1977

Report of tentative conclusions: letters of comment

Commission on Auditors' Responsibilities; Cohen Commission

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CPA

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B. L. Thurman, Jr.
Assistant Comptroller

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Lonnie A. Arnett

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Orrin T. Colby, Jr.
Assistant Controller

A-32 American Bar Association
Joseph Hinsey, Chairman
Thomas E. Baker, Chairman

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S.C. Gross
International President

A-34 New York State Society of CPAs
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Executive Director

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Controller

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S.R. Sibley
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J. C. Jacobsen

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J. Lee Ledbetter
Vice President - Finance and Controller

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Bernard Z. Lee
Managing Partner

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A-41 William A. Bryden
CPA

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Kenneth E. Tigges
Vice President and Comptroller

A-43 Chemical New York Corporation
George C. Deecken
Controller

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D. W. Dusendschon
Assistant Controller

A-45	General Electric T. O. Thorsen Vice President - Comptroller
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A-49	Times Mirror Harvey V. Guttry, Jr. Vice President and Controller
A-50	Household Finance Corporation J. W. Ostrem Group Vice President
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A-54	New York State Society of CPAs (revised comments) Robert L. Gray Executive Director
A-55	George L. McCalla
A-56	Arthur Young & Co. Fred L. Tepperman
A-57	Frederick B. Hill and Company Patrick S. Callahan Seab E. DuVall, Jr.
A-58	National Association of Accountants Martin V. Alonzo Chairman

A-59	The California Society of CPAs Louis G. Baldacci Executive Vice-President
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A-61	General Mills, Inc. E. K. Smith Vice President and Controller

CPAE

A-1

Continuing Professional Advancement & Enhancement

April 18, 1977

Mr. Douglas R. Carmichael
Commission on Auditor's Responsibilities
1211 Avenue of the Americas
New York, New York

Dear Doug:

I have just finished scanning the Commission's Report. In all material respects, outstanding -- both courageous and practical -- conceptual and logical -- a real giant step. Hang on, hopefully.

There is, to me, a glaring omission in the Recommendations for Changes in the Legal Environment, about which I would like to make an appearance before the Commission. A strong recommendation should be made on the makeup, duties, responsibilities (if you please, mandates) of state boards of accountancy, the only instrumentalities possessing police power over the entire profession.

I may be in a unique position to testify on this matter. After almost thirty years in public practice, including starting my own practice, partnership in a large local firm, management of a state-wide firm and managing partner of a large office of a national firm, I am now devoting virtually all my time to various educational activities. C.P.AE. is a family-owned company which holds review courses for CPA exam candidates and conducts accounting and auditing professional education courses and re-exam review courses for local firm professional personnel. C.P.AE. also conducts peer reviews for local firms -- about 20 to date. I am now in my fourth year teaching auditing at both the graduate and undergraduate levels at Florida International University on a year-round basis.

More germane, I served as member and Chairman of the Florida State Board of Accountancy 1967-74 and have been one of its principal investigating officers since then, mostly investigating professional accounting and auditing matters involving local firms. As a member of the Board, I made the motion which set the wheels in motion for mandatory continuing education in Florida, early in this game. I am a co-father and principal advocate of a periodic re-examination as an alternative to CPE courses. More significantly I believe, I am credited as the principal person responsible for changing the Florida Board from a typically passive one to the now most activist in the nation (yet still a long way from optimum for a variety of reasons).

In addition, I would like to have as much of the Appendix B stuff not otherwise available which is available for distribution or purchase.

Very truly yours,

R. Bob Smith, CPA
President

CPAE INCORPORATED

Continuing Professional Advancement & Enhancement

June 7, 1977

Mr. Douglas R. Carmichael
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, N. Y.

Dear Doug:

I will plan to be at the meeting the morning of June 22nd.

Within the time frame of twenty-thirty minutes, I would also like to discuss the CPA examination and education - a continuum. I am in the process of an analysis of Florida exam statistics, have followed Bob Ellyson's NASBA committee closely, operate a CPA review course and, of course, teach at Florida International University. The NASBA committee has taken a first step in recommending better management of the process.

Simply stated, just as the enhancement of the role of boards of accountancy is the key to effective regulation of the profession, changing the exam from its present memory-oriented state and trend to a thoughtful, analytically-oriented state is the key to the future of the people in the profession. As goes the exam, so goes the education and the caliber of educators. As go they, so go the caliber of entrants into the profession.

A key shift is needed. What we primarily and ultimately do in this profession, either as outside "auditors" or inside "accountants", is to deal with the "fair presentation" of information. The process is one of critical, skeptical appraisal. In essence, we are all "auditors". Perhaps dramatically stated,students should major in auditing in schools of auditing (taking whatever accounting is necessary to aid that process) to become experts in auditing (not accounting), take an examination in auditing theory and practice (including the necessary accounting, law and regulation) to become Certified Public Auditors to render either auditors' or unauditors' reports. Putting write-up shops to one side (we shouldn't be in that business anyway), everything else we do, irrespective of firm size, is ancillary to this central purpose.

Very truly yours,

R. Bob Smith, CPA

A-2

EMORY UNIVERSITY
ATLANTA, GEORGIA 30322

School of Business Administration
Office of The Dean

April 19, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Doug:

I am teaching a graduate seminar at Emory University as part of my Dean's Role and one of the students is working on the report of the Cohen Commission. For that reason, I spent a good deal of time this weekend reading the report in detail. I want you and the other members of the commission to know that as an AICPA board member who helped appoint the commission, I honestly believe it is one of the finest and most thoughtful documents ever put out on the accounting and auditing profession. I congratulate you and the others for the ability to dig under the surface and to respond with non-political answers to serious problems.

The only part of the report that is not in depth is the material on pages 88 and 89 which relate to the Uniform CPA examination. I am a member of the current national CPA review committee. If your commission could get the tentative report of our committee when it is released you would find that the CPA examination needs some thoughtful direction.

For example, the auditing standards commission should tie in to the Board of Examiners on the CPA exam. The exam tends to be much more theoretical than practical. The reason for it is that practitioners simply have not had a vehicle or perhaps the desire to submit the very practical and real problems of the profession. This in turn means that the textbooks themselves that are used in the schools tend to be highly theoretical in auditing and therefore, the schools are really not preparing individuals for the tremendous responsibility of auditing. While this is overcome by the larger accounting firms through training and development, the smaller firms must use the AICPA professional development courses and these in turn may not get down to the real day-to-day problems.

This is a small suggestion in relation to your total report. You will have difficulty in illuminating sub-standard practice. We have tried for generations to find a way for the profession to monitor itself but nothing seems to work. Part of it is concern over your competitors professional standing, part of it is the time problem, and part of it is a lack of facts that enables a CPA to report on another CPA's sub-standard work. I hope you find a practical answer.

Again, congratulations on a superb job.

With best wishes.

Sincerely,

Al

Albert J. Bows

AJB/emb
CC: Mr. Manuel Cohen
Mr. Robert C. Ellyson
Mr. William H. Van Rensselaer

A-3

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April 19, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

I have just finished reading your Report of Tentative Conclusions. It is a splendid piece of work that easily sustains the reader's interest, and the conclusions are significant and clear. Particularly important, it seemed to me, were your Sections 3 and 7 (which should result in major changes) and I was glad to read the careful analysis behind your conclusions in Section 10. Congratulations.

Is it possible to obtain copies of two of your research project reports: Jaenicke on "The Import of the Current Legal Climate" and Radoff's "Court Decisions on Auditors' Liability: the Role of GAAP and GAAS?"

Yours sincerely,

Frank Wheat

Francis M. Wheat

FMW:MC

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Wright State University

Dayton, Ohio 45431   513 873 2377

Department of Accountancy

April 19, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

I have just read the conclusions and recommendations of the Commission on Auditors' Responsibilities and I am deeply impressed with the quality and direct of your recommendations. The entire report is much better than I had expected; it really gets to the heart of the issues in a number of controversial areas. Normally, I do not give my opinion so generously without appropriate monetary consideration but your recommendations so moved me that I feel morally obligated to write this letter. As a college professor with business experience in auditing and investment banking, I strongly support these particular recommendations:

1. A separate note in financial statements should be required on uncertainties similar to that required on accounting policies. This is an excellent recommendation; it should be adopted as soon as possible.

2. It should be a duty of the independent auditor to search for illegal or questionable acts and the auditor should be expected to detect those acts that the exercise of professional skill and care would normally uncover. This is a very good recommendation; however, I would expect that some difficulties will arise in trying to implement this particular requirement of accountability.

3. The auditors' standard report should be revised. A new, expanded, flexible report should be developed which consists of a series of paragraphs, each describing a major element of the audit function. I was really impressed with this recommendation.

There was only one area of your recommendations that I was not completely pleased with: the section on the Education, Training, and Development of Auditors (Section 8). Here I question the suggestion that an educational program should include a four-year undergraduate and a three-year graduate program in a professional school of accounting. Briefly, I believe that the desired educational task could be accomplished just as successfully in 5 or 6 years in a well-organized, better structured accounting program within the Accountancy Department of a school of business administration. Nevertheless, I fully endorse your recommendation that accounting educators who are not CPAs (like myself) should be allowed to join the AICPA and state CPA societies and be able to take an active part in their professional activities.

Again, I give you the highest possible praise for your Report on Auditors' Responsibilities. Yes, there IS a big gap between the present performance of auditors and the expectations of the users of financial statements. As a sophisticated user of financial statements for many years now, I sincerely believe that the adoption of the Commission's recommendations is desirable and will be successful in greatly reducing the amount of that gap in the future.

Cordially yours,

Dean S. Eiteman

Dean S. Eiteman
Professor

A-5

DONALD A. HELMER
CERTIFIED PUBLIC ACCOUNTANT
429 Central Avenue
FARIBAULT, MINNESOTA 55021
507/332-7447

May 1, 1977

Douglas R. Carmichael
Research Director
Commission on Auditors Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

Following my review of the "Report of Tentative Conclusions", the following two items summarize what I believe they would accomplish:

1) Shift some burden of lawsuits resulting from the use of undefined words or phraseology from the Auditor to Management.

2) Increased and improved audit procedures and increased auditor involvement in client operations with better educated, publicized, paid and independent auditors.

These may be desireable, but I believe auditor uncertainties evolved in the following manner.

In the 1960's and earlier it was common to include in financial reports a summary of the auditing procedures performed along with the results obtained. Since that time auditor responsibility has evolved through the scope expression, "based upon generally accepted auditing standards, etc". This has resulted in auditors assuming the role of insurer as evidenced by legal claims filed by disgruntled stockholders, Managements, and the S.E.C.. Those auditing standards have not been generally accepted because it is impossible for the standards to encompass all areas where the auditors judgement and skill must be applied in todays diverse business environment. I do not suggest that auditors retreat to the past, however, your recommendations do not address the problem that has been thrust on todays auditor.

The problem causing todays auditor uncertainty is the impossibility of performing on an audit as a ; lawyer, actuary, appraisor, engineer, risk-management specialist, etc. These are the roles the auditor is expected to assume in the course of performing the audit function "based upon generally accepted auditing standards, etc.". The largest accounting firms cannot afford to have this variety of skills readily available for the audit engagement. Some of the large accounting firms do have these skills available in conjunction with their Management Consulting services. However, this raises two questions, 1) independence and 2) the accounting firms internal ability to review and judge the specialists conclusions in the course of an audit.

The resolution of the auditor uncertainty may be accomplished by developing a system of financial reporting with attestations from the professions, including auditors, in areas where their respective expertise and judgement is required in assessing and reporting an Management business decisions affected by the ever present fluidity of the business environment.

Respectifully submitted

Donald A. Helmer CPA

Donald A. Helmer, CPA

DAH:jjh

A - 6

RECEIVED

MAY

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CERTIFIED PUBLIC ACCOUNTANT
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April 21, 1977

American Institute of CPAs
1211 Avenue of the Americas
New York, NY 10036

Re: Report of the Commission on Auditors' Responsibilities

Gentlemen:

Since I do not have the addresses of the members of the Commission I will just have to satisfy myself with a hearty - Bravo!- addressed to them through the Institute. Obviously, the report is filled to overflowing with provokative ideas. The reasoning and lucid style of the authors leaves a reader with a feeling of inevitability about the broad outline of their proposal. I am on my second reading now and probably will do it yet again. Congratulations!

Very truly yours,

R J Sullivan

Richard J. Sullivan

A-7

TULANE UNIVERSITY
Graduate School of Business Administration
NEW ORLEANS, LA 70118

May 9, 1977

STEPHEN A. ZEFF
Professor of Accounting

Telephone:
(504) 865-4612

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, NY 10036

Dear Doug:

I have a few comments on those parts of the Commission's report which I have been able to read in the last few weeks.

On page 78, I am not at all sure that the proposed penultimate paragraph of the Report of the Independent Auditors is necessary. The auditors' review of controls would, I assume, be covered by the statement relating to controls in the third paragraph. I don't see why this additional reference is required even in the present climate. The last paragraph would, I suppose, be most important in the case of companies outside the jurisdiction of the SEC. If the auditors did not have access to the audit committee of the Board--if there were an audit committee at all--this point should be made known.

I was particularly pleased to see the Commission's recommendation on page 89 that state CPA societies develop a form of membership to accommodate educators who are not CPAs. A number of state societies have already taken this initiative, and I am urging the incoming president of the Louisiana society to do the same.

I hope to study other parts of the Report carefully in the near future, and if I have any comments I will write again.

Sincerely,

Steve

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THE INSTITUTE OF INTERNAL AUDITORS, INC.
INTERNATIONAL HEADQUARTERS, ALTAMONTE SPRINGS, FLORIDA 32701 PHONE: 305·830·7600

May 16, 1977

Mr. Douglas R. Carmichael
Managing Director of Technical Services
AICPA
1211 Avenue of the Americas
New York, N. Y. 10036

Dear Doug:

The Institute of Internal Auditors desires to make a written presentation to the Commission on Auditors' Responsibilities on their Report of Tentative Conclusions. We will send this to you no later than June 13.

We would appreciate it if you would send copies of the Commission's Report of Tentative Conclusions to the individuals as shown on the attached list, as we desire to obtain and consolidate their comments. Thank you.

Sincerely yours,

Bill

William E. Perry, CIA, CPA
Director of EDP and Research

WEP/mp

Enclosure

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A-9

JOHN R. CONNELLY, JR.
2621 Tremont Street
Dover, Ohio 44622

May 19, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditor's Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

I have read with great interest the Report of Tentative Conclusions of the Commission. They are to be commended for doing an outstanding job.

As a former practicing certified public accountant with one of the "Big Eight" firms, I have great empathy for many of the comments and recommendations of the Commission. As a practicing manager in industry I believe that the study has been long overdue.

My only contribution to add to this great work is to share with you my understanding about the language of the report of independent auditors as the draft appears on page 77.

The expression "present fairly" as used in the opinion paragraph has been a troublesome convention for too many years. Auditors have never been able to adequately express their feeling as to just what it is that financial statements depict for the entity. The Commission's choice of terminology by using "in all material respects" is an improvement in that it is more precise in implying a quantitative criterion. But materiality alone is inadequate.

More than quantitative criteria must be used to prepare financial statements. There must be a recognition of the purpose of financial statements. Financial statements communicate the history of an entity. Additional criteria are necessary to make sure that all of the history of an entity is represented by the financial statements. The popular term "off balance sheet financing" suggests that our criteria for measuring the adequacy of financial statements is incomplete. Time is a changing influence in itself. Twenty five years ago

JOHN R. CONNELLY, JR.

2621 Tremont Street
Dover, Ohio 44622

we didn't even think about capitalizing finance or leverage leases; today we wouldn't think of not doing so.

There must be an entity criterion that describes the nature of the business so that appropriate recognition is given in the financial statements to portray a financial profile of what the entity has done within all of its functional jurisdiction boundaries. Our financial recording techniques must provide for producing a financial image of the underlying business activities that have occurred not just in their cash terms, but to portray in adequate financial terms of services received, of services rendered and of financial medium of exchange devices, the substance of what the business activities really are. Under this criterion, "off-balance sheet financing" would never have occurred in our accounting history.

I suggest the use of the term "presents a reasonable impression". Why? Simply, because I believe that's what financial statements do. They present a reasonable impression not of isolated financial transactions, nor of just assets or liabilities separately, but of the whole business and its "completed" transactions todate and its "uncompleted" transactions. Financial statements communicate aspects of the historical life span of an enterprise. As such, financial statements are molded by a significant influence - the influence of management. Financial statements for an enterprise present either a reasonable impression of the business enterprise or they do not. Financial statements put into a common denominator all of the actions of management in its functions of marketing, production and finance to portray a financial profile of results and expectations within a compartment of time.

My recommendation to the American Institute of Certified Public Accountants is to provide for the implementation of all of the Commissions recommendations before the end of 1978.

Sincerely,

John R. Connelly, Jr.

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avery, olson, christie, lyle
certified public accountants
915 W. SECOND AVE. – SPOKANE, WASHINGTON 99204

May 19, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Re: The Commission on Auditors' Responsibilities
Report of Tentative Conclusions -
Section 7 - The Auditor's Communication with Users

Gentlemen:

Your opening sentence of Section 7 in Communication states: "Evidence abounds that communication between the auditor and users of his work -- especially through the auditor's standard report -- is unsatisfactory."

I suggest that you have identified one of the major problems of our accounting profession. Further, I respectfully submit that the Commission's recommended illustration of a revised auditor's report does not solve the problem.

It is requested that the Commission reconsider this problem giving study to the following thoughts.

1) Accounting is essentially a measurement process. The heart of this process is to express the economic condition and operations of a business unit in numbers. Numerical expression is the essence of measurement.

2) The accounting profession has done a remarkable job in mastering this process.

3) The auditor has failed in his "certification" of this measurement. Consider the auditor's key expressions:

   "in accordance with generally accepted auditing standards..."

   "included such tests ... and other auditing procedures as we considered necessary in the circumstances."

   "present fairly the financial position ... and results of operations ... in conformity with generally accepted accounting principles consistently applied."

3) Cont'd. -

These phrases are so vague they communicate little.

Consider for a moment the auditor's reaction if the accountant discharged his responsibilities with similar expressions on his financial statement:

CPA Corporation	Balance Sheet As of December 31, 1976
ASSETS -	
Current assets:	
Cash	Substantial balance
Receivables	Mostly collectible
Inventories	Generally saleable
Plant, property and equipment	Fair condition under the circumstances
Accumulated depreciation	Consistently applied
LIABILITIES AND STOCKHOLDERS' EQUITY -	
Liabilities	No more than considered necessary
Stockholders' equity	Fairly substantial

Obviously, generalized statements in the measurement process are useless. As a reader, I have received no useful information on the financial position of the above corporation.

Likewise, even with training and experience as a CPA, I receive no useful information from the standard auditor's report.

.... I do not know what degree of reliability I can place on the statements.

.... I do not know what allowable error is permitted in the report.

.... I do not even know what accounting principles were used, just that they are generally accepted, and do not even know by whom.

4) Suppose the auditor were required to express his "certification" numerically in the following manner:

Auditor's Report

"We have examined the balance sheet of CPA Corporation as of December 31, 1976, and the related statements of income and changes in financial position for the year then ended.

The financial statements have been prepared by the management of CPA Corporation.

We audited the statements utilizing standard statistical sampling techniques. Our findings indicate the following reliability and possible error in the amounts stated on the financial statements:

	Reliability	Maximum Tolerable Error (or $ Amount ±)
ASSETS:		
Cash	99%	½%
Receivables	95%	2%
Inventories	95%	5%
Plant and equipment	90%	10%
⋮		
DEFERRED DEVELOPMENT COST	30%	100%
⋮		
INCOME	95%	6%
EXPENSES	95%	6%

Our evaluation of the accounting system and internal control indicates a 95% general reliability.

The accounting principles used by company management are detailed in the "Statement of Significant Accounting Policies".

We concur in the principles used except (note any exceptions).

Subject to the degree of reliability, allowable error and accounting principles used, as stated above, we certify that the financial statements of CPA Corporation present accurately its financial position at December 31, 1976, and the results of operations for the year then ended."

February 20, 1977

Avery, Olson, Christie & Lyle
Certified Public Accountants

4) Cont'd. -

An auditor's report of this type has certain advantages:

1) It removes the implication that accounting statements are exact, a wide spread misunderstanding among users.

2) It communicates to the user the degree of reliability and potential error in numerical terms so he may make an informed decision. Our present decisions are an act of blind faith in the auditor.

3) It establishes a more definite responsibility for the auditor rather than the present vagueness.

I sincerely hope consideration will be given to a study of this approach.

Sincerely yours,

Joseph B Olson

Joseph B. Olson, C.P.A.

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PENNSYLVANIA INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Office of the President • 1845 Walnut Street • Philadelphia, Pennsylvania 19103 • (215) 491-1821

May 20, 1977

Douglas R. Carmichael, Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

This is to advise the Commission on Auditors' Responsibilities that the Council of the Pennsylvania Institute of Certified Public Accountants approved a resolution at its meeting on May 17, 1977 "to support the tentative conclusions of the 'Cohen Commission Report' as a meaningful basis for resolving the problems facing the accounting profession." The Council further directed that the report immediately be used as a means for educating members of the PICPA and the general public of the CPAs responsibilities.

In view of the Council's resolution, I have appointed a special committee to implement the resolution. As our plans develop, we will be glad to keep you advised.

Sincerely yours,

George L. Bernstein

George L. Bernstein
President

GLB:kvp

THE CLEVELAND ELECTRIC ILLUMINATING COMPANY
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VICE PRESIDENT & CONTROLLER
FINANCE

A-12

May 19, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

The Cleveland Electric Illuminating Company submits the following comments on the Report of Tentative Conclusions issued by the Commission on Auditors' Responsibilities. The Company furnishes electric service to about 700,000 customers in Northeast Ohio, has annual revenues of over half a billion dollars, gross property and plant investment of nearly two billion dollars and about 75,000 common and preferred share owners. As a corporate preparer and user of financial information, we find the report extremely well done and a credit to the Commission and others responsible for its publication.

In the preparation of the final report, we suggest that the recommendations (stated as forty in the current report) be listed succinctly in "laundry list" fashion, with reference to the page numbers on which the respective subjects are more fully dealt with. This would aid the reader to locate more conveniently the subjects in which he is especially interested, either currently or as a matter of future reference.

Of particular interest to us in the Commission's Report are the following points which we endorse and which warrant continuing attention and recognition:

1. The gap of misunderstanding between the intent of the auditor's report and its misconstrued interpretation by the general public -- and even some courts -- needs to be narrowed, even eliminated if possible. This calls for a more explicit message by the auditor to preclude its misinterpretation by others.

   In a matter related to the preceding point, the public must be made aware of the limitations of audits as a means for detecting evidence of fraud, illegal acts, or other irregularities.

3. Expansion of the audit function to include a more comprehensive study and evaluation of internal controls would enhance the credibility of the auditor's report. Information on this point would help the reader of financial statements to determine the degree of reliance he could place on the integrity of the statements.

4. Greater involvement by the board of directors or its audit committee in selecting auditors, setting the audit fee, and in establishing the audit scope should be encouraged. This is especially true of those firms which have only recently established audit committees as a condition of continued listing on the New York Stock Exchange. This would help to reinforce the auditor's independence of management, an essential ingredient to the auditor's objective assessment of management's judgment and stewardship.

5. A full-time Auditing Standards Board should be established, as recommended, to demonstrate the profession's determination not to forfeit its responsibilities to a governmental agency as some individuals have suggested. Also, broader participation in the standard-setting process by other affected groups should be encouraged.

6. Auditors should do more to ensure the adequacy of disclosure of uncertainties, recognizing the possible reluctance of management to be as candid as they should be in disclosing potential risks which may be adverse to their best interests.

7. The proposal that accounting firms exchange information on developments in the perpetration and detection of fraud seems a worthy endeavor. Likewise, pertinent details of audit failures should be published and disseminated to interested parties.

8. The auditor's responsibilities should not be expanded to embrace an evaluation of social programs, e.g., equal employment or environmental protection, except insofar as such programs may materially impact a firm's financial statements.

9. To increase the meaningfulness of the auditor's report to its users, the language and terminology should be made more meaningful. The expression "in accordance with generally accepted auditing standards," for example, has a meaning known only to the relatively few people who are familiar with auditing standards.

10. The evidence presented in favor of retaining the same audit firm should help to dispel the notion of some individuals that auditors should be rotated periodically.

