant has to carry out in order to accomplish the function intended for him; a description, an indication of the *function* is necessary. In other words, the *objective* of the engagement should be known to the accountant; how that objective must be attained cannot be defined by the inexpert principal and can only be determined by the accountant himself, who has to decide in accordance with the technical requirements of the profession.

Confusion is now caused by the form in which the function is of ten indicated; for frequently the form of the engagement entails a description of the work to be done. That is sometimes even unavoidable, namely in those cases where the principal requires an investigation whose objective does not accord with the customary investigations which have already acquired a certain status in the

community, and whose objective is consequently already known. Practice shows, moreover, that for those investigations for which a standard already exists in the community, and for which any indication about the objective is, in effect, superfluous, the engagement is still of ten given in the form of a brief description of the task to be carried out, without intending thereby to give an instruction on the manner in which the function will be accomplished. The accountant who is appointed as auditor of an enterprise which publishes its annual report, no doubt receives his appointment and in consequence the indication of his function in the form of an engagement to verify the financial statements, without the principal in any way meaning to introduce any limitations to the function of the accountant-auditor of the enterprise.

The circumstance now that, even in those cases where the principal does not intend to introduce a limitation to the professionally necessary task, the function is often indicated in an engagement with a brief description of the task, has given rise to the idea that this description actually defined the task of the accountant in those cases. Nothing is further from the truth. In such a case, the accountant accepts without objection a function which entails a more extensive task than could be concluded from the engagement given, because, in reality, the principal does not with that description imply a limitation or any interference in the professional approach of the official and will not therefore raise any objections if the accountant, during his work, goes beyond the task described in the engagement. From such defects in the form, in reality carelessness in the professional practice, the conclusion may therefore by no means be drawn that the principal defines the task of the accountant.

In the meantime, the problem is not solved by this negative remark. We must establish the significance of the description of the task as incorporated in the engagement, if the principal does intend to define the substance of the function somewhat further.

To that end, it is necessary to classify the audit into the *general* audit, the audit with a *special purpose* and the *fragmentary* audit.

Part IV. (November 1933)

The *general* audit - i.e. the audit of the enterprise without a particular objective - forms by far the most important work of the accountant as confidential agent of the community. And, conversely, it can be said that out of that general audit, carried out continuously or as a continuous periodical audit, has grown the accountant's most important social function. The objective of this function is generally known and differences of opinion about that objective and therefore about the import of the function do not exist. It follows that, with the coming into being of a specific function within the framework of the general audit, there is no longer a need nor a place for the description of that function. A further indication

regarding the substance of the function - in whatever form - is only meaningful in that case if a *limitation* of the standard is intended; only if the principal aims to create a specific function which falls outside the scope of the normal function are there grounds for him to provide further indications concerning the substance of the function which he has in mind.

It is now very important to realize that a limitation in this case generally means an offence against the Theory of Inspired Confidence. Not even a clear disclosure of the limitation in the auditor's certificate can prevent this. As I already remarked at an earlier opportunity⁵: if, in the community, a standard has grown for the objective of the investigation, then every digression which lowers that standard will unavoidably lead to the certificate describing the limitation inspiring a greater confidence that is justified by the investigation carried out.

The standard prevailing in the community has not come about by chance; it is the result of a growth process, in which the needs of the community have sought and found a rational provision.

Therefore the standard entails the objective *necessary* for the community; for the rational economic need, there is only one rational economic function. If a part of that function is removed - and that must be the result of the introduced limitation, however it may be described - then generally an irrational function must remain with no benefit to the community. And that would be very evident indeed if the accountant who submits to such a limitation or introduces it himself, were really, in all sincerity, to disclose as a professional man the consequences which such a limitation would have for the effectiveness of the function. As long as the accountant does not do so - and he cannot in so many words make his own certificate derisory - so long will the community accept that with the introduction of the specific function it is intended to furnish the assurance which it demands.

For investigations as meant here, an independently formulated task engagement cannot be a constituent element of the function; that function already has its necessary substance and from it flows a task equally substantiated by the requirements of the audit technique. The accountant cannot limit that task by shifting his responsibility to the layman; he cannot expect the reader of his certificate to define the significance for his interests of the function's restriction. And even if this reader were to be in a position to do this, the matter would not improve; for, even with a complete insight into the significance of the restriction, the interested party is not satisfied. He receives tricks for bread; he is sent home with the outcome of an imperfect function which the community has decided does not suit its needs.

In the meantime, I do not wish to imply with the foregoing that as regards the general audit *every* limitation to the function is excluded. Assuming, of course, that it is made clearly evident to outsiders, a limitation here and there can leave a

⁵ The Accountant's Certificate in connection with the Accountant's Responsibility (paper given at the 1926 International Accountants' Congress).

rational specific function intact. If this condition is met, then the Theory of Inspired Confidence does not oppose this limitation in principle.

And, in addition, I wish to establish that the limitation to the *function*, discussed here and generally rejected, has nothing to do with those limitations of the *task* which leave the function Intact. In this respect, I distinguish between a *perfect* audit and a *complete* audit. Every audit must be "perfect", i.e. it must form a composite whole, effective for the accomplishment of the function and consequently for the objective set; but it does not therefore need to cover all events, all facts, all entries, all data, it does not need to be "complete". The Theory of Inspired Confidence does not give any general instruction at all with respect to the completeness of the audit.

