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# First external auditors of the Hudson's Bay Company, 1866

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# THE FIRST EXTERNAL AUDITORS OF THE HUDSON'S BAY COMPANY, 1866

*Abstract*: At the request of shareholders, the Hudson's Bay Company had its financial statements audited for the first time in 1866. Two external auditors were hired, one for the shareholders and one for management. Three inter-related forces led to this decision: (1) most importantly, the company's shareholders demanded audited financial statements, (2) there was emerging in London at the time the capacity and willingness among London accountants to provide external audit services, and (3) the British Parliament passed various acts that required financial statements of companies in other industries to be audited. After a few years, only the management's external auditor was retained. He subsequently influenced the company's development of management accounting. In addition, the company's early external auditors were influential in the development of the Institute of Chartered Accountants of England and Wales.

## INTRODUCTION

The Hudson's Bay Company (HBC) is the world's longest surviving commercial organization that continues in its original line of business [Milgrom and Roberts, 1992, p. 9]. It was a successful, London-based, joint-stock company for 300 years before it became a Canadian public company in 1970. In recent decades, the HBC became less competitive, and in 2005, it was acquired and subsequently converted into a private company.

In its 341 years, the HBC has experienced many accounting and auditing changes. The HBC's management accounting changes have been discussed by Spraakman and his co-authors.[1] That research traced the management accounting practices of the HBC from 1670 to 2005 and found that the company had four different management accounting programs with the fifth

[1] See references for relevant HBC articles by Spraakman and his co-authors [Spraakman and Davidson, 1998; Spraakman, 1999, 2002, 2010; Spraakman and Margret, 2005a, b; Spraakman and Wilkie, 2005.

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in the initial phase in 2005. The overall conclusion was that management accounting was slow to change, but when it did, the justifications and changes were significant. This research noted briefly that the HBC's first external auditor appointments had been made in 1866.

Despite its richness in terms of longevity and comprehensiveness, the HBC's archives have not been used to examine in depth the beginnings and development of its external auditing. The archive of no other commercial company in the world contains so many years of accounting documents. E.E. Rich [1958, p. xi], HBC scholar and Cambridge University professor, observes that the company "preserved a unique and magnificently full series of documents which take the story back even to before the Charter of 2nd May, 1670, and with great cost and sense of purpose it has assembled its archives, sorted and catalogued them, and prepared them for the use of the historian."

Short shrift to auditing is common as Matthews [2006, p. 2] concludes "that there has been very limited primary research into the history of the audit on either side of the Atlantic." This paper will address in part this shortcoming by documenting the first external auditors at the HBC. It demonstrates how the external auditors and their audits changed the way in which accounting was done. In addition, this paper will document the affiliation of the HBC's earliest external auditors to the development of professional external auditing in London as well as within the Institute of Chartered Accountants of England and Wales (ICAEW).

The context and environment surrounding the introduction of external auditing in 1866 will be revealed in the next section, followed by section three which describes the conditions accompanying the introduction of the HBC's first external auditors. There were two external auditors, one for the shareholders and the other for the governor and committee (comparable to the contemporary board of directors). Section four documents the evolution of the auditor's external audit activities for several decades at the HBC, while the next explores his management advisory activities. The last section is a discussion of findings and conclusions.

## CONTEXTUALIZATION

The decision to hire external auditors can best be appreciated by understanding the context. More specifically, in 1860, the HBC's longest serving governor, George Simpson, died. For the previous 40 years, he had run the company's fur trade business successfully in his inimitable way. The HBC had achieved much during those years. Due largely to its success especially during the Simpson years, economists have evaluated the HBC to be one of the few companies in the world to have earned an economic rent from its unique resources. It appears to have been singularly successful [Schoemaker, 1990, p. 1,180] as were IBM and Proctor & Gamble at later points in time.

Added to the loss of Simpson's strong leadership, the HBC faced four external but related shocks during the last 40 years of the 19th century. First**,** modernization changed the way in which the HBC conducted its fur trade business. Canoes and boats on lakes and rivers were no longer the means for communications and transportation. The first significant challenge to the value of the HBC's communications and transportation system came in 1859 from the introduction of steamboats [Innis, 1956, p. 344]. Transportation costs were further reduced with the extension of the Northern Pacific Railway, which was completed to Winnipeg by the Canadian Pacific Railway (CPR) in 1878. The CPR, however, had a much greater impact on lowering costs when the trans-Canada line was completed in 1885. The rail was not only cheaper than canoes, York boats, and steamboats, but it was also quicker and more reliable [Barris, 1977, p. 41].

Similarly, modernization enabled barter in North America to be gradually replaced by cash transactions.[2] Previously, the HBC had to create a trade currency, which it did by equating all furs and trade goods to a prime beaver pelt, called a "made beaver." This "made beaver" system was a means of influencing the lives of the aborigines; trapping and the consumptions of European goods became a more significant part of their lives [Neu and Therrien, 2003, pp. 27-28]. The "made beaver" system worked well from 1670 to the last half of the 19th century when modernization gradually demanded that it be replaced with cash transactions. The conversion from "made beaver" to cash changed how the aborigines dealt with the HBC. Unlike barter, they did not have to conduct both transactions – the sale of furs and the acquisition of trade goods – with the HBC.