On the foregoing points, we find ourselves closely allied to the positions expressed by the Commission. On the other hand, we find several points which raise questions in our minds, among them the following:

1. The statement on benefit-cost analysis (Page 53) raises the question of how to assess "the loss that would be sustained" when the consequences of any suggested misstatement or omission cannot be reasonably established unless such an audit finding is actually made. This suggests an attempt to measure the immeasurable.

2. The fourth paragraph of the suggested "Report of Independent Auditors" (Pages 77-78) seems to overstate the uncertainties which could undermine the validity of the audited financial statements. The comments as stated, although true, are sufficiently inflammatory as to cast aspersions upon the financial data.

3. Notwithstanding the responsibility of management to report on consistency in the application of accounting principles, it seems to us that a reaffirmation of the same nature in the auditor's report is still called for. We don't understand how a statement to this effect casts the auditor in the role of an "originator of financial information," as stated on Page 81. The last paragraph in this section seems a more reasonable alternative.

4. The conclusion that cost and time constraints have a negative effect on the auditor's <u>independence</u> (Page 92) is subject to question. The potential effect on quality is apparent, but independence shouldn't be affected.

We appreciate the opportunity to review and comment on the work of the Commission on Auditors' Responsibilities, and trust that our observations may be of some assistance to you. We will not make an oral presentation at your public meeting.

Yours truly,

Edgar H. Maugans

Edgar H. Maugans
Vice President and Controller

EHM:ag

cc: J. P. O'Brien
Price Waterhouse & Co.

Commission on Auditors' Resp.
1211 Avenue of the Americas.
New York.

H-10

Utrecht, may 17, 1977.

Dear Douglas.

I hereby sent you some remarks on the Report of Tentative Conclusions.
In the Summary of Conclusions and Recommendations you say that the financial statements are developed by and are the representations of management. I think that this is not wholly correct because the auditor certified these statements and if he certified them he is also responsible for it; because if he is not responsible for it what is then the use of the certification ? (I exclude ensemble acting from the responsibility of the auditor).

On page 4 you say: the auditor as an agent of social control. I believe that this is not be good if this would be so. In the circumstance that the auditor an agent is of social control he is - and must be- employed by the institute of the social control, in other words: he is employed by the Government. The task of the Government is to make the rules and norms for Social Costs and she must also audit or control these rules and norms.
The only thing that the auditor can and may do is to give information about costs or revenues. But the principal task of the auditor is to be a confidant for the whole community. The Government is a part of this community. Therefore is it not correct to give one of the members of the community more information than the others.
An other problem is the fact that the local rules and requirements of authoritative bodies in matters like air-pollution etc. can give the circumstance that the social costs for the same object diverge. In other words: in State one the auditor must say on subject A : no social costs; but in State two - same circumstances- he must say on the same object A ; social costs. The danger lies in the inconstancy way of information presentation. Like we say in the economic profession: an article cannot häve two cost-prices at the same time of cost-priceadjustment.

The auditor's relationship to parties interested in the audit function.
In this section you are saying: the auditor must be independent of management etc. But one party you did not mention: the other auditors. I shall explain this to you. The generally accepted accounting principles are mostly very detailed and there is little space for a own interpretation.
Let us suppose that on the matter B of an g.a.a.p. is a little space for own interpretation. The matter is important for the financial statement. Auditor A says: this matter must be disclosed and I cannot certify therefor the financial statement. On this very moment the company threats with: you certify the financial statement or you may go. The auditor goes.
Because there are always auditor's which have a very broad limit on cases which well or not may; thus it won't be problematic - for the company - to

and an other auditor who is willing to certify yhe financial statement.
We can also say: the auditor's are not solidary enough with eachother. This is a consequence of the fact that not everything is ruled.
But we have to weight this bias and a totally standarized control or auditing system. I don't know which is the best !!

I also want to make a general remark.
I am glad that the Commission has not attempted to provide a definitive assesment of the performance of auditors. The consequences of all the assesments and regulations is - in my opinion - that - in the future- it is not necessary - for the auditor- to make a judgement of the financial statements because the only thing he has to do is to ascertain himself that the company - which he is auditing- has followed all the regulations. We can also say : by a further regulation and standarization of the auditing principles there will be no room left for the skilled judgement of the auditor.

Section 2. Forming an Opinion on Financial Presentations.

In the beginning of this section You are speaking about a objevtive judgement. On page 19 you say:" A basic condition must be that the judgement have an objective basis" in other words: when two auditors must give a judgement on a subject - independently- they will have the same judgement. This is not realistic. You know this(page 19): the position that no objective basis exist to choose among alternative principles should not be taken lightly. If you want to achieve a objective basis for judgements than you must make regulations and accounting principles which are not open to doubt. This imply the basis of the regulations etc. have to be mathematic, because only mathematic principles are (in generally) not open to question. But this is in my opinion impossible.
Therefor I want to make the following suggestions: the generally accepted accounting principles must be extended with rules about to what extend these regulations are proper. This will have the consequence that the subjective opinion is - piece by piece- eliminated. On the other hand the notes by the financial statements must disclose the limits which are used. For example. the invoices: we have audited them with the unit-sampling-methode, limits certainty 95 %, maximun fault $ 200,000.
If this kind of information is in the notes than it will be possible to give a better judgement about the information and about the company itself.
I believe that this kind of information must be embodied in the financial reporting.

Yours sincerely

Rob G.Berkhof.
Vossegatselaan 13 bis.
Utrecht.
Nederland.

Commission on Auditors' Resp.
1211 Avenue of the Americas.
New York.

H-17

Utrecht, may 25, 1977.

Dear Douglas.

On page 28:Recommendations for improving reporting on uncertainties You discussed only that kind of uncertainties on which no body can say- in my o - pinion- something sensible.
But a kind of uncertainties which - principally- are based on valuations You don't mention.
For example: One of the assets of a firm is real property. The initial expen - se on 01-01-1972 was Hfl. 250,000. We may say deprecation $2\frac{1}{2}$ % p.a. (fiscally accepted). On 01-01-1977 this estate is valued on Hfl 700,000.(by three inde- pendent real-estate agents). When we look at the price-index for this kind of property we see a rise of 20 % p.a. total rise ± 150 %. According to the price- index Hfl.250,000 on 01-01-1972 is Hfl 250,000 x 250 % = Hfl 625,000 on 01-01-'77.
But in the financial statement the real property shall be glittering for Hfl. 250,000 minus (5 x $2\frac{1}{2}$ %) = Hfl.218,750..
Difference with actual price Hfl. 700,000 minus Hfl.218,750 =Hfl 481,250.
In other words: why don't we try to design a system in which we incorporate the matter I mentioned in the example, because the limits of these uncertain - ties are much more narrowed then the uncertainties You mentioned.
The example containes a very important problem by financial reporting: inflation.
In my opinion is it better to try to come to a system that can handle the infla- tion in the financial reporting. When we have accomplished this mission there will be less uncertaintie. At the same time it will be a perfect base to mini - mize Your kind of uncertainties, but a elimination of Your uncertainties is not possible because the great number of dependent variables which are concernt.

Yours sincerely

Rob G. Berkhof.
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Utrecht.
Nederland.

A-15

AT&T

W. W. Brown
Assistant Comptroller

American Telephone and
Telegraph Company
195 Broadway
New York, N. Y. 10007
Phone (212) 393-3034

May 27, 1977

Mr. Douglas R. Carmichael
The Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

This is to offer two comments regarding the "Report of Tentative Conclusions" of the AICPA Commission on Auditors' Responsibilities.

My initial comment is in the area of extension of the auditor's role; it impacts on other issues identified in the report as well. That is, the fact that management, the audit committee, and share owners need from the auditors an evaluation of the adequacy of internal controls of the company. The only guarantee any of these users have with respect to this important matter is an evaluation by an outside party. I am aware that existing generally accepted auditing standards (GAAS) provide for this service through a separate engagement; however, present GAAS also require that the auditor evaluate the system of internal control to determine the extent, nature and timing of audit examinations and while the client pays for this examination in the annual audit fee, the auditing standards do not provide for a report of findings.

Secondly, I believe the present process of establishing auditing standards is an effective one and that the AICPA should retain this responsibility. My concern is that far too many users of financial statement data are not sufficiently aware of nor given an opportunity to participate in this process; in fact, I am not too sure that all members of the Institute are given this opportunity. More exposure should be given to the pronouncements of AudSEC, and I recommend that public hearings be held prior to the issuance of the more significant pronouncements. This would give more widespread knowledge of the important activities of this body and provide an improved forum for interested parties to have their say.

I appreciate this opportunity to express my views on this matter.

Yours truly,

W. W. Brown

A-16

P.O. Box 2669
University of Arkansas
Fayetteville, AR 72701
May 31, 1977

Dr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, NY 10036

Dear Dr. Carmichael,

Following are my comments on Section 3 of the Report of Tentative Conclusions of The Commission on Auditors' Responsibilities. I may have comments on other sections at a later date.

The recommendation for a footnote describing material uncertainties and other uncertainities to which financial statements are subject is excellent. It should give the users of financial statements a better basis for evaluating the total information presented. However, the recommendations to relieve the auditor of the responsibility to evaluate and, where necessary, point out to the reader (with the "subject to" opinion qualification) the uncertainties that are so significant that the reader must exercise special caution in relying on the financial statements, is a step backward.

The information in this section does not support the conclusion and, in fact, contradicts it. The Armstrong Cork Company example is a case in point. The auditors apparently believed that there was a reasonable chance that the litigation could have a material adverse effect, but the footnote states that "... it is management's opinion that the potential liability could have no material adverse effect on the business or financial position of the company." There can be no question but that a reader of these financial statements would attach more significance to the litigation with the qualified auditors' report than without it. Yet, how can an auditor reasonably question management's subjective opinion in this case? They cannot, but they can emphasize the uncertainty through their opinion.

It is stated repeatedly that the auditor's reporting decision becomes a prediction of the outcome of future events. This is not the case at all. He evaluates the opinions of management, legal counsel and others and points out to the reader of financial statements when these opinions are insufficient, in his opinion, for a final determination of financial statement amounts. How can this function be reasonably placed on the reader? Who has the opportunity for detailed and in-depth discussions of the uncertainty with management at all levels? Who obtains legal representation letters from legal counsel? Who has access to and reviews in detail the legal documents where litigation is involved or cost accounting data, budgets and forecasts where recovery of cost of assets is involved? Who is in the best position to evaluate the significance of the uncertainty? The answer is obvious.

To eliminate the "subject to" qualification would be interpreted, and seemingly rightly so, as another attempt to limit the auditor's responsibility. The question now being asked by the public and Congress is what is the auditor responsible for? In this case, to say the auditor, with access to management, legal counsel, financial records, legal documents, etc. is not responsible for evaluating the significance of an uncertainty, but that the reader of the financial statements, which include a one (or ten) paragraph description of the uncertainty, is responsible can only foster the decline of the audit function in the public and Congressional eyes.

I appreciate this opportunity to comment on this important matter.

Sincerely,

Bill Glezen

G. William Glezen, Jr.

A-17

VALLEY NATIONAL BANK

MEMBER FEDERAL RESERVE SYSTEM HOME OFFICE: PHOENIX, ARIZONA

HOWARD C. McCRADY
SENIOR VICE PRESIDENT
CHIEF FINANCIAL OFFICER

June 3, 1977

PHOENIX
P. O. BOX 71 85001

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

We wish to register a generally negative reaction to the Report of Tentative Conclusions of the Commission on Auditors' Responsibilities. We believe the recommendations, if adopted, would result in more confusion among the users of our financial statements than currently exists, more expense to produce the statements, more expense for the audit and raise serious doubts in the minds of those of us who pay for audits whether they would be worth the cost.

More specifically, we offer the following comments:

1. A statement is made that "Many users are not aware, for example, that the financial statements are developed by, and are the representations of, management". One apparent theme running throughout the report is that the Commission wants to correct this deficiency. Users of financial statements have to put forth some effort to make proper use of such information. If they have not learned enough to know who prepared the statements they will never be able to comprehend them and auditors should not try to solve this deficiency.

2. We believe dropping the standard, easily understood certification letter would be a mistake. The sample letters shown on Page 77-80 would confuse the average stockholder (if he read them). A standard

letter (with or without the word "fairly") should continue to be used. Descriptions of how the audit was conducted could be carried in a special section of the notes. We also object to the inclusion in the letter or the notes weak statements, such as "We believe our auditing procedures were adequate in the circumstances to support our opinion".

3. We question the advisability of the recommendation of reporting on "all material uncertainties". Such an approach could easily lead to very lengthy expositions on all kinds of remote possibilities because both management and the auditor were trying to protect themselves. As a result, really significant matters would be hidden from all but the most perceptive reader of financial statements.

4. If all the auditor's report is going to be is a document that "could include his conclusion on compliance" we have to doubt whether the report has much value to management or the user.

5. The potential "Pandora's Box" that is opened by the section on the boundaries of the auditor's role is also disturbing. Carried to its ultimate conclusion the recommendation could lead to the need for management to clear each decision with the auditor. However, the auditor would disclaim all responsibilities for the decisions. In our judgement, the disclaimer at the end of Section 6 is not sufficient to overcome the tone of the rest of the section and the report.

6. We believe management should continue to have the right to set deadlines for completion of audits. If auditors feel the deadlines are going to "threaten audit quality", they can discuss the subject with a client beforehand and refuse the engagement if a satisfactory solution cannot be reached. Many of the deadlines imposed by

management result from regulatory requirements.

We do concur with some recommendations:

1) More public reporting of activities of the auditing profession, in general, and individual firms, in particular, should take place.

2) We agree that the Audit Committee of the Board of Directors should evaluate the relationship between the Auditor and management and approve all arrangements for the audit.

Thank you for your attention to our opinions. We hope full airing of the issues involved results in an improved set of guidelines for auditors, their activities and their reports.

Sincerely,

Howard C. McCrady

HCM:pc

TENENBAUM & THAW, P. A.
CERTIFIED PUBLIC ACCOUNTANTS

20451 North West 2nd Avenue
Miami, Florida 33169
651-3020

CIAR - A file

A-18

May 26th, 1977

American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York

Gentlemen:

We wish to express our approval of the reorganization of Audsec, particulary as long as there is a standing sub-committee on procedures on non-public companies.

We desperately need help in coping with financial statements for non-public companies and strongly feel that the same disclosure requirements for the public companies are simply inapplicable to the small companies. They merely run up the cost of competent accounting simply to protect the accountant, and not because the client needs the extended procedures.

Very truly yours,

Tenenbaum & Thaw, P.A.

TENENBAUM & THAW, P. A.
Certified Public Accountants

MAT/b

A-19

REX MEIGHEN, C. P. A. (1892-1976)
MARK W. EASTLAND, JR., C. P. A.
ROBERT E. VALDES, C. P. A.
WM. H. STAFFORD, C. P. A. (RETIRED)
M. R. MEIGHEN, C. P. A.
FRED F. LADO, C. P. A.
HAROLD G. GIBSON, C. P. A.
JOHN K. MILLER, C. P. A. (1915-1977)
WILLIAM J. FERLITA, C. P. A.
JOHN C. ROBERTS, C. P. A.
RICHARD M. CHAPMAN, C. P. A.
WM. DOUGLAS STAFFORD, C. P. A.

REX MEIGHEN & COMPANY
CERTIFIED PUBLIC ACCOUNTANTS
EXCHANGE NATIONAL BANK BUILDING
TAMPA, FLORIDA 33602

MEMBERS
AMERICAN INSTITUTE OF
CERTIFIED PUBLIC ACCOUNTANTS
FLORIDA INSTITUTE OF
CERTIFIED PUBLIC ACCOUNTANTS

June 7, 1977

Douglass R. Carmichael
Research Director
Commission on Auditor's Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

We have made a preliminary study of the "Report of Tentative Conclusions" and wish to make a few comments as suggested in the Preface.

The Commission has undoubtedly made a significant contribution to the profession even though the tentative report raises more problems than it solves.

The Commission's primary attention to and emphasis on audits of publicly held companies is set out and explained in the introduction. Some of our comments may, therefore, be considered inappropriate but it is hoped that they may be considered in the implementation of the Commission's recommendations.

We are interested in the Commission's recognition of the vast differences between publicly held companies and the closely held companies which constitute the bulk of the audit practice of all except the very large CPA firms. We do not understand, however, how the profession can ever have a double standard of audit responsibility for big clients and little clients.

Section 2

On Page 20, the second paragraph appears to us to be arbitrary, too broad and imprecise. If there is no authoritative literature, how can the auditor take exception to an alternative selected by management? By what right may the auditor propose that management cannot select a principle which is not forbidden or how can he fail to accept management's rejection of a principle that is not required?

If what is meant is that the auditor is not bound to accept a principle or an application which is grossly improper or misleading in a particular circumstance, the language should clearly so state.

Section 3

On Page 29, the final paragraph under "Recommended Changes in Financial Accounting Standards" seems to say that every uncertainty no matter how small must be disclosed. We do not agree that materiality should not be given consideration in respect to disclosing uncertainties.

We have carefully considered the suggestion that "subject to" opinions be discontinued and that disclosure of uncertainties be adequate for the reader to evaluate the possible effect of the uncertainty. It may be of interest to you to know that by a vote of 5 to 4 we endorse the suggested elimination of "subject to".

Those in the minority favor retaining the "subject to" because they believe the reader should be alerted to an uncertainty which should be considered in using the financial statements. They do not feel that including the information about the uncertainty among today's voluminous footnotes, which are seldom read by the typical investor, is sufficient notice.

Section 4

On Page 36, recommends that the auditor's responsibility for management fraud should be greater than that prescribed by SAS 16, which in itself is far from clear. The discussion, however, is not explicit, the excerpts from "The Philosophy of Auditing" speak of

> A concept of professional care which indicates in more or less specific terms the considerations which must govern the performance of an examination.
>
> he is neither excused from discovering any and all irregularities nor charged with an examination so extensive that it will uncover any and all irregularities
>
> a standard of professional skill and care is needed to evaluate the performance of auditors.

It is assumed that the Commission expects the profession to develop specifics. Two things are certain, with the benefit of hindsight, the auditor will be blamed for every undetected fraud and the cost of audits will substantially increase.

Section 5

It is proposed that corporations adopt and publicize codes of conduct and procedures for monitoring compliance.

Insofar as large publicly held companies are concerned, it is inconceivable that such codes will not uniformly forbid such things as bribes, kick-backs and other illegal acts.

The report appears to make no distinction in this regard between large publicly held companies and small one-man or one family businesses.

What sense would it make for the auditor to be required to report that his small local client had failed to adopt a "policy"?

How can the accounting profession dictate such things?

The discussion on Page 47 seems to suggest that materiality is not a factor in dealing with illegal acts, even though Page 48 talks about alternatives. Would "fixing" a parking ticket have to be accorded the same disclosures as bribing a witness, a competitor's employee or a revenue agent?

Section 6

As is true, understandably, throughout the report, the suggested requirement to disclose weaknesses in controls contemplates an organization large enough to make effective controls practical. There are thousands of audit reports on small closely held businesses which have no internal control, but where the auditor is able to satisfy himself by extending procedures. What possible purpose would be served by requiring the auditor in such circumstances to include in his report a statement that the controls were inadequate and that he could not provide assurances on the control system?

The suggested disclosure requirement is acceptable for reports on widely held companies, but would be more of going through motions to no purpose for the small closely held companies, like the earnings per share requirement.

The suggested expansion of the boundaries of the auditor's role sounds good in theory but how is a businessman to be convinced that he should pay more and more for audit services?

Section 7

We fully understand the necessity to emphasize the fact that the financial statements are the representations of management and that management is primarily responsible for them. We do not, however, understand why it is suggested that both the auditor and management state an untruth that the statements were prepared by management. All of us know that, in the vast majority of cases, the financial statements, particularly the footnotes, are prepared by the auditor and adopted by management.

The report suggests that an eight paragraph auditor's report will be read whereas a two paragraph report is not read. We hold no particular brief for the present standard report but we have serious doubts that a longer report is more likely to be read. The present report, has, at least, the advantage that the reader can readily recognize any departure from the norm.

Section 8

It is refreshing that the Commission recognizes that today's college graduates, who major in accounting, are not prepared to practice public accounting. In most cases today's graduates have never seen a set of books or an income tax return.

It may be an impossible dream, but it has been our experience that students who have actually worked in an office and participated in the day to day bookkeeping process more readily learn and understand the academic side of accounting and become productive in public accounting much more rapidly than those who have no working experience.

While the internship suggestions may be the only available solution, it has definite disadvantages in a local firm, such as ours, which does no write-up work. We question whether the three or six month internship in the middle of academic instruction is any more helpful than the same amount of time spent after graduation.

It is also questionable whether small firms, such as ours, would be willing to expend the time and resources on an intern with no assurance that he would become an employee on graduation.

We concur that the assignment of accounting faculty to the colleges of business has certainly "held back" the development of adequate practical accounting curricula.

We do not oppose, but we feel that professors having associate memberships in accounting societies will not cure the problem of the practical v. theoretical.

Section 9

We think the Commission's concern over employment recruiting and placement is well founded, but we are uncertain as to a fair solution.

Section 11

The suggested acceleration of disciplinary action is laudable, but we do not understand how it can be accomplished in cases where litigation is pending.

Yours very truly,

Merl W. Eastland Jr.

MWE:mja

TR-9487

A-20

DU PONT
REG. U. S. PAT. OFF.
ESTABLISHED 1802

E. I. du Pont de Nemours & Company
INCORPORATED
Wilmington, Delaware 19898

COMPTROLLER'S OFFICE

June 8, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

We appreciate this opportunity to respond to the Report of Tentative Conclusions of The Commission on Auditors' Responsibilities. We compliment the Commission on its thorough analysis of auditors' responsibilities and are in general agreement with the conclusions and recommendations set forth in the report, except as noted below.

The Independent Auditor's Role in Society

In this Section (page 11), it is indicated that "An active board of directors with a significant proportion of independent outside directors can also be of benefit to an independent auditor in fulfilling his responsibilities." Further (page 12), "Directors should regularly receive a report on the company's accounting system and the controls over it from the independent auditor." In later Sections, it is clearly noted that the auditor's primary interface at the board level would generally be with the audit committee rather than the full board. We suggest this Section indicate, in lieu of the comments quoted above, that the board should have enough independent outside directors to form an effective audit committee, and that the independent auditors should render their reports to such committee.

Forming an Opinion on Financial Presentations

We question whether, as a general rule, auditors are in better position than management to judge the preferability of alternative generally accepted accounting principles. Therefore, we would restrict the auditor's responsibility in this respect to insuring that alternatives selected do not produce misleading results. To have auditors judge on preferability would effectively shift primary responsibility for preparation of financial statements from management to the auditors, which would be inconsistent with other conclusions set forth in the report. Also, it might encourage companies to shop around for auditors who would agree with the alternatives they wished to use.

Clarifying Responsibility for the Detection of Fraud

We agree in principle that an audit should provide reasonable assurance that the financial statements are not affected by material fraud, particularly as regards fraudulent activity by corporate management. However, audit procedures designed to provide such assurance should be drawn with care to insure the cost does not exceed potential benefits, and we believe the recommendation should so specify.

Boundaries of the Auditor's Role and its Extension

We are not sure what is intended by the recommendation to extend the audit function to other information in the annual report. We believe the Commission's final report should indicate that such review would be limited to financial information which is (1) also included in the financial statements or (2) reconcilable to the financial statements. It is clearly beyond the auditor's competence to evaluate, for example, management's discussion of research projects or capital investment programs.

We disagree with the implication that procedures for developing financial forecasts should be standardized and subjected to audit. We do not believe auditors are in position to prescribe forecasting procedures or to evaluate management judgment in this highly subjective area.

The Auditor's Communication With Users

While we agree the auditor's report on the financial statements can be expanded to make it more meaningful and useful, the draft on page 79 seems unnecessarily negative (e.g., comment that the auditors "found no material disagreement" between the financial statements and information in the annual report). Also, we believe the comments on audit procedures, while lengthy, are incomplete and therefore potentially misleading (e.g., reference to "a sample of the transactions" and "an analytical review of the information presented"). It is not feasible to summarize the scope of audit procedures within the auditor's report.

We agree that a brief management report would be meaningful, but suggest the Commission provide only broad guidelines for such a report, with details left to management's judgment and changing circumstances.

Education, Training, and Development of Auditors

We do not believe that a 7-year college program should be required to enter the accounting profession. There is no evidence that such extensive training is needed or that the cost could be justified.

Maintaining the Independence of Auditors

We strongly support the Commission's conclusion that further government regulation or takeover of the independent audit function is not warranted. We also agree with recommendations for maintaining and enhancing the independence of the auditor, except that we do not believe any useful purpose would be served by disclosing in proxy statements the nature and extent of other services provided by the auditor. Such disclosure would tend to imply a conflict of interest.