It demands a perfect audit, because only in that way can the inspired confidence be justified; but it does not oppose those limitations which do not affect the function and which are otherwise even prescribed by the theory of auditing as rational simplifications. The question, whether and in how far incompleteness is possible without affecting the function, is in the meantime one which again must only be answered by the accountant as an expert; no layman can participate in the decision. The principal does not have any say in the matter either.

The problem becomes more difficult as regards *special investigations*.

A further indication is strictly necessary for the definition of the function and, more so than in the case with the general audit, there is the motive or the necessity to give a description of the task to be carried out. Yet here, too, the fundamental solution of the problem is given if the principle is kept in mind that the accountant as an expert does not need to be informed by the layman-principal regarding what he considers necessary to reach the objective set; all he needs is the indication of the *objective* for which the investigation must be carried out. If a specification of the task is necessary or effective here, then it can still only have the meaning of an indication of the *function*.

Indeed, for these investigations, too, a standard which has developed in the community can of ten be recognized. Credit investigations, fire damage investigations, investigations for a prospectus and for the acquisition of a company, are all special investigations whose objective is known; here too the specific function has already obtained a fixed import. But even if this is not so, the rational objective of the investigation is still decisive for the import of the function from which the task can then again be derived by the expert; again by the *expert*, not by the principal, who is a layman as regards the technical requirements of the audit.

Yet, in principle, the conventional element must in the case of a special audit play a greater role in the definition of the function in the case of a general audit.

While with the general audit the appointment of the person can already be sufficient for the definition of the function - accountant X is "appointed" auditor of a limited liability company - and, with some special investigations, a single indication too may be sufficient, yet in numerous other cases, more detailed indications are necessary. The engagement for the investigation into, for example a fraud either presumed or proven, will most probably include an indication as to the place in the administration where the fraud has taken place or is expected and in which direction therefore, the investigation should be conducted.

Such a necessary indication can also be accepted without any objection in the form of a task description, provided a rational objective and a rational function are thereby obtained. In consequence, the accountant can accept the description of the task as a constituent factor of his function if and to the extent that he, as expert, is of the opinion that the objective - confirming and combating the fraud - is also reached. The danger of a clash with the Theory of Inspired Confidence does not exist, if a rational function results from the engagement.

It is again the expert who in the end has to decide the question of whether the function is indeed rational. And, for that decision, he has a basis in the general need for an audit which exists in the enterprise. The special investigations have their rational places within the framework of the general audit; they must, or must be able to, be considered as supplements to the general audit. They are incidental investigations, induced and necessitated by special events in the enterprise. These investigations thus have a limited objective compared with the general audit. But that limitation does not and may not lead to an *imperfect audit*. On the contrary, through this limitation the audit focuses on special elements. The result of the limitation is an *incomplete* audit but it remains a self contained whole, a *perfect* audit; the special investigation is even a *perfected* audit, one-sidedly directed at the special objective.

There is, in that respect, a fundamental difference with the other kind of limited investigation which I have called a *fragmentary* audit. The two, the special and the fragmentary audit, have one thing in common, that both have a limited character compared with the general audit. On the other hand, there is a fundamental difference between them; the former remains, within its limitation, a perfect function, whereas the latter is in reality nothing but an imperfect general audit, a function that has been nibbled at so that only a smaller or larger piece of a rational function has been left. These imperfect investigations particularly are condemned by the Theory of Inspired Confidence, because they inspire more confidence *at all times* than is justified by the work done.

Such a fragment of a general audit appears in two forms: a part of an enterprise is audited or one or more activities are omitted from the general audit of the enterprise as a whole. Both forms are in principle of the same nature; they also practically blend into each other. Therefore I can speak about them together.

As soon as a link is left out of the general audit, an imperfect and therefore also ineffective investigation must generally remain. An effective audit system does not contain superfluous links. When, consequently, one of these links is removed, the system collapses and the audit becomes worthless. The same can be said of the audit of a part of an enterprise. I am not thinking of an incidental investigation with a special objective but of the continuing or continuous periodical audit of the part. The principal wants to have 'the cash' audited; only the cash, because he audits the remainder of the enterprise himself. There really are accountants who are willing to accept such an engagement. The task is supposedly described in detail and therefore constitutes a function defined in detail. Incidentally, it is claimed that the certificate in no way lacks clarity. Oh, how pitiful; as if in so doing, anything changes in the nature of this audit. The investigation is – as every expert knows - totally irrational. The audit is imperfect within the framework of the general audit needs within the enterprise and, it is in addition - one could also say it is therefore - technically imperfect; the audit of the cash book only has, as is known, no value whatsoever, not even as a guarantee against errors or frauds 'in the cash' only.

It is an alarming occurrence that a fragmentary investigation of this kind is still being defended in principle; and that by appealing to the clarity of the Certificate and to the principal's right of disposition. In this respect I am leaving the significance of the Certificate's clarity for a moment and now only wish to say something about the attitude of benevolence towards the principal and about modesty of those who, usually even with some display of indignation, set themselves up as defenders of the right of the principal. To some, it sounds perhaps acceptable that, on behalf of the principal, one wishes him to retain the freedom to decide what he requires from his agents. When he wants something unsuitable, then it is in the end, so it is said, his business; it is he alone who has to decide what will be audited in his enterprise.

At the outset, I wish to state that, in my former practice, no request was ever made to me to carry out such a fragmentary audit. I am also surprised that there are businessmen who want such an investigation. But the supporters of the freedom meant here, assure us that there really are such businessmen. they are - this is willingly admitted - not numerous and such engagements do not of ten occur, but what the supporters are concerned with is the *concept* of the principal's right of free decision. They also assure us that they set forth the ineffectiveness of the investigation in all clearness to the principal; the fact is that such a businessman does not seem to listen to reason.