The isolation of the fur posts and employees decreased in relative terms after 1860 with communications and transportation developments. Correspondence and travelling times were also reduced significantly. With the telegraph that accompanied

[2] The paper will refer to "North America" as the location of the HBC's operations prior to Canadian Confederation (1867) and "Canada" thereafter.

modernization, instructions could be detailed and given frequently to the traders along with advice on the latest market prices in London.

Second, the company was required to give up its charter that had been received from the King of England in 1670. The HBC, in 1870, turned its trade monopoly, charter, and lands over to the Canadian government for remuneration (£300,000). One important term in the transfer was that the HBC received a 1/20th share of prairie-parkland real estate in what became Western Canada, thereby entering the land business.

Third, in 1868, the concerns over the future (e.g., loss of charter, modernization, and consequences on business) encouraged the governor and committee to hire an external consultant, Cyril Graham. He was a vice-president at the Transatlantic Cable Company and had been in the British Colonial Office. Thus, Graham had both business and governmental credentials. The governor and committee followed Graham's recommendations, which included pursuing modernization as the most significant. With the steam ships on rivers and lakes and later the railway, the HBC largely replaced its own communications and transportation system by contracting with suppliers. At the same time, the company got out of the business of supplying food and clothing to its employees by relying upon an emerging infrastructure. Hence, the company shrank and with improvements in communications and transportation, it became easier to manage. Consequently, the HBC was able to change its fur-trade organizational structure by eliminating a level of management. Prior to the forces of modernization, there were four levels in the fur-trade business: posts, districts, departments, and the commissioner (the new title for inland governor). Departments were eliminated and subsequently district managers reported directly to the fur-trade commissioner, thus increasing the number of managers directly reporting.

Fourth, the International Financial Society (IFS) acquired the HBC shares from its existing shareholders in 1863 and sold those shares at a premium to new shareholders who expected more from the company. The IFS had an effect on how the HBC was managed. The new owners became increasingly demanding [Mitchell, 1953, pp. 220, 241; Ray, 1986, p. 5]. The HBC also followed the advice of Graham when it entered the retail business with saleshops in 1871. Thus, the company had three businesses-fur trade, land, and saleshops. In this context, this paper will examine how the company came to hire its first external auditors.

## EXTERNAL AUDITORS AND AUDITING

The HBC's first external takeover was initiated in 1863 by the English promoter Edward Watkin, who at the time was a member of the British Parliament [Hodgkins, 1999, p. 2]. He was familiar with both Canada and the HBC. In 1861, he went on a mission to Canada at the request of the British government to investigate the possible confederation of five British provinces into the dominion of Canada and transferring the HBC lands to the new Canadian government [Sutton, 2004]. At this time, there was a group of businessmen and British government officials interested in building a telegraph line to the Pacific and a related group who wanted to expand the Grand Trunk Railway into an inter-colonial railway connecting Nova Scotia through Upper Canada (now Ontario) to the Pacific Ocean [Mitchell, 1953, pp. 222-227]. He also informally represented some of the owners of the Grand Trunk Railway.

An obstacle to the plans for the inter-colonial railway and the telegraph was the HBC. The company was not willing to cooperate with either plan. Instead the governor and committee wanted the company to be purchased for £1.5 million. The IFS was an investment group formed by Watkin and some of his investor friends willing to put up their personal money to acquire the company's shares from the existing owners for £1.5 million, about 50% over the market price [Mitchell, 1953, pp. 241-242]. None of the members of the IFS had a dominant share position. With promotion of the HBC's untapped potential from future settlement, the IFS sold the shares for approximately £2 million. None of the buyers had dominant share positions at the time at this transaction. Watkin and his fellow investors benefited handsomely. After replacing existing shareholders (except for two), the IFS disappeared.

The HBC was not removed as an obstacle by the purchase of 1863, but the new owners were more cooperative [Mitchell, 1953, p. 220]. The groups representing the interests of the Grand Trunk Railway and the proposed telegraph to the Pacific Ocean were not represented by the new owners of the HBC.

The hiring of external auditors was initiated on November 28, 1865 at the general court by a Mr. R.A. Heath, who made a motion which was carried unanimously [HBC, annual report, 1865]. Heath was a proprietor or shareholder but not a committee (board) member. The minutes of the general courts suggest that shareholders were active in questioning the governor and committee about financial prospects [HBC, annual reports, 1866-1900]. Active shareholders at this time were not as described by Maltby [1999, p. 38], who found that "investors tended to rely on personal acquaintances and experience rather than on accounting data." The HBC's financial statements were audited for the first time and signed by the external auditors in 1866 [HBC, annual report, 1866].