The Process of Establishing Auditing Standards

We support the establishment of a full-time Auditing Standards Board within the AICPA. We also believe it essential that adequate provision be made for greater participation by industry in the auditing standards setting process.

Very truly yours,

W. E. Buxbaum
Comptroller

A-21

The School of Business

FACULTY SUITE
913-864-3536

June 7, 1977

Douglas R. Carmichael
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Doug:

I have just completed reading through the Commission's "Report of Tentative Conclusions" and found all of the material highly interesting and, of course, the entire report is thorough and extremely well done. I know you had an important part to play in the preparation of that report, and I commend you and the Commission for the work that has been done.

I would like to have the enclosed working paper "Some Proposals for Strengthening Auditor Independence" considered in the general category of written presentations to the Commission in response to the request for such presentations. The paper was presented at a meeting of the Southeast AAA conference two years ago and was subsequently submitted to the Journal of Accountancy but was rejected primarily on the basis that rotation of auditors is old hat. I should like to point out, however, that my stress is not primarily on rotation but rather on retention, through a fixed period of tenure, and the proposal is specifically directed at the idea of improving auditor independence. A later version of the paper was presented at the Wichita State University conference last month, and the newer version of the paper is once again being prepared for submission to a publication. I as well as many others were disappointed that you were unable to be present to deliver your own paper at that conference.

Referring to other matters in the report, I was especially interested in the responses on education. I am hopeful that from our two-course auditing sequence at the undergraduate and then the graduate level that many of the stated deficiencies would be satisfied through our program. Also, I have tried to address the matter of understanding the mechanics of the accounting system, the question of related documentation, and emphasis on how to audit as well as the whys of auditing in my text Systems Based Independent Audits. I was pleased to see the quotation from my Auditing Principles text in the report, but hope that the research staff also had available to it a copy of Systems Based Independent Audits which contains the same information but does a much more extensive job of treating the accounting system.

I am looking forward to the eventual outcome and effect of the Commission's activities.

Sincerely,

Howard

Howard F. Stettler

working paper no. 92

SOME PROPOSALS FOR STRENGTHENING AUDITOR INDEPENDENCE

Howard F. Stettler

SCHOOL OF BUSINESS

THE UNIVERSITY OF KANSAS · LAWRENCE

Some Proposals for Strengthening Auditor Independence

Howard F. Stettler

University of Kansas

April, 1975

SOME PROPOSALS FOR STRENGTHENING AUDITOR INDEPENDENCE

Howard F. Stettler, University of Kansas

Although the U.S. public accounting profession was beginning to recognize the importance of independence in connection with audits of financial statements in the late 1920's, independence did not receive really forceful attention until the passage of the Federal Securities Acts of 1933 and 1934. The earlier lethargic attention to what is today a vital consideration in auditing practice is largely attributable to the fact that prior to the public disclosure requirements of the Securities Acts, auditing services were rendered primarily for the benefit of management, directors, and the financial community. Management was concerned about fraud and accounting errors, and directors were interested in the determination of the amount of "surplus" available for the legal payment of dividends.

Under the conditions then prevailing, frequently the only information available to the public was a corporation's dividend record, and with the pressure to establish favorable records to support stock prices, corporate managements sometimes stretched dividend payments to the limit of available surplus. The correct determination of the "profit and loss account" balance to be added to surplus as a basis for dividends could thus be of vital concern to corporate directors in avoiding the personal liability that could arise from the payment of dividends in excess of the legal limit, and consultation with auditors on these matters was not uncommon.

The rash of merger activity in the last decade of the nineteenth century similarly involved an "internal" use of auditing services. The respective interests of the companies involved in a combination necessitated reliable data, and audited balance sheets were often specified to provide an equitable basis for working out the exchange of ownership interests. Independence was of little concern with respect to these services, and the financial community considered reputation as being more important than independence.

Investors' Right to Know

Although the pre-eminent importance of dividend records was widely recognized, some forward-looking companies began to publish limited supplementary financial information in the form of a usually abbreviated balance sheet that displayed the profit for the year as the balance of the profit and loss account added to surplus. Occasionally these figures were audited. Additionally, there was some likelihood that loan negotiations might involve banker pressure for the submission of "certified" balance sheets. It was from these early developments that full disclosure, generally accepted accounting principles, and the dominant position of the attest function within the CPA profession eventually emerged.

January 1933 was an important milestone in the development of the attest function, as it was then that the New York Stock Exchange announced that listing applications after July 1, 1933 must be accompanied by audited financial statements; companies whose securities were already listed were also urged (but not required) to be audited. An article in Fortune Magazine of June, 1932 indicated that about two-thirds of the companies listed on the New York Stock Exchange at that time were audited. Even these tentative steps were undoubtedly influenced by an awareness of government interest in making reliable financial information available for publicly held companies; an interest that culminated in passage of the Federal Securities Act of 1933. It was at that point that the investor's right to know became fully recognized.

Additional Leverage Becomes Necessary

When public accountants were almost exclusively engaged in being of direct service to management, their reports and recommendations were accepted and acted upon by clients without question, with this unquestioned acceptance a consequence of the faith manifested in the practitioner through his selection by the client. Under these circumstances the client had complete freedom to act or react to the practitioner's findings as the client saw fit, but these conditions changed as public accountants' services began to have value to third parties. Practitioners experienced the frustration of having clients refuse to accept disclosures or accounting methods that the practitioner "knew" were right. Instead, clients sometimes insisted on alternatives that better satisfied immediate objectives, despite the fact that the alternatives might be misleading to third parties.

Out of these conditions developed the need for the practitioner to have a higher authority that could be invoked to strengthen his position; i.e., to increase the practitioner's leverage in seeking to accomplish needed change. Thus, in addition to the practitioner's personal insistence that the financial statements be changed, there was a need for a mandate that required it. The first evidence of a higher authority other than published accounting books intended for instruction and guidance came in the form of the booklet "A Memorandum on Balance Sheet Audits" prepared by the then American Institute of Accountants. The impetus for the preparation of the booklet was a request by the Federal Trade Commission, which subsequently approved the document and forwarded it to the Federal Reserve Board. The Board gave the document its provisional endorsement and published it in the Federal Reserve Bulletin of April 1917. Subsequently, reprints bearing the title "Uniform Accounting: A Tentative Proposal Submitted by the Federal Reserve Board" were distributed to members of the American Institute and other accounting organizations and to banks, merchants, manufacturers, and associations of those groups. That booklet was revised by a committee of the American Institute of Accountants in 1929 and the revised booklet was again published and distributed by the Federal Reserve Board.

Reporting problems surged to the fore with the collapse of stock prices that began in 1929, and in 1932 discussions were initiated between the AIA Committee on Cooperation with Stock Exchanges and the NYSE Committee on Stock List with the intention of attacking the problem of misleading financial reporting practices of the pre-crash period. The awareness of the magnitude of the reporting problem that developed from these discussions was subsequently reinforced by pressure from the SEC for an authoritative pronouncement on generally accepted accounting principles, and in 1938 the AIA formed the Committee on Accounting Procedure to begin work on this task. The Committee on Accounting Procedure chipped away on this task until 1959 when it was succeeded by the Accounting Principles Board, which functioned until 1973 when it was supplanted by the Financial Accounting Standards Board. Although none of these activities succeeded in producing the comprehensive and definitive pronouncement that had been sought, there was at least a recognized authority for auditors to invoke to increase their leverage in dealing with recalcitrant clients.

Independence As an Aid to Leverage

The importance of independence as a leverage factor is evident in the move to transfer the rule-making authority for accounting principles from the previous appendages of the AICPA to a completely independent FASB. Although not so stated, presumably one reason that the Wheat Commission recommended a completely separate rule-making board was to assure maximum independence and thereby avoid the suspicion that had previously existed that accounting firm representatives on the APB sometimes voted according to the expressed preferences of major clients rather than according to their true convictions.

Independence can similarly provide leverage in the direct confrontations that may occur over accounting matters between auditor and client. Losing the client is a Damocles' sword that inevitably is present to some degree (sometimes only subconsciously) whenever an auditor questions or disagrees with a client's predilections. In some of the recent imbroglios that have surfaced through legal action there have been "grey area" questions of interpretation as to disclosures or the determination of accounting figures, and there is a strong possibility that the decisions made might have been different had the defendants been truly independent--in other words, had they been completely free to follow personal convictions or preferences. The more likely orientation in such situations, however, tends to be to "serve" the client by searching for an authoritative statement or position that can be interpreted as countenancing the client's preferences.

It is entirely possible in those unfortunate cases that went against the auditor-defendants that had the defendants been practicing with the independence of IRS agents (who never need fear losing a client and thus have maximum leverage in resolving differences), the hapless defendants might have insisted on alternative treatment or disclosure and the cases might never have occurred.

Client Confrontations and Gresham's Law

Closely allied to the potential loss of a client over a disagreement concerning disclosure or accounting treatment is the possibility that the client may be able to find a more "understanding" accountant who, for a variety of possible reasons, may stand ready to accept both the client and the client's position in the controversy with the predecessor accountant. To the extent that the successor accountant may be tempted to subscribe to the prospective client's position as a means of assuring his selection, Gresham's law for the circulation of money tends to be applicable to the circulation of accountants as well. The difference between the predecessor and successor accountants is not actually "good" and "bad" as with money, but is more likely to represent a difference in standards or in the interpretation or application of the standards. When such differences exist, there follows a tendency for the standards of the profession as a whole to be reduced to the lowest common denominator.

To avoid such pressure on standards, to strengthen the accountant's position vis-à-vis the client, and to relieve currently engaged auditors of the temptation to be biased in the client's behalf as a means of assuring client retention, it is proposed that the profession's code of ethics be expanded to include a rule that would preclude a successor auditor from assenting to an accounting treatment or nondisclosure of information if the predecessor accountant held to a different position. The necessary information for the operation of such a plan already exists in the SEC's 8-K reporting requirement concerning the disclosure of differences between registrant and accountant when a change of accountants occurs.

Not to be overlooked in connection with such a plan, however, is the possibility that a client's position may actually be justifiable and the accountant's position is the one that is in error. Clients must, of course, have some recourse from such a situation, and the recourse that is proposed is to form within the Financial Accounting Foundation an appeals board to which either party of a dispute would have access, and with the parties to the dispute sharing the cost of maintaining such a board.

Tenured Appointment As a Further Source of Improved Leverage

The thrust of the proposal that the public accounting profession close ranks in opposition to "imaginative" and anti-disclosure clients is a reduction of the ever-present concern over the possibility of losing a client, but so long as the accountant is dependent on his client for his fee he can never be truly independent. It is perhaps in part for this reason that the Congress considered the possibility of having the federal government assume the responsibility for the attest function when the 1933 Federal Securities Act was being deliberated. Fortunately for all concerned, however, that alternative was rejected, and even an SEC commissioner is quoted in Rappaport's SEC Accounting Practice and Procedure as having stated, "I believe we can all agree that independent certification was, and is, the better choice." Another possibility that is equally distasteful would be to have a special tax generate the revenues necessary to permit the federal government to compensate (and presumably also to select) the auditors certifying financial statements related to SEC registrations.

To obtain much the same benefits of these possibilities in terms of increasing the auditor's leverage by removing the threat of client loss, but without incurring the obvious shortcomings of the two alternatives of government audits or payment of fees from public coffers, a system of finite tenure for auditors is proposed. The intent of such a proposal is to retain most of the favorable aspects of the auditor/client relationship but to improve the auditor's position vis-à-vis his client by removing the pressure for client retention. The key words of the proposal are finite and tenure, reflecting a contractual relationship for audit engagements for a specified number of years, with a mandatory change of auditors at the expiration of the specified period.

Using the accepted sabbatical concept of Jewish antiquity and academic tradition, the tenure period is proposed at seven years. Longer periods would forcibly tie a client to a given auditor for an unreasonable length of time, although regardless of the established period, there would have to be some form of escape involving the normal constraints of a formal breach of contract action. Nevertheless, the period should be fairly long in order to spread the added costs of new auditor indoctrination over as many years of service as possible. Partially offsetting the cost of changing auditors is the value of a "fresh approach"--a factor that has been responsible for the voluntary periodic change of auditors made by some companies.

Maximizing Independence

The focal point of any change affecting the auditor/client relationship must be the protection of the financial interests of third parties by assuring maximum objectivity of the audit review of client financial statements. Anything less than absolute auditor independence must of necessity involve some loss of relative strength for the auditor in resolving differences that may arise. Although auditor independence has been strengthened in many ways, notably through the profession's code of ethics in proscribing relationships that would reflect on the *appearance* of independence and also in removing the determination of acceptable accounting principles from the contemporaneous audit situation, client power associated with the selection and compensation of auditors has remained a potentially insidious element in the auditor/client/third-party triangle. To maximize the strength of the auditor's bargaining power *vis-à-vis* his client--i.e., to strengthen auditor independence, two proposals have been made:

First, the auditing profession should close ranks and agree to support the position of the displaced auditor when differences exist between the client and the auditor and are unresolved at the time of dismissal or non-reengagement. As a related matter, an independent appeals board on accounting and disclosure questions is also proposed to further relieve the pressure on auditors to accede to client preferences.

Second, audit engagements involving publicly held companies should be based on a seven-year period of tenure with no successive reappointment of the same auditor.

No. 46 "The Predictive Ability of Alternative Parts of Interim Financial Statements," Frank K. Reilly, David Morgenson and Marilyn West (September, 1971).

No. 47 "Simulation of Water Recreation Users Decisions," J. Gaumnitz, R. Swinth, and J. Tollefson (September, 1971).

No. 48 "A Behavioral Model for Risky Investments," F. Hutton Barron and O. Maurice Joy (September, 1971).

No. 49 "Efficient Algorithms for Conducting Stochastic Dominance Tests on Large Numbers of Portfolios," R. Burr Porter, James R. Wart, and Donald L. Ferguson (October, 1971).

No. 50 "Alternative Industry Performance and Risk," Frank K. Reilly and Eugene Drzycimski (October, 1971).

No. 51 "The Use of Real Time Computing in Teaching Business 68, A Preliminary Report," Lawrence A. Sherr (November, 1971).

No. 52 "A Comprehensive Empirical Comparison of Stochastic Dominance and Mean-Variance Portfolio Models," R. Burr Porter (December, 1971).

No. 53 "Alternative Specifications of Monetary Policy," Frank K. Reilly (January, 1972).

No. 54 "Predicting Job Preferences from Discrimination Net Survey," Robert L. Swinth (February, 1972).

No. 55 "Insurer Postinsolvency Guaranty Funds," Harold C. Krogh (March, 1972).

No. 56 "An Analysis of 'Real' Rates of Return on Common Stocks," Ralph E. Smith, Glenn L. Johnson and Frank K. Reilly (March, 1972).

No. 57 "Organizational Change," Kenneth D. Mackenzie (March, 1972).

No. 58 "A Semi-Strong Test of Market Efficiency-Profit Opportunities After Major Announcements," Frank K. Reilly and Eugene Drzycimski (April, 1972).

No. 59 "A Constrained Optimization Model of Risky Decisions: Solving the m-Alternative Case," F. Hutton Barron (May, 1972).

No. 60 "Exchange Valuation: An Empirical Test," Robert Sterling, John O. Tollefson and Richard E. Flaherty (May, 1972).

No. 61 "A Comparison of Stochastic Dominance and Stochastic Programming as Corporate Financial Decision Models Under Uncertainty," R. Burr Porter (May, 1972).

No. 62 "Using Fishburns Technique for Analysis of Decision Trees: Some Examples," F. Hutton Barron (July, 1972).

No. 63 "Accounting Power," Robert R. Sterling (July, 1972).

No. 64 "Research Methods Approach for Accounting," Robert R. Sterling (July, 1972).

No. 65 "Accounting Research, Education and Practice—Conflicts, Compromises or Complements," Robert R. Sterling (July, 1972).

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No. 67 "Matrix Algebra and Cost Allocation: Clarifications and Extensions," William F. Bentz (July, 1972).

No. 68 "Consensus Ranking in Small Groups: Self Ranking Included and Excluded," Jack E. Gaumnitz and David P. Gustafson (September, 1972).

No. 69 "Capital Budgeting Selection Criteria Optimization and the Risk of Ruin," Jack E. Gaumnitz (September, 1972).

No. 70 "A Nonparametric Alternative to Canonical Analysis in Testing the Independence Between Two Multidimensional Variables," James F. Horrell and V. Parker Lessig (October, 1972).

No. 71 "Swift: Converting Ill Defined Problems into Well Defined Problems," Robert L. Swinth, Charles B. Fegan and Francis D. Tuggle (October, 1972).

No. 72 "Input-Output Analysis for Cost Accounting, Planning and Control: A Proof," William F. Bentz (December, 1972).

No. 73 "Market Segmentation Theory and Optimal Aggregation," John O. Tollefson (December, 1972).

No. 74 "Observed Non-Selection of Maximum Expected Utility Alternatives," F. Hutton Barron (February, 1973).

No. 75 "The CPA Examination: Has the Venerable Become Vulnerable," Howard F. Stettler (February, 1973).

No. 76 "Examining the Consumer Belief-Behavioral Space," V. Parker Lessig and Thomas P. Copley (April, 1973).

No. 77 "The Motivation of the Measurer," Robert R. Sterling and Darrell Harden (April, 1973).

No. 78 "Optimal Exercise Timing for American Call Options," Don Panton (May, 1973).

No. 79 "The Use of Probability Inequalities in Multiproduct C-V-P Analysis Under Uncertainty," Glenn L. Johnson and S. Stephen Simik, II (November, 1973).

No. 80 "Behavioral Constitutions," Kenneth D. Mackenzie (May, 1974).

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No. 82 "Optimal Choice of the Smoothing Constant in General Order Exponential Smoothing," K. O. Cogger (October, 1974).

No. 83 "A Survey of Discriminant Analysis with a Presentation of Some New Results," K. O. Cogger (October, 1974).

No. 84 "Mnemonic Devices for the Multiple Group Discrimination Problem," K. O. Cogger (October, 1974).

No. 85 "Where is Mr. Structure?," Kenneth D. Mackenzie (November, 1974).

No. 86 "A Theory of Committee Formation," Mary E. Lippitt and Kenneth D. Mackenzie (December, 1974).

No. 87 "An Exploration of the Consumer's Judgmental Rules," C. Whan Park (January, 1975).

No. 88 "Learning Transfer in Professional Education and Training for Accounting," William F. Bentz (January, 1975).

No. 89 "Good Decisions and Bad Outcomes," Douglas R. Emery and Francis D. Tuggle (January, 1975).

No. 90 "A Contour Theoretic Approach to the Determination of Negotiated Wage Change in the Building Construction Industry," David E. Shulenburger (April, 1975).

No. 91 "The Theory and Format of an Income Statement to Accompany Exit-Price Balance Sheets," Laurence A. Friedman (April, 1975).

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Dayton Hudson Corporation

777 Nicollet Mall
Minneapolis, Minnesota 55402

Executive Offices

June 8, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Sir:

Dayton-Hudson Corporation is a publicly held company subject to the reporting requirements of the Securities and Exchange Commission. The Corporation has been audited by the same firm, a member of the "Big 8", for 46 years.

We commend the Commission for its pragmatic approach to the subject of Auditors' responsibilities. Its analysis of current problems is complete and well balanced between the needs and expectations of financial statement users and the inherent limitations of the auditor's role. We believe both the short-term and long-term recommendations suggest practical, workable solutions. We strongly agree that solutions for existing problems should be logical extensions of the practices developed in the past. Radical departures from existing standards and methods may cause more problems than they resolve.

As the accounting profession changes in response to current criticisms, we suggest it should emphasize a continuing program to educate users of financial data both about the assurances provided by various types of audit work and the methods used to provide those assurances. As long as users do not fully understand the auditor's role, the accounting profession will continue to be criticized.

We appreciate the opportunity to submit the attached comments on this report.

Yours very truly,

Thomas E. Nave
Vice President and
Controller

TEN:lj
attachments

The Independent Auditor's Role in Society-(Section 1)

We agree that the auditor's most useful role is that of a third party intermediary in an accountability relationship between the issuer of audited financial information and users of that information, with primary responsibility to users of his work. Management also benefits from this independent auditor relationship through the confirmation that it is properly fulfilling its stewardship function.

We support the concept of closer, more active cooperation between auditors and independent outside directors. We believe this interaction strengthens both the actual and perceived independence of the auditor to the benefit of both financial statement users and company management.

Forming an Opinion on Financial Presentations-(Section 2)

We agree with the Commission that the phrase "fairly presents" is vague and subject to varying interpretations. A more effective role for the auditor would be to evaluate the choices made by management and comment on the appropriateness of the accounting alternatives chosen. However, we view this as a long-term goal. While the auditor could state that the company's choice of accounting principles tend to reduce or increase earnings, the current availability of acceptable alternatives prevents him from concluding that the company has made the most appropriate choice. If accounting principles are refined in the future to permit objective determination of preferability, the auditor's role could then extend to reporting on the propriety of management's choices.

Reporting on Significant Uncertainties-(Section 3)

We concur with the recommendation for changing the auditor's focus from predicting the outcome of uncertainties to evaluating the adequacy of disclosure of uncertainties. As there is always risk inherent in doing business, it is appropriate that the primary concern of the independent auditors should be the usefulness of financial statement disclosure to the users in the evaluation of that risk. Users are better served by complete information as a basis for their own judgement than by reliance on an auditor's evaluation of the risk. There is no reason to believe the auditor is in a better position than the company management or financial statement users to assess continued business success/failure or the outcome of other business uncertainties.

Clarifying Responsibility for Detection of Fraud-(Section 4)

We believe the auditor's responsibility for the detection of fraud must be clarified and communicated to the financial statement user. Clarification of the auditor's responsibility will be of direct benefit to all three interested groups - financial statement users, auditors and company management. Establishment of a standard of "due professional care" will result in consistent standards of fraud detection being applied to all auditors and aid the auditor in improving the quality of audits. The standard should also protect auditors from unrealistic user expectations. Users of financial information will benefit from a better understanding of the type of fraud that should be revealed by audit.

We support the recommendation for exchange of information on fraud detection methods within the accounting profession. Such a program would result in higher standards of audit work and better protect corporate assets.

We believe the auditor's role in detecting fraud could be expanded; however, the cost benefit relationship of such expanded role must be of prime concern. The clarification of the auditor's role, establishment of effective standards and healthy skepticism on the part of the auditors will do much more in solving the current difficulties regarding fraud detection than would expanding their role to that of a criminal investigator.

Corporate Accountability and the Law-(Section 5)

We agree that auditors should search for illegal or questionable acts that would normally be uncovered by the exercise of auditors' professional skills, once those acts are defined. However, we believe that both management's disclosure and the auditor's responsibility to uncover illegal or questionable acts must be evaluated in light of the legal and business climate at the date the financial reports are published, rather than the conditions prevailing at some later date. The accounting profession should work with the SEC to develop and maintain current standards for defining questionable acts.

We support clarification of the auditor's responsibility and the expansion of the legal profession's role in dealing with illegal or questionable acts. The legal profession has the competence to uncover illegal acts, advise management on the possible consequences, and evaluate the outcome of actual or potential lawsuits. The auditor should not be in the position of evaluating the advice of a company's legal counsel. The auditor should only be responsible for the adequacy of the financial statement disclosure.

We concur that the conventional materiality standard is not appropriate for known illegal or questionable acts, as it relates to the independent auditor. All illegal or questionable acts discovered should be brought to the attention of management and their lawyers. The auditor, lawyer and management should then work together in determining what disclosure is necessary. However, the primary responsibility for disclosure or lack thereof must rest with management. The auditor should retain the responsibility for disclosing illegal or questionable acts only if managment does not fulfill its responsibility.

The Boundaries of the Auditor's Role and Its Extension-(Section 6)

We believe the public accounting profession must respond positively to change in developing auditing standards and responsibilities as well as in developing accounting standards. Resistance to change will encourage government intervention. We believe it is in the best interests of financial information users and corporate management, as well as auditors, for auditing and accounting standards to be developed in the private sector.

Financial reporting should continue to be the responsiblity of corporate management - it is their report to the owners of the company on how they have fulfilled their stewardship function. The auditor's role must be restricted to evaluating management's disclosure. Involving the auditor in preparation of financial information inevitably erodes his independence.

The auditor should only be responsible for evaluating information of an accounting or financial nature. The field of business is complex enough to provide a challenge simply to achieve and maintain competence in financial matters. Any attempt to broaden the auditor's role to include competence in other fields such as law could only result in decreased competence in his primary field. Society can draw on the expertise of professionals in other fields for the assurances on matters outside the auditor's competence.