This all accepted, I am of the opinion that such work is below the dignity of the accountant; no serious expert can lend himself to such self-deceit on the part of his principal, can he now? But, apart from this ethical side, the accountant in this way inspires unavoidably a greater confidence than is justified by his work. He must, as an expert, acknowledge this and ... he also does acknowledge it. Well

then, an appeal to the principal's freedom cannot purge him of the mistake he makes in accepting a function of whose ineffectiveness he is convinced. The principal may be self-opinionated, but we cannot assume that he is a fool, and therefore he does expect - be it despite the clear explanation of the expert - a result from that audit, in other words he continues to assume that he has to do with an effective and perfect audit, the limitation notwithstanding.

This is really so clear and so self-evident that I would not have said more than a few words about these imperfect investigations, were it not that the appeals that are instituted, for a small number of special cases, to the 'principle' of the free decision of the principal are now also being made applicable to those other very numerous fragmentary investigations, which is what the whole struggle regarding the Theory of Inspired Confidence is really all about; on the basis of that principle *the voluntary, irrational limitation of the general audit is now also defended*. Once the freedom of the principal is accepted, we are also to resign ourselves, so it is concluded, to every decision by the principal concerning the substance of the function and thus also as regards the work to be carried out. At the same time the irrational fragment of a general audit would then in principle have been justified thereby. If the principal does not wish to be involved in certain matters, why then should they be forced upon him? And, if the principal cannot or will not pay for the rational general audit, he will then be provided with as many fragments of that general audit as he wishes to pay for; regardless as to whether these fragments do form a balanced whole, a perfect audit or not. One gets what one pays for.

Of course, the advocates of this view assure solemnly that the Certificate will show in all clearness that the audit has not been "complete". In this way, the problem is reduced to one of wording the Certificate. And so, one sees one's way clear to hide the so much sought after freedom of movement for principal and agent behind the Theory of Inspired Confidence. The *explicit* opinion is postulated, is it not; in that way it is assumed that the requirement, according to which no greater confidence may be inspired than is justified by the work done, has been met.

I have already disputed this argument and have, on that occasion also, called to mind what I said at an earlier opportunity; I still wish to add some further comments to this.

The concept, whereby the root of the present problem lies in the Certificate, is a mistake which is understandable but therefore no less serious. It is understandable, because the Certificate is the observable form in which the accountant supplies his opinion and the result of his work to the community. In a certain sense, it can be said that the accountant inspires confidence by means of his Certificate and so it is, perhaps that one forms the idea of the Certificate really defining the task.

But this is not so. The Certificate⁶ is in the end only the *instrument* by which the function of accountants as confidential agents of the community acquires an exact form in that community and by which the function works in the community. It indoubtedly follows, that the import and form of the Certificate are not without significance, in many respects even of great significance. The Certificate too is a constituent factor of the inspired confidence and this time one with which the accountant can exercise an individual influence on the import of that confidence, be it that, apart from that individual influence, general influences too are at work, since for the Certificate's import and form there also exist standards in the community. Be that as it may - I hope to write in more detail about the Certificate in a later paper - above it and supporting that instrument there is the function itself. That function is the gist of the matter; and it accordingly penetrates into the community, over and through the Certificate. The Certificate must meet many requirements if it is to be used and tolerated as an efficient and reliable instrument of the function in the community; but those requirements all find their origin in the demands which can be attached to the function itself.

That is why no Certificate can go against the rational demands which the community attaches to the function. As I pointed out earlier, the Certificate cannot prevent the community from attaching more significance to the work of the accountant than he himself considers justified according to his Certificate. Every qualification in the Certificate - whether or not indicated by that word - which is not the result of the audit, but postulated by the accountant for the definition of his own task, implies an *imperfection* in the function, in the function which the community appears to need. That qualification must thus fall short in effect, while the community must assume that the accountant wishes to satisfy its needs by accepting the function; any other supposition would be meaningless. Even the qualification deriving from the audit, for example as a result of flaws noted in the organization, errors, etc., and which is therefore not the result of a restriction set by the accountant, becomes misleading if it concerns an essential element of the unqualified opinion. There are dedicated advocates of the Theory of Inspired Confidence who think that they are faithfully applying the Theory so long as they indicate the flaws in the examination by a clearly formulated qualification in an otherwise unqualified opinion. That conception is wrong. Even such a qualification cannot prevent the Certificate, as instrument of a rational function, from inspiring a greater confidence than is justified by the result of the task performed. If the qualification intended here affects the function in an essential manner, the accountant has only the choice between abandoning the function or issuing an *adverse* opinion; every unqualified opinion, no matter how carefully drafted, will be in conflict with the Theory which one means to follow.

From the above, it has become clear that the conventional factor in determining the task of accountants does not play a role, or only plays a secondary role. The

⁶ Under the accountant's Certificate, I include every communication from the accountant which expresses an opinion, irrespective of its form or scope. In this sense, the mere placing of a signature on financial statements is, in consequence, a Certificate as would be an exhaustive report.

engagement is the mere instrument by which the function is created and the principal is merely the intermediary between the interests brought together in the community and the accountant. It is the function itself which through its objective and through the rational import determined by this objective, defines the technical task fixed for its fulfilment.

