1940
* Nov. 4, 5, 6.
* Dec. 20.

GUARDIAN INSURANCE COMPANY OF CANADA (PLAINTIFF) ..... APPELLANT;

AND

F. W. SHARP AND OTHERS (DEFENDANTS) ..... RESPONDENTS.

ON APPEAL FROM THE COURT OF KING'S BENCH, APPEAL SIDE, PROVINCE OF QUEBEC

Insurance — Fidelity — Companies — Auditors' duties — Statutory audit — Special and complete audit—Cashier's dishonesty—Failure to check customer's accounts—Cash book—Bank deposit slips—Dominion Companies Act, 1934, 24-25 Geo. V, c. 33, s. 120.

When a firm of accountants has merely been appointed to act as auditors of an advertising company, without any special terms or conditions as may have been contained in a by-law or a special contract and, thus, where the definition of their duties must be found entirely within the language of section 120 of the Dominion *Companies Act*, their duties are those, and only those, imposed upon them by the statute.

A contract imposing upon them the duty of making the statutory audit therein referred to and of issuing a certificate to the effect that the balance sheet was "properly drawn up so as to exhibit a true "and correct view of the state of the company's affairs * * * as "shown by the books of the company" does not call for a more complete and detailed audit, unless some circumstances would give rise to suspicion of dishonesty or irregularities.

In the absence of any suspicion as to the honesty of a cashier, who as a fact had been guilty of defalcations for a period of nearly six years before they were discovered, the auditors were not obliged, as in this case, to compare the details of the bank daily deposit slips with the entries in the cash book: they were bound only to exercise a reasonable amount of care and skill in order to ascertain that the books were showing the company's true position; or, adopting the words used by Lopes L.J. in *In re Kingston Cotton Mill Co.* (1896 2 Ch. 279), "it is the duty of an auditor to bring to bear on the work he has to perform, that skill, care and caution which a reasonably competent, careful and cautious auditor would use"; and, using a term of the Quebec law system, auditors must act "en bons pères de famille".

Upon an action brought by an insurance company, which had issued a fidelity bond on the employees of the advertising company and which had been subrogated in that company's rights, if any, against the auditors, *held*, applying the principles enunciated in the decisions below-mentioned to the particular facts of this case, that there was no such neglect or default on the part of the auditors as would entitle the advertising company, were it the plaintiff, to succeed in the action.

* PRESENT:—Rinfret, Crocket, Davis, Hudson and Taschereau JJ.

1940

GUARDIAN INSURANCE COMPANY OF CANADA v. F. W. SHARP AND OTHERS.

In re London and General Bank (No. 2) ([1895] 2 Ch. 673); *In re Kingston Cotton Mill Company (No. 2)* ([1896] 2 Ch. 279); *London Oil Storage Company Limited* v. *Seear, Hasluck and Co.* (Dicksee on Auditing, 11th ed., p. 783) and *In re City Equitable Fire Insurance Company Limited* ([1925] Ch. 407) referred to.

Comments as to whether, assuming that there was some breach of duty on the part of the auditors, a claim based on such a breach of duty would have been covered by the subrogation document in favour of the appellant; and also, assuming it were covered by the subrogation, what would be the measure of damages for such a breach of duty.

APPEAL from the judgment of the Court of King's Bench, appeal side, province of Quebec (1), reversing the judgment of the Superior Court, L. Cousineau J. and dismissing the appellant's action.

The appellant company, having by its policy of insurance guaranteed to the Claude Néon General Advertising, Limited the honesty of its cashier, A. O. Clément, was, since the cashier turned out to be a defaulter, obliged to pay the Néon Company $5,000, and, having received subrogation of that company's rights, instituted an action against the respondents, alleging that the theft, misappropriation or fraudulent conversion by Clément, were rendered possible and caused through the neglect and want of professional skill of the respondents, in particular because they failed to check the bad accounts of the company and to compare, check and verify the moneys received, as shown by the general cash book and the certified bank deposit slips, in which were entered the names of the makers of cheques which did not appear in the cash book itself. The respondents alleged that they exercised reasonable care and skill in the performance of their duty; that Clément was never subject to their discipline or control, and that he succeeded in deluding his employers, the officers of the Néon Company, into extraordinary practices, by which were created possibilities for dishonesty which were beyond the scope of investigation and inquiry of an ordinary audit; that any loss sustained by the Néon Company is attributable to the dishonesty of Clément and the gross negligence and incompetence of the assistant-secretary of the Néon Company, whose duty it was to supervise Clément.

The questions at issue and more detailed statement of the facts are contained in the judgments now reported.

(1) (1940) Q.R. 68 K.B. 391.

1940

GUARDIAN INSURANCE COMPANY OF CANADA v. F. W. SHARP AND OTHERS.

Aimé Geoffrion K.C. and *N. Charbonneau* for the appellant.

John T. Hackett K.C. and *Lindsay H. Place* for the respondents.

The judgment of Rinfret and Taschereau JJ. was delivered by

TASCHEREAU J.—La Guardian Insurance Company, l'appelante, avait émis une police d'assurance destinée à indemniser la Claude Néon General Advertising Limited jusqu'à concurrence de $5,000 contre les défalcations de ses employés. Comme résultat de la manipulation de certains comptes, le caissier de cette dernière compagnie a détourné durant une période de près de cinq ans une somme de $6,756.41, et l'appelante a dû payer à son assurée, en vertu de sa police, la somme de $5,000.