Expansion of the auditor's responsibilities to include an evaluation of the function of the accounting systems and controls is desirable from the viewpoint of both users and company management. If auditors must detect fraud, and illegal and questionable acts to expand their role in insuring the reliability of reported financial data, they must audit the systems, procedures and controls that produce the financial information on an ongoing basis rather than the numbers in the financial statements at a point in time. While most large companies have internal audit departments to review control systems, the internal auditor may not be totally objective as he is an employee of the company. Users of financial information frequently rely on the outside auditor's review

The Boundaries of the Auditor's Role and Its Extension-(Section 6) (Cont'd)

of controls for independent assurance that control systems are adequate and functioning as intended. This reliance is misguided as the auditor primarily reviews internal controls to determine the scope of his audit work. Management also benefits from independent confirmation that accounting systems are working properly, as it makes operating decisions based on data provided by these systems. Both management and investors in the company benefit if those decisions are based on complete, correct data.

A report by the independent auditors on the company's control system would reward those companies with good systems by making them more attractive to investors. Investors would be able to better evaluate the risk involved in their investment decision.

We support the involvement of auditors on a continuous basis. Our auditors have been involved with the issuance of interim financial data for several years. Since 1975 they have performed a limited review in accordance with SAS #10. We believe this involvement has improved reporting systems. Continuous auditor involvement has a number of advantages. The auditor obtains a better understanding of the client company. Potential problems can be corrected before they become serious. Financial data is improved through the emphasis that it will be reviewed by the auditor. Properly planned, interim audit work can reduce work normally done at year end, with no significant increase in total audit fees.

The Auditor's Communication with Users-(Section 7)

While we believe that users of financial information should carefully read audit reports rather than viewing them as a symbol, we agree that the current report should be revised to be more explicit about the work performed and the auditor's conclusions. The reader should not be expected to guess at the meaning of the report. We support the recommendation that auditors' reports should be revised to cover the entire audit function and be tailored to meet the specific circumstances of each company.

We also specifically agree that a report covering the financial information should be issued by management. This should help to clarify the responsibilities of management and the auditors as they pertain to the financial statements. A report by management would help the user to better understand that the primary responsibility for financial statements rests with the issuer not the auditor.

We agree there is currently a deficiency in audit reports when more than one auditor is involved. Rather than having the primary auditor review the other auditor's work, we favor the option of having management present the other auditor's report. Assuming all portions of the data are audited by competent professionals, the additional fees necessary to have the primary auditor review the work of the other auditors to cover all data in his opinion do not appear to be justified by any benefit to users.

Revision of the opinion currently given on unaudited statements should be given high priority. This revision should be accompanied by a program to educate users as to the level of assurance intended. Adoption of several descriptive reports on unaudited statements would be greatly beneficial both to users and to auditors. The current disclaimer on unaudited statements confuses financial statement readers by implying that the data is or may be erroneous. The reader is unable to evaluate the assurance related to auditor involvement with the data. With no data available on the reliability of the company's accounting systems and controls, or the level of work performed by the auditor, the auditor's involvement is meaningless. This confusion on the part of users only increases potential liability for the auditor. A revised auditor opinion that indicates the data is correct within certain defined limits would be of great benefit to both users and auditors.

The Auditor's Communication with Users-(Section 7) (Cont'd)

The mixing of unaudited data (but with which the auditor is associated), such as replacement cost, within audited financial statements is also very confusing to the average user. The changing of the auditor's report to address what work the auditor did should eliminate the need for such "unaudited" labels.

The Education, Training, and Development of Auditors-(Section 8)

We do not have strong feelings regarding the formal accounting education in schools of business. However, we think that it is important to consider the responsibility and requirements being placed on auditors. Financial data is so widely disseminated that the impact of auditor's decisions and the related exposure to liability are equal to if not greater than that of the legal or medical profession. In both of these professions, separate graduate schools of education are required.

A uniform CPA examination is given throughout the country. Upon successful completion of the CPA exam, the experience required is not uniform. We recommend that the education requirements to take the examination and the experience requirements after passing the exam be standardized. We also recommend a continuing education requirement similar to the programs recently adopted by several states.

Maintaining the Independence of Auditors-(Section 9)

We strongly concur that the present system of a private profession, regulated by a combination of private and governmental efforts including the SEC and courts is superior to the other alternatives available. Although there is certainly room for improvements in the workings of the current system, sweeping changes such as those calling for substantially more government involvement are not necessary.

The audit committee and/or board of directors should have the final responsibility for reviewing the audit scope and fees after appropriate review by management. This final review should be done with the auditors present, to allow them to answer questions and communicate their concerns to the audit committee. Total service, including those other than the normal audit, and their impact on the audit should be discussed at this meeting.

Companies should not subject the independent auditor to unreasonable pressure. Keeping the auditors informed of the major developments on a continuing basis should eliminate the need to place extreme pressures on the auditor. However, it must be pointed out that on occasion management is placed under unavoidable time pressures and that it may be necessary for the auditors to be subjected to the same pressure. However, such situations should be rare.

We support the concept of rotating auditors. Such a procedure should yield a good return to all concerned - shareholder, management and auditor.

The Process of Establishing Auditing Standards-(Section 10)

We strongly advocate retaining responsibility for setting audit standards in the accounting profession. We believe this strengthens the independence of auditors. In disputes with management the auditor is, and should be, defending standards he has helped establish. If auditing standards were set by a governmental agency, the auditor would be encouraged to identify with management on questionable issues. The potential liability for noncompliance with government established standards would force auditors into a narrow approach of auditing to avoid legal liability. We believe this would discourage the overall viewpoint and innovative judgement necessary for a professional audit. We also believe that accounting practioners with broad experience are more competent to set technical auditing standards than a governmental agency.

Regulating the Profession to Maintain the Quality of Audit Practice-(Section 11)

The proliferation of "nuisance suits" against companies and their auditors is a deterrent to the auditing profession and to the experimentation and implementation of new financial disclosures such as current value and forecasting. We concur with the Commission's recommendations of assessment of costs against unsuccessful plaintiffs, statutory limitations of damages and the extension of the "safe harbor" concept.

A-23

Graduate School of Business Administration · The University of Michigan · Ann Arbor 48109

June 8, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, NY 10036

Dear Doug:

The Report of Tentative Conclusions is a very timely and definite answer to many of the charges made in the Metcalf report against the profession. I am impressed with the Commission's Report. The conclusions and recommendations appear to me to be internally consistent and fully supported by substantive evidence and logical reasoning.

The comments which follow will be addressed to the major conclusions and recommendations of the Commission. In most instances my comments will be supportive of the Commission's tentative positions. In one or two cases, my comments will reveal a contrary point of view.

1. The Independent Auditor's Role in Society. Section 1 is a good exposition of the auditor's role. The section, however, is weak on recommendations. I believe the final report of the Commission should contain specific suggestions for educating the public as to the auditor's role, his responsibility for fraud, and his relationship with management. One approach is for the AICPA to undertake a vigorous public relations program.

2. Forming an Opinion on Financial Presentations. I concur in the recommendation to eliminate the word "fairly" from the auditor's report and in the need for additional guidance from the profession concerning generally accepted accounting principles. The recommendations in this section should be addressed specifically to the Auditing Standards Executive Committee.

3. Reporting on Significant Uncertainties. The tentative conclusions of this section are well stated and adequately documented. Steps should be implemented as soon as possible to implement these conclusions. The SEC may prove to be a major obstacle in this process in the light of their outright rejection of the elimination of "subject to" in the development of SAS No. 2.

4. Clarifying Responsibility for the Detection of Fraud. SAS No. 16 is an improvement but not a complete answer to clarifying the auditor's responsibility for fraud. I concur that an explicit positive statement is needed to the effect that an audit should detect material fraud. The specific recommendations on "standards of care" have merit. I worry, however, about the concept (standard) of "due professional care." This concept is both broad and nebulous. Moreover, Statements on Auditing Standards offer very little guidance for complying with this standard. Additional SAS's are urgently needed on clarifying this standard in the conduct of an audit.

5. Corporate Accountability and the Law. The conclusions and recommendations here are sound. A more positive and less defensive approach should be taken by AUDSEC, particularly in the area of public disclosure. I concur that traditional standards of materiality are not applicable in this area.

6. The Boundaries of the Auditor's Role and its Extension. The conclusions and recommendations on interim reporting should be vigorously pursued. The material on financial forecasts, however, is a major disappointment. While this topic is admittedly on the back burner currently, the final report should discuss the issues, state conclusions, and make suggestions for possible auditor involvement if financial forecasts are required.

7. The Auditor's Communication With Users. The recommendations for a management report and an expanded auditor's report are excellent. Suggestions for implementing these recommendations should be included in the Commission's final report. I concur in the elimination of the second standard of reporting. I am disappointed, however, that this section makes no reference to the third standard of reporting. With the increased emphasis on disclosure and with an expanded auditor's report, I believe the auditor should be required to make a positive statement on the adequacy of disclosures in his report. I further urge the Commission to evaluate the recent trend on AudSEC to "bury" disclosures under GAAP. There are many examples in practice of differences between GAAP and disclosure requirements and these differences should continue to be recognized in Statements on Auditing Standards.

8. The Education, Training, and Development of Auditors. Arguments for and against separate professional schools have been widely publicized in recent years. My personal view is that a professional accounting program is more important than the organizational structure in which it is given. There are major obstacles in academia that must be overcome before there will be any significant trend toward separate schools in AACSB member institutions. The Commission may wish to suggest both short-term (professional programs) and long-term (professional schools) as objectives for entry into the profession. It is conceivable that the Commission may also wish to comment on the advantages and disadvantages of separate accounting accreditation.

9. Maintaining the Independence of Auditors. Conclusion No. 1 is a status que position which is not likely to be an adequate response to the Metcalf charges. My article in the April 1968 Accounting Review contained some suggestions in this area. The other three conclusions are sound.

10. The Process of Establishing Auditing Standards. The setting of auditing standards should definitely remain in the private sector. I strongly support the recommendation of a 5-9 member full time auditing standards board, with one member from academia. My preferences would be for the board to be independent of the AICPA but organizational and economic considerations may well be overriding. I would urge prompt and vigorous action on this proposal to head off any Washington efforts to have the SEC become the standard-setting body.

11. Regulating the Profession to Maintain the Quality of Audit Practice. The conclusions and recommendations here appear to be sound. I have only two comments: (1) I do not believe the voluntary AICPA quality control programs have been very successful. The AICPA should establish mandatory peer review requirements at the earliest opportunity. (2) Some reference to Hochfeider or the significance of this case might be included in the final report, in view of the fact that Metcalf has called for a reversal of this decision.

The Commission is to be commended for its efforts and on its tentative conclusions. I trust that this letter will be useful to the Commission in the issuance of its final report. I do not request an opportunity to make an oral presentation to the Commission. However, if the Commission wishes to solicitate my oral comments I will, on your request, be pleased to oblige.

Very truly yours,

Walter G. Kell
Professor of Accounting

WGK/mb

A-24

NORTHWEST ENERGY COMPANY

JAMES W. ALLEN
CONTROLLER

June 10, 1977

P. O. BOX 1526
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Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

Northwest Energy Company ("Northwest") is engaged, through subsidiaries and investees, in the interstate transmission and sale of natural gas subject to Federal Power Commission regulation, the exploration for and production of oil and gas, the operation of an underground coal mine, the manufacture and sale of chemical fertilizer, and the production, refining and marketing of oil and petroleum products. Northwest's common stock is publicly traded on both the New York and Pacific Stock Exchanges and the preferred stock and debentures of its principal subsidiary, Northwest Pipeline Corporation, are also publicly traded. Northwest and most of its subsidiaries are required by law, regulation or contract to have audits at least annually and more frequent audits can result from such situations as general rate increase filings with the Federal Power Commission or the public issuance of securities. Accordingly, Northwest has an interest in the role and responsibilities of independent auditors and appreciates this opportunity to comment on the "Report of Tentative Conclusions" by the Commission on Auditors' Responsibilities ("Commission").

Northwest notes that the Commission's report is oriented toward publicly held companies. Northwest, as stated above, is publicly held and, therefore, believes that it is in a position to comment upon the Commission's tentative conclusions as they relate to that type of environment. With this background, Northwest offers the following comments and observations for the consideration of the Commission.

There are two general areas which are of particular concern to Northwest. First, the Commission does not appear to have explicitly defined the objectives of the audit function. It is apparent that the Commission considers that an audit provides an important service to users of financial statements, including audit committees made up of companies' outside directors as representatives of the shareholders. In Northwest's opinion, the primary objectives of an external audit are twofold: (1) To comply with legal or contractual requirements and (2) to supplement existing internal controls. The first objective carries with it the connotation that an auditors' report lends credibility to management's financial statements. This concept of ensuring credibility has given rise to auditing standards and appears to be the focal point of the Commission's report. Northwest notes that an audit may add credibility, but it does not necessarily add quality, nor is it necessarily significant, to all financial information (such as interim reports) published by a company. The second objective, as stated above, explains why an audit is not significant to all financial information. Simply put, a publicly held company typically has an extensive and relatively effective system of internal controls, including an active internal audit function. An external audit, in this situation, serves only to complement other internal controls which are in place and operating continuously to ensure the integrity of financial information.

Secondly, the Commission's report appears to be recommending what Northwest considers to be infringements on management's perogatives. Northwest commends the Commission for stressing that an auditor should evaluate the propriety of management's financial disclosures (thus resulting in the abolition of the "subject to" opinion) but feels that the Commission is overstepping its bounds by suggesting, for example, that management should adopt and publicize detailed policy statements on employee conduct. Any matter of this nature should be implemented, if at all, at management's option and not at the direction of the AICPA. Managements and boards of directors commonly recognize their responsibilities to shareholders and to the public and should be considered responsible enough to fulfill these responsibilities even though the methods used will vary depending upon individual facts and circumstances. In Northwest's opinion, encroachments upon management's perogative, such as the one discussed above, are not the proper concern of the Commission or of auditors generally. In addition, Northwest is concerned that if management is to be responsible for its financial accounting and reporting, as it must be, then it needs the freedom to fulfill this responsibility without limitations in the form of auditing standards. For example, in discharging its responsibility, a company's management, including the audit committee of its board of directors, should be the ones to decide whether to expand auditor association with interim or special financial information or whether to limit such association to an annual examination of financial statements.

Northwest has made certain other observations which it also submits for the Commission's consideration. They are:

1. The proposed auditors' report appears to effectively preclude the auditor from expressing his opinion on the financial statements taken as a whole. If the term "fairly" is not considered acceptable, some other word or phrase should be used since an auditor's expertise is wasted unless he is required to reach a conclusion in his report.

2. The FASB's "Tentative Conclusions on Objectives of Financial Statements of Business Enterprises" states that financial statements should be understandable to those "who have a reasonable understanding of business and economic activities and financial accounting and who are willing

to spend the time and effort needed to study financial statements." Presumably, this same knowledge and study would be applied to the accompanying auditors' reports and would eliminate much of the confusion perceived by the Committee.

3. Monitoring compliance with management's policies is typically an internal audit function and delegation of this responsibility to outside auditors should be done only at management's option.

4. Reports to the public on internal control, whether by management or by independent auditors, would have only very limited usefulness. This is so because the disclaimers included in such reports would largely negate their potential impact, because an understanding of the reports would require a high degree of sophistication and because the conclusions drawn from such reports would not impact any specific past or future financial disclosures.

5. Northwest concurs that participation from outside the public accounting profession should be sought in setting auditing standards.

Northwest appreciates the opportunity to comment on these issues which it considers to be of extreme significance to the business community.

Yours truly,

Jim W. Aiken

JWA:bh

A-25

THE INSTITUTE OF INTERNAL AUDITORS, INC.
INTERNATIONAL HEADQUARTERS, ALTAMONTE SPRINGS, FLORIDA 32701 PHONE: 305·830·7600

June 10, 1977

Mr. Douglas R. Carmichael
Managing Director, Technical Services
AICPA
1211 Avenue of the Americas
New York, N. Y. 10036

Dear Doug:

We put together comments on the exposure draft from the Commission on Auditors' Responsibilities. This was based on a consensus of opinion from our membership and will be signed by our international president (Stan Gross) and sent directly to you.

After receipt of that, we have gotten some additional comments that I would like to give you for your consideration. These are:

Section 1 - Auditor relationships with client management should include exploration of the relationships with Internal Audit Departments.

Section 4 - It seems appropriate for the external auditor to recommend to client management the assignment of internal audit work as a supplementary aid in fraud detection; at least this matter should be discussed and reviewed in this section.

Section 4 and/or 6 - Possibly some consideration should be given to planned discussion with client employees or client consultants which have the business ethics and security responsibilities as part of internal control reviews.

Section 8a - The body of knowledge requirements are expanding so fast that a justification can be made for developing the future auditor at the graduate or masters level. On-the-job experience should be a part of the graduate work.

Section 8b - Semester courses should look at auditing in a general way and include internal as well as external auditing as part of the body of knowledge.

Section 8c - EDP knowledge in some depth should also be required.

Section 8d - A greater emphasis should be made on the sociological aspects (Behavioral Patterns) than is being done at present.

Sincerely yours,

Bill

William E. Perry, CIA, CPA
Director of EDP and Research

WEP/mp

MACHINERY and ALLIED PRODUCTS INSTITUTE

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June 10, 1977

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Commission on Auditors' Responsibilities
American Institute of Certified Public
Accountants
1211 Avenue of the Americas
New York, New York 10036

Attention: Mr. Douglas R. Carmichael
Research Director

Dear Members of the Commission:

<u>"Report of Tentative Conclusions" of the Commission on Auditors' Responsibilities</u>

The Machinery and Allied Products Institute is pleased to have this opportunity to comment to the Commission on Auditors' Responsibilities (hereinafter "the Commission") of the American Institute of Certified Public Accountants (AICPA) on the Commission's "Report of Tentative Conclusions." We assume that the Commission is making a public record of its proceedings, and therefore request that this commentary in its entirety be made a part of that record.

As you may know, MAPI is the national organization of manufacturers of capital goods and related equipment. Most of the Institute's member companies are publicly held and all of the Institute's member companies at one time or another either are subject to independent audit or engage the services of independent accountants for audit or other purposes. Also, all of these companies are users of financial statements and other materials that have been subjected to verification or other oversight by independent accountants.

For these reasons, it is fair to say that organizations such as MAPI and its member companies have as direct an interest in the Commission's study, findings, and recommendations as any other group, including independent accountants and their associations. We make this point at the outset because portions of the Commission's Report seem to reflect a belief that audit reform is mainly auditors' business. In our opinion, self-regulation of financial audit could not continue for long on any such basis.

To capsule our views as to the tentative conclusions and recommendations of the Commission, we have mixed feelings. On the positive side, we are completely in accord with the view that financial audit should remain a private sector responsibility. Also, we concur that changes might be made in the audit process to improve public understanding of the auditor's role. Further, we accept that the mechanism for standard-setting for financial audit can be improved. Finally, as noted in the Report, there are a number of areas in which the professional standards for independent accountants might be clarified.

On the other side of the ledger, MAPI does not concur in those of the Commission's findings which would substantially enlarge the auditor's role because they are likely to be cost-ineffective. Nor do we agree with those recommendations that would have auditors narrowly circumscribe their liabilities while increasing their functions, or insulate themselves from clients' managements, from time budgets, and from competition. We noted earlier that audit reform should not be considered mainly auditors' business, and that is particularly true for proposals such as these.

Before moving to our more specific views, we wish to commend the Commission on Auditors' Responsibilities for its work even though we do not agree with all the points covered in the Report. The Report is a candid and illuminating analysis of issues which concern independent accountants, and it is timely in that the accounting profession has been subjected recently--along with its clientele--to much careless and very demeaning criticism, although we would not presume to conclude that all criticism has been of this nature. In reviewing the mechanism for self-governance of financial audit, we should, of course, evaluate the system objectively and not be pressured by those who have been incapable of such analysis. The Commission's Report is an important start in this task, and it is significant to us that many of the changes recommended could be implemented by voluntary, cooperative action between auditor and client.

Finally, we agree with the Commission that a gap exists between the expectations of users of financial statements and the performance of independent auditors. Also, we recognize that this gap results in significant part from a misunderstanding of the audit function. The way to deal with this, in our opinion, is to correct the misunderstanding, and not to enlarge the audit function or make it over into something it was never intended to be. Also, inasmuch as much of the worry with financial audit stems from so-called questionable corporate payments, critics of the audit process should be advised that these problems are being addressed in other more appropriate ways.

The remainder of this letter consists of our specific views on selected recommendations of concern to us, and a concluding comment.

Comments on the Commission's Recommendations

Our comments to follow are concerned with (1) "fairness" and "consistency" as a part of the auditor's report; (2) uncertainties and the "subject to" qualification; (3) detection of fraud; (4) corporate accountability and the auditor; (5) extension of the audit function; (6) the auditor's report; (7) independence; and (8) the setting of auditing standards.

"Fairness" and "Consistency"

The Commission reports that there are difficulties arising from the different meanings attributed to the phrase "present fairly in conformity with generally accepted accounting principles," and that the word "fairly" should be eliminated from the auditor's report. According to the Commission, "fairly" is often used loosely as a synonym for other qualitative characteristics of financial information on which attention might better be focused directly. Also, the Commission would rather have auditors not be responsible for reporting on consistency because that is considered to be management's responsibility.

Comment.--It is not clear to us from a reading of the Report, with particular attention to Chapters 2 and 7 dealing with the auditor and his communications, how if at all the auditor's report would be modified to deal with such characteristics of financial information as the adequacy of disclosure, substance over form, inherent imprecisions, etc. Evidently, "fairness" and all the word conveys would be abandoned with nothing in the form of standard terminology to replace it, but the Report is not clear in this matter.

We have no strong feelings about the Commission's proposal to drop a "value" concept such as "fair" from the auditor's report. Nor do we take strong exception to the proposal in regard to "consistency." However, the impression easily derived from the Commission's Report overall is that auditors would like to have more work assured to them and less potential liability with respect to it. Part of this pattern is reflected in the proposals to delete all references to fairness and consistency from the auditor's report.

Although we understand the reasons behind these recommendations, it seems to us that the process of independent audit is more likely to remain in the private sector if it results in reports to the public which contain some assurances they can understand--even if they interpret them differently. As the Commission notes, the current standard report has been around since 1948, and is a known and tested vehicle for communicating the auditor's message. Whereas improvements obviously can be made, we question the timeliness of those just mentioned which appear to be mainly offered in anticipation of beneficial effects on auditors' liability.

Uncertainties

The Commission finds that present reporting does not adequately emphasize uncertainty. Accordingly, the Commission believes that management should be required to include a separate note in financial statements on this subject similar to that required for accounting policies. This note would identify uncertainties and explain their significance for earnings and financial position. Auditors' requirements pertaining to the "subject to" qualification would be eliminated.

Comment.--The subject of uncertainties has been a sore point for auditors if only because they perceive that they may incur liability when misfortunes befall the clients whose financial statements they have examined. The solution, in our judgment, lies not in disclaiming responsibility for uncertainties, but in defining that responsibility and communicating information consistent with the definition. We disagree that a report and disclosure such as presented on pp. 24-25 of the Commission's Report is "confusing" to statement users. Also, we do not believe that the absence of a "subject to" qualification causes statement users to believe that a company faces no uncertainties that could materially affect its financial condition or operating results.

As to management's disclosure responsibility for uncertainties, we think they were explicitly stated in Statement of Financial Accounting Standards No. 5, and we feel the matter should be allowed to rest until FASB sees fit to review it. In fact, FASB has just commissioned a study on the economic side-effects, if any, of Statement No. 5. With that evaluation in process, we see no purpose in returning to the subject soon for rulemaking. Regarding the "subject to" qualification, we doubt that it has misled users, and the Commission's argument seems rather strained to us. If anything, such a qualification serves as a useful "flag" for a user, quickly directing him to important financial statement analysis of material uncertainties.

We should point out that it may not be of much consequence to statement preparers that they would henceforth be relieved of this type of qualification in the auditor's report. Indeed, some may find it advantageous. If the Commission feels that elimination of the qualification is clearly in the public interest, then we do not take strong exception. However, if this is construed by others as the withdrawal of a protection now afforded by independent audit, then elimination of the qualification requirement is likely to attract more criticism of the way financial audit now is handled.