A completely different picture is thus obtained of the function of the accountant from that which is based on the concept according to which the accountant would have a 'derived' responsibility; a responsibility which would be 'derived' from that of the principal, in fact from the manager of the enterprise. Evidently, there can only be a 'derived' responsibility if there is also a 'derived' function.

The Theory of Inspired Confidence opposes the view as though the public accountant had such a derived function. It is not, of course, denied in that Theory that the accountant is, in his specific function, legally dependent on the competence of his principal to engage him, but otherwise the substance of the specific is "derived" only from its objective. For that matter the whole idea, transferred at an unfortunate moment from poorly understood legal rules to the issue of our economy, causes confusion. It is clear that the function - and therefore also the responsibility - of the expert in the area of his expertise entails more than the corresponding function of the layman; and similarly the function of the expert goes further than that of the amateur. The help of the expert is called in precisely because the layman-amateur falls short. So, for example, the accountant is appointed to stand by the board of supervisory directors as auditor.

Certainly, what the accountant takes over from the supervisory director - let us even assume from the supervisory director-principal - is only a part of his function; *but that part of the function does immediately become much more exhaustive too when taken over by the accountant; it acquires a completely different substance from the corresponding part of the supervisory director's function.* That is how it becomes possible for the supervisory director, although legally only competent to conclude the engagement if that competence belongs to his function, to transfer a greater responsibility than he ever carried himself.

And so it can also be explained how the accountant, who has been assigned and provides assistance to the supervisory director, bears a greater responsibility than that director. The "Certificate" of both can in this case even be identically worded - for example, the mere signing of the financial statements - and yet the additional significance, which in accordance with the nature of the assignment, no doubt attaches to the auditors' certificate, will not be able to prevent that certificate from having a much more far-reaching effect. Because the signature of the accountant inspires, in relation to a certain part of the inspection a more extensive confidence, a confidence with a different import from that of the supervisory director.

The following is yet a brief comment related to the fact that only now, for the first time in my paper, is there mention of the responsibility of the accountant. It seems that, for the development of the Theory of Inspired Confidence, a consideration of

the responsibility can be dispensed with.

Once the function has been determined, then the extent of the responsibility is also established. We are not in this regard thinking of some special sanction based upon the non-fulfilment of the function; nor of an ethical responsibility but exclusively of the blame which will attach to the accountant as expert in the event of a shortcoming and which makes him economically unwanted or harmful and which thus suppresses him in the long run. The accountant is 'responsible' for the efficiency of his general and his special function and he is 'responsible' for the effectiveness of the manner in which he fulfils that function. The substance of the function - which is also the *objective* of the function - at the same time defines the task and the responsibility of the accountant.

Many who, when it comes to the public accountant's function in the community, are willing to accept without reservation the train of thought based on the Theory of Inspired Confidence as regards the relationship of the public accountant to his principal, oppose its application in those cases where the objective is directed at the interests of a restricted circle. One wants to differentiate between the public and the private task.

I hope later on to consider that differentiation separately, but all the same I still ought to say something about it within the context of this general analysis of the accountant's function.

I have, in the first part of this paper, shown that the public accountant is also the appropriate official to carry out the audit on behalf of the leader of the production process; and I have fundamentally distinguished this function from that of confidential agent of the community. That fundamental distinction is in principle also not without significance as to the question of how far the engagement can be a constituent element of the task of the official; to that extent it is therefore in principle not excluded, that the distinction between private and public task, which distinction partly coincides with that made by me, will turn out to be of same significance for the application of the Theory. But let it be emphasized already right now: also as regards the function of an auditor in a restricted circle, the demand can and must be made that it be a rational function; it too cannot be curtailed at random without scan shrivelling into something ineffective and therefore meaningless. In the restricted circle, too, the irrational function inevitably results in the accountant, by accepting that function, inspiring greater confidence that he can justify by his work; nor can anyone in the smaller circle expect that the accountant accepts a function, the fulfilment of which he, as expert, does not consider effective.

I could conclude my considerations here, since with these I have, in relation to the accountant's function, explained the basic principles of the Theory of Inspired Confidence, we re it not that I must expect the misunderstanding which arose in the past not to have disappeared vet following these considerations. Not only is

there bad writing, but also bad reading. And though I myself am undoubtedly also guilty of this misunderstanding, I still have good grounds for my opinion, according to which the strange concepts that have now and then been proclaimed about my views are above all attributable to the prejudiced look and the prejudiced mind with which my considerations have been read. I therefore believe that I must add to my analysis some thoughts about a few misunderstandings which have so arisen. True to my promise in the introduction to the first of these papers, I will not concern myself with certain expressions of opinion but I will generally attempt to refute some reservations which have been raised against the Theory of Inspired Confidence. I have restricted myself in this paper to the general objections.

PROFESSOR LIMPERG'S AUDIT PHILOSOPHY - THE THEORY OF INSPIRED CONFIDENCE

An Appreciation by David Flint, Professor of Accountancy, University of Glasgow, Scotland.

Fifty years have passed since Professor Dr. Theodore Limperg Jr., published a series of essays explaining and defending his philosophy of auditing under the title of the "Theory of Inspired Confidence", but it is only now on the initiative of the Limperg Institute that they have become available to readers in an English translation. The content of these essays has been well known to Dutch accountants - a study of the essays has been prescribed work for many of them as students; and, although they have not been directly available to others, it is more than likely that, as a result of Dutch participation in European and international committees, conferences and study groups, and the example of Dutch practice and private expression of views, the evolutionary development of practice and the formulation of auditing standards have been influenced world wide by the ideas which they express. Publication of the essays is no less welcome at this date because, even now, the study and discussion of them has still much to contribute to an understanding of the social significance of auditing and of the philosophical concepts from which practice should be developed.