It is important to understand the specific business environment in London at the time Mr. Heath made the motion for appointing external auditors. The Joint Stock Companies Act of 1844 made incorporation easy and inexpensive [Boyns *et al.*, 2000, p. 97]. It required that a balance sheet be presented to the shareholders at the annual general meeting and a copy of the balance sheet had to be filed with the Registrar of Joint Stock Companies. Auditors could be appointed; directors of the company could be selected as the auditors. Then the Joint Stock Companies Act of 1856 cancelled the requirements under the 1844 Act for the presentation of a balance sheet to the shareholders at the annual general meeting. The 1856 act included a model set of Articles of Association for preparing the balance sheet and profit-and-loss statement for an audit [Maltby, 1999, p. 33].

The Companies Act of 1862 consolidated various acts to become the principal act without changing the voluntary requirements. However, it was not until the Companies Act of 1900 that compulsory external audits were reintroduced for all limited British companies [Edwards and Webb, 1985, p. 179; Chandler and Edwards, 1996, p. 8]. The act defined an appointment method and remuneration for auditors, their rights of investigation, and their general duties. Only then were directors and officers of the company ineligible to act as external auditors. In the half century prior to the 1900 act, there were no requirements for the auditor to hold a professional qualification [Maltby, 1999, p. 38]. It was frequently stipulated in a company's articles that the external auditor should be a shareholder.

During the 40 year period prior to 1900, there was a steady increase in the external audit of British companies, attributable to regulations. The HBC is significant to study as unlike many firms that introduced external audit at the same time, it was not regulated or required to produce audited financial statements. The shareholders demanded audited financial statements. Moreover, the governor and committee were willing to accept the inherent risk of a "special" or unique fur-trade accounting system that could be misunderstood [HBC, annual report, 1866].

Maltby [1999, p. 41] concluded that the requirement for external audits was likely facilitated by the gradual development of the accounting principles. She said:

> The late [19th] century saw the elaboration of accounting principles by the profession, in the pages of *The Accountant*, in textbooks written by Francis Pixley, Lawrence Dicksee and others, and in the lectures and papers read to students' societies. The principles developed gave a key role to *prudence;* current assets should be valued at the lower of cost and realizable value, fixed assets should be depreciated, irrespective of their market value, and provision should be made for losses as soon as they appeared possible.

The principles became the base against which the auditors assessed a company's financial statements.

Chandler and Edwards [1996, p. 7] claimed that 1900 was the beginning of a "golden age" for external auditors. They articulated a definite position among the new professions (e.g., engineering, architecture), and there was for the first time general understanding of the "nature and limitations" of external audits. Nevertheless, professionally qualified auditors were not required by the Companies Act until 1947 [Edwards, 1989, p. 209]. The HBC's decision to engage external auditors came 35 years before required by law. The shareholders, who unanimously approved the motion to engage external auditors, were aware of the advantages of external auditors.

For the nearly 200 years prior to the IFS, the HBC's financial statements did not appear in the minutes to the semi-annual general courts. The first financial statements appeared in the minutes for 1864 [HBCA,2.3.84]. Prior to 1864, there was no evidence in the minutes about the inclusion of copies of the financial statements although there was discussion in the general courts about the financial condition of the company when the governors announced the payment of dividends. Apparently, the "grand ledgers" were placed on the "table" for shareholder viewing. The HBC broke with this tradition by publishing its audited financial statements in 1866. Comparable publication was introduced for railways in 1868, life assurance companies in 1870, the gas industry and waterworks in 1871, building societies in 1874, and the electricity industry in 1882 [Maltby, 1999, p. 33].

The first audit report is recorded below verbatim [HBC, annual report, 1866].

REPORT OF THE AUDITORS

To the Governor and committee of the Hudson's Bay

Company

Under and in accordance with the following resolution of the proprietors of the HBC:

That a professional auditor be appointed by the governor and committee, and that Mr. Watkin be appointed shareholder auditor.

That the two auditors report to the shareholders at the next general meeting as to the state of the accounts of the company.

We have audited the accounts of the company for the year ended May 31, 1866, and have made out and signed an account which is attached hereto in accordance and conformity with the Deed Poll.

We would, however, draw your attention to the fact that the stock of goods and stores has been increased by £71,991 14s.11d., which sum includes the usual addition of 33 percent on the cost price, equal to £17,997 18s.9d., to cover freight and charges, it being understood that such freight and charges do not, in practice amount to so much as 33 percent: therefore, this credit contains an amount of assumed and unrealized profit, and it is for the governor and committee to consider how far such a profit can be now divided amongst proprietors.

Again: the following charges for interest, viz.: North West Telegraph, £8,41 2s. 5d., Puget Sound Company, £1,246 8s.3d., James Douglas, £145 8s.10d., are credited to the interest account, and although it is quite true such charges have accrued due and may ultimately be recovered, still, their amount has not yet been received, so that the above remark is equally applicable to these items.