Fraud

The Commission feels that an audit should be designed to provide reasonable assurance that the financial statements are not affected by material fraud. To help define and evaluate auditors' responsibilities with respect to the detection of fraud, the Commission recommends a concept of "due professional care" and describes it to include such things as (1) the establishment of effective client investigation programs; (2) prompt action on evidence that management may be untrustworthy, including resignation where the evidence cannot be refuted; (3) observance of conditions suggesting predispositions to management fraud; (4) maintaining an understanding of a client's business and industry; and (5) concern with controls related to fraud prevention and detection.

Comment.--This may be the most important subject covered by the Commission inasmuch as fraud and questionable activity is one of the main reasons for this reevaluation of auditors' responsibilities. All of the steps listed above are important, and conscientious auditors already conduct themselves with "due professional care." We have some question about the study and evaluation of internal control beyond that now required because fraud and questionable activity generally are performed outside of the system of internal control--according to government's experience--frequently with collusion by the persons involved. Although it is appropriate for an auditor to evaluate and comment on controls and that is useful to management as well, we doubt that formalization of the process would be cost-effective generally or very useful in detecting fraud in particular.

Further along these lines, SEC is studying proposals to require that registered companies maintain accurate books and "adequate" controls. Here again, the proposal is not really responsive to the problem (i.e., questionable payments), and we do not favor it for that reason. It appears that the public's reaction to questionable corporate practices and the widespread misunderstanding of auditors' capabilities in this area has resulted in some casting about for remedies, however ineffective they may be.

We should hope that both SEC and the Commission on Auditors' Responsibilities would keep in mind that much has already been done to curtail inappropriate practices. To establish "police" measures now for all companies in an attempt to discourage errant activities of a few would exact a huge toll in exchange for comparatively little benefit. Auditors can and should express their views about clients' controls, but the process need not, in our opinion, be any more formal than it is.

Corporate Accountability

Here, the Commission would have the independent auditor search for illegal or questionable acts, and he would be expected to detect those acts that the exercise of professional skill and care would normally uncover. However, management would bear the primary responsibility for corporate accountability. More specifically, the Commission believes that management should adopt and publicize detailed policy statements indicating the conduct that will not be tolerated and develop appropriate compliance procedures. The independent auditor then could be involved in monitoring compliance with these policies, and his report could include his conclusion on compliance.

Detected illegal or questionable acts, according to the Commission, should be considered by the auditor without regard to traditional standards of materiality. Also, the principal responsibility for assurance on information on legal claims and litigation against clients would lie with management acting in consultation with their lawyers.

Comment.--We see some merit in the recommendations above for management. Management already does bear primary responsibility for corporate accountability, and many companies have policy statements relating to business ethics. "Appropriate" compliance procedures should in our judgment, be left to management judgment because of organizational differences, personnel relations considerations, and the need to evaluate known costs and likely benefits in widely varying contexts. However, we would not formalize the auditor's role by having separate procedures for monitoring compliance, for all the reasons stated earlier.

As to materiality in this context, we think it should be a facts-and-circumstances determination, as described at some length in the Securities and Exchange Commission's report of May 12, 1976 to the Senate Committee on Banking, Housing and Urban Affairs. To put aside materiality altogether would give an appearance of significance to some events which are isolated, non-recurring, and unimportant for financial reporting purposes by any reasonable measure. On a final point, any shifting of responsibilities for disclosure in this area toward lawyers will have to be very carefully considered in light of the attorney-client privilege. We do not suggest that auditors should have duties for which they are not trained. However, there will be situations in which lawyers cannot be involved in any way.

Enlargement of the Auditor's Role

According to the Commission, the audit function should expand to include information of an accounting and financial nature that management has a responsibility to report, provided that it is produced by the accounting system and the auditor is competent to verify the information. Also, the Commission feels that the audit function should include greater involvement in a company's financial reporting process on a more current and continuing basis.

Comment.--It is ironic to us that the Commission would significantly enlarge the auditor's role because many financial statement users recognize that an auditor's "association" with data does not necessarily add to its credibility. Indeed, the Commission would practically assure, through disclaimers and caveats to users, that they not rely on any of the costly work for which clients are charged. In our opinion, this expensive exercise has been carried quite far enough with "limited review" of interim reports. As the Commission knows, this newly instituted practice results in financial statement footnotes labeled "unaudited."

We thought the process of limited review to be most unusual when it was first imposed on larger SEC registrants, and there are companies which to this day cannot reconcile the sizable additions since made to their audit fees with any benefits derived. In fact, there are many managements so firmly convinced of the cost ineffectiveness of this that they refuse to permit so-called limited review on any basis other than a look-back from year-end. In considering enlargement of the auditor's role, the Commission should, we think, recognize that independent audit is another form of overhead. It strains reasonable minds to find costs of "professional" service justified where the persons delivering the service will only do so with blanket disclaimers of liability. Also, as the Commission acknowledges, there is more than the usual amount of imprecision involved in reporting for periods of less than a year. No amount of third party oversight will cure that.

We understand the auditor's lament with respect to seasonality of the accounting industry, as well described by the Commission in its discussion of time-budget pressures. Also, we recognize that current and continuous auditor involvement in all aspects of a client's financial reporting would relieve this problem to some extent. However, the benefits derived from auditor involvement in financial reporting diminish sharply in relation to cost when such involvement is made more nearly current and continuous. Therefore, we cannot support the Commission in its recommendations to substantially enlarge the auditor's role.

The Auditor's Report

The Commission recommends a new, expanded, flexible report consisting of a series of paragraphs with standard wording or alternatives, each describing a major element of the audit function. Also, the Commission would have corporate management present a report that acknowledges management's responsibility for the representations in the financial statements; states that the information is presented in conformity with generally accepted accounting principles appropriate in the circumstances; and states that legal counsel has communicated the company's position with respect to litigation, claims, and assessments to the independent auditor and is satisfied that it is properly disclosed in the financial statements. Management's report also would present its assessment of the company's accounting system and controls over it, and describe the response of the company to material weaknesses in controls identified by the independent auditor.

As previously noted, references in the current auditor's report to "fairness" and "consistency" would be deleted, and responsibility for disclosure of changes would be reserved to management. Also, the method of referring to the work of other auditors would be revised, and the auditor's reporting requirement for unaudited information (associated with audited information) would be clarified and expanded.

Finally, auditors would be required to be present and available to answer questions at the annual meeting of shareholders.

Comment.--The Commission's proposed auditor's report in part reflects other recommendations of the Commission. We take no issue with the idea that the auditor's report should be upgraded to communicate more effectively with statement users. However, it taxes our credulity to be told that many persons who, in fact, know what an auditor's report is and read it now consider it to be a "seal of approval" or a symbol that the audited entity is financially sound. We doubt the problem is that serious, and, of course, do not agree with those changes in the report to which we already have taken exception. For example, we refer the Commission to our remarks on "fairness" and "consistency," uncertainties and the "subject to" qualification, fraud, corporate accountability, and the enlargement of the auditor's role.

As to the management report, we have no immediate problem with the concept and acknowledge that the report could help improve users' understanding of the respective roles of statement preparers and auditors. It seems to us that much of what is needed for this purpose is set forth in paragraph 1 of the illustration on page 79 of the Commission's Report, and we have no objection to that. Certain other sections of the illustrative management report reflect proposals to enlarge the audit function, alter the responsibility for uncertainties, etc., and our views on those subjects were expressed earlier. We would add to this that managements would want some discretion as to both the form and content of any such report, assuming the practice of reporting in this way is adopted, and we agree that management should not be confined to standard language or a standard form of presentation.

Independence

According to the Commission, principal responsibility for the selection and appointment of the auditors and the setting of fees should be centered in the board of directors or its audit committee. Also, the board should evaluate the relationships between the auditor and management; review and approve all arrangements for the audit, including the fee, scope, and timing; and recommend the appointment of independent auditors to shareholders.

Elsewhere pertaining to the independence of auditors, the Commission recommends that the nature and extent of other services provided by the auditor should be disclosed in proxy statements. Finally, the Commission states that elements in the business environment, such as arbitrary deadlines, affect the quality of the audit, place unnecessary stress on the auditor's independence, and should be changed. To that end, the Commission believes that arbitrary deadlines imposed by clients should be resisted when they threaten audit quality.

A further suggestion of the Commission is that the disclosures now required by SEC when auditors are changed should accompany all audited financial statements.

Comment.--The audit committee principle is one which has found wide acceptance on a voluntary basis, and we think that it has merit for a number of reasons which include auditors' independence. Some companies already have in place the kinds of procedures recommended by the Commission. However, their purpose is not to "insulate" auditors from management. Indeed, this would not be appropriate because management is in a position to make judgments about such matters as the scope of audit and auditor performance, whereas an outside audit committee is not. Also, management is much better situated to reconcile audit objectives with other demands on the company, including filing deadlines and other timing requirements for the release of financial information. In sum, on this point, we do not object to the interposition of the audit committee in this relationship as long as it is not structured to eliminate those checks and balances which normally should operate between auditor and client.

As to the management advisory services and other auditor work considered by some persons to give the appearance of conflict, these could be disclosed in proxy statements, as the Commission has recommended, or they could be disclosed in some other appropriate document. It is unfortunate, we think, that there must be any disclosure at all when the Commission's investigations of these services have failed to disclose any effect on auditors' independence. Certainly, the disclosure itself will do nothing to correct the appearance of conflict. Considering that the remedy would be nonresponsive to a non-problem, the Commission should reconsider whether it is necessary at all.

On another item, the Commission gives much space in its Report to time budgets and competition, and the substandard audit performance to which they allegedly can lead. We agree that there may be cases in which "arbitrary" deadlines imposed by clients could threaten audit quality and should be resisted. Obviously, one cannot expect miracles of independent accountants. On the other hand, what may seem arbitrary to an auditor whose only principal concern is his own calendar, may be not arbitrary at all and be absolutely necessary in the circumstances confronting management. Also, an auditor who is inexperienced, slow, and/or inefficient for other reasons may consider that almost any deadlines are arbitrary and threaten the quality of services he would deliver.

Consequently, we strongly disagree with the thrust of any Commission recommendations which aim to insulate auditors from the constraints of time budgets and competition. These are elements of the work environment which keep all providers of services efficient, and there is no good reason we can see to exempt independent accountants.

Auditing Standards

The Commission proposes to replace the present Auditing Standards Executive Committee of AICPA by an Auditing Standards Board within AICPA composed of five to nine full-time members. Changes would be made to encourage participation from outside the profession. Also, auditing standards would be restructured to recognize the changes in the audit function recommended by the Commission; to give more attention to the special needs of public accounting practices involving nonpublic companies; and to increase the quality and timeliness of the guidance provided.

Comment.--Although we do not consider the existing apparatus for standard-setting to be inadequate, we of course are aware that it has drawn some criticism. If we may generalize, the criticism comes from those who want increased accountability and believe that uniformity in financial accounting and audit practice is a means to that end. Auditors and clients alike recognize the fallacy of this position, but the cost of failure to respond could be high. In that light, the Auditing Standards Board proposal strikes us as an acceptable compromise for now. However, as in the case of FASB, it may be necessary over time to have this organization be less dependent on its auditor constituency.

On that point, we are concerned by the insularity of the Commission in its discussion of the Board and the expected participation in the process of setting standards. It is evidently assumed that all members of the Board would come from public accounting, and that there would be no other representation. Also, in the Commission's discussion of participation in the standard-setting process, there is practically no recognition that management accountants should be involved, except with the Industry Audit Guides. We would remind the Commission that management has a direct and legitimate interest in audit standards as a preparer and user of financial statements. As AICPA's Accounting Principles Board learned to its regret, generally accepted accounting principles will not be defined by a narrow segment of those persons affected by the principles being defined. The same experience may be encountered with auditing standards as the stakes in that activity increase.

Although a FASB-type mechanism may lie ahead for auditing standards, the Commission's proposal is a logical intermediate step. However, we recommend that there be business representation and active solicitation of management participation in the work of the Board.

Concluding Comment

In conclusion, we repeat that in spite of our several criticisms of the Commission's Report, we find it illuminating. On a fundamental point addressed by the Commission, we agree fully that financial audit should remain in the private sector. To keep it there, auditors and their clients must perform reasonably to the public's expectations. Also, because statement users' needs for financial information and audit assurances are not static, auditors and their clients must strive constantly for improvement in their respective functions and accept that their roles may change.

Indeed, it is quite clear from recent events that these roles are changing, and that more is expected of auditors as well as of the enterprises they examine. We feel that the Commission should thoroughly reconsider its tentative conclusions as to their consistency with the growing expectations of the public regarding financial audit and the mushrooming costs to clients of financial reporting, including audit costs. As we have suggested elsewhere in this letter, it appears that, in part, the Commission would have independent accountants withdraw from responsibility for their work, greatly enlarge the territory within which they operate, and shift potential liabilities to management. Neither the statement users who want reasonable audit assurances nor the statement preparers asked to pay for "audit" procedures that are increasingly cost-ineffective will find these changes to their liking. Accordingly, we suggest further study.

The Commission is well situated to influence the direction and pace of change in the audit function, and we hope that MAPI's thoughts on the tentative conclusions will be of some help.

Very truly yours,

Charles Stewart

President

CWS:mcr

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LEWITTES & COMPANY
CERTIFIED PUBLIC ACCOUNTANTS

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June 10, 1977

Douglas R. Carmichael, CPA
Research Director
Commission on Auditor's Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

With regard to the Commission on Auditor's Responsibilities: "Report of Tentative Conclusions", I have several comments and/or suggestions which follow:

1. Scrutiny of Auditor Changes (Pages 104 and 105)

I basically agree with the discussion and the concept of correspondence between predecessor and successor auditors. However, I believe that the last paragraph in this section should be expanded in order to make it clear that not only should management explain why the change in auditors was made, but that the predecessor auditor would also have an opportunity to express his side of the disagreement in the event he did not agree with management's statement.

As a practical matter how this could happen, I'm not certain, but I could envision a procedure whereby users would have the right to contact the predecessor auditors directly and ask them to confirm the position taken by management or explain their side of the change. The confidential nature of our relationship would be involved. One thought that has occurred to me to cover this point in private situations (i.e., non-SEC) is to suggest to users to have their customers agree to allow the users to speak with the predecessor auditor in the event the customer did make a change at some future time. For example, a bank could have this agreement before lending money to a customer. The result would be basically no different than the SEC arrangement which also gives the predecessor auditor an opportunity to explain disagreements with management. Ultimately, this could become a normal operating procedure.

The thought behind my proposal is that a dishonest client is now able to find a dishonest, naive, or hungry successor accountant and be able to readily make changes in accountants knowing that the predecessor accountant is not able to give his side of the story, especially to a user. In our profession, the repercussions of an improper or inadequate audit only occur if the client fails; but, if the client is lucky enough to carry on a little bit longer or have the business cycle turn in his favor, then improper statements and/or disclosures might never be known. It is only when the client fails in some manner that the scandal is known and then the auditor and the profession as a whole get a black eye. This kind of occurence could be minimized by giving the predecessor accountant an opportunity (and preferably making it mandatory) to express his side of the story to the financial community known to be using the statements.

2. <u>A New Approach to Reporting (Pages 75 through 80)</u>

Though I understand the problems with the current standard language described in the report, I am afraid that the revised report as illustrated in the booklet and also as explained on pages 75 and 76 is also doomed to failure. I feel it is impossible for any report to cover all of the problems of auditing. It is impossible for any auditor's report, whether short form or long form, current or revised, to explain all of the problems and pitfalls related to auditing, especially to a layman. I think what is necessary is a recognition on the part of the profession, as well as the public, that a layman is just not going to realize all of the ramifications of what a professional auditor's report says.

When I read the proposed revised illustrations of an auditors report on pages 77 and 78, I shudder to think of some of our smaller clients trying to understand the ramifications of "a study and evaluation of the accounting system and controls...having the following uncorrected material weaknesses not described in the report by management...". Doesn't this also raise questions in the minds of the readers and is it ever going to be possible to explain to the reader that it may or may not have significance and how much, and when, etc.? I feel that the report could be better served if it were to say something to the effect that the accounting statement should be read in conjunction with the advice of a CPA (or a professional trained in the reading of financial statements); or in conjunction with the help of accounting and auditing information published by the AICPA. This would be similar to standard law forms which can be obtained at any stationery store, where there is a notation that the form should be prepared in connection with the appropriate law or sometimes it says with the assistance of an attorney. I feel that the commission is missing the mark by not warning the reader that the statements can be complicated and should be read with the assistance of a professional rather than try to expand the auditors report to make it all inclusive and all explanatory, which is impossible.

3. Reporting on Significant Uncertainties (Section 3 - Page xviii)

In the last sentence of the second paragraph in the above noted section it states that footnotes should describe "all material uncertainties, not only those that might have resulted in a qualification". I am concerned that this kind of a footnote would actually become boiler-plate. After all, everything in business is uncertain and I am afraid that some kind of a general comment by management in the footnote would end out being so standard that people would not read it. I am not certain that this accomplishes what we are after, namely, warning the reader of a problem. What this is saying is that the reader has to read all the footnotes, which unfortunately does not happen, and certainly will not if they become routine.

Thank you for understanding and reading of my comments. I will be happy to expand on any if I have not made myself clear. In general, I found the Commission's, "Report of Tentative Conclusions" stimulating, generally accurate, and on the right track.

Sincerely,

David J. Lewittes

DJL:jw

John Rapp, CPA
17 Butler Parkway
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June 8, 1977

Dr. Douglas R. Carmichael

Research Director

Commission on Auditors' Responsibilities

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Dear Dr. Carmichael:

In connection with the tentative conclusions as to the education of auditors, I would like to suggest that the interchange of personnel between the world of pratice and the groves of academe be made into more of a two-way street than it is now. To that end, I wonder whether colleges, schools of business and schools of accounting might be persuaded to have auditing and certain accounting practice courses taught by practising CPAs seconded to the faculties for one or two years on a part-time or a full-time basis, to impart to the students some idea of the diversity and the challenges of the real world.

Those CPAs involved in college-level teaching could probably further their own continuing education through such work and concurrently earn CPE credits towards the requirements that seem to become increasingly mandatory. It would be well to draw such visiting professors from local, regional, national and international firms. In the case of large firms that have or will have specific partners in charge of auditing standards and others in charge of quality control, it might be interesting to try out a procedure by which those considered for assignment to those positions would serve as visiting faculty as a condition for attaining those important posts in their firms; this would permit giving technically competent people diversified practice in effective teaching.

It might also be worth whole to consider the use, in graduate schools, of practitioners and partners seasoned by many years of experience and faced with compulsory retirement from their pratice units when they still have years ahead of them to devote to constructive service to the CPA profession and can convey to qualified students that broad sense of perspective accumulated from their experience.

Some firms or groups of firms might even band together to endow chairs of auditing on leading institutions of higher learning. While there are currently some endowed chairs of accounting, I do not believe this to be the case for auditing. Some of these chairs might be named for retired or deceased prominent leaders of the profession in the field of auditing.

As to the composition of the suggested full-time Auditing Standards Board, I would favor 9 rather than 7 members, including professors, bankers, financial analysts, CPAs currently practising in large and small firms, plus an active and interested "elder statesman" of the CPA profession.

To help maintain the quality of audit practice, I would view with favor a procedure by which practitioners would be invited to submit, with all identification deleted, practical accounting and auditing problems encountered and solved in their own practices. In time, such an effort may result in the building up of local, regional or even national subject files which could form the basis of the kind of case library usual in most other learned professions that could be a powerful instrument for accounting and auditing research, give participating firms a sense of accomplishment, and enhance the standards of practice of our profession.

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United States Steel Corporation

ACCOUNTING DEPARTMENT

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June 10, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

AICPA Commission on Auditors' Responsibilities -
Report of Tentative Conclusions

U. S. Steel believes that the Commission has done an outstanding job in developing the Report on Tentative Conclusions. We think that many of the recommendations have merit and are very timely. We trust that the accounting profession will accept the report and embrace the general thrust of the recommendations so that the public will gain a better insight into the audit responsibility as well as the responsibility of management.

U. S. Steel's Management has always recognized our primary responsibility for the integrity and objectivity of financial statements and for the necessity of sound internal controls. To closely monitor in depth on a current and continuing basis the significant financial happenings, a strong and independent internal auditing organization is maintained. This group as well as our line accounting organization and other affected management work closely with the Audit Committee of our Board of Directors consisting of five outside directors.

We believe that this comprehensive internal accounting control functioning augmented by the present oversight responsibilities of our outside auditors, assures full and accurate disclosure of significant financial information. Such benefits are obtained at what we consider a reasonable cost.

We do not believe that so-called arbitrary management deadlines should be cited as a possible cause of poor quality audit performance. We think that management requests normally arise from a true need. Certainly any truly independent outside auditor should decline an engagement in which sufficient time were not allowed for adequate coverage and completion. Management cannot be expected to know such things as staff availability, etc., of the independent auditor.

United States Steel Corporation

Although we see no problem of disclosing the amount paid to independent auditor for other than auditing services, we fail to see where a proxy disclosure of this information would be of any particular use to the shareholder. Also, the definition of "auditing services" as distinguished from other services as might be rendered from time to time would involve problems of definition of services which could be inconclusive as to the type of service actually performed.

We fail to see the need for footnote disclosure of uncertanties beyond that now required by FAS No. 5. In fact, the disclosure in a particular note related to a financial statement item would appear preferable to inclusion in a multi-faceted note on "uncertainties".

There is not, in our opinion, a need for a further increase in the scope or scheduling of outside audit work. With the association of the independent auditor with quarterly results, certain work is now required during the entire year. To try to spread this work out further could well cause inefficiencies, the cost of which must be borne by the client with no value to him or to the shareholder. A soundly established and functioning internal auditing and accounting control system precludes the need for any further expansion of the outside auditor's role. The publication of a management report, as recommended by the Commission should provide an excellent means to so communicate to the public.

We appreciate the opportunity afforded us to comment on the Commission's important report.

Yours truly,

B. L. Thurman, Jr.
Assistant Comptroller
General Accounting

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ARMCO STEEL CORPORATION

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June 9, 1977

Douglas R. Carmichael
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Dear Mr. Carmichael:

THE COMMISSION ON AUDITORS' RESPONSIBILITIES:

REPORT OF TENTATIVE CONCLUSIONS

We are pleased to respond to the "Report of Tentative Conclusions" (the "Report") of the Commission on Auditors' Responsibilities. In general, we agree that there is a need to clarify the responsibility of auditors of major publicly held companies. We disagree, however, with the majority of the tentative conclusions of the Commission, as set forth later in this letter. We also question whether these conclusions should apply to all companies or whether the responsibilities of auditors for major publicly held companies should be segregated from those responsibilities of auditors of smaller privately owned companies.

Summary

We think the Commission's tentative conclusions fail to recognize a significant credibility problem for auditors in their association with the business managers and financial managers of their clients. We think the Commission's tentative conclusions are extremely self-serving, reflect inconsistent logic, are biased toward relieving auditors of their publicly perceived responsibility, and places additional burdens on financial management and companies which are not cost justified. The principal conclusion which emanates from this report is that the time pressures placed on auditors by business managers and financial managers are too great for the complex problems involved with financial reporting. We in industry would like to be able to tell our superiors that they should not be concerned about the cost or the timeliness of information given to them, but should only be concerned about its quality. We also know that our salesmen would like to tell our customers that they should not be concerned about the cost of the product which we are manufacturing or the timeliness of its delivery but should only be concerned about its quality. We know, however, that this is not capable of practical application.

We question whether the Commission has fully considered the practical economic effects of its recommendations on auditors' clients because the Commission has apparently failed to consider the concept of cost justification. We are sure that the Commission is well aware of the positive economic impact of increased fees its recommendations will have on auditors.

We agree with the Commission's conclusion that the financial statements are a representation of management and that management should so indicate; however, the recommended report of management on financial statements does not improve the current situation and contains many ambiguous terms which do not clarify the situation with the average reader of financial statements. We think a simple statement that the financial statements are representations of management is all that is warranted.

1. THE INDEPENDENT AUDITORS' ROLE IN SOCIETY

We agree that there is a need to clarify the auditors' role in society. We also think there is a need to clarify the investors', consumers', laborers', managers', businessmen's, etc., role in society and to educate society in general in the workings of our American economic system. The need to clarify the auditors' role arises from the fact that users of financial statements outside the enterprise expect complete accuracy of the financial information they receive. We think it is impossible for financial statements to summarize the complex business, financial, and economic activities of an enterprise in a limited amount of numeric information and verbage with the degree of accuracy expected by the users of financial statements. We must emphasize that accounting has always been defined as an art. Scientific rules or laws cannot be applied to financial information because of the complex involvement of judgment and estimates in almost all facets of accounting. Net income and earnings per share receive significant attention from users of financial statements; however, such amounts are not capable of being scientifically proved. Those numbers are nothing more than an estimate of the results of operations of a particular enterprise for a particular segment of time. Pragmatically speaking, no amount of clarification of auditors' responsibilities or promulgations by the AICPA or any other authority outside of Congress will alleviate the auditors' current problems of litigation. Investors will invariably seek redress from officers, directors, and auditors when an enterprise experiences financial difficulty and actual or perceived losses are experienced regardless of the quality of the audit or management.