At the time when Limperg was writing, auditing in The Netherlands was not subject to any statutory or other regulatory direction. Auditing of business enterprises was undertaken to meet the requirements of both management and external parties who were interested in control and monitoring performance; and Limperg was very aware of the social dependence of the function and the need for the reassurance which an audit gave to meet the reasonable expectations of the groups who depended on it. He was aware too that this "voluntary", "unregulated" situation differed from that in other industrialised countries, particularly Great Britain where audit of limited companies was a requirement imposed by law.

Enactment in Great Britain in 1900 of the law requiring compulsory audit of all companies was, no doubt, an expression of the public will, but it did create a different environment for the evolution of auditing, and perhaps imposed some constraint, compared to the situation in The Netherlands where, in the absence of legal force and sanctions, the audit required to be more sensitive to the public perception of the nature of the audit objective. In the USA, where the audit is not a universal legal requirement for business corporations, the approach has, perhaps curiously, more closely corresponded to the British practice, although development of new ideas on practice was earlier than in Great Britain and the pace of development was for a time faster. In its origins, of course, the American auditing profession drew heavily on Great Britain - even to the extent of using British textbooks - and, more recently, regulation by the SEC and the Stock Exchange has been an influential factor.

In the English speaking countries, however, there has been little intellectual curiosity about auditing and almost no attempt to develop any theoretical premises. Auditing evolved as a matter of practice without there being seen to be much need to examine what the social function of auditing was, or to consider as a matter of social philosophy whether the needs and expectations of user groups were being met; what the level of assurance was which an auditor's report should convey; and, whether there could be systematically determined what investigation and evidence were necessary to support an auditor's opinion, or, indeed, what were the basis and the grounds on which an auditor's opinion was accepted and relied on. The authority of the audit grew and became well established and highly regarded as a result of the public reputation and record of those who practiced, and of the standards of knowledge and experience required by the professional accountancy societies in which the practitioners were organised.

In Great Britain, practice in relation to audit of companies, at least, has been largely protected from the consequences of any public dissatisfaction or from pressure for self-examination because, being a legal requirement, the audit could not be avoided; and, the legal dicta in early decided cases has reassured auditors, and encouraged them in the view that auditing standards and practices were set by auditors. The standards of audit practice in the English speaking world have, of course, made enormous advances in this century particularly since the 1930's; more recently, the professional accountancy societies have stimulated greater interest in the quality of practice by publication of approved statements of auditing standards and guidelines; and, among other factors, appreciation of the disastrous consequences of audit failure has prompted recognition of the need for positive measures of quality control.

The confident belief of auditors in the social acceptance of their interpretation of their role has, however, been found to have been illfounded. The Cohen Commission* in the USA (1978) and the Adams Committee in Canada (1978) have formally concluded, and a number of Department of Trade Inspectors' Inquiries in Great Britain have indicated, that there is an "expectation gap" between what the auditor believes and what the user groups believe is the objective of the audit. This conflict of belief and the shock effect of a number of celebrated audit failures have been damaging to public confidence. The extent of the damage actually sustained is uncertain but its occurrence is important because, if the confidence that society places in the effectiveness of the audit and in the opinion of the auditor is once lost, the social usefulness of the audit is destroyed: and it is to the meaning of confidence and its implications that Limperg directs his argument. "... the significance of the confidence (in relation to the function of the auditor) is of a very special kind; "he states "it is the essence of the function itself"; and he concludes "The confidence in the effectiveness of the audit and in the opinion of the accountant thus forms the *raison d'etre* of his function".

* The work of the Cohen Commission and the interest of the United States Congress in auditing in the 1970s identified and drew attention to the social implications of a number of the issues involved.

Limperg recognised that the audit function has two branches, one internal as a management control, and the other external as an instrument of accountability to the community which has an interest in the organisation. An important matter of conception is that Limperg saw these responsibilities as two branches of the same function, whereas in the English speaking world the two activities have developed and are generally regarded as separate although related functions. This has had consequences for development and, particularly in Great Britain, for the limited extent of the formal responsibility which external auditors consider they have to directors and management.

It is important to an understanding of Limperg's philosophy to recognise the origins of the Dutch accountancy and auditing profession. The profession's foundations are deeply rooted in the Dutch conception of business economics. Dutch professional accountants approached their initial responsibilities of advising and assisting management as independent experts in financial reporting, without any regulatory framework, from the standpoint of the application of business economics and the presentation of financial/economic information about the business in question. "Certifying", or auditing, the accounting report so prepared, which came later, developed from the earlier role of this professional assistance to management. Business economics provided the guiding principles for the evaluation of financial statements. It is against this background that Limperg's explanation of the evolution of the audit function, both for internal control and external accountability can be appreciated. In relation to external accountability, however, Limperg perceived a wider function for the audit, emphasising a public social responsibility of the auditor and arguing that the auditor acts not only for investors but, in the role of confidential agent, for the community at large.

The core of Limperg's theory, however, is the proposition that the authority and the social justification of the audit are dependent on the confidence which is engendered firstly, by the continuous interaction between the public's expectations and the auditor's interpretation of his role - a philosophy echoed some forty years later in Mautz's (1975a) paper for the Cohen Commission on the role of the auditor - and secondly, by the relationship between the confidence inspired in the public and the audit work necessary to justify that confidence. The Limperg thesis is well stated in the two following quotations.