Elle poursuit maintenant pour ce montant les intimés-auditeurs de la Claude Néon, et ayant été subrogée dans les droits de cette dernière, elle allègue qu'ils ont été négligents dans l'exercice de leurs fonctions et qu'ils n'ont pas, comme ils auraient dû le faire, découvert le système employé par Clément pour frauder son employeur. En Cour Supérieure, l'action a été maintenue, mais la Cour du Banc du Roi, l'honorable juge-en-chef et l'honorable juge Gibsone dissidents, en est venue à la conclusion que la responsabilité des intimés n'avait pas été établie, et a rejeté l'action.

Le système employé par Clément pour convertir à son usage personnel les fonds dont il avait la garde était assez ingénieux. Lorsqu'un client de Claude Néon se prévalait de la *Loi des Faillites,* ou lorsqu'on faisait avec lui un compromis pour la paiement de son compte, ou bien encore lorsque l'on confiait la réclamation contre lui aux avocats de la Compagnie, on inscrivait son nom dans un régistre spécial avec tous les autres mauvais comptes. L'assistant-secrétaire-trésorier, M. Tulloch, apposait ses initiales vis-à-vis le nom de celui qui ainsi était considéré comme incapable de remplir son obligation. Depuis ce moment, aucune facture n'était adressée à ce débiteur et il fallait attendre la remise de l'avocat de la Compagnie ou les dividendes du syndic à la faillite. Le système imaginé par Clément consistait à s'emparer de ces remises, à ne les

entrer nulle part dans les livres, et à garder ces chèques en sa possession jusqu'au moment où des clients dont les comptes étaient actifs venaient au comptoir payer en argent ce qu'ils devaient.

Clément s'appropriait alors cet argent, jusqu'à concurrence du montant des chèques des mauvais comptes, entrait dans le livre de caisse les noms de ceux qui payaient en argent, et, pour balancer, déposait en banque les chèques qu'il avait en sa possession. Ce système dont les auditeurs ne s'aperçurent pas dura au-delà de quatre ans et permit au caissier de détourner la somme de $6,756.41. A cause d'un changement dans le système de perception des comptes, on découvrit qu'un montant de $13.50 qui avait été payé n'était crédité nulle part. La Compagnie en avertit aussitôt les auditeurs qui firent une enquête spéciale avec les résultats que cette fraude fut mise à jour et le montant de la défalcation définitivement établi.

La faute des auditeurs réside, prétend l'appelante, dans le fait qu'ils n'ont pas comparé les entrées quotidiennes du livre de caisse avec les copies des bordereaux de dépôts. On aurait pu s'apercevoir ainsi, parce que les noms des signataires des chèques apparaissaient sur les bordereaux, qu'il y avait sur ceux-ci des noms ne figurant pas au livre de caisse et ces dissemblances auraient immédiatement fait naître des soupçons.

Il est nécessaire, pour bien déterminer les responsabilités, s'il en existe, d'examiner la nature et l'étendue des services que les intimés étaient appelés à rendre à Claude Néon. Aucun contrat écrit n'a été produit, mais on trouve cependant un règlement des actionnaires passé conformément aux dispositions de la Loi Fédérale des Compagnies, nommant les intimés auditeurs, et rien dans le dossier ne détermine les devoirs qu'ils doivent remplir. Il n'y a aucune restriction qui limite, et aucun engagement qui augmente leurs obligations. Il s'ensuit donc qu'ils ont à remplir les devoirs imposés par la loi telle qu'interprétée par les auteurs et la jurisprudence.

L'article 120 de la Loi Fédérale des Compagnies se lit de la façon suivante:—

120. (1) Les vérificateurs doivent faire aux actionnaires un rapport sur les comptes qu'ils ont examinés et sur tout bilan présenté à la Compagnie lors d'une assemblée annuelle pendant la durée de leur charge. Ce rapport doit mentionner:

1940

GUARDIAN INSURANCE COMPANY OF CANADA v. F. W. SHARP AND OTHERS.

(*a*) s'ils ont obtenu ou non tous les renseignements et explications qu'ils ont demandés; et,

(*b*) si, à leur avis, le bilan qui fait l'objet de leur rapport est bien dressé de manière à donner un état véritable et exact des affaires de la Compagnie, du mieux qu'ils ont pu s'en rendre compte par leurs renseignements et les explications qui leur ont été données et d'après ce qu'indiquent les livres de la Compagnie.

Taschereau J.

Comme il est facile de s'en rendre compte, cet article ne détermine pas tous les devoirs des auditeurs. Il dit bien que ceux-ci doivent faire un rapport aux actionnaires, qu'il est de leur devoir de révéler si le bilan, dans leur opinion, représente l'état véritable des affaires de la Compagnie d'après les informations obtenues et les livres de la Compagnie. Mais, jusqu'où va leur rôle d'investigateurs, et où s'arrête leur obligation de chercher dans les livres pour trouver des irrégularitiés, voire même des fraudes?

Cette cause qui a pris naissance dans la province de Québec, doit nécessairement être jugée suivant les lois de cette province. Il ne s'agit nullement d'une réclamation délictuelle ou quasi-délictuelle fondée sur l'article 1053 C.C., mais bien d'une réclamation basée sur le défaut d'accomplir certaines obligations résultant d'un contrat d'engagement.