The amount standing to the debit of the account of the purchase of Governor Douglas's interest as a trader being to a considerable extent irrecoverable, should be written off in these or in the next accounts.

As regards the bills held as security for the amounts placed in deposit with Overend, Gurney and Company, we accept the assurance of the secretary that the governor and committee are satisfied that these deposits will be fully repaid, a conclusion in which, from an inspection of the bills themselves, we quite concur, although some delay may arise in the realization.

> Referring to the capital account we observe that the item of £1,073,192 16s. 2d for territory, rights and fixed property, can only be taken as a balancing item dependent, first, upon the cost and value of the forts, stations, cultivated farms and other property valuable and necessary for the conduct of the trade, and which, paid for from time to time mainly out of revenue, have no doubt cost a very large sum, not specially debited from time to time; and, secondly, upon the future realization of wild lands, and of mines, fisheries and other rights and royalties over the vast area comprised in the company's possessions: it clearly would be impossible to define the latter and it might even under present circumstances be highly inexpedient; but it is not impossible to make a reliable estimate in detail of the former, and to record the result in the books as a separate and special item of capital, liable to annual addition or deduction. We recommend this subject to your consideration.
>
> We have received every assistance from Mr. Roberts, your valued accountant, in conducting the audit, and although the books of the company exhibit a special system, they are very regularly and carefully kept.
>
> Edw. W. Watkin William Quilter
> Auditors
>
> London, June 19, 1866.

Watkin and Quilter prepared the 1866 financial statements, consisting of the balance sheet, profit-and-loss statement, and general account (which exhibited the profit-and-loss results for the outfit of the previous year), and then audited them. This is divulged in the fourth paragraph, i.e., "we have made out and signed an account." In 1866, when Watkin and Quilter signed the HBC's financial statements, external auditors tended to prepare the financial statements and audited them. Further support comes from the observations during the time period that companies failed to distinguish between accounting and audit fees [Matthews, 2006, pp. 12, 16].

> If today 'auditing can be viewed as the checking of the work of one set of skilled financial accountants by another' [Sherer and Kent, 1983, p. 17] this has only relatively recently become the case....The professional audit in Britain then was from the start closely bound up with bookkeeping and…this accountancy role often preceded that of auditor. From the 1860s, accountants... had to put the client's accounts in order, and when they

> subsequently assumed the role of auditor as a matter of course they continued responsibility for the accounts …At least down to the 1960s, the majority of British 'audits' were therefore something of a polite fiction and not pure audits which the articled clerks were taught in their textbooks…Accounting firms…were frequently asked to finish the balance sheet and take out the balance and write up the book.

The financial statements of 1866-1868 appeared to have been prepared and audited by the external auditors. The two auditors claimed to have "made out and signed an account." In contrast, the financial statements in 1869 and thereafter were not prepared by the external auditor. He only audited them. More specifically, in his 1869 audit report, he averred that he had "examined and found to be in due accordance with the Books, Accounts, and Vouchers of the Company" [HBC, annual report, 1869]. There was no admission that the auditor prepared the financial statements. Also, there was only one external auditor by that time, Quilter, who had been the external auditor for management, (i.e., governor and committee). It should be noted that in 1869, Quilter did a detailed audit to the voucher level.

There is further evidence that the external auditor examined the financial statements and books but did not prepare the financial statements. This evidence came from the governor at a general court. Specifically, in response to a question from a shareholder about the external auditor's fees, Governor Sir Stafford Northcote said of the external auditor:

> Mr. Quilter [the external auditor], with the assistance of two of his clerks, has been a very considerable time in the examination of the company's books, that all the books are laid open before him, and not only so, but it has frequently happened, since I have been connected with the company, that we have had meetings with Mr. Quilter, and discussed with him for perhaps more than one day at a time – or rather, for more than one sitting – the mode in which certain accounts ought to be presented – what should be reckoned as profit, what should be reckoned as due to capital, and so forth; and I should certainly think the company would behave very unwisely if they were to dispense with the services of a first-class auditor for such purposes.

Note, the governor specified that the external auditor examined the books that were made available to him. These appeared to be discussions between the governor and the external auditor on presentation and classification matters. Moreover, there were no indications on the financial statements that the external auditor prepared the financial statements in 1869 and in subsequent years.

Matthews [2006, p. 7] and Edwards *et al*. [2007, p. 82] found that Quilter had been frequently requested "to sort out railway frauds and other financial problems, and…[was]… often responsible for putting…accounting systems on a sound footing." It was accountants such as Quilter who improved accounting practices among companies particularly when going public [Edwards, 1985, pp. 36-38; Matthews, 2006, p. 9]. He was also active in the Institute of Accountants of London (IAL), one of the five groups that would form the ICAEW. Walker [2004, p. 143] reported that on June 8, 1870, nine of the leading accountants in London gathered at the offices of Quilter's firm to consider establishing the IAL. In addition, Quilter chaired the meeting on November 29, 1870 that actually established the IAL. The ICAEW received its royal charter in 1880. Its formation was the result of the amalgamation of five public accounting groups, each of which had been formed in the 1870s [Walker, 2004, p. 127].