"The auditor - confidential agent - derives his general function in society from the need for expert and independent examination and the need for an expert and independent opinion based on that examination. The function is rooted in the confidence that society places in the effectiveness of the audit and in the opinion of the accountant. This confidence is, therefore, a condition for the existence of that function; if the confidence is betrayed, the function too is destroyed, since it becomes useless."

"The accountant (auditor) is obliged to carry out his work in such a way that he does not betray the expectations which he evokes in the sensible layman; and,

conversely, the accountant may not arouse greater expectations than can be justified by the work done.... the theory expects from the accountant that in each special case he ascertains what expectations he arouses; that he realises the tenor of the confidence that he inspires with the fulfilment of each specific function. To that end, it is necessary that he has an insight into the factors that determine the substance of that confidence."

While these propositions may be implicit in anglo-american audit practice and development they are not generally articulated as basic audit precepts for the guidance of practitioners. User confidence is, certainly, at the root of the authority which an audit opinion enjoys - a view shared by the American Accounting Association Committee (1973) who stated unequivocally "This faith or confidence on the part of the user in the auditor and the audit process are as vital to the success of the audit function as the skills and techniques used to perform the audit... Where confidence does not exist, the audit function fails". Confidence to Limperg, however, is more than a belief in the quality of the auditor and of the audit; it relates to an expectation which an auditor must understand because it imposes an obligation to do the work without which the auditor is not able to meet that expectation and justify that confidence. If the work falls short of what it should have been to justify the understanding which the opinion induces in users of what the audit has achieved the auditor will have connived at, allowed, or acquiesced in the users having - in the short term - an illfounded confidence conveyed by the audit opinion, and an erroneous belief about the expectations which have been met.

The general tenor of the social philosophy for auditing has found expression in legal comment and decision in recent years in the English speaking countries. Not without some alarm to auditors, it is becoming clear that the law courts will have regard to societal expectations of the audit opinion, and will make their own assessment of reasonable standards of auditor skill, care and diligence in passing judgment on professional performance; although, it is not disputed that the evidence of the auditing profession of what is considered to be good practice will be very persuasive (but not compelling) evidence of what is an appropriate standard.

The Limperg propositions are precepts which, as has been suggested above, may be able to be identified as implicit in anglo-american audit practice, which has developed pragmatically in a more regulated framework than prevailed in The Netherlands. Since they have not, however, been explicitly recognised or enunciated it would be difficult to represent that they have patently influenced institutional consideration of the requirements of audit practice. Such implicit recognition as there is may owe more to expediency than to principle. Indeed, the identification of an "expectation gap" and the tendency towards "defensive" auditing (understandable perhaps in the context of damaging litigation, but socially unacceptable as frustrating the audit purpose) are persuasive evidence that auditing is failing in its social function.

Auditing is an important institution in the social framework. It is a matter of great concern in the public interest that it should be properly carried out. The difficulties and the responsibilities are becoming increasingly onerous as user groups in society seek to extend its scope.

There are also economic and social pressures - quite apart from technical change - requiring auditors to examine their assumptions and practices analytically and systematically, to test their adequacy for the needs of the current situation, and to justify them and their cost in relation to the social benefits which auditing provides. It is a feature of all professions that standards of "due care" are more demanding than hitherto and are being applied more rigorously by reference to independent criteria which are not yet completely explicit.

Limperg was writing fifty years ago in a different world, in different economic and social conditions, with different corporate structures and different ideas of accountability than those of today; and Government, state or public economic and financial activity and involvement were different.

The theoretical framework which can be deduced from his writing is, however, still sound and relevant. Although auditors' reports and opinions cannot give unreserved reassurance to users, and users' expectations cannot necessarily be met because of the inevitable economic and practical constraints - a degree of uncertainty for users and a residual risk for auditors always exist - there are, nevertheless, systematic and logical relationships in the various elements of the audit process which are enduring and universal.

Auditing is a social science the adequacy of the practices of which require to be constantly tested, revised and developed to meet the needs and expectations of a changing and evolving society. This requires an understanding of the nature of the audit phenomenon, its social function and objectives and the interdependence and relationships of the elements in the process necessary for their achievement; and these are the constituents of the theory and philosophy of auditing. Limperg's writings which were addressed to these matters were seminal in their pioneering contribution to theory construction, but their circulation was limited. The contributions of Mautz (1961 and 1975) and the American Accounting Association (1973) have been more widely available, but there is little evidence yet of their direct impact on audit policy formulation. There has been little interest in audit theory construction. It would be a fitting tribute to Limperg's pioneering work if publication of his writings in English were to stimulate an international effort to build on the foundation which he laid.

University of Glasgow

December 1983

REFERENCES

American Accounting Association (1973), Committee on Basic Auditing Concepts, *A Statement of Basic Auditing Concepts*, (AAA, 1973).

American Institute of Certified Public Accountants (1978), The Commission on Auditors' Responsibilities, *Report, Conclusions and Recommendations (The Cohen Report)*, (AICPA, 1978).

Bindenga, Andre, J. (1983), *Dutch Accountancy - A Managerial economics based approach* (Pilot (Netherlands) 13) (Nederlands Instituut Van Register-accountants, 1983).

Canadian Institute of Chartered Accountants (1978), Special Committee to Examine the Role of the Auditor, *Report, (The Adams Report)*, (C.A. Magazine, April 1978).