Il n'y a pas dans la province de Québec d'arrêts qui ont été rendus et qui puissent nous aider à solutionner le problème de la responsabilité des auditeurs. Ayant en vue toujours qu'il s'agit de l'inexécution d'une obligation contractuelle, je crois qu'il est difficile de mieux définir les devoirs résultant d'un semblable contrat, que ne l'a fait l'honorable juge Létourneau qui s'exprime de la façon suivante:—

> Or, il n'y a de responsabilité en dommages pour inexécution d'obligation que si le débiteur de cette obligation a fait ou omis ce que n'eut pas fait ou omis en semblable occasion un bon père de famille. Et ceci dépend entièrement, dans l'espèce qui nous est soumise, du critère que voici: qu'aurait donc fait dans les mêmes circonstances, tout autre vérificateur compétent, diligent?

Ce principe qui doit nous guider est bien semblable à la doctrine maintes fois appliquée en Angleterre, et où les juges des plus hautes cours ont maintenu que les auditeurs doivent dans l'exercice de leurs fonctions, faire preuve d'un degré raisonnable d'habileté et d'attention. Et nous devons d'autant plus nous inspirer de cette jurisprudence, si l'on

considère que l'article 120 de la Loi Fédérale des Compagnies que je viens de citer est semblable au texte de la loi anglaise.

Quelques extraits des causes les plus importantes nous font voir l'uniformité de la jurisprudence anglaise, et ceux-ci, dans les limites déterminées par cette Cour dans *The King* v. *Desrosiers* (1), et *Latreille* v. *Curley* (2), peuvent sans doute nous servir de guides. Dans *In re London and General Bank (No. 2)* (3), Lindley L.J. s'exprime de la façon suivante:—

> He must take reasonable care to ascertain that the books show the Company's true position.

Dans *In re Kingston Cotton Mill Company (No. 2)* (4):

> He is bound only to exercise a reasonable amount of care and skill.

Et plus loin, Lopes L.J. dit:—

> He is only bound to be reasonably cautious and careful.

Et plus loin, à la page 288 de la même cause:—

> It is the duty of an auditor to bring to bear on the work he has to perform, that skill, care and caution which a reasonably competent, careful and cautious auditor would use.

Les auditeurs, comme dans le cas actuel, à qui on n'a pas confié la tâche d'exécuter un travail spécial, doivent donc remplir leurs devoirs avec la prudence, l'attention et l'habileté qu'un autre auditeur compétent montrerait dans des conditions identiques. C'est en "bons pères de famille" qu'ils doivent agir. Leur tâche consiste à vérifier si le bilan représente bien la position financière de la Compagnie, d'après les livres et les informations obtenues. Ils ne sont pas des détectives et ils ne sont donc pas tenus de prévenir et de retracer toutes les fraudes que des employés malhonnêtes et ingénieux peuvent commettre au préjudice de leur employeur.

Ils sont justifiables de croire à l'honnêteté de certains employés qui jouissent de la confiance des directeurs de la Compagnie depuis de nombreuses années de service, et il leur est également permis, lorsque les livres ne donnent naissance à aucun soupçon, de s'abstenir de faire certaines recherches et investigations, qui pourraient être nécessaires dans des cas d'auditions particulières où des instructions

(1) (1919) 60 Can. S.C.R. 105.
(2) (1919) 60 Can. S.C.R. 131.
(3) [1895] 2 Ch. 673.
(4) [1896] 2 Ch. 279.

1940

GUARDIAN INSURANCE COMPANY OF CANADA v. F. W. SHARP AND OTHERS.

Taschereau J.

spéciales leur sont données. C'est d'ailleurs la jurisprudence constante telle qu'établie et par les arrêts cités antérieurement et aussi par les suivants:—

Dans la cause de *In re London and General Bank (2)* déjà citée (1), Lindley L.J. dit:—

> An auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a Company is being conducted prudently or imprudently, profitably or unprofitably. * * * his business is to ascertain and state the true financial position of the Company at the time of the audit, and his duty is confined to that.

Dans la même cause, à la page 683:—

> Where there is nothing to excite suspicion, very little inquiry will be reasonably sufficient * * * where suspicion is aroused, more care is obviously necessary; but still an auditor is not bound to exercise more than reasonable care and skill even in a case of suspicion, and is perfectly justified in acting upon the opinion of an expert where special knowledge is required.

Dans *In re Kingston Cotton Mill Company (2)* (2),, il a été décidé:—

> that, it being no part of the duty of the auditors to take stock, they were justified in relying on the certificates of the manager, a person of acknowledged competence and high reputation, and were not bound to check his certificates in the absence of anything to raise suspicion and that they were not liable for the dividends wrongfully paid.
>
> An auditor is not bound to be suspicious where there are no circumstances to arouse suspicion; he is only bound to exercise a reasonable amount of care and skill.

Lopes L.J., dans la même cause, nous dit:—

> An auditor is not bound to be a detective, or as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a bloodhound. He is justified in believing tried servants of the Company in whom confidence is placed by the Company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should prove it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful.

Et plus loin,

> Auditors must not be made liable for not tracking out ingenious and carefully laid schemes of fraud when there is nothing to arouse their suspicion, and when those frauds are perpetrated by tried servants of the company, and are undetected for years by the directors. So to hold would make the position of an auditor intolerable.