The Commission's conclusions emphasize that accounting results can be no more accurate or reliable than the underlying accounting measurement methods permit and that the quality of financial statements cannot be overcome by that inherent limitation. In section 2 of the Report, the Commission indicates that when business transactions are structured to comply with the form of specific accounting requirements and ignore their substance, the auditor should insist on reporting the transaction in conformity with its substance or qualify his opinion. These two positions appear contradictory, if not mutually exclusive, to us. When accounting rules are prescribed in strict, rigorous form and when accounting promulgations ignore what management perceives to be economic substance and economic reality, transactions will always be structured in a manner to present what management believes is in the best interest of the Company. This involves designing transactions with the specific accounting results in mind. There will always be differences of opinion between management and auditors and among auditors (or more specifically among auditing firms) as to "the substantive issues of accounting pronouncements" and as to "economic substance and economic reality." We question the Commission's obvious conclusion that the auditor is omniscient.

In this section, the Commission also discusses the duties of financial statements to potential shareholders and potential creditors as opposed to such duties to existing shareholders and existing creditors. We think the discussion of what is owed shareholders and creditors by financial statements or the purpose of financial statements should be left to the Financial Accounting Standards Board's current discussion on the "Conceptual Framework for Financial Accounting and Reporting." The Commission's conclusions and discussions of this subject are unwarranted.

The Commission indicates that directors should regularly receive a report on the enterprise's accounting systems and controls from the independent auditors. Most companies currently receive management letters or comment reports from auditors. These reports comment on weaknesses in internal control and other matters and include recommendations for improvement of the accounting system. We have noted that such reports rarely distinguish between material problems and other matters which the auditor believes should be brought to the attention of the audit committee or the board of directors. A significant amount of work is yet to be done in the definitions of a "material" weakness in internal control and an "adequate" system of accounting. We think, therefore, a significant amount of pragmatic research in this area is required before the Commission recommends such a report be issued.

2. FORMING AN OPINION ON FINANCIAL PRESENTATIONS

The Commission indicates that the auditor is responsible for determining whether management's judgment (as applied to its financial activities) was appropriate and goes further to indicate that the substantive requirements of accounting pronouncements should be followed. There will always be situations in which there is a difference in opinion or judgment as to the economic or financial substance of a specific transaction and "economic reality." Many of the recent pronouncements from the Financial Accounting Standards Board have raised questions regarding whether economic substance is being reflected in financial statements and there are an equal number of respected opinions on both sides of a particular position. Again, we think when financial accounting requirements are so verbose and provide such restrictive criteria and guidelines, that it is impossible for differences in opinion over substance to be used by the auditor for insisting on revision in accounting or financial statements.

In this section of the Report, there is a discussion regarding selecting among alternative accounting principles and the Commission mentions specifically accounting for investment tax credit, depreciation, and inventory costing as areas in which there are several acceptable alternatives under generally accepted accounting principles. We contend that there are many other areas not mentioned by the Commission for which there are acceptable alternatives and involve differences of personal opinion regarding the preferable method of accounting or reporting. In those specific cases mentioned, the Commission indicates that the auditor can conclude that there is no objective basis for evaluating management's selection and, therefore, the auditor may accept management's selection. In the very next paragraph of the Report, the Commission goes on to say that the mere absence of authorative literature specifying choices among alternatives is not sufficient grounds for the auditor to accept a particular selection and, when there is a change to a new principle of accounting, the auditor would be expected to qualify his opinion if the required justification were not given. We believe these three paragraphs in the Report highlight the inconsistency that permeates the entire document. We see no justification for an auditor's qualifying his opinion on financial statements when the accounting principles used therein are generally accepted either in specific literature or through practice. Because the financial statements are primarily the responsibility of management, we think an auditor's qualification regarding the selection of a specific accounting principle when several acceptable alternatives exist is completely unwarranted. As the Commission has stated in other sections of this Report, an auditor neither adds to nor detracts from a bad principle of accounting. Personal views and personal opinion on accounting matters will always differ and we think the auditor should have no responsibility to let his personal views on a particular matter enter into the financial reporting process of an enterprise.

3. <u>REPORTING ON SIGNIFICANT UNCERTAINTIES IN FINANCIAL PRESENTATIONS</u>

The Commission has discussed an area in this portion of the Report that has caused significant problems for both auditors and management in recent years. We agree with Commission's recommendation to eliminate "subject to" opinions for the reasons stated in the Report; however, we think the Commission's recommendation for a separate note in the financial statements to discuss uncertainties has "opened Pandora's box." With the complexities of business transactions today, the uncertainties regarding financial information presented are unlimited. The user of financial information must recognize the technological, economic, and political uncertainties surrounding the mere existence of business enterprises in the free world today. To discuss any uncertainties other than those loss contingencies required to be disclosed by FASB Statement No. 5 can only lead to more litigation for both management and auditors regarding the adequacy of disclosure. Again, the Commission has apparently decided to expand its purpose by recommending changes in financial reporting. We think this should be left to those authorities charged with that responsibility.

4. CLARIFYING RESPONSIBILITY FOR THE DETECTION OF FRAUD

The Commission is finally discussing in this section of the Report what we perceive to be the major contributor to "audit failures" i.e., the auditors' maintaining an understanding of business and industry. We contend that a study of the well publicized "audit failures" will yield that, in the majority of the cases, the auditors failed to attain a thorough understanding of the business and industrial problems of a particular client, or ignored their findings, and also failed to use common sense in understanding the intent and motives of management. We believe this particular problem (i.e., understanding the client's business) cannot be over emphasized to auditors. In our own experience, we have noted a significant number of auditors who fail to have or obtain the most meager amount of knowledge pertaining to the operation of business in the current economic and political environment.

5. CORPORATE ACCOUNTABILITY AND THE LAW

Much attention and publicity has been given to this particular area that the Commission is addressing in the so called "Watergate Era." Industry has been required to spend an inordinate amount of time and money to satisfy the current moral philosophy of the nation. We think too much attention has already been placed on this particular subject and we believe the Auditing Standards Executive Committee's recent promulgations (SAS Nos. 16 and 17) should adequately cover the auditor in this area.

We have noted recent proposed legislation that would require Corporations to maintain "accurate books and records and an adequate system of internal control." We think the terms "adequate" and "accurate" are too nebulous and not susceptible to a sufficient precise practical definition that would be acceptable to all parties involved; accordingly, we recommend that the Commission not use such terminology. We also recommend that auditors and legislators refrain from using such terminology in any promulgation or legislation.

The Commission has indicated its preference for Corporations to adopt codes of conduct and for an annual reporting on compliance with this code by the auditors. Such implies a requirement for auditors to audit against a code which will vary from company to company. We think that this is not susceptible to practical application and is not cost justified.

The Commission has indicated its preference for increased involvement in public financial reporting by lawyers and presumably by other experts such as actuaries, engineers, appraisers, etc. We think business in general is sufficiently bogged down by present rules and regulations that there is an inherent requirement for continued involvement of legal counsel, both internal and external. To require, however, increased involvement of lawyers and other experts in public financial reporting is, we think, unwarranted and not cost justified.

6. THE BOUNDARIES OF THE AUDITORS' ROLE AND ITS EXTENSION

This section makes clear the self-serving nature and illogical conclusions of this Report. The Commission indicates conclusions which are not supported by research, documentation, logic, or common sense. The first example of such is in the consideration of the audit function regarding audit services and the extent of those services. The Commission states that "the extent of audit services cannot be determined by a free market in the mixed economy of the United States in the 1970's." We do not understand what the Commission is trying to say in that statement because it arises unexpectedly in the reading of the Report without adequate consideration or support in research, theory, or logic.

The Commission seems to take for granted that there is a need to expand the audit function. We think there is a need to contract the audit function and for redefinition and better understanding of the audit function. This need should be aimed primarily toward auditors and users of financial information. There is, as emphasized in the Report, a misunderstanding by users of financial statements of the auditors' involvement in the preparation and examination of financial statements of an enterprise.

Our most recent experience in involving auditors in financial information other than annual financial statements causes us to believe that the auditors themselves do not want expanded responsibility for financial information or involvement with that financial information. Our examples include the type of reports that we have been able to receive from our auditors on interim financial data, comfort letters for public offerings, and replacement cost data required by the Securities and Exchange Commission. In all of these instances, auditors have insisted upon such qualifying language in their report as to render their involvement almost useless from the company's point of view and, we think, from the users' of financial information point of view.

The Commission advocates increased involvement of the auditor in financial information if the auditors' competence is relevant. The auditors' competence, we think, would be substantially enhanced if their knowledge of general business, financial management, and economics was increased. Auditors' increased involvement in financial reporting is, we think, not cost justified and only serves to increase the auditors' fees. Financial analysts, auditors, and management do not want increased involvement by auditors in the financial reporting process as has often been stated by distinguished members of these professions.

The Commission's proposed timely reporting by auditors on interim financial data does not provide any greater assurance to the user of such data than is currently provided by management. The only conclusion recommended by the Commission is a statement that such work performed by the independent auditor disclosed no material weaknesses in the process of preparing interim financial information and any adjustments or additional disclosures proposed by them have been reflected in the information. We think such a broad statement regarding adjustments or disclosures brought to the auditors' attention by his review is not capable of practical application because it involves no concept of materiality. Also, we disagree with the concluding statement of that report regarding subsequent information or events may require adjustment to the reported data. Adjustment would be required only if there has been a misapplication of facts existing at the time financial information was issued (i.e., a correction of an error is required). This concluding sentence does not enhance the validity of interim financial information but only serves to raise more questions regarding the interim reporting process. As we have previously indicated, the definition of material weaknesses in internal control for accounting processes has never been defined and is probably less susceptible to a definition that is acceptable to all parties involved than the concept of materiality in relation to pure financial data.

The auditor already has a responsibility to review other information contained in financial reports to attain reasonable assurance that such information is not inconsistent with the basic financial statements. The Commission's recommendations that the auditor recompute information stated in percentages or combined in a manner different from that in the financial statements, etc., is unwarranted as such is already performed under the current auditing standards.

The Commission discusses the auditors' involvement with financial forecasts without reaching a conclusion and, therefore, we are unable to respond except to state that we think the auditor should not be involved in forecasting and that companies should not be required to publicly disclose forecasts.

The Commission also discusses whether the auditor should be involved in reaching conclusions regarding the efficiency, economy, and effectiveness of the use of corporate programs and funds as is sometimes required during the audits of governmental units or units funded by governments. We think the auditors' expertise in accounting and auditing does not lead him to an ability to judge efficiency, economy, and effectiveness of policies. This information cannot be drawn from financial statements or financial data alone.

We agree with the Commission's conclusions that auditors should not evaluate management or corporate performance, but not for the reason given in the Report. The Commission is concerned that such may jeopardize the audit function. We think that the auditor does not have the necessary expertise to perform such evaluations.

7. THE AUDITORS' COMMUNICATION WITH USERS

In this section of the Report, the Commission recommends a changed auditors' report by replacing the current terminology of "fairness" and "consistency" with the terminology "in all material respects" and "appropriate in the circumstances." We think this is regression rather than progression because such terminology is more nebulous and less susceptible to a reasonable definition that would be acceptable to management, the auditor, and the users of financial information.

The Commission is also recommending that the auditor state a conclusion regarding uncorrected material weaknesses in internal control. Again, we question the validity of such a requirement in public reporting when internal control, as it is currently defined, recognizes a cost justification principle. Comments regarding uncorrected weaknesses in internal control should not be included in an auditors' report on financial statements when the auditor has performed sufficient work to be satisfied with the reasonableness of such statements and management has decided that the costs of correcting the weakness exceed the benefits to be derived. The definition of a material weakness in internal control would be a personal decision by the auditor as there are no definitive criteria generally acceptable to all parties. Also, the qualifying language in the proposed auditors' report concerning internal control renders such almost useless.

The Report also recommends a conclusion stated by the auditor regarding other information appearing in the annual report or other document containing financial statements regarding material disagreements. We think the word "disagreement" is inappropriate because the information either agrees or disagrees and we cannot understand how a material disagreement can arise. The concept of materiality does not appear to apply to the term agreement.

The Commission is also recommending that management's report on financial statements indicate that "appropriate" accounting principles have been applied and "best estimates and judgments" have been made. We think the auditor would loathe to use such terminology and we, therefore, question management's use. We think this type of reporting is inviting litigation and, accordingly, recommend that such a report not become a requirement.

We recommend that the management report on the financial statements simply state that such financial information is principally the responsibility of management. This has been understood by most parties for years. We think such a statement should be made in order to clarify the principal or primary responsibility for financial statements; however, we think the lengthy report recommended by the Commission does not add any information to the users of financial statements. (We recognize the Securities and Exchange Commission is the only authority that could require management to issue such a statement and our recommendations will be submitted to the SEC if the subject is considered.)

8. <u>THE EDUCATION, TRAINING, AND DEVELOPMENT OF AUDITORS</u>

We cannot respond to the Commission's recommendations in this section of the report other than to add that we think auditors should be trained in financial and business management and economics to a much greater extent. Our experience has shown their level of knowledge in these areas is weak.

9. MAINTAINING THE INDEPENDENCE OF AUDITORS

We agree with the Commission's conclusions that "total independence is a practical impossibility." We think the term "objective" would be much better applied to the auditors relationship with his client than the term independent.

We think the Commission reaches conclusions in this section of this Report which emphasize the self-serving nature that permeates the entire Report. Specifically we are referring to the support the Commission uses in reaching its conclusion that there is no evidence that the auditors' providing services other than auditing has actually impaired the independence of auditors while concluding that the pressures of pricing have a negative effect on the ability of auditors to remain independent and the arbitrary time deadlines established by clients place unnecessary stress on the auditors' independence. The Commission admits that no "audit failures" have specifically been traced (1) to time pressures placed on the staff of auditing firms by pricing policies of management of accounting firms or arbitrary time deadlines placed on the auditor by clients or (2) to the auditors' providing services to clients other than auditing. Yet the Commission reaches exactly opposite conclusions in these two areas. The Commission believes that by being able to provide services other than auditing, the accountant auditor should be able to provide better services to his client without impairing his independence and, therefore, no change is justified. Price and time pressures, however, by the management of accounting firms and clients, respectively, inherently cause problems with the auditors' independence and, therefore, should be changed according to the Report. The Commission indicates that there is no empirical evidence to reject either conclusion and we contend that there is no empirical evidence to support either conclusion.

The Commission states "the evidence contradicts the theory" when discussing the matter of other services provided by auditors and the theory that such impairs the auditors' independence. We contend the proper statement based on the support the Commission developed for its position would be "the theory is not supported by evidence." The Commission put forth no evidence to contradict the theory but was merely unable to find instances to support the theory. We do not necessarily agree or disagree with the Commission's conclusion in the area of other services. We think, however, the Commission does not adequately support its conclusion and several other statements in this section of the Report with empirical evidence or logic.

"The Commission's research <u>suggests</u> that time pressure generated by unduly low fees and by arbitrary deadlines are the most significant cause of substandard performance by auditors". "Although there are other factors, the Commission <u>believes</u> that excessive time pressures are the most pervasive cause of audit failures" (emphasis added). The above quotations from the Commission's Report emphasize what we perceive to be a major creditablity problem. The Commission has not supported its conclusion with evidence or logic for the unbiased reader. We believe a survey of financial and business managers and industry accountants would yield a similar conclusion that "if we had more time, we could perform better." We also believe that the work load has a tendency to expand to fill the time available for both industry accountants and auditors. We put little faith in the objectivity and creditability of the responses by auditors to the Commission's surveys and the conclusions the Commission reaches from such surveys.

We think these specific examples emphasize the overriding problem in the Commission's conclusions and causes us to believe the document is extremely self-serving for auditors by recommending changes which are neither cost justified nor supported by researching "audit failures" or other empirical evidence. Again, we think the "audit failures" that the Commission has considered and "audit failures" in general have been caused principally by a failure of auditors to have the most rudimentary level of knowledge regarding business management and financial management concepts in the client organization they are auditing. An objective review by auditors of the financial and business management decisions in many of the well publicized "audit failures" combined with a simple understanding of business and financial management concepts and, in some cases, common sense would have caused the auditor to question his involvement with a particular client. One rule, however, which overrides all others is that regardless of the business ethics or auditors ethics involved someone, somewhere will risk reputation and make the necessary judgements to become involved in difficult situations for the financial remuneration involved.

The Commission's conclusions regarding scrutiny of auditor changes and rotation of auditors again emphasizes the self-serving nature that permeates this entire Report. Financial managers and auditors almost unanimously have disagreed with the SEC's attempt to require disagreements between auditors and clients to be disclosed in financial statements when auditor changes are made or anytime. The question of rotation of auditors has been discussed for a number of years and has never been required principally because of the high cost involved. We question, however, the Commission's motive in discussing the problem of auditor rotation because of the conclusion that rotation would place a large number of clients "up for grabs" which would intensify the competition among auditing firms.

10. THE PROCESS OF ESTABLISHING AUDITING STANDARDS

Our comments regarding the Commission's conclusions in this area are simply that a full time auditing standards board may be appropriate and may be cost justified. We would encourage that members of industry also be represented on any such a board and that the board realize that its promulgations will be applied to practicing auditors who audit the financial statements of small privately owned companies in addition to those auditors who are involved with the audits of financial statements of major publicly owned corporations. We would encourage any such board to adopt a cost justification concept that must be considered in connection with each promulgation.

11. REGULATING THE PROFESSION TO MAINTAIN THE QUALITY OF AUDIT PRACTICE

Auditors in general, based on our experience, fail to have an appreciation of the cost justification principle of financial management. Auditors tend to react to external and political pressures without recognizing someone must bear the cost and that someone is the client and ultimately the consumer. Therefore, we would recommend that those who may be responsible for regulating the auditors' profession keep that simple concept in mind in any promulgations.

We would be pleased to discuss any of the above matters with the Commission or its staff at its convenience.

Yours truly,

ARMCO STEEL CORPORATION

Lonnie A. Arnett

Lonnie A. Arnett
General Auditor

A-31

UTAH POWER & LIGHT COMPANY
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ORRIN T. COLBY, JR.
ASSISTANT CONTROLLER

June 9, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors'
Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

RE: Response to Report of Tentative Conclusions - The Commission on Auditors' Responsibilities

I am enclosing a copy of my comments made to the Utah Association of CPA's special "Member Forum" for your consideration.

Very truly yours,

OTC:HAW:gh

Enclosure

RESPONSE SHEET

MEMBER FORUM DISCUSSION

"Commission on Auditors' Responsibilities: Report of Tentative Conclusions"

Section 1: The Independent Auditor's Role in Society

A. Should AICPA encourage closer cooperation between audit committees of Boards of Directors and auditors? Should Boards regularly require a report from the auditor on the accounting system and controls over it?

Yes X No ____

Comments:

Independent objective review of the accounting system and controls by the independent auditors can be reported to an audit committee of the Board as long as all facts have been cleared for objectivity through management.

Section 2: Forming an Opinion on Financial Presentations

A. Should the auditor's reporting role be clarified as recommended?

Yes X No ____

Comments:

Caution must be exercised, however, to make sure the statement reader is presented with a clear explanation of any disagreements with clients on application of accounting principles.

If you need additional space for comments, please use back of page

Section 3: Reporting on Significant Uncertainties

A. Do you agree that the auditor's report should be revised as recommended?

Yes X No______

Comments:

B. Should AICPA urge the FASB to adopt a standard that requires a separate note on uncertainties?

Yes X No______

Comments:

Care should be taken to assure that the user of the financial statement evaluate the risk a business faces and the auditor only evaluate the adequacy of the disclosure of risks as indicated on pages 26 and 27.

Section 4: Clarifying the Auditor's Responsibility for the Detection of Fraud

A. Do you agree that the application of the recommended guidelines would benefit both third parties and auditors?

Yes X No______

If you need additional space for comments, please use back of page

Comments:

We agree that if auditors adhere to standards of professional skill and care that covers detection of fraud, they should not be held liable for failure to detect all material frauds.

B. Should guidelines cover recommended requirement:

a. Yes X No ____

Comment:

b. Yes X No ____

Comment:

c. Yes X No ____

Comment:

If you need additional space for comments, please use back of page

d. Yes __X__ No______

Comment:

e. Yes __X__ No______

Comment:

f. Yes __X__ No______

Comment:

If you need additional space for comments, please use back of page

g. Yes X No______

Comment:

h. Yes X No______

Comment:

Section 5: Corporate Accountability and the Law

A. Should AICPA urge the SEC or the stock exchanges to implement this recommendation?

Yes______ No X

Comments:

This area should be studied further before arriving at any conclusions.

If you need additional space for comments, please use back of page

Section 6: The Boundaries of the Auditor's Role and its Extension

A. Should the profession support the expansion of the auditor's role as recommended in Recommendation 14?

Yes______ No __X__

Comments:

See response to item C.

B. Should the profession support the expansion of the auditor's role as recommended in Recommendation 15?

Yes______ No __X__

Comments:

See response to item C. Uncorrected material deficiencies in a company's internal control that are not disclosed by management should be disclosed to the Audit Committee of the Board of Directors who as outside directors could insist on better compliance. A detailed report of internal control weaknesses to statement readers

(over)

C. Should the profession support the expansion of the auditor's role as recommended in Recommendation 16?

Yes______ No __X__

Comments:

The recommended expansion of the Auditors' role must be considered in relation to cost-benefit relationships. Public companies

(over)

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Section 6 - Part B.

would be very confusing and could be considered to be much more serious than necessary and a real disservice to the client.

Section 6 - Part C.

operating at historically low net-earnings levels would not be able to afford expanded audit functions.

Section 7: The Auditor's Communication with Users

A. Should the auditor's standard report be revised to provide for an expanded flexible report?

Yes X No ______

Comments:

But the expansion must be carefully worded so as to not complicate things with so much detail, i.e. descriptions of internal control weaknesses, that after the statement reader has read the flexible report he wonders how serious the matter really is. The non-accountant reader of the report would well be inclined to "write-off" a company where internal control problems may not be all that serious.

B. Should the report reflect the recommendations concerning:

1. Consistency

Yes X No ______

Comments:

2. Reliance on work of another auditor

Yes X No ______

If you need additional space for comments, please use back of page

Comments:

3. Unaudited information associated with audited information

Yes X No

Comments:

Additional research should be done in this area before implementation is required.

C. Should AICPA urge the SEC or the stock exchanges to require that corporate management present a report as recommended?

Yes No X

Comments:

The requirement of a report by corporate management could be viewed as an additional hedge on behalf of the auditor to relieve his liability exposure.

If you need additional space for comments, please use back of page

D. Should AICPA urge the stock exchange to implement the recommendation that auditors be required to be present at the company's annual meeting to answer questions of shareholders?

Yes__X__ No______

Comments:

Section 8: The Education, Training and Development of Auditors

A. Should AICPA's goal be a four-year undergraduate and three-year graduate program of entrance education?

Yes__X__ No______

Comments:

B. Should AICPA work toward separate schools of professional accounting or place principal emphasis on graduate degree programs in professional accounting regardless of organizational structure?

Yes__X__ No______

Emphasis should be placed on schools of professional accounting.

If you need additional space for comments, please use back of page

Comments:

C. Should AICPA provide a form of membership for non-CPA accounting educators?

Yes X No

Comments:

D. Should AICPA encourage state societies to provide similar forms of membership?

Yes X No

Comments:

If you need additional space for comments, please use back of page

Section 9: Maintaining the Independence of the Auditor

A. Should AICPA urge the SEC or the stock exchanges to implement Recommendation 25?

Yes X No ____

Comments:

B. Should AICPA urge the SEC or the stock exchanges to implement Recommendation 26?

Yes X No ____

Comments:

C. Should AICPA urge the SEC or the stock exchanges to implement Recommendation 27?

Yes X No ____

Comments:

If you need additional space for comments, please use back of page

D. Should AICPA adopt a Rule of Conduct to implement Recommendation 28?

Yes X No ______

Comments:

Although audit firms should not "place" former employees in these positions, it should be appropriate for a client, on client's volition, to hire an employee of the audit firm for any position.