Flint, D. (1980), *An Essay in Audit Theory - The Formulation of Basic Postulates*, a Working Paper for the Third Annual Congress of the European Accounting Association, 1980, unpublished.

Limperg, Th. jr. (1926) *The Accountant's Certificate in Connection with the Accountant's Responsibility* (The International Congress of Accountants, 1926).

Mautz, R. K. (1975a), *The Role of the Independent Auditor in a Market Economy*, A Study Paper Prepared for The Commission on Auditors' Responsibilities, AICPA, unpublished.

Mautz, R. K. (1975b) *The Role of Auditing in Our Society*, A Study Paper Prepared for The Commission on Auditors' Responsibilities, AICPA, unpublished.

Mautz, R.K. and Hussein A. Sharaf (1961), *The Philosophy of Auditing* (AAA, 1961).

United States Congress (1976) *The Accounting Establishment: A Staff Study Report of the Sub-Committee on Reports, Accounting and Management, of the Committee on Government Operations*, United States Senate (the Journal of Accountancy, March 1977).

United States Congress (1976) *Federal Regulation and Regulatory Reform, Report by the Sub-Committee on Oversight and Investigations, Committee on Interstate and Foreign Commerce*.

United States Congress (1977) *Improving the Accountability of Publicly Owned Corporations and their Auditors, Report of the Sub-Committee on Reports, Accounting and Management of the Committee on Government Affairs (The Metcalf Committee)* United States Senate (The Journal of Accountancy, January 1978).

A COMMENT BY GIJS G.M. BAK, CHAIRMAN OF THE INTERNATIONAL AUDITING PRACTICES COMMITTEE (IAPC) OF IFAC

Being a Dutch accountant and a professor in Accountancy, Limperg's series of essays has been well known to me since I studied to qualify as accountant. The "Theory of Inspired Confidence" is still a great inspiration when practising and teaching Accountancy in the Netherlands. Limperg Institute asked me, however, to comment on my experiences as the Dutch representative in the IAPC. To what extent the philosophy behind this 50 year old theory is relevant to the accountant's profession internationally? Have Limperg's ideas been overruled by new developments in auditing?

I believe the main thrust of the Theory of Inspired Confidence is still the driving force behind the public accountant's profession. Accordingly I will demonstrate the parallel between the "Common Principle" as developed by Limperg and IAPC's "Basic Principles Governing an Audit".

Secondly I will discuss the area of limited Assurance, where I believe Limperg's ideas have indeed been overruled by new developments in auditing.

A common principle

Limperg believed, as IAPC does today, that auditors need a common principle as a basis for their work:

"For the man in practice, I am only seeking a common principle for his task. Why? Because without that principle he is like a ship without a rudder when taking the decisions which he has to take regarding what to do or not to do in a specific case. There must be a guideline for all these special cases, a line of action which makes it possible to keep one's course in the infinite variety of specific instances arising in practice. It is impossible with such variation in circumstances to lay down rules for every special case. It is therefore necessary to establish principles that have a general value and whose application leads to a consistent solution for all the cases differing in detail from one another. No book of recipes, which is still asked for now and then when the directions for the performance of the audit provide no answer as to what may and what may not be omitted in a particular case, but a general principle on which the accountant himself, as an expert, can base the plan for this work."

Limperg, as indicated in the foregoing quote, stressed the need for a general principle, as opposed to a "book of recipes". The general principle has been summarized by Limperg at the beginning of his third article as follows:

"The normative core of the *Theory of Inspired Confidence* is therefore this: the accountant is obliged to carry out his work in such a way that he does not betray the expectations which he evokes in the sensible layman; and, conversely,

the accountant may not arouse greater expectations than can be justified by the work done."

In comparing IAPC's current line of action to Limperg's ideas the following questions should be answered:

- Does IAPC (still) follow the general principle as defined by Limperg?
- Do the guidelines, developed by IAPC, represent the book of recipes that Limperg rejected?

As to the first question, there is no doubt that IAPC adheres to the general principles as defined by Limperg. In IAG 3 the "Basic Principles Governing an Audit" are developed from an independent, professional point of view. The Basic Principles apply not only to an audit of statutory financial statements, but to every audit of financial information. Although his client decides on the engagement, it is the auditor who decides on the scope of the audit. In IAG 13, para 23 IAPC clearly takes this position regarding a limitation on the scope of the auditor's work, as follows:

"..... when the limitation in the terms of a proposed engagement is such that the auditor believes he would need to issue a disclaimer of opinion, he should not accept such a limited engagement as an audit engagement".

In an audit engagement the scope of the auditor's work is determined by the confidence the reader of his opinion will place on the auditor, that is "... (to help) establish the credibility of financial statements" (see IAG 1 para 3). The concept of the public accountant as a confidential agent of the community at large is not explicitly defined by IAPC. Nevertheless the main reasons for the efforts of IAPC to enhance and harmonize the quality of audits internationally are very close to this concept. IAPC recognizes that the auditor may inspire confidence even where he does not have a statutory or contractual obligation to report specifically on certain information. This is expressed in IAG 14, para 3, in a statement regarding other information in documents containing audited financial statements. The auditor should apply certain procedures regarding such other information, because "the credibility of the audited financial statements may be undermined by inconsistencies which may exist between the financial statements and other information".

As to the second question, IAPC seems to have engaged in a project that will provide a much more detailed "common principle" than envisaged by Limperg.