Aller au-delà de cela serait créer pour les auditeurs, comme il est dit dans les arrêts ci-dessus, une situation

(1) [1895] 2 Ch. 673. (2) [1896] 2 Ch. 279.

intolérable, et signifierait qu'ils assurent contre la fraude, et qu'ils sont responsables des habiles manipulations d'employés peu scrupuleux qui réussissent à tromper la surveillance de leurs employeurs.

Dans le cas actuellement soumis à la Cour, on reproche aux intimés, et c'est le seul grief sérieux invoqué contre eux, de ne pas avoir comparé les bordereaux de dépôt avec les entrées au livre de caisse. Il est utile de se rappeler ici que tous les mauvais comptes de la Compagnie étaient initialés par l'assistant-secrétaire-trésorier, M. Tulloch, et, en conséquence, soustraits du compte des profits et pertes. M. Turner, le vice-président, le trésorier et le gérant général de la Compagnie nous dit:—

> When the bankrupt estate of a customer was wound up, Mr. Tulloch's job was to see to it that we had received whatever dividends were due to the Company as disclosed by the report of the Trustee, and to authorize the balance of the account being written off as a bad debt. Mr. Tulloch was instructed to signify his scrutiny of the whole transaction by placing his initials on the entry writing off the bad debt.

Lorsque Clément réussissait à percevoir le montant de certains de ces comptes, il déposait, comme nous l'avons vu, ces chèques au compte de banque de la Compagnie sans faire d'entrée au livre de caisse, et s'appropriait d'autres montants égaux payés en argent. Il est possible que la vérification des bordereaux eût révélé certaines de ces malversations, mais les experts entendus, sauf M. Parent et M. Grant, nous disent qu'on ne peut se fier à une pareille comparaison. M. Gordon Scott nous affirme que l'examen détaillé des bordereaux de dépôt n'est d'aucune utilité. M. Young, un des associés de Price, Waterhouse & Co., nous dit que l'examen des copies de bordereaux de dépôt a peu de valeur comme moyen de vérifier l'exactitude des recettes en argent. Il affirme que ces bordereaux ne sont pas une preuve de réception d'argent, mais bien une preuve que de l'argent a été donné à la banque. M. L. E. Potvin jure que le bordereau de dépôt peut faire mention d'entrées qui n'ont aucune relation avec le commerce du client, qu'il peut y avoir eu échange de chèques avec ce client et autres accommodations, et il nous dit qu'il ne pourrait pas se fier à ces copies de bordereaux de dépôt. C'est aussi l'opinion de M. Maurice Chartré et de M. K. W. Dalglish qui tous deux croient que cette façon de vérifier n'est pas certaine et qu'elle n'est pas généralement employée.

1940

GUARDIAN INSURANCE COMPANY OF CANADA v. F. W. SHARP AND OTHERS.

Taschereau J.

La raison se devine facilement. Il peut se présenter des cas nombreux où un caissier honnête ne pourra jamais faire concorder les entrées d'un jour inscrites au livre de caisse avec le bordereau de dépôt. Si, ainsi, il reçoit au comptoir d'un client débiteur de $25, un chèque de $50, et lui remet $25 en change, le livre de caisse comportera une recette de $25 et le bordereau un dépôt de $50. Si un autre client paye le même montant au moyen de trois chèques différents signés par des tiers, et endossés par lui il y aura encore une entrée de $25 au livre de caisse, et sur le bordereau, le dépôt de trois chèques qui n'ont aucune relation avec les affaires de la Compagnie. Le caissier peut changer le chèque d'un officier de la Compagnie, qui apparaîtra au bordereau mais nullement au livre de caisse. Il peut aussi recevoir des chèques postdatés qui ne seront pas sur le bordereau à la date qui correspond à celle inscrite au livre de caisse.

L'on voit donc par ces témoignages des experts et les exemples cités que cette faute reprochée aux intimés n'en est pas une en réalité. Ils se sont contentés de vérifier le total des dépôts, comme le font tous les auditeurss prudents et ayant un degré raisonnable d'habileté professionnelle. Les intimés ont agi comme les autres auditeurs agissent dans des conditions identiques, et parce qu'ils ont omis de faire cette vérification qui ne se fait pas habituellement, on ne peut pas dire qu'ils n'ont pas agi en "bons pères de famille".

Devaient-ils surveiller davantage des comptes considérés comme mauvais comptes? Il ne faut pas oublier que l'appelante a été subrogée aux droits de Claude Néon Limited. Elle a tous les droits de celle-ci, mais elle n'en a pas davantage. Les auditeurs ont suggéré à M. Turner, vice-président et gérant général, d'adresser une circulaire à tous les débiteurs de la Compagnie pour vérifier l'exactitude des montants dus, mais celui-ci a refusé cette suggestion en disant que le contrôle interne de la Compagnie était suffisant. Il y avait donc lieu d'assumer que ces comptes disparus des livres l'étaient régulièrement. On sait que des auditeurs, qui louent leurs services à une corporation employant de nombreux commis, sont tenus de donner moins d'attention à certains détails précisément à cause du contrôle interne exercé par les employés.