Matthews [2006, p. 7] found that after the aforementioned railway act of 1868, the financial statements of railway companies exceeded all other British companies in detail and accuracy. The railway companies had by that date established skilled accountants and routine accounting practices that made the recruitment of external auditors to prepare the financial statements unnecessary. Due to the quality of the financial statements, the external auditors were able to limit themselves to auditing the financial statements of railway companies. The fact that the HBC's financial statements were no longer prepared by the external auditors in 1869 attests to the ability of the HBC accountants and the quality of its financial statements. The railway companies and the HBC were more advanced in the accounting for financial statements than most other companies in Britain during the last quarter of the 19th century [Matthews, 2006, p. 8].

It was noted that Quilter continued as the external auditor, but Watkin, the shareholder external auditor, did not. Matthews [2006, p. 10] discussed the use of shareholder auditors in the second half of the 19th century:

> it…was an established practice in joint stock companies (like the old trading concerns such as the East India

> Company or the canals, gas and water works) for the shareholders, who took no part in running of the companies, to elect at their annual or bi-annual meetings one or two of their number to audit the accounts, and so keep an eye on their investments.

Matthews [2000, p. 11] labelled them "amateurs" and assessed their contribution to be "no more than a cursory inspection on the day of the general meeting." Consequently, he concluded that these amateurs quickly had themselves replaced by professional external auditors. For example, in 1883, all major British companies had amateur external auditors, but in 1900, nearly all had professional external auditors.

In addition, Edwards *et al*. [2007, p. 82] say that these shareholder auditors were motivated to ensure that the company's "resources…[were]…properly safeguarded and honestly managed." They concluded that these enthusiastic amateurs were unorganized and offered little defence against competition from professional external auditors. Consequently, they were easily replaced. There was no indication of any such tension at the HBC. However, this questions the need for both Watkin and Quilter with the audited financial statements in 1866-1868. Quilter would have been able to prepare and audit the financial statements himself. He was familiar with the accounting records as he had been employed by the HBC as an accountant or auditor from 1863 [Edwards, 2004], but there was no evidence that he prepared the previously mentioned first set of financial statements of 1864 as those statements were not signed by him. Rather, they were unsigned [HBCA. A.2.3.84]. They could have been prepared by or in conjunction with the chief accountant at the time, the highly lauded Edward Roberts, who had introduced numerous accounting system changes during his 1803-1870 career with the HBC [HBCA, A.10.35.129. A.64.38.16d]. Watkin did not have the credentials to prepare and/or audit the HBC's financial statements.

There has always been concern about the independence of the external auditor when reporting to management [Staubus, 2005, p. 5]. This may have tended to encourage shareholders to appoint their own external auditor. The question is, can the external auditor report honestly to shareholders about the performance of management when being paid by management? The existence of an external auditor for the shareholders attests to such questioning. At the same time, the managers wanted an external auditor reporting to them. Both the shareholders and the managers appeared to believe that the reporting relationship would affect the external auditor's reporting.

Maltby [1999, p. 46] has similarly argued that the audit profession in Britain has identified itself with management rather than shareholder interests. According to Maltby, it occurred because at the end of the 19th century, small investors were in the minority. The dominant form of governance continued to be the "insiders," who were prudent and tended to hold the shares for the long term. These investors were able to rely on private links with management.

## EVOLUTION OF THE COMPANY'S AUDITOR

The 1865 motion specified that Mr. Watkin was the shareholders' external auditor. Mr. Quilter was the second external auditor and obviously the external auditor for the management (the governor and committee). Both auditors, listed in alphabetical order, signed each of the three financial statements for 1866. There were two external auditors for each year until the 1869 financial statements which were signed by only one external auditor, Quilter, described by the governor in the report to the shareholders as the "Company's Auditor" [HBC, annual reports, 1867-1869]. It should be noted that it was the company's external auditor that continued, not that of the shareholders.

Watkin and Quilter were eminent in their respective endeavors which overlapped with their railway activities. There was no indication of disharmony between the two external auditors. They likely knew each other before becoming the HBC's external auditors. Watkin had formed the IFS to acquire the shares of the HBC, and was thus well known to the HBC shareholders. He was still a member of the British Parliament. In 1845, he became secretary of the Trent Valley Railway, which was subsequently sold to the London and North Western Railway Company by which he was also employed [Sutton, 2004]. In 1853, he became the general manager of the Manchester, Sheffield, and Lincolnshire Railway. By 1865, he had become the chairman of the Manchester and Liverpool and the Grand Railways [Hodgkins, 1999, p. 2].