On the other hand the authority attached to the IAG's and the style of wording do certainly not qualify the total set of IAG's as a "book of recipes". More important, it should be noted that Limperg's environment - The Netherlands, early thirties - differs largely from the environment IAPC is facing today. As stated on page 7, the first article Limperg did, "want to investigate the economic function of the accountant in The Netherlands in the present state of the accountants' profession in this country". The scope of the public accountants' profession at that time was very much locally oriented, many auditors were sole practitioners or they worked

together in small local firms of less than 10 partners. A profession in such an environment is still in the position to monitor the quality of its members' work by setting a very broad standard. The Dutch profession has been following this line (in my personal view for too long) until the recent past.

IAPC's environment is the large scale audit profession of today, with an urgent need for worldwide harmonization. In this environment a broad standard like the one developed by Limperg would not serve its purpose. It would be very hard to express the basic principles governing an audit in a few words without the serious risk that such words would be understood differently in different languages. (For example, it is obvious that the concept of "true and fair" has a different meaning in different languages.)

Therefore, expanding on the basic principles in a series of Guidelines is a prerequisite for achieving worldwide harmonization.

In summary, I believe the basic views expressed by Limperg regarding the audit function are still the principles adhered to by IAPC. Taking into account the differences in environment the development of a detailed set of Audit Guidelines by IAPC does not really conflict with Limperg's approach to refrain from setting detailed auditing standards.

Limited Assurance

From this Theory of Inspired Confidence Limperg gathered the ammunition to combat forcefully the "opinion that a limitation (on the scope of the audit) may be accepted without objection, provided this is clearly disclosed in the certificate" (see page 25). In other words: Limperg totally rejected the concept that the public accountant would accept an engagement to perform less than a full audit even if the scope restriction is reflected in his report.

Limperg's arguments can be briefly summarized as follows: The confidence created by the public accountant in performing the audit function adheres to him regardless of the terms of a specific engagement. A limitation on the scope of the auditor's work will therefore necessarily create a gap between the inspired confidence and the work performed to justify such confidence.

On that basis Limperg rejects any engagement that is intended to provide a lower level of assurance than a full audit, such as (in today's wording): limited review or agreed upon procedures. All this is discussed in the IVth article, that is clearly written in a more combative style than the previous articles.

The overriding theme from which Limperg's arguments flow is a black and white view of the "inspired confidence": the user of the auditor's report is not in a position to assess the impact of different levels of assurance. Therefore every limitation does create an imperfect/irrational function.

Not only the user "receives bricks for bread", even the auditor is fooling himself in performing a set of audit procedures that as a whole does not meet the test of the "perfect audit", "i.e. it must form a composite whole, effective for the

accomplishment of the function and consequently for the objective set" (see page 28).

There is no way the public accountant can repair the fundamental damage done to his function by modifying the wording of his report in an attempt to clarify the (impact of the) limitations on the scope of his work.

This black and white view, expressed in 1933 by the "guru" of the Dutch profession still permeates the professional rules of the Dutch Institute. According to these rules a written auditor's report is considered to contain a clean opinion, based on a full audit, unless it is clearly stated that:

- there was no audit at all
- after the completion of a full audit the public accountant expresses a modified opinion (adverse, disclaimer or otherwise qualified).

A "grey area", recognizing the viability of limited assurance engagements, does not exist in The Netherlands.

At the present time IAPC has entered into a project to develop a Basic Guideline on Limited Assurance and to discuss this issue in relation to such topics as "Unaudited Financial Statements", and "Prospective Financial Information".

Although IAPC decided to draw a clear and distinct line between the present set of Guidelines, elaborating the Basic Principle Governing an Audit and the Guidelines dealing with Limited Assurance, it is not IAPC's intention to reject this concept as Limperg did.

As all this is still under discussion in the IAPC meetings, there is no published material available to analyse the position of IAPC regarding Limited Assurance and to compare this with Limperg's arguments against it. Therefore I can only express my own personal views as a contribution to the debate.

I believe Limperg's arguments against limited assurance engagements are still strong enough to keep the profession on guard. On the other hand, actual practice in many countries seems to contradict Limperg's black and white view in this area. The dramatic consequences for the profession if it would enter the area of limited assurance engagements are capably described in such a way that the reader of the IVth article is easily convinced of the realism and logic in Limperg's conclusions. However, the unbiased observer of today's profession in countries where limited assurance engagements are accepted, has to admit that problems relating to the confidence gap between the profession and the public do flow from the profession's full audit activities, and not from limited assurance practices. Moreover, the strict black and white view precludes public accountants from responding to the reasonable demands of users.

Following a CICA research study* I quote here from the Adams report: "Accounting and auditing standards are not static; they have developed over time to meet changed conditions. They are not derived from some immutable law of nature; their legitimacy springs from general acceptance and consensus in the circumstances of the day".

*Limited Audit Engagement and the Expression of Negative Assurance by J. ALEX MILBURN, Ph.D., CA. CICA, 1980 (page 19).

By the same taken I welcome the line of action initiated by IAPC to develop Guidelines on Limited Assurance Engagements in order to assess where the general acceptance and consensus can be found internationally in the circumstances of today. It is better do define the conditions for such engagements relying on experiences in countries where they are common practice, than to deny the usefulness of such practice as if Limperg's Theory of Inspired Confidence was an "immutable law of nature".

It will certainly benefit the accountant's profession worldwide, if IAPC Guidance in this area is followed also in countries - like The Netherlands - where limited assurance is still a real tabu!

Amsterdam, March 1985