Les tribunaux ne doivent pas être plus sévères vis-à-vis les auditeurs qu'ils ne le sont vis-à-vis les autres professionnels. Du moment qu'ils agissent suivant les principes que j'ai mentionnés déjà, ils sont à l'abri de responsabilité civile, et ne peuvent pas être recherchés en dommages si l'on découvre des vols dont l'examen raisonnable des livres ne faisait pas soupçonner l'existence. Il est vrai, comme on l'a dit, qu'ils ne sont pas employés seulement pour additionner, soustraire ou diviser, et qu'on a droit d'attendre d'eux un degré d'habileté qui permette à la Compagnie de se rendre compte de sa situation financière. Mais il est également vrai qu'on ne peut pas exiger d'eux que le bilan qu'ils contresignent comporte une garantie d'honnêteté de tous les employés, et qu'il est une assurance que leur vigilance n'a pas été trompée.

Le certificat qu'ils donnent aux actionnaires indique la situation de la Compagnie, telle que révélée par les livres qui n'ont pas éveillé de soupçons, et d'après les informations fournies par des employés responsables qui ont la confiance des directeurs. Ils sont des auditeurs, et non des enquêteurs spéciaux qui, eux, souvent doivent présumer, à cause de soupçons préexistants, la malversation et le détournement.

Pour ces raisons, je crois que le jugement de la Cour du Banc du Roi, qui a rejeté l'action, est bien fondé, et je suis d'opinion de le confirmer avec dépens.

The judgment of Crocket, Davis and Hudson JJ. was delivered by

DAVIS J.—Claude Néon General Advertising Limited (hereinafter for convenience called "the company"), with head office in the city of Montreal in the province of Quebec, carries on the business of manufacturing and leasing advertising signs. The company was incorporated in 1929 for the purpose of consolidating the activities of several advertising businesses theretofore carried on separately and became one of a group of nine companies whose consolidated balance sheet shows total assets to the amount of approximately four million dollars. That indicates in a general way the nature and extent of the business of the company.

In November, 1935, shortly after a collector of accounts in the employ of the company had introduced for his own

1940

GUARDIAN INSURANCE COMPANY OF CANADA v. F. W. SHARP AND OTHERS.

Davis J.

protection the use of a counterfoil receipt book, the auditors discovered that the company's cashier, Clément, had stolen some money from the company. He had been a trusted employee against whom there had never been any suspicion of wrongdoing but when the defalcation was discovered an investigation was at once commenced to ascertain if there had been any other defalcations by this man. A thorough investigation of all customers' accounts, deposit slips, bankruptcy dividends and agreements with customers was made, with the result that this special investigation disclosed that comparatively small sums of cash had been taken by Clément from time to time from as early as January 29th, 1931 (when $13.50 was taken) over a period of nearly six years, the total amounting to $6,756.41. Each of the items going to make up this total was a comparatively small sum, such, for instance, as $11.50, $7, $21.25, $18.65, $2, $14.44, $6.20, $1.74, $83.25, $10.31, $27.50, $19. I have picked out these items at random throughout the long list. In only a few instances was more than $100 taken at one time; the defalcations were usually of small amounts at a time.

One at once asks how this sort of thing was done in that it was not discovered for nearly six years. The obvious answer on the evidence is that Clément was fully trusted by his superior officers in the large business, that there was no suspicion that anything like this was going on. And one naturally asks then: How did Clément do this so as to evade discovery? Like most consistent practices of fraud, the system when explained seems very simple, though perhaps ingenious at its inception in the mind of the guilty person. What happened was this: Clément from time to time induced Tulloch, the assistant treasurer of the company whose duty it was to supervise Clément and who was specifically entrusted with credits and bad debts, to write off some comparatively small accounts as bad debts, though apparently Clément himself regarded them as accounts from which the company might well receive some further payments. These accounts, I should think negligently by Tulloch, were closed and written off on the books of the company and became dead accounts. No further monthly or other statements of account went out to these customers and therefore if any of them subsequently paid in anything on their accounts they did not

thereafter receive statements of account which would have indicated at once that their payments had not been properly credited to their accounts on the books of the company. Further, there were accounts of persons or firms which went into bankruptcy; when notice of bankruptcy was received the company filed its claim with the trustee in bankruptcy and these accounts were then closed out on the books of the company. Other accounts from time to time were given over to the solicitors of the company for collection and when that was done these accounts were closed on the books of the company and no further statement of account was sent by the company to the customer; the matter was left in the hands of the solicitor. Those three named classes of accounts, I take it from the evidence, represent the basis of the system upon which Clément, the cashier, worked in taking moneys from the company. He did it this way: the company had an ordinary cash ledger in which he daily recorded or was supposed to have recorded all the incoming moneys which in most cases were by cheques but in some cases by small cash payments. Every day the cashier sent, or was supposed to send, all the moneys taken in that day, whether represented by cash or by cheque, to the company's bank for deposit. On the whole this was done faithfully day after day during the six years in question. But from time to time in order to take some money to himself Clément did this: having received a cheque from a bankrupt estate or from the company's solicitor on a collection or in respect of one of the accounts that had been written off as a "bad debt," he would hold the particular cheque and not enter it in the cash ledger. And then, when sufficient cash was in to amount to or exceed the amount of the cheque, he deposited the cheque at the bank to the company's credit but would take to himself the equivalent amount out of the cash in hand. It is plain that each day Clément deposited or caused to be deposited in the company's bank the exact amount of money, represented by cheques or cash, which was shown in the cash ledger of the company as having been received that day by the company. The amount of the daily deposits as shown on the original bank statements to the company agreed exactly with the amount of the daily receipts as shown in the company's cash ledger.