Quilter had also been active with railways as an auditor rather than as an investor [Edwards, 2004]. As an accounting expert, he was invited in 1849 to present evidence to a House of Lords select committee (Monteagle Committee) on the audit of railway accounts. The committee was established to investigate the "railway mania" of 1845. Quilter testified that (unnamed) railway companies were paying dividends out of capital rather than profits thus misrepresenting the financial situation [Bryer, 1991, pp. 456-457]. One aspect of Quilter's evidence was his stated opposition to any requirement that the auditors of railway companies be shareholders. Accordingly, he also believed that auditor ownership of shares compromised independence. He advocated the replacement of the shareholder auditors by professional auditors as was done by the HBC. Quilter became the sole external auditor for the HBC.

From 1869, the same auditor statement "examined and found to be in accordance with the Books, Accounts, and Vouchers of the Company," was used until 1892, when it was changed to [HBC, annual report, 1892]: "I have examined the books, accounts, and vouchers of the company in London, and the various authenticated statements and certificates received from Canada, and I hereby certify that the balance sheet and profit and loss accounts are in accordance therewith. Thomas A. Welton, Welton, Jones & co., 5, Moorgate Street, London, E.C."

Thomas Welton, from the same firm as Quilter [Matthews *et al.*, 1998, p. 26], became the HBC's external auditor in 1889 in succession to Quilter. Welton had also been active with the formation of the IAL [Walker, 2004, p. 143]. Subsequently in 1892, as president of the ICAEW, he lauded the "security we have taken, in the way of articles and examinations, for the proper training of the next generation of accountants" [Anderson *et al.*, 2005, pp. 22-23].

Governor Donald A. Smith noted at the 1892 general court that, "there is also appended to the statement of accounts the external auditor's certificate, more extended and more precise than in former years." The extended certificate noted that "various authenticated statements and certificates received from Canada" were included in the audit and the auditor's explicitly certified balance sheet and profit-and-loss accounts.

A major change came in the 1901 auditor's report, when Thomas Welton, the external auditor, specified [HBC, annual report, 1901]:

> In accordance with the provisions of the Companies' Act, 1900, I certify that all my requirements as Auditor have been complied with. I report to the Shareholders that I have audited the above Balance Sheet, and, in my opinion, such Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs as shown by the Books of the company in London, and the audited statements received from Canada.

In 1909, there was a slight change to the auditor's statement. Welton dropped "the Companies' Act, 1900" basis for the audit. He also referred to the accounting documents as "certified" rather than audited. The latter was a correction. Although external auditors were hired for the London financial statements from 1866, these external auditors did not travel to Canada to audit the accounting records. Welton, as well as the external auditors before him, depended on others to verify the HBC's Canadian accounting records. These records were not verified by the external auditors until 1912, as will be discussed later in the paper.

Chandler and Edwards [1996, p. 17] report on an 1890 survey by a senior partner on common certifications contained in external audit reports:

> The most common certifications included the succinct, if uninformative, 'Audited and certified,' 'Audited and found correct,' and simply 'Audited'…The clear implication being that the signature of a reputable accountant was sufficient to attest to the reliability of the accounts. Indeed, according to Pixley [an auditing textbook author], the last-named certification was the strongest the auditor could give as it implies that without a single reservation the accounts are correct in every particular…[The senior partner] favoured what would today be regarded as less primitive formats, including the following which anticipated fairly well the contents of the Companies Act 1900.
>
> We have examined the foregoing Balance Sheet with the books of the company, and in our opinion it is a full and fair Balance Sheet properly drawn up, so as shown by the books of the company…

The death of the external auditor, Mr. Thomas Welton, was announced at the July 18, 1918 general court. He was the company's third external auditor. Mr. Welton was replaced by Messrs. Deloitte, Plender, Griffiths & Co. They used similar wording with their first audit in 1919; the major difference was the use of "we" for the auditor rather than "I."

The London external auditors made their judgments on the company's financial statements which included documents prepared in Canada. The vast majority of the HBC's business had always been conducted there. As the external auditors were in London, there were requests for the verification or audit of an increasing number of recorded Canadian transactions. From about 1892 to 1911, the governor and committee, with the cooperation of the London external auditor and the commissioners (senior Canadian managers), hired "auditors" in Canada [HBCA. A.12.ft203.1.1-14]. The London external auditor provided instructions for the audits of the cash accounts and inventories primarily that were sent annually to the London accounting office. For example, in 1897, the London external auditor, Welton, wrote the following letter requesting the Winnipeg "auditor" (a Bank of Montreal manager) to verify the balance sheets, trading accounts, and profit-and-loss accounts [HBCA. A.12.203.1.13-14].