E. 1. Should AICPA urge the SEC or the stock exchanges to implement Recommendation 29?

Yes X No ______

Comment:

2. Should AICPA adopt a Rule of Conduct which would require a successor auditor to insist on such disclosure?

Yes X No ______

If you need additional space for comments, please use back of page

Comment:

F. Should AICPA support Recommendation 30?

Yes X No

Comments:

G. Should AICPA implement Recommendation 31 through its Quality Control Review Program?

Yes X No

Comments:

If you need additional space for comments, please use back of page

H. Should AICPA implement Recommendation 32 through its Quality Control Review Program?

Yes__X__ No______

Comments:

I. Should AICPA adopt a Rule of Conduct to implement Recommendation 33?

Yes__X__ No______

Comments:

Section 10: The Process of Establishing Auditing Standards

A. Should an Auditing Standards Board of full-time members be established?

Yes__X__ No______

Comments:

Care should be taken to ensure that the Board is not predominantly membered by Big-Eight firm members.

If you need additional space for comments, please use back of page

B. Should AICPA implement the recommendation that more attention be directed to the needs of firms involved with non-publicly-owned companies?

Yes__X__ No______

Comments:

Section 11: Regulating the Profession to Maintain the Quality of Audit Practice

A. In re Recommendation 36, should AICPA publish the names of all members involved in Trial Board actions and name all those against whom action is taken?

Yes__X__ No______

Comments:

B. In re Recommendation 37, should AICPA initiate action in support of this recommendation?

Yes__X__ No______

If you need additional space for comments, please use back of page

Comments:

C. In re Recommendation 38, should AICPA urge CPA firms to experiment with the type of reporting suggested?

Yes__X__ No_____

Comments:

D. In re Recommendation 39, should AICPA regularly conduct studies and publish findings about cases involving significant audit failures, as it did in the Equity Funding case?

Yes__X__ No_____

Comments:

If you need additional space for comments, please use back of page

June 13, 19 77

From the desk of

JOSEPH HINSEY

To Mr. Douglas Carmichael

Additional copies are
enclosed for your
convenience.

Joseph Hinsey

AMERICAN BAR ASSOCIATION
1155 EAST 60TH ST., CHICAGO, ILLINOIS 60637 TELEPHONE (312) 947-3860

A-32

June 13, 1977

Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Attention: Douglas R. Carmichael
Research Director

Dear Sirs:

This letter relates to the Commission's Report of Tentative Conclusions (the "Report") and is submitted in response to the Commission's solicitation of comments and suggestions for change. This letter has been prepared by the members of the Committee on Audit Inquiry Responses and of the Committee on Corporate Law and Accounting of the Section of Corporation, Banking and Business Law of the American Bar Association. The following are personal comments and do not represent the official position of the American Bar Association or any of its Sections or Committees, and do not necessarily reflect the positions of individual members of the Committee on Audit Inquiry Responses or the Committee on Corporate Law and Accounting.

We believe it appropriate under the circumstances to limit our comments to those portions of the Report dealing with concerns and proposals which would involve lawyers in the auditing function and create new responsibilities for lawyers in the presentation of audited financial statements (or otherwise). Our comments revolve around the Report's treatment of the subject of reporting on uncertainties and legal matters in financial presentations.

(1) Commission Recommendation: "The present requirements for disclosure and presentation of uncertainties should be modified. Users should be better informed about the uncertainties involved in the preparation of financial statements, and the information required to be disclosed should be expanded to improve the ability of users to identify and evaluate significant uncertainties. A separate note, similar to that on accounting policies, should be required for uncertainties. It should explain the significance of the information for future operations." (page 29)

Discussion: At the outset, we wish to express our strong concurrence with the Commission's recommendation that the audit requirement to express a "subject to" qualification when financial statements are affected by material uncertainties should be eliminated. We express this view in the context of the difficulties frequently encountered in predicting the ultimate resolution of uncertainties presented by legal matters, but recognize the validity of the recommendation in other contexts.

While the Report is not specific in this regard, it is assumed that this recommendation is not intended to extend the required disclosure of uncertainties broadly to the variety of economic risks faced by all companies (see page 26) or the general business risks referred to in paragraph 14 of Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 5, Accounting for Contingencies (March 1975) ("FAS 5"). A number of the uncertainties to which this recommendation would apply, if such were the case, are mentioned throughout the Report; for example:

- jeopardy to assets in a foreign location due to political unrest or threat of expropriation (page 23)
- recoverability of investments (page 24)
- future changes in the national economy (page 26)
- inflation (page 26)
- changes in national laws and regulations (page 26)
- unasserted legal claims (page 26)
- ability to obtain additional financing (page 27)
- compliance with fair employment practices or antitrust laws (page 57)
- product safety or efficacy (page 57)

The foregoing is, of course, but a bare beginning for the listing of the total universe of uncertainties which confront companies today.

Such an interpretation of the Commission's recommendation would be consistent, however, with the observation that financial statements should represent a self-contained disclosure document detailing all uncertainties a company faces and their possible effect on its earnings and financial position (see page 26). Setting aside the fundamental question whether such an expanded objective (to be contrasted with the traditional historical perspective for financial statement presentation) would be desirable for financial statements _qua_ financial statements, we question whether the almost limitless array of disclosed uncertainties predictably engendered by this approach would comport with the recognized needs of users for information in an understandable form. Boiler plate cautions would quickly emerge and multiply, and the proposed footnote regarding uncertainties would soon be recognized as a legal defense mechanism calling for the most wide-ranging and elaborate disclosures.

Recommended Change: If this recommendation is intended to broaden the scope of the disclosure of uncertainties to include future risks, it is proposed that required disclosures of uncertainties other than overtly threatened or pending litigation, claims and assessments be expressly limited to those (i) coming within the usual framework of quantitative measures of materiality, and (ii) meeting a standard of imminence, which we would suggest be framed on the basis that within a stated time period the prospects of occurrence seem reasonably certain (i.e., supported by extrinsic evidence strong enough to establish a presumption that the event changing a future risk to a present loss contingency and/or resulting in asset impairment or liability incurrence will happen) and the prospects of non-occurrence seem slight. In this way, the disclosure of future risks would be made capable of meaningful evaluation by users. The accounting standards for recording and disclosing uncertainties involving overtly threatened or pending litigation, claims and assessments, as set forth in FAS 5, would remain unchanged.

(2) _Commission Recommendation_: "Management's responsibility for disclosure of litigation, claims, and assessments can be better fulfilled if greater reliance is placed on, and greater assistance obtained from, corporate or outside

counsel, who would thus assume greater responsibility for the disclosure of legal matters. ... [M]anagement and its legal advisors should provide whatever assurances are necessary for such matters." (page 49)

Discussion: This recommendation overlooks the fundamental distinction between the role of the auditor and the lawyer. As recognized in the Report:

> "The auditor is a third-party intermediary in an accountability relationship between the issuer of audited financial information and users of that information. His primary responsibility is to the users of his work. While the auditor is not an adversary of management, he must be independent." (page xvii)

> "The auditor is an intermediary in an accountability relationship. He is a third party in the relationship between the issuer of financial statements and those who use and rely on those statements." (page 4)

> "An independent audit is necessary because of the inherent potential conflict between the entity's management and the users of its financial information. ... The auditor attempts to achieve an equitable balance among management and the various users." (page 5)

> "The independent auditor is responsible to a variety of interested parties, but his responsibilities vary in nature and extent. ... Much of the auditor's work involves equitably resolving the conflicts that arise among interested parties." (page 11)

In contrast, the lawyer is not a third-party intermediary, is not expected to be independent and is not responsible to a variety of interested parties; indeed, the lawyer's role is that of advocate and advisor whose responsibility is customarily solely and always principally to protect the interests of his client. A lawyer employed or retained by a corporation or similar entity owes his allegiance to the entity (and not to any other person), must keep paramount its interests in advising the entity and has the fundamental duty to represent his client zealously within the bounds of the law. (See ABA Code of Professional Responsibility, Ethical Considerations 5-18 and 7-1.)

Fundamental to this relationship is the strict obligation placed upon the lawyer to preserve his client's confidences and secrets. The discussion of the public policy considerations in protecting lawyer-client confidentiality, set forth in the Preamble to the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information, well summarizes the important concerns underlying the lawyer's different role and relationship with his client; for convenience, such Preamble is set forth in Annex A attached hereto.

Recommended Change: While it is appropriate for the Commission to suggest that corporate and outside counsel provide full assistance to management, within the professional experience and competence thereof, to enable management to fulfill its disclosure responsibilities, it is inappropriate for the Commission to suggest that such counsel assume direct responsibility for the disclosure of legal matters or provide whatever assurances to auditors or other third parties are deemed necessary for such matters. We assume that this was not the Commission's intention and we request revision of the Report to eliminate any such suggestion.

(3) Commission Recommendation: "A substantial portion of the work and responsibilities in these areas [the conformity of corporate actions with laws and regulations and information on the status of pending and future litigation] should fall on the corporate or outside legal counsel". (page 45)

Discussion: The discussion of the lawyer's role and the protection of lawyer-client confidentiality in (2) above is equally applicable to this recommendation. While we can understand the Commission's concern that "some parties view independent auditors as public agents to be used to improve the functioning of the enforcement system as it relates to the conduct of business", we believe it entirely inappropriate that the Commission volunteer the legal profession to assume that the Commission volunteer the legal profession to assume responsibility for greater assurance to auditors and other third parties as to the compliance of corporations with laws and regulations. While the lawyer is of course concerned that our laws and regulations are observed and "shall not counsel or assist his client in conduct that the lawyer knows to be illegal or fraudulent"*, the lawyer has no responsibility to third parties to

* ABA Code of Professional Responsibility, Disciplinary Rule 7-102(A)(7).

police his client's conduct in order to assure compliance with our laws and regulations. Obviously, such a proposal would fundamentally alter the lawyer's role in our society and would therefore warrant the most thoughtful and thorough consideration if it were to become the subject of serious attention.

In this connection, it is relevant to review the background for the current concerns in the area of legal compliance by corporations. As noted in the Report (page 42), current attention is being paid to illegal or questionable corporate payments. Virtually without exception, these payments have involved accounting irregularities and, in most cases, covert acts which have placed corporate assets outside of the corporation's regular system of accounting and control; as a consequence, cash has been made available for disposition by corporate personnel free of normal accountability constraints. Because the integrity of the corporation's system of accounting and control was placed in question by the deliberate circumvention thereof, the responsibilities of those concerned with such system (including the auditor) have been the subject of reexamination and, in this context, the usual framework of quantitative measures of materiality has been considered irrelevant. In a parallel but separate vein, issues of morality and management integrity (where there has been participation in illegal acts) have been raised and, in the context thereof, materiality has again been considered irrelevant.

Consistent with framework set forth at the outset of this letter, we do not undertake to comment upon the auditor's responsibility to detect illegal or questionable acts or the auditor's response to detected illegal or questionable acts. We do believe, however, that the discussion in Section 5 of the Report should be reconsidered and we would urge that the Commission adopt the position that financial statement presentation is not the appropriate vehicle for dealing with wide ranging areas of societal concern falling outside the channels of economic information with which users have been traditionally concerned.

Recommended Change: We request revision of the Commission's Report to eliminate any direct or indirect suggestion that lawyers assume responsibility to the auditor or other third parties for assurances regarding the compliance of corporations with laws and regulations. Further, we believe that the discussion suggesting acquiescence by the Commission in proposals that financial statement presentation serve as a mechanism for monitoring legal compliance, be reconsidered. Specifically, absent legislative prescriptions or accounting irregularities (including covert transactions outside of the normal channels of financial control), we would propose that determinations regarding financial statement disclosure, where questions regarding conformity of corporate actions with laws and regulations are concerned, be made within the usual framework of quantitative measures of materiality and detected illegal or questionable acts be treated as contingencies to be evaluated as a component part of the universe of uncertainties discussed in Section 3 of the Report.

(4) Commission Recommendation: "The report by management [suggested by the Commission] could include the statement that management believes that all material uncertainties have been appropriately accounted for or disclosed, and that it has consulted with legal counsel with respect to the need for, and the nature of, the accounting for or disclosure of legal matters. Alternatively, a separate report by legal counsel might be included". (page 49)

The Commission illustrates this recommendation as follows:

> "The company's legal counsel has reviewed the company's position with respect to litigation, claims, assessments, and illegal or questionable acts; has communicated that position to our independent auditors; and is satisfied that it is properly disclosed in the financial statements." (page 79)

Discussion: This recommendation would implement the recommendations discussed above; to facilitate analysis, its various aspects are separately considered below.

(a) "all material uncertainties" - we refer you to the discussion in (1) above.

(b) "consulted with legal counsel" - there is no objection to the lawyer providing assistance to management, if within his professional competence and experience and so long as lawyer-client confidentiality is protected.

(c) "need for, and the nature of, the accounting for or disclosure of legal matters" - it is not within the lawyer's professional competence to advise in this area. It is for the accountant to determine the need for, and the nature of, the accounting for or disclosure in financial statements of legal matters.

(d) "a separate report by legal counsel" - we refer you to the discussion of lawyer-client confidentiality in (2) above. Separate and apart from this concern, we note that, even if cost were to be disregarded, a legal compliance audit in the sense suggested by the Report is simply not a workable concept. In this connection, we refer you to the observation in the Report that "the audit function is more effective when applied to matters with a factual base and less effective to the extent that information lacks that support" (page 58); as you know, there is no data base (akin to the corporation's accounting and control system) by which all of the acts and omissions of the corporation's employees and agents are recorded. Finally, we note that, if disclosures in the corporation's audited financial statements are to be expertised by persons other than the auditor, the lawyer is but one of a host of advisors to the corporation who might provide assurance as to management's representations (e.g., geologists, actuaries, economists, lobbyists, insurance brokers, real estate appraisers, to name but a few).

(e) "the company's legal counsel" - as pointed out in (d) immediately above, the inference that legal counsel has pervasive knowledge required for a legal compliance "certificate" along the lines suggested by the Report is categorically wrong.

(f) "the company's position with respect to litigation, claims, assessments, and illegal or questionable acts" - there presently exists a mechanism* for review by counsel of the company's position with respect to pending or overtly threatened litigation, claims and assessments and specifically identified unasserted possible claims and other matters (including illegal or questionable acts) and communication thereof to its independent auditors, which we believe to be working well.

---

* The ABA Statement of Policy referred to above and Statement on Auditing Standards No. 12 - Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments.

If the Commission intends that this cryptic language have a broader compass and deal with the subjects of uncertainties and legal compliance, we refer you to (1) and (3) above.

(g) "communicated that position to our independent auditors" - we refer you to (f) immediately above and (2) above.

(h) "satisfied that it is properly disclosed in the financial statements" - we refer you to (f) immediately above and note that the question of proper disclosure <u>in financial statements</u> is a matter to be resolved by the accountant, by reason of his close familiarity with the enterprise's financial transactions and financial position and his special competence to apply concepts of materiality and contingency disclosure established by his profession for financial statement presentation.

<u>Recommended Change</u>: Assuming the concept of a Report by Management is preserved, we would suggest the portion under consideration be changed to read:

> "Having consulted with those advising the company regarding material uncertainties, including a review with legal counsel of the company's position with respect to litigation, claims and assessments, in each case to the extent we believe appropriate, we believe that the company's position in regard to these matters is properly accounted for or disclosed in the financial statements."

* * * * *

In summary, we do not take issue with the Commission's recommendations that disclosures in financial statements regarding litigation, claims and assessments and regarding uncertainties involving legal matters be removed from the direct ambit of the independent audit function. We do, however, raise strong objection to the Commission's suggestions that the auditor be replaced by the lawyer, for these suggestions, if pursued, would result in fundamental changes in the lawyer's role in our society. We are sympathetic with the Commission's desire to establish acceptable working boundaries for expansion of the audit function, but the collateral changes in the lawyer's function and duties proposed by the Commission are clearly unacceptable and will be resolutely resisted.

Should the Commission desire to meet with representatives of our Committees to discuss the foregoing comments and suggested changes, we would be pleased to do so at your convenience.

Very truly yours,

Joseph Hinsey

Joseph Hinsey, Chairman
Committee on Audit
Inquiry Responses

Thomas E. Baker

Thomas E. Baker, Chairman
Committee on Corporate Law
and Accounting

cc: Section Officers and
members of Committees

AMERICAN BAR ASSOCIATION

STATEMENT OF POLICY REGARDING LAWYERS' RESPONSES TO AUDITORS' REQUESTS FOR INFORMATION

Preamble

The public interest in protecting the confidentiality of lawyer-client communications is fundamental. The American legal, political and economic systems depend heavily upon voluntary compliance with the law and upon ready access to a respected body of professionals able to interpret and advise on the law. The expanding complexity of our laws and governmental regulations increases the need for prompt, specific and unhampered lawyer-client communication. The benefits of such communication and early consultation underlie the strict statutory and ethical obligations of the lawyer to preserve the confidences and secrets of the client, as well as the long-recognized testimonial privilege for lawyer-client communication.

Both the Code of Professional Responsibility and the cases applying the evidentiary privilege recognize that the privilege against disclosure can be knowingly and voluntarily waived by the client. It is equally clear that disclosure to a third party may result in loss of the "confidentiality" essential to maintain the privilege. Disclosure to a third party of the lawyer-client communication on a particular subject may also destroy the privilege as to other communications on that subject. Thus, the mere disclosure by the lawyer to the outside auditor, with due client consent, of the substance of communications between the lawyer and client may significantly impair the client's ability in other contexts to maintain the confidentiality of such communications.

Under the circumstances a policy of audit procedure which requires clients to give consent and authorize lawyers to respond to general inquiries and disclose information to auditors concerning matters which have been communicated in confidence is essentially destructive of free and open communication and early consultation between lawyer and client. The institution of such a policy would inevitably discourage management from discussing potential legal problems with counsel for fear that such discussion might become public and precipitate a loss to or possible liability of the business enterprise and its stockholders that might otherwise never materialize.

It is also recognized that our legal, political and economic systems depend to an important extent on public confidence in published financial statements. To meet this need the accounting profession must adopt and adhere to standards and procedures that will command confidence in the auditing process. It is not, however, believed necessary, or sound public policy, to intrude upon the confidentiality of the lawyer-client relationship in order to command such confidence. On the contrary, the objective of fair disclosure in financial statements is more likely to be better served by maintaining the integrity of the confidential relationship between lawyer and client, thereby strengthening corporate management's confidence in counsel and encouraging its readiness to seek advice of counsel and to act in accordance with counsel's advice.

Consistent with the foregoing public policy considerations, it is believed appropriate to distinguish between, on the one hand, litigation which is pending or which a third party has manifested to the client a present intention to commence and, on the other hand, other contingencies of a legal nature or having legal aspects. As regards the former category, unquestionably the lawyer representing the client in a litigation matter may be the best source for a description of the claim or claims asserted, the client's position (e.g. denial, contest, etc.), and the client's possible exposure in the litigation (to the extent the lawyer is in a position to do so). As to the latter category, it is submitted that, for the reasons set forth above, it is not in the public interest for the lawyer to be required to respond to general inquiries from auditors concerning possible claims.

It is recognized that the disclosure requirements for enterprises subject to the reporting requirements of the Federal securities laws are a major concern of managements and counsel, as well as auditors. It is submitted that compliance therewith is best assured when clients are afforded maximum encouragement, by protecting lawyer-client confidentiality, freely to consult counsel. Likewise, lawyers must be keenly conscious of the importance of their clients being competently advised in these matters.

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THE INSTITUTE OF INTERNAL AUDITORS, INC.
INTERNATIONAL HEADQUARTERS, ALTAMONTE SPRINGS, FLORIDA 32701 PHONE: 305·830-7600

June 7, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, N. Y. 10036

Dear Doug:

In May, 1977, The Institute of Internal Auditors solicited opinions from its key leaders on the "Report of Tentative Conclusions" issued by the Commission on Auditors' Responsibilities. The following is a consensus of opinion that has been consolidated from the reactions of the members solicited. These comments represent an extension of the initial review conducted in December, 1975 on the booklet entitled "Statement of Issues: Scope and Organization of the Study of Auditors' Responsibilities."

As reflected in Bill Perry's previous letter of June 3, 1976 (copy attached), the IIA recognizes the positive initiative taken by the AICPA in this vital area. The specific comments that follow are additional items submitted for the Commission's consideration.

General Comments

The report focuses directly on the public accounting profession and the inference carried in most of the report is that there should be expanded scope and more audit coverage by public accountants.

The need and importance of internal control is stated repeatedly (for example, pages 35, 39, 51, and 61), but we were unable to find internal auditing identified with internal control.

It would seem to be in the best interest of the public accounting profession for the Commission to demonstrate its responsibilities to shareholders and the public by recognizing available resources within the corporate structure. This would be to give fair evaluation and place appropriate reliability on the internal audit function as an existing factor of corporate accountability.

If the CPAs' responsibilities and accountabilities are increased, it would seem to follow that internal audit responsibilities and accountabilities will be increased also.

Various recommendations of the Commission have the effect of having external auditors assuming responsibilities in areas heretofore covered by the internal auditors. (SEC and Metcalf are currently critical of external auditors for engaging in services tenuously related to the basic purpose of their certificatory mission.) In recommendations made to narrow the gap between auditor performance and user expectations, the role of the internal auditor seems to have been completely ignored and, as such, would have the effect of not recognizing an important management control. These recommendations, if implemented, could make corporate management subservient to outsiders (external auditors) for review and evaluation of the soundness, adequacy, and application of accounting, financial, and other operating controls.

The report could lead one to conclude that no one is studying and evaluating an organization's system of internal control. We do not believe this conclusion, if reached, is true. We in internal auditing have done and are doing a great deal of work in this area. Internal auditors have been studying and evaluating the system of internal controls for many years (this includes the whole spectrum of internal controls, i.e., accounting, administrative, etc.).

Internal auditing was mentioned very few times in the entire report. But, when internal auditing was referred to, the report's wording (primarily pages 78 and 79) appears to put internal auditing in the role of the company's policemen, whose primary duty, we presume, will be to prevent and detect irregularities, fraud, legal policy violations, etc.

We feel the Commission should address the question of internal auditing's independence role and reporting relationship. We do not feel the Commission's findings fully represent internal auditing's present role within most organizations. The Commission should recognize the misunderstanding the report's proposals (if adopted) could create between presently established internal audit functions and their respective executive managements.

It is generally felt there are many ways the internal and external auditor can assist each other. To maximize this relationship, the two groups (AICPA and IIA) have to recognize each other more, support each other more, and most importantly, understand each other's problems better. In our opinion, the report could be improved by greater understanding, recognition, and support of the role of internal auditing.

Specific Comments

Section 3 - Reporting on Significant Uncertainties - This section deals with a different method of reporting significant uncertainties on the part of the independent auditor. For the most part, since this deals basically with uncertainties regarding the marketplace, litigation, the economy, or other items of an environmental nature, the internal auditor would not be affected. However, if the uncertainty is related to the completion of a project such as a building, or an information system, etc., internal audit could be called upon by management to evaluate project control and project progress, thus allowing management to respond to the reported uncertainty.

Section 4 - Clarifying Responsibility for the Detection of Fraud - The program recommended in this section for a Standard of Care for Fraud Detection has two steps that have bearing on internal audit.

The first step is to observe conditions suggesting predisposition to management frauds. Several examples are given, but not mentioned under this heading is an evaluation of the independence or objectivity of the internal audit function. An examination of the internal audit program and a review of internal audit reports in sensitive management areas should indicate whether the internal audit function is acting objectively vis-a-vis the organization's management. The organization and reporting structure of internal audit as well as an assessment of the qualification of personnel would also be of great importance in the independent auditor's evaluation as to the effectiveness of internal audit in preventing management fraud.

The second step is to extend the study and evaluation of internal control. This adds considerably to the scope and responsibility of the work of the external auditor, but pressures of time, money, and competition referred to elsewhere in this report may stop him from effectively performing the extra work. To overcome this, the external auditor may find it necessary to rely heavily on the work and objectivity of the internal audit function.

Section 6 - The Boundaries of the Auditor's Role and its Extension - This section talks about expanding the role of the external auditor beyond the accounting system to the entire financial reporting system. Much of the material in Section 6 essentially duplicates work associated with, and expected from internal auditing groups which also have a professional code of ethics.

Increased emphasis on the evaluation of internal control, both of the accounting system and the entire financial reporting system, would seem to be leading to increased emphasis on the assistance of the internal audit group. The extent to which the independent auditor could rely on the work of the internal staff would either be an approval or indictment of the internal audit function. At present, any prudent auditing firm would expand its work if there was an ineffective internal auditing program. Since lack of reliance would result in the request for increased auditing fees, the internal audit staff would be placed in a highly visible position by this requirement.

The discussion on efficiency, economy, and effectiveness relates purely to the external auditor. While the report refers to cost benefit relationships, the emphasis is on the cost of not doing rather than measuring what benefit would accrue from the cost of doing. Any extension of the audit role of independent public accountants requires a capability to perform and qualifications which state licensing, i.e., certification, may or may not fully evaluate.

Certainly, the external auditor should not place himself in a position to make management decisions. However, the internal auditor is currently an extension of management and, thus, depending on the internal audit charter, could address such matters with no conflict of interest.

Auditor involvement on a continuous basis may be acceptable for some (large) companies, but would most certainly be too costly for others. No company, shareholder, or the economy should be asked to absorb the cost to review and test the entire system of internal accounting control as suggested unless it is fundamentally structured.

The degree of sophistication through integrated systems, control interrelationships, etc., makes it highly questionable that anything other than a limited test within a defined scope is practical. At the present time, too much of the audit costs which are absorbed by the company's shareholders (not the management) results from subsidizing the learning process for new outside accountants and to expand the scope would further reduce the ratio of productive audit hour to dollar cost.

While we agree that the outside accountant has an obligation to comment on weaknesses in internal control, any such weaknesses can be resolved within the existing structure of the audit committee, company management, and the independent accountant. For that reason, we are not in full accord with the paragraphs in the proposed reports of the independent auditors and the report by management as they pertain to internal control weaknesses.

Section 9 - Maintaining the Independence of Auditors - This section finds no conflict between the same firm having both auditors and management advisory service people at the same client. It even suggests that this could be good from an audit viewpoint since the MAS people learn things not always known by the auditor. While it is not our purpose to comment on the effect of MAS services on the external auditor's independence, we would hasten to add that these same principal benefits may be realized by following the guidelines established by SAS 9, "Using the Work of Internal Auditors."

<u>Summary</u>

We feel the overall conclusion of the report is that the external auditors' role, as expressed in formal traditional opinions, is too narrow and needs to be expanded to cover the entire accounting and reporting systems to form an opinion on a more current and continuing basis. A similar expansion of scope includes reviewing and testing the entire system of internal accounting controls and not just the controls which determine the scope of audit procedures. The objective of these expanded scopes is to enable the external auditor to reach a conclusion as to whether controls over each significant part of the accounting system provide assurance that the system does not contain material weaknesses.

In the environment we are in today (the Proxmire Bill and proposed SEC regulations which will make a crime of erroneous information) increased responsibilities and liability on the part of external auditors seem inevitable. The report seems to accept and to guide the approach toward that trend. The report makes little mention of internal auditors but assigns to external auditors the responsibility for independent appraisals of an organization's systems of internal accounting controls and for preventing and detecting fraud.

These responsibilities, of course, are one of the primary functions of many internal audit staffs today. It would seem that the degree of reliance external auditors place on internal audit work, which is already an important area of coordinating audit reports to accomplish audit coverage in the most efficient manner, should be reflected in the recommendations of the report.

Sincerely,

Stan

S. C. Gross, CIA
International President

SCG/mp

NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS
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A-34

June 13, 1977

Dear Doug:

Enclosed is the report of our Society's Committee on the Future of the Profession commenting on the tentative report of the Cohen Commission.

Robert L. Gray, CPA
Executive Director

Douglas R. Carmichael
Research Director
Commission on
Auditors' Responsibilities
1211 Avenue of Americas
New York, N. Y. 10036

REPORT TO THE

COMMISSION ON AUDITORS' RESPONSIBILITIES

BY THE

COMMITTEE ON THE FUTURE OF THE PROFESSION

OF THE

NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

Committee:

Peter R. Lasusa, Chairman, Arthur Andersen & Co.
Richard A. Eisner, Richard A. Eisner & Co.
James Gillick, Haskins & Sells
Michael Goldstein, S.D. Leidesdorf & Co.
Philip Greene, W.R. Grace & Co.
William Holtz, Holtz Rubenstein & Co.
Joseph Rascoff, Touche, Ross & Co.
Dr. Emanuel Saxe, Baruch College
Professor George Sorter, New York University
Fred L. Tepperman, Arthur Young & Company
Eli Werlin, Urbach, Kahn & Werlin
Michael A. Walker, Mann, Judd, Landau

Staff Liaison:
Max Block
W. Douglas Sprague

June 13, 1977

The Committee on the Future of the Profession of the New York State Society of Certified Public Accountants is pleased to offer the following comments and recommendations to The Commission on Auditors' Responsibilities on its Report of Tentative Conclusions.

RE: THE INDEPENDENT AUDITOR'S ROLE IN SOCIETY (SEC. 1)

Our committee concurs in the Commission's views on this subject. Regarding the role of auditors in serving non-public companies, with which the Commission admittedly does not deal, we urge the earliest possible attention to this subject.

On page xvii, last paragraph, the report states that "Audits are designed to assure..." We suggest the use of "reasonably assure."

The paragraph continues with "Audits are designed...to help safeguard the assets..." Our committee could not unanimously concur in this position since some feel that safeguarding a company's assets is solely management's responsibility.

RE: FORMING AN OPINION ON FINANCIAL STATEMENTS (SEC. 2)

We accept with some concern the Commission's position that the independent auditor should undertake the responsibility for judging the preferability of the accounting principles employed by a company in the preparation of its financial statements.

The concern arises from the foreseen difficulties in reaching a judgment in some, perhaps many, situations. It is therefore essential that the Commission recommend the development of guidelines for judging preferability in order that a frame of reference be available to assist auditors and to help achieve such uniformity as is possible.

As to the recommended exclusion of the word "fairly" from the term "presents fairly" in the auditor's report, our committee was evenly divided on the advisability of this action.

RE: REPORTING ON SIGNIFICANT UNCERTAINTIES IN FINANCIAL PRESENTATIONS (SEC. 3)

I. Approximately half the committee agreed with the primary recommendation in Section 3 that "subject to" qualifications should no longer be required in accountants' opinions with respect to uncertainties. The remainder of the Committee was not prepared to endorse this recommendation for the following reasons:

A. The need to obtain more data as to the possible legal consequences to the auditor. The courts may not accept a pronouncement of the profession that uncertainties do not require reference in the auditor's opinion even if there is adequate disclosure in the financial statements. This is an area that should be investigated thoroughly before any change in reporting standards is adopted.

B. The need to educate the public prior to implementing such a significant change in reporting practice. The Commission's Report points out that presently many users may believe that there are no uncertainties in financial statements if the auditor's opinion is "clean." They are more likely to believe this if, as recommended, material uncertainties would not be cited in the auditor's opinion.

C. The practical desirability of retaining "subject to" qualifications to ensure adequate emphasis in financial reports having material uncertainties.

II. The support for the premise that auditors cannot evaluate the outcome of most uncertainties any better than users of financial statements should be improved. This is a concept that many people outside the profession may disagree with since, as indicated in the Commission's Report, financial statements contain numerous estimates (also see IV below). The profession should be prepared to undertake a public relations effort to clarify this misconception.

If "subject to" opinions are eliminated, the responsibility for evaluating material uncertainties would rest almost entirely with the user. There is some doubt that the user (with some exceptions) is as qualified to evaluate uncertainties as is the independent auditor. Accordingly, the recommendation that "subject to" be eliminated deserves further study.

III. Further, if "subject to" is eliminated, a standard should be promulgated to set forth the requirements for disclosure of uncertainties in financial statements. Particular attention should be given to unasserted claims and other actions.

If it is intended that all material uncertainties should be disclosed, a statement from the FASB should set forth in great detail the nature of the items that should be included and the information that should be given about each, though this may prove to be a most difficult task. A single footnote which purports to include all uncertainties, which, in fact, does not deal with all the uncertainties that face a business enterprise, could be more misleading than useful. Companies and their auditors might innocently overlook some of the uncertainties which should be disclosed even if there is extensive guidance in this area. In addition, without adequate guidance, serious disagreements may occur between auditors and clients over some disclosures of uncertainties.

The need for disclosure guidelines for "going concern" uncertainties is acute. Because such a disclosure can be a self-fulfilling prophecy, the auditor confronts a most agonizing dilemma -- to disclose or not to disclose. In periods of economic distress many such cases may exist, making the development of guidelines an urgent matter.

IV. There is a need to develop cautionary expressions to accompany an uncertainty disclosure. Illustrative of such a caveat is that appearing in the disclosure in 1976 financial statements pertaining to replacement cost data. Such cautionary expressions might also relate to estimates of the provisions for bad debts, obsolescence in inventories, outstanding warranties and other estimates.

V. The use of a middle paragraph in the auditor's report, to emphasize a situation affecting the financial statements, is suggested in paragraph 27 of Statement on Auditing Standards No. 2. The committee feels that the Commission should deal with whether this provision of SAS No. 2 would be appropriate for the disclosure of uncertainties in the absence of a "subject to" qualification.

In suggesting that "subject to" opinions be eliminated, the Commission should also address itself to the use of a disclaimer where there is a material uncertainty (see footnote 8, paragraph 25 of SAS No. 2). Further, in addressing the appropriateness of adverse opinions, the Commission should also deal with the propriety of "except for" qualifications where there is inadequate disclosure of material uncertainties.

RE: CLARIFYING RESPONSIBILITY FOR THE DETECTION OF FRAUD (SEC. 4)

The committee supports the Commission's desire to clarify the auditor's responsibility. It believes that SAS No. 16 adequately defines the responsibility of the independent auditor for the detection of errors and irregularities. As stated in SAS 16, the independent auditor has the responsibility to plan his examination to search for errors and irregularities that could materially affect the financial statements, and to exercise due professional care in the conduct of that examination. While we agree with the recommendations proposed by the Commission to further expand on the general concept of due professional care, we do not believe that the concept of due professional care can be reduced to a detailed list of steps and procedures because, in our view, auditing involves a considerable amount of professional judgement.

RE: CORPORATE ACCOUNTABILITY AND THE LAW (SEC. 5)

We agree with the Commission that the independent auditors should take steps to improve corporate accountability. However, as indicated by the Commission, accountants are not trained to detect violations of law; therefore, we support the need for a clear definition of prohibited corporate conduct.

We also agree with the Commission's conclusions that management has the primary responsibility in this area. Corporations should adopt statements of policy and monitor compliance with such policy. Companies should be encouraged to disclose the existence of the policy in public documents.

The auditors should report any questionable or possibly illegal activities noted during their audit to the Audit Committee or the Board of Directors. The Audit Committee or the Board of Directors should seek the advice of legal counsel on these matters.

We do not agree with the Commission that auditors should disclose confidential information to government agencies or publicly disclose any questionable activities without regard to materiality. We believe that a reasonable standard of materiality should be adopted for disclosure in the financial statements.

The committee supports the Commission's view that better assistance and involvement by the legal profession should be sought by management to enable them to fulfill their responsibility for disclosure of litigation and illegal or questionable acts. A report by management covering accounting systems and internal control and their discussions with legal counsel with respect to accounting for and disclosure of legal matters, would be desirable. We agree with the Commission that the auditor's responsibility should be to review the information and the representations of management and counsel to determine that the financial statements properly reflect the information provided.

RE: THE BOUNDARIES OF THE AUDITOR'S ROLE AND ITS EXTENSION (SEC. 6)

We concur in the Commission's proposal for a continuing involvement by the auditors in a company's accounting and reporting process. We also concur with (1) the concept of the fundamental separation of the roles of management and the auditor, and (2) limiting the auditor's association to information of an accounting and financial nature which is verifiable.

However, we believe that before new areas of auditor involvement are mandated, further study should be recommended in order to provide for the orderly evolution of the audit function. Specifically, the study should focus on (1) the question of the auditor's independence as a result of his assumption of a new responsibility; (2) the auditor's inability to provide assurance on matters with which he is associated; and (3) the benefits of extending the auditor's responsibility against the cost of such extension. This same cost-benefit analysis should be made before mandating a comprehensive review of internal control for the purpose of detecting all deficiencies.

We recommend that independent auditors be required to communicate internal control weaknesses to the Audit Committee or the Board of Directors. We do not agree, however, that a brief summary of such weaknesses would be meaningful to the public because of the difficulty of communicating inherent limitations in internal control.

An agreement could not be reached on the suggested form of "negative assurance" to the public with respect to quarterly financial statements. Further study is necessary of the auditor's ability to convey to users the degree of assurance which can be expected from limited reviews.

RE: THE AUDITORS' COMMUNICATION WITH USERS (SEC. 7)

While we agree with the Commission's conclusion that many users instinctively view the auditor's report as a seal of approval with respect to the financial soundness of a company, we question whether the Commission's suggested revised auditor's report and report by management should be implemented at this time. Rather, the Commission should recommend research and study of the feasibility and implications of an expanded auditor's report and of a management report.

We are concerned with the suggestion that the auditor's report cover such matters as internal controls, association with quarterly information, corporate codes of conduct and meetings with the Audit Committee. The auditor may not be able to convey, and the user may not be able to comprehend, the extent of the auditor's involvement in such matters. If reporting of this information is deemed valuable to users, such communication should be channeled through the company's Audit Committee rather than public reporting.

The committee could not reach a consensus as to whether "fairly" should be eliminated from the auditor's report with the substitution of "in all material respects". A material number of committee members urge that this matter be further studied.

Although the committee endorsed the concept of the report by management, it was divided on the need for a statement by management with respect to its communicating with legal counsel regarding litigation. Outside legal counsel may not be qualified to make a determination on the disclosures required in financial statements. Management's statement on the efficiency of internal controls should eliminate the need for an additional statement on illegal and unethical activities.

RE: THE EDUCATION, TRAINING AND DEVELOPMENT OF AUDITORS (SEC. 8)

The committee concurs in the Commission's conclusion that there is a need for improvement in the educational process. However, it could not agree on the proposed solution that a separate professional school of accountancy is ideal for improving the educational process.

The committee agrees that in the last decade the academic accounting community in graduate B-schools with executive training motivation has increased its emphasis on managerial accounting and financial analysis with a heavy mathematical emphasis. However, it is only the degree to which this has been done that should be of concern to those engaged in educating public accountants.

We also agree with the Commission that the emphasis on the attainment of the Ph.D. degree, generally following directly after undergraduate work, most often precludes the completion of any significant amount of audit experience (which is, incidentally, also a basic prerequisite for the CPA certificate in many states). The result is that such academics lack the professional background necessary to a full understanding of the needs and problems of a public accounting practice.

It is agreed that possession of a Ph.D. Degree and a CPA certificate, coupled with professional experience and scholarly attainment will remain the optimum type of academic preparation. However, we recognize the difficulty of attaining this optimum combination of credentials.

The mere establishment of a professional school of accountancy will not in itself solve this type of faculty problem. Rather, a solution, not suggested by the Commission, is to accept an approved MBA degree plus a CPA certificate, supplemented by high-level practical experience and an acceptable record of scholarly writings in lieu of the Ph.D. degree.

It is submitted that neither the inadequacies in auditing instruction nor the substandard audit performance cited in detail by the Commission will be corrected unless the accounting curriculum (in the first instance) and the accounting firms' policies (in the second) undergo substantial change. Merely spinning off the educational vehicle as a separate professional school of accounting would not, of itself, cure the cited defects.

The Committee believes that what is needed is a major reorganization of existing collegiate schools of business along lines that would recognize all other student career goals than that of executive administration. Accounting (as well as the other departments) should be free to develop and control its own curricular offerings according to preceived professional needs within the appropriate time frame, as well as to prescribe the criteria for the appointment and advancement of its own personnel. The instruction would be more responsive to professional needs, students would have less cause for complaint on this score, and the professional identity of a public accountant would be greatly enhanced.

The Commission also proposes an internship program as a curriculum requirement. This proposal may be desirable but it would be difficult for business schools to administer. If it is to be a curricular requirement, <u>every</u> student must be provided with an opportunity to enjoy substantially the same extent and level of exposure to actual practice, which is a virtual impossibility.

Thus the committee believes that the solution of the educational problems cited by the Commission may lie in the establishment of separate professional schools of accounting regardless of whatever other merits they may have, but rather in the reorganization of existing collegiate schools of business.

The report recommends the gradual extension of the educational process with a four year liberal arts under-graduate program followed by a three year graduate professional program as the ultimate goal. The committee was divided on the necessity for more than a bachelor's degree as preparation for a professional accounting career.

RE: MAINTAINING THE INDEPENDENCE OF AUDITORS (SEC. 9)

In general, the Commission's conclusions on problems involving independence appear sound and are based on reasonable and impartial evidence. Our committee endorses them, with one exception. Rather than prohibit a specific management services activity (i.e., certain executive recruitment and placement services) the committee feels that all management services activities should be authorized and approved by a committee of outside directors of the client being served.

RE: THE PROCESS OF ESTABLISHING AUDITING STANDARDS (SEC.10)

The committee is in general agreement with the recommendations in respect to the establishment of auditing standards. However, we believe that auditors are the best qualified to set auditing standards -- that outsiders should be encouraged and invited to <u>participate</u> and to <u>contribute their views</u> in task force and subcommittee deliberations, particularly in their field of expertise, they should not be <u>members</u> of an official standard setting body.

RE: REGULATING THE PROFESSION TO MAINTAIN THE QUALITY OF AUDIT PRACTICE (SEC. 11)

We are in general agreement with the Commission's recommendations with respect to regulating the profession to maintain the quality of audit practice.

However, we question the Commission's recommendation for moving more expeditiously in disciplinary matters when litigation is invloved. Unleashing the disciplinary mechanism prior to conclusion of the litigation clearly could have an adverse effect on the defendant's right to "due process." Nevertheless, we believe that the profession, in response to public expectations, should re-evaluate the practice of waiting until litigation is concluded before commencing its investigations.

The Commission suggests that users of audited financial information rely heavily on the name and reputation of the particular accounting firm performing the audit. From this, it concludes that experimentation with disclousure of information by a firm about itself would be useful. Although unstated, it is clear that this recommendation implies that the information include financial information. We believe this is a questionable recommendation which, as the Commission acknowledges, is not supported by a demonstrated user need. Absent such a demonstrated need, we believe it is the right of a private partnership to limit distribution of its financial information to its partners. Recognizing that the public has an interest in the reputation of an accounting firm, we believe that one of the best ways to provide it with meaningful information about the firm's professional standing is through publication of the results of the AICPA peer review program.

International Business Machines Corporation

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Armonk, New York 10504

Office of the Controller

June 13, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

We appreciate the opportunity to comment on the Report of Tentative Conclusions by the Commission on Auditors' Responsibilities. We believe the Commission has focused its attention on issues of the day and offered many sound recommendations for improvement. Our comments, limited to areas of disagreement, are submitted as preparers of financial statements, communicators of financial information to stockholders and others, as well as users of financial information provided by others.

Auditors' Responsibilities

Management is responsible for all financial information released by an enterprise whether the information is inside or outside the financial statements. Accordingly, we believe that the auditors' responsibility should continue to be limited to attesting to data in financial statements only. However, we do agree that when audited financial statements are presented and the accompanying data is inconsistent or misleading and management is unwilling to modify its statement, then the auditor should so note in his report.

It is recognized that it has and will continue to be the auditors' responsibility to evaluate management's choices among alternate accounting principles, the appropriateness of those principles in the circumstances and the cumulative effect of their application on financial statements. Wherever judgment is required, differences of opinion will always exist and, thus, we believe the auditors' primary role should continue to be to exercise professional judgment with respect to the results of management's interpretation and application of accounting principles. Accordingly, we believe that any guidelines on preferability among alternative accounting principles should emanate from the FASB and, therefore, reject the Commission's recommendation to develop audit guidelines to assist auditors in the determination of preferability. We do not believe the auditor is or should be placed in the position of making determinations as to preferability except when a change is made. Further, we continue to believe consistency is a very important consideration to users of financial statements and, therefore, warrants comment in the auditors' report.

Uncertainties

We believe that most preparers of financial statements are well aware of the need for providing as much information as possible on each potentially material uncertainty and attempt to fulfill that responsibility. Further, we believe that the auditor should be in a position to assess the completeness of the disclosure and the magnitude of the uncertainty. Accordingly, we favor the continued use of the "subject to" opinion in those instances where the uncertainties are such that the auditor cannot satisfy himself to the extent necessary to express a judgment on the financial condition of the enterprise as a whole. If properly used, we believe that a "subject to" is an appropriate means of emphasizing material uncertainties.

Internal Controls

In our view, the Commission's emphasis on the auditors' responsibility with regard to internal controls is justified. Since management and auditors depend on an effective system of internal controls as the foundation for proper financial reporting, we are sympathetic to having the auditor elaborate thereon in his report.

Except for actual material frauds or frauds involving top management, we do not share the Commission's view that this is a proper subject to specifically address in the auditors' report.

Form of Auditors' Report

We believe the present short form report has stood the test of time and has served the informed users well. We accept the desirability of possible modifications thereto, but we see little justification for the major changes proposed by the Commission. In addition, we believe that the negative implications therein do little to serve the needs of the preparer, user, or the auditing profession. Although we recognize that the auditor's report is his prerogative, we question whether the suggested areas of expansion (other than perhaps internal controls) truly represent better communications with users, and believe it raises additional questions in the minds of users as to the scope of the audit in other perhaps more significant areas not addressed.

Personnel and Recruiting Services

Although we can appreciate the Commission's concern about public accounting firms providing clients with personnel and recruiting services, we would like to state that we as well as other industrial companies look upon the public accounting field as a potential source for qualified technical people.

Therefore, we would urge the Commission in preparing its final report to focus only on situations which could create the appearance of a conflict of interest, such as the placement of those responsible for expressing an opinion on particular financial statements in a management position with that client.

Sincerely,

C. A. Northrop

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A-36

Our Ref. SRS/DRW/C3/1 10th June, 1977

Douglas R. Carmichael Esq.,
Research Director,
Commission on Auditors' Responsibilities,
1211 Avenue of the Americas,
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New York 10036,
U.S.A.

Dear Mr. Carmichael,

The Commission on Auditors' Responsibilities

Report of Tentative Conclusions

We have pleasure in submitting our comments on the above report, which have been prepared by our Auditing Practices Sub-Committee.

Yours sincerely,

S.R. SIBLEY,
SECRETARY-TECHNICAL.

Enc. two copies.

THE ASSOCIATION OF CERTIFIED ACCOUNTANTS
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SUBMISSION OF COMMENTS ON
THE COMMISSION ON AUDITORS' RESPONSIBILITIES
REPORT OF TENTATIVE CONCLUSIONS

The Association of Certified Accountants wishes to thank the Commission on Auditors' Responsibilities for providing the opportunity for them to comment on its Report of Tentative Conclusions.

The Association congratulates the Commission on the production of a splendid document and looks forward to the release of the final report.

The Association also wishes to thank the American Institute of Certified Public Accountants and the various contributing firms for the provision of the facilities and finance that have made the report available to the accountancy profession.

The comments which follow are of course based on United Kingdom experience and whilst the basic problems may be the same our own professional and legislative structure must by definition affect our observations.

Auditing Practices Sub-Committee
DP/DW/C3/1
10/6/77

SECTION 1

It is noted and agreed that in a fast changing economic and social scene it is difficult to keep pace professionally with rapid changes. The enormous burden of new legislation which often affects every economic entity makes the task a formidable one, but any attempt to accelerate the pace of change in the profession is to be welcomed. However, a note of caution should be sounded in that any changes should be thoroughly analysed and discussed before acceptance as an auditing standard.

We agree that there is a lack of understanding by many users of the distinction between auditing and accounting. Many are also unaware of management's responsibility in this respect. We agree that there is a clear need to explain the audit functions and in particular to ensure that users in general do not regard an unqualified audit report as a guarantee or insurance that a corporate entity is sound. In our opinion the profession should initially concentrate on the clarification of functions and definitions.

In considering the clarification of the auditors' role it would seem important to explain in clear terms what is meant by 'fairly presents' or, as is used in the UK, 'true and fair'.
We do not agree with the suggestion that 'fairness' as a standard is not fruitful and that references to fairness should be eliminated from the auditors' report. There should instead be renewed efforts to explain the objective judgments that make up the auditors' opinion. It should be mentioned that UK legislation at present obliges auditors to report on whether or not the financial statements of corporate entities show a 'true and fair view', and that the EEC member states have only recently been persuaded of the efficacy of this approach to reporting by auditors.

We consider that it must be made abundantly clear that in the final analysis the auditors' report is an expression of a considered opinion and not a guarantee, The