1940

GUARDIAN INSURANCE COMPANY OF CANADA v. F. W. SHARP AND OTHERS.

Davis J.

The company carried a fidelity bond on its employees which had been issued to it by the appellant, Guardian Insurance Company of Canada, and the appellant paid the company in respect of Clément's defalcations $5,000, being the full amount of the bond. Upon payment the appellant took from the company a document headed "Subrogation Receipt," in which the company acknowledged receipt of the $5,000 from the appellant in full settlement of all claims and demands under the bond in respect of defalcations on the part of Clément and, in consideration of such payment, the company

> hereby assign and transfer to (the Guardian Insurance Company of Canada) each and all claims and demands against any other party, person, persons, property or corporation, arising from or connected with such loss and the said (the Guardian Insurance Company) is hereby subrogated in the place of and to the claims and demands of the undersigned (Claude Néon General Advertising Limited) against said party, person, persons, property or corporation in the premises to the extent of the amount above named, and the said (Guardian Insurance Company) is hereby authorized and empowered to sue, compromise or settle in its name or otherwise to the extent of the money paid as aforesaid.

The document is dated July 10th, 1936.

Neither the appellant nor the company itself took any proceedings against Clément to recover the amount of his defalcations, or any part of them, but the appellant commenced this action on November 10th, 1936, in its own name, against the auditors of the company (who are the respondents in this appeal) to recover $5,000, the amount it had paid on its bond, alleging that the "theft or misappropriation or fraudulent conversion" by Clément

> was rendered possible by and was caused through the neglect, want of professional skill of the defendants; that such conversion would have been impossible if the defendants had done what they were bound to do, and what they had agreed to do towards the said company, Claude Néon General Advertising Limited, and its directors, and that the said loss was caused immediately by the said negligence, want of profesional skill of the defendants.

The appellant put its case on the alleged neglect of the auditors in failing to check what are called the "deposit slips." Clément had made out day by day the usual form of bank deposit slip in connection with the daily deposit of company's moneys at the bank. The original deposit slip was retained by the bank. The amount of the daily deposit would vary considerably but on some days would be several thousand dollars. But on any day that Clément

intended to misappropriate some of the cash on hand, he would deposit the particular cheque which he had been holding back with the other cheques received that day but the amount of cash he would deposit would be the amount actually received less the amount of the cheque which he had been holding back until that day. Clément kept a carbon copy of each of these daily bank deposit slips. They appear to have been kept by him openly on a file on his desk; he must have known that it was not customary for auditors to check these carbon deposit slips or else he would not have adopted the system he did. While the bank stamped each of these carbon copies, it merely acknowledged that it had received "the total amount" as shown on the slip. The original deposit slips, which were left with the bank, do not appear to have been produced but I understand it is admitted that they were the same as the carbon copies. Strange as it may appear, on the days when misappropriations took place Clément made marginal notes on the copy of the deposit slip for the day which he retained which would give him the information, if he ever wanted the information, as to what cheque was added in the deposit of that day that had not been shown in the cash ledger, and in some cases a notation of the difference in the cash. There was no explanation for the making or for the keeping of these annotated copies but I suspect that Clément, at least at the inception of the defalcations, hoped to make good later on and wanted a record of exactly what he had taken. However that may be, the appellant says that if the auditors had checked not only the books of the company but these copies of bank deposit slips in Clément's possession, his system would have failed and the company would not have lost the money. What the auditors say is that it is not customary in the practice of auditors to check copies of bank deposit slips because they are not original documents and that the bank's stamp on them is expressly limited to an acknowledgment that "the total amount" shown on the slip has been received and deposited to the credit of the company's account. The auditors say that they entirely shared the confidence of the superior officers of the company in Clément's honesty and had no ground for suspicion and that as a matter of auditing practice a stamp by the bank on a carbon copy of a deposit slip

1940

GUARDIAN INSURANCE COMPANY OF CANADA v. F. W. SHARP AND OTHERS.

Davis J.

that the total amount shown thereon had been received by the bank was not something which in the ordinary course they would examine because they had before them the company's original cash ledger with its details of the daily receipts and they checked and examined the original statements received by the company from the bank, showing the total daily deposits, against the daily receipts as shown by the company's cash ledger. The appellant's factum contains the admission:

> There is no doubt that if these duplicate deposit slips had been in the form usually employed, they could have been of no assistance, in order to check the cash book.

The auditors had been appointed at the time of the incorporation and organization of the company in 1929. They then made out a programme or chart of their work which was known and accepted by the company and to which they adhered. They are admitted to be an old Montreal firm with an excellent reputation.

It is indeed a striking fact that Turner (himself a chartered accountant), who was the senior officer in charge of the company's office (being vice-president and secretary-treasurer for some years), testified that the company had foreseen "something like this" and had sought to cover it by internal checks and controls which he described. He said he did not criticize the auditors after the investigations had revealed the losses. Further, the Hon. Gordon W. Scott, who is acknowledged to have been one of the outstanding chartered accountants in this country and who was himself a director of the company, testified that had the audit of the company been under his supervision he would not have thought it an essential part of his duty to check the deposit slips. "In a large public corporation," he said,

> I think the greatest safeguard you have is the internal organization, that one man is checking another all through the process, and if that is functioning properly, as is done in the larger corporations, we rely on the organization for the honesty of the employees, and in no sense do I believe it is the duty of an auditor to be a detective.

Mr. Scott said there was

> something like three or four hundred thousand dollars coming in within a year

and

> something like a million and a half dollars on the books of the company and three thousand accounts and a lot of little accounts in instalments,

and he thought the checking of the daily deposit slips by the auditors would be "superfluous" and "useless" work in the circumstances. Dempster, one of the partners in the auditing firm, testified that he had at one time suggested to the company that a communication be sent to each customer to ascertain if the customer admitted that his indebtedness to the company was exactly as shown on his card or ledger sheet but that his suggestion had not been carried out; Mr. Turner felt that the system of internal control was a sufficient safeguard against defalcations.

But Mr. Geoffrion for the appellant, with his usual vigour and lucidity of argument, pressed upon us his contention that the appellant was entitled to succeed in the action upon the ground that it was negligence on the part of the auditors not to have examined these copies of the bank deposit slips and that if they had, Clément would have been frustrated in his scheme of taking the moneys from the company and consequently the auditors were responsible in law for the company's loss caused by Clément's misappropriations. The liability of the auditors was put as coterminous with the liability of Clément himself to the company.

In the view I take of the case it is unnecessary to determine the question whether or not under Quebec law the so-called subrogation receipt is sufficient to entitle the appellant in its own name to maintain this action against the auditors.

I turn now to the consideration of the nature and extent of the duty of the auditors to the company. It was admitted that they had merely been appointed by resolution of the company "to be the auditors of the company," without any special terms or conditions by by-law or agreement, and that the definition of their duty was to be found entirely within the language of sec. 120 of the Dominion *Companies Act*, 1934, ch. 33, which reads as follows:

120. (1) The auditors shall make a report to the shareholders on the accounts examined by them and on every balance sheet laid before the company at any annual meeting during their tenure of office, and the report shall state

(*a*) whether or not they have obtained all the information and explanations they have required; and,

(*b*) whether, in their opinion, the balance sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of

1940

GUARDIAN INSURANCE COMPANY OF CANADA v. F. W. SHARP AND OTHERS.

Davis J.

the state of the company's affairs according to the best of their information and the explanations given to them, and as shown by the books of the company.

(2) Every auditor of a company shall have a right of access at all times to all records, documents, books, accounts and vouchers of the company, and shall be entitled to require from the directors and officers of the company such information and explanation as may be necessary for the performance of the duties of auditor.

(3) The auditors of a company shall be entitled to attend any meeting of shareholders of the company at which any accounts which have been examined or reported on by them are to be laid before the shareholders for the purpose of making any statement or explanation they desire with respect to the accounts.

The respondents were engaged then to make what is called a statutory audit for the company and their duties were those and only those imposed by the statute. A distinction was very properly made in the argument between a statutory audit and a special investigation that may be undertaken by auditors under terms of a special contract.

The language of the statutory duty here is substantially the same as the language in the *Companies Act*, 1879, which was under consideration in *In re London and General Bank (2)* (1). In that case Lindley L.J. said at p. 683:

> An auditor, however, is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly shew the true position of the company's affairs; he does not even guarantee that his balance-sheet is accurate according to the books of the company. If he did he would be responsible for error on his part, even if he were himself deceived without any want of reasonable care on his part, say, for the fraudulent concealment of a book from him. His obligation is not so onerous as this. Such I take to be the duty of the auditor: he must be honest—i.e., he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true. What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion very little inquiry will be reasonably sufficient, and in practice I believe business men select a few cases at haphazard, see that they are right, and assume that others like them are correct also. Where suspicion is aroused more care is obviously necessary; but, still, an auditor is not bound to exercise more than reasonable care and skill, even in a case of suspicion, and he is perfectly justified in acting on the opinion of an expert where special knowledge is required.

Lopes L.J., who concurred in the judgment of Lindley L.J., said in another case that came up the following year, *In re Kingston Cotton Mill Company (2)* (2):

(1) [1895] 2 Ch. 673. (2) [1896] 2 Ch. 279, at 288, 289.

But in determining whether any misfeasance or breach of duty has been committed, it is essential to consider what the duties of an auditor are. They are very fully described in *In re London and General Bank* (1), to which judgment I was a party. Shortly they may be stated thus: It is the duty of an auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful, and cautious auditor would use. What is reasonable skill, care, and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful.

Lord Alverstone C.J., in summing up to a special jury in a case in the King's Bench Division on June 1st, 1904, said (*London Oil Storage Company Limited* v. *Seear, Hasluck and Co.* reported in Dicksee on Auditing, 11th ed., p. 783, at pp. 785 and 786):

I will not adopt any fanciful expression which may be quoted from any particular judgment, but he (the auditor) has got to bring to bear upon those duties reasonable and watchful care, he has got to discharge those duties remembering that the company look to him to protect their interests. He is not, however, supposed to be a man constantly going about suspecting other people of doing wrong, and that is the only respect in which, I think, Mr. Bankes in his most able speech pressed the matter a little too high. While Mr. Hasluck has by the exercise of due and reasonable care to see that all the officials of the company are doing their duty properly in so far as the accounts are concerned, he is not bound to assume when he comes to do his duty that he is dealing with fraudulent and dishonest people; and there comes in the most important consideration from one point of view—perhaps more important than the other, though I do not think of such substantial weight in this matter—if circumstances of suspicion arise, it is the duty of the auditor, in so far as those circumstances relate to the financial position of the company, to probe them to the bottom.