> Dear Sir,
>
> Audit at Winnipeg
>
> Referring to our conversation on 8th inst., I beg to say that I agree in thinking that efficiency in this case is more important than any small economy in the fee paid.
>
> The auditor seeks to check the voucher for each expended and agree the balance of cash monthly. I presume he also sees the books periodically (at least annually) and verifies a balance sheet, trading account and profit and loss account. The account current with the head office is doubtless referred to in this connection and any items not yet responded to are considered, as to the time having been adequate for a response, and as to anything peculiar in themselves. Items out of date (which ought to have been responded to) should be reported to Head Office.
>
> The auditor cannot be expected to test valuations, but should see that the whole of the inventories are in, have been duly certified by proper persons, and are summarized accurately.
>
> As respects issues of goods
> (a) to fur stations
> (b) to shops
>
> there is doubtless a systematic record of such issues and a proper officer (other than the auditor) whose duty it is to see that these are acknowledged and a note made systematically of the fact. The auditor might see whether any acknowledgment was wanting which ought to have been received.
>
> The only real test on the receipt side of the cash account is the making out and keeping of books, invoices

> and statements for debtors by men who do not handle cash and the certainty that if each was not duly credited to debtors these men would apply for payment until proof was afforded by such debtors that payment had been made.
>
> As regards sale shops, a custom has been in use here of invoicing all goods to sub-stores at fixed nominal prices, so that in sale books both nominal and real prices are shown and the stock, taken at nominal prices must agree. It is for your commissioner to consider whether this plan can be employed but it would have little to do with the audit.
>
> [signed Thomas Welton]

This arrangement was observed by Deputy Governor Skinner and committee member Burbidge when they toured the HBC's Canadian operations in 1910 for the purpose of assessing retail opportunities [HBCA. A.12.203.1.43]. Skinner was knowledgeable on financial matters, while Burbidge understood retailing since he was the managing director of Harrods Limited, the London department store. Instead of part-time bank managers and the HBC's accounting staff, they recommended a professional auditor. Two reasons were given. First, Canada-based HBC accountants, as subordinates, were not able to question the vouchers of the three commissioners. Second, the pending retirement of a Bank of Montreal manager provided an opportunity to change the process. Skinner and Burbidge wanted professional auditors for the growing Canadian operation rather than an ad hoc combination of accounting employees without independence and part-time bank managers. Marwick Mitchell, an American firm with a Winnipeg office [Boys, 1989], was contacted. Marwick Mitchell presented the HBC with an external audit proposal that included purchasing, sales, cash, capital and revenue expenditures, accruals and allowances, inventories, bad and doubtful accounts, land department, stores, general, reporting, and remuneration [HBCA. A.12.203.1.51-59]. The firm was hired with the governor and committee reducing the scope: "Instead of the exhaustive method proposed, the [governor and committee] desire Marwick Mitchell…audit Winnipeg books as at present kept for the current year beginning February first" [HBCA. A.12.203.1.63].

## MANAGEMENT ADVISORS

The growth in British joint-stock companies during the last half of the 19th century encouraged shareholders to demand that the company exert fiduciary responsibility. In this context, the HBC operations in Canada were evolving from entirely barter trade to cash transactions. The operating or management accounting statements for barter had been relatively simple with relatively few different accounts.

A memorandum dated April 30, 1889 from the external auditor, Thomas Welton, to the London governor and committee lamented the condition of the fur trade or operating statements and made recommendations for improvement [HBCA. 67.26.17]:

> The mode in which the company's accounts are kept is essentially that of single entry.[3] The London books no doubt are on a double-entry basis, but as the outcome of each successive outfit is merely an inventory of assets plus the shipments made to England, there are no means of preparing an orderly statement of Profit & Loss, or of arriving at a regular comparison of one year's business cost with that of another year. It is not shown for example what the payroll of the fur trade was in any year, nor what money was drawn by the several stations from the chief offices on the other side, in addition to the stores and goods forwarded to them respectively, nor to what use such money was applied.

In a barter economy, the HBC had a meaningful list or chart of accounts; all inventories, trade goods and supplies, could be lumped together without clearly differentiating between cost of goods sold and inventory. The replacement of barter with cash meant there were in the HBC's Canadian business for the first time cash transactions, (i.e., cash outlays to pay for trade goods and supplies purchased from vendors in Canada and cash inflows from Canadian customers). Welton noted that the accounting for these cash flows with the barter system was to add or subtract these flows of cash from the overall cash generated from the fur trade. When cash transactions were a small part of the business, this was not a problem. However, by 1889, these cash transactions were a significant part of the business, thereby distorting the fur-trade accounting statements.

Welton believed that the wide variety of items included in the specific balance sheet item, "inventory," led to inaccurate information. As an example, Welton stated "(a) large increase

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[3] At the time that these changes were being proposed, a part of the work of external auditors involved introducing double-entry bookkeeping [Edwards *et al.*, 2007, p. 83].

of payments might indicate a new policy of purchasing supplies elsewhere than in England, or might mean that a greater portion of the furs shipped had been purchased for cash" [HBCA. A.67.26.21-22]. His contention was supported by item 70 of the HBC's 1887 "Rules and Regulations," which showed the components of inventory to include such heterogeneous assets as trading goods, supplies, country-made articles, livestock, outstanding balances, buildings and land, ships, etc. [HBCA. D.24.9.13]. Welton's recommendations led to the division of the inventory account into cash, goods held for barter, furs and country produce, livestock, ships and steam boats, and other assets. The purpose was to differentiate between the amounts of assets and liabilities for current accounts, for barter, and for other purposes [HBCA. A.67.26.17-23]. This was the first time in more than 200 years that the Canadian operation reported fixed assets.