And further on at p. 787:

Mr. Isaacs is quite right in saying to you, as I have already indicated, that the auditor is not bound to assume that people are dishonest. On the contrary, he is entitled to think that they are honest.

Lord Alverstone later on said, p. 787:

* * * I think the best concluding direction I can give to you for which I am responsible is, that he must exercise such reasonable care as would satisfy a man that the accounts are genuine, assuming that there is nothing to arouse his suspicion of honesty, and if he does that he fulfills his duty; if his suspicion is aroused, his duty is to "probe the thing to the bottom," and tell the directors of it, and get what information he can.

(1) [1895] 2 Ch. 673.

1940

GUARDIAN INSURANCE COMPANY OF CANADA v. F. W. SHARP AND OTHERS.

Davis J.

In re City Equitable Fire Insurance Company Limited (1) affords an exhaustive discussion, by Romer J. (as he then was) and on appeal by Pollock M.R., Warrington L.J., and Sargant L.J., of the duties of auditors. The report of the case extends to 125 pages. I shall quote only one passage from the judgment of Pollock M.R., at p. 509:

> What is the standard of duty which is to be applied to the auditors? That is to be found, and is sufficiently stated, I think, in *In re Kingston Cotton Mill Co. (No. 2)* (2). As I have already said it is quite easy to have discovered something which, if you had discovered it, would have saved us and many others from many sorrows." But it has been well said that an auditor is not bound to be a detective or to approach his work with suspicion or with a foregone conclusion that there is something wrong. "He is a watchdog, but not a bloodhound." That metaphor was used by Lopes L.J., in *In re Kingston Cotton Mill Co. (No. 2)* (2). Perhaps, casting metaphor aside, the position is more happily expressed in the phrase used by my brother Sargant L.J., who said that the duty of an auditor is verification and not detection. The *Kingston Cotton Mill* case (2) is important, because expansion is given to those rather epigrammatic phrases. Lindley L.J. says: "It is not sufficient to say that the frauds must have been detected if the entries in the books had been put together in a way which never occurred to anyone before suspicion was aroused. The question is whether, no suspicion of anything wrong being entertained, there was a want of reasonable care on the part of the auditors in relying on the returns made by a competent and trusted expert relating to matters on which information from such a person was essential." The judgment of Lopes L.J., as well as that of Kay L.J., may be looked at in support of the words of Lindley L.J., and also in support of what I have called the epigrammatic way of putting the auditors' duty.

The legal standard of duty of auditors (to adopt a phrase of Lindley L.J.), in the absence as here of any special by-law or stipulation of the terms of employment, is plainly defined in the decisions to which I have referred, and applying the principles of those decisions to the particular facts of this case I am unable to hold that there was any such neglect or default on the part of the auditors as would entitle the company, were it the plaintiff, to succeed in the action. The question is whether before the discovery of the thefts, in the then existing state of experience, failure of knowledge or foresight is to be imputed to the auditors for a breach of duty. Conduct pursued in the light of experience derived from the present knowledge of the system of defalcations can hardly be taken as a sufficient basis for a charge of want of care. There was nothing to indicate that the accounting methods and con-

(1) [1925] Ch. 407. (2) [1896] 2 Ch. 279.

trol of the company were so lax and inadequate that reliance could not properly be placed upon the books.

But assuming that there was some breach of duty on the part of the auditors to the company, there would be two answers, I should think: firstly, a claim based on such a breach of duty may not be covered by the subrogation document in favour of the appellant; and, secondly, assuming it were covered by the subrogation, what is the measure of damages for such a breach of duty? The auditors did not steal the money; they were not the direct cause of the loss. As Lord Alverstone told the jury in the *London Oil Storage Company* case above mentioned (Dicksee on Auditing, 11th ed., at p. 797):

> I do not know that I ever remember a question the solution of which was more difficult in the concrete. It is easy to put it in general terms: Was he guilty of breach of duty, and, if so, what loss was occasioned to this company by that breach of duty? You must not put upon him the loss by reason of theft occurring afterwards or before, but you must put upon him such damages as you consider in your opinion were really caused by his not having fulfilled his duty as auditor of the company.

The loss of the plaintiff amounted to £760; the jury awarded five guineas against the auditors.

Canadian Woodmen of the World v. *Hooper et al.* (1), was a somewhat recent Ontario case. The auditors were held liable for breach of their duties to the plaintiff corporation. The trial judge, Raney J., awarded the corporation the full amount of its loss, $8,840.32, against the auditors as well as against an official of the corporation, but after the case had been twice before the Ontario Court of Appeal (1) the protracted litigation ended, so far as the auditors were concerned, with a judgment against them of only $1 as nominal damages. I do not pursue the difficult question of the measure of damages because, in my view of the case, it is unnecessary to do so. Nor do I find it necessary to consider the question of prescription raised by the respondents.

I would dismiss the appeal with costs.

Appeal dismissed with costs.

Solicitors for the appellants: *Charbonneau, Charbonneau & Charlebois.*

Solicitors for the respondents: *Hackett, Mulvena, Foster, Hackett & Hannen.*

(1) (1932) 41 O.W.N. 328; [1935] O.W.N. 113.