To ensure proper recording of cash transactions and communicating those transactions, Welton further recommended the following records be sent to the London accounting office: receipts and payments in account with head office; receipts and payments in account with officers and servants; receipts and payments in account with persons having current accounts; receipts and payments connected with the fur trade, under several headings.

Welton's recommendations led to the trading account which is shown in pre-printed format in Exhibit 1. The trading account replaced the balance sheet as an operating statement. With the previous barter trade and no-fixed assets, the balance sheet could satisfactorily calculate profitability. Welton's recommendations led the HBC to manage its fur posts and saleshops with financial information.

By 1896, some of the pre-printed forms had been customized for the saleshops which had been established in 1871 [HBCA. D.24.11.1-9]. An important change to performance measures was the reporting of the return on capital employed (ROCE) by fur posts and districts, and saleshops. ROCE was the profit or loss from sales divided by the capital employed. With the HBC operating almost entirely in a cash economy, the financial records became more detailed and were used more frequently because of improvements in communications and transportation.

## EXHIBIT 1

## Trading Account Format

Trading Account _______________District Outfit 1910, Form 20
To inventory of goods
To goods from depot and mills
To goods and country produce purchased
To goods from other posts, etc.
To freight on goods
To insurance on goods __________

By supplies on expense accounts
By supplies on servant accounts
By supplies to other posts, etc.
By inventory of goods __________

Net cost of goods sold
By cash sales
By credit sales
By bartered for furs, country produce
Gross profit (Per cent. Of C.L.)

*Add* - Gain on: live stock, bad debts recovered, fur purchased, [Aboriginal] debts recovered
__________

*Less* - Expenses as per Form No. 14
Repairs and improvements (annual depreciation)
Loss on articles at fixed prices (goods depreciation)
Loss on: bad, doubtful, [Aboriginal] debt __________
Apparent gain

==========

Furs purchased
Cash
Freight, insurance, packing, etc.
Bartered for goods
Credit [Aborigines]
Credit Customer __________
Cost
Tariff valuation

Gain exclusive of profit on goods bartered

__________

==========

Source: HBCA. D.31.14.

These actions of the external auditors were expected of the "professional" external auditor. In 1883, *The Accountant* was quoted in Maltby [1999, p. 43] as saying:

> A true audit…goes far beyond the checking of vouchers, items and balances. It means behind the scenes, searching out the causes by which the effects have been created, the discovery of managerial errors, and the suggesting of remedies. A true auditor is in the confidence of his client. The latter almost invariably consults him on matters for removal from the simple question of the balance-sheet and profit and loss.

Welton was obviously a "true auditor."

## CONCLUDING COMMENTS

The regulatory requirement for external audits in many industries in the last 40 years of the 19th century was a major event in the development of the public accounting profession. Similarly, the 1866 introduction of external auditors was a significant accounting event not just for the HBC but for other public companies as the driving force was not regulation. It was the shareholders who saw the benefits and who requested that the financial statements be audited to make them more useful. In that way, it was an early example of shareholders and managers with external auditors working together in pursuit of standardized and informative audited financial statements. The purpose was to provide the shareholders with a better understanding of the company's ability to pay dividends and to expand in North America.

The introduction of the external auditor at the HBC was a result of three forces that reinforced one another. First, the HBC's shareholders that came after the IFC were more demanding then prior owners. Second, there was a capacity among London accountants to provide external audit services. These external auditors were keen on pursuing new businesses and turning themselves into a new knowledge profession. Third, the British Parliament was passing various acts for regulated companies that required audited financial statements. Even when regulation was missing, this signalled that audited financial statements provided more useful information than unaudited ones. In this context, the HBC appointed external auditors decades before legally required to do so.

The external auditors also had a significant impact on how internal or management accounting was conducted. With the

HBC, external auditor Welton assisted with the transition of the management accounting from a barter economy to one in which cash predominated. The external auditor's recommendations were completely accepted. In this way, the external auditor served as an advisor to the HBC's management for improving the precision and thereby the effectiveness in using financial information to manage the hundreds of fur posts and saleshops.

The HBC had a long history with its external auditors. When the HBC's head office was moved from London to Canada (Winnipeg) in 1962, the board (the name for the governor and committee after 1930) decided it only needed one external auditor. The London external auditor from 1918 to 1962 was Deloitte, Plender, Griffiths & Company. The Canadian external auditor from 1911 to 1962 was Peat, Marwick, Mitchell & Co. Since more than 90% of the HBC's operations were located in Canada, the board recommended that the Canadian external auditor be appointed for the entire company. Peat, Marwick, Mitchell & Co. was appointed the sole external auditor for the HBC, and remained so until 2005, but with the name of KPMG LLP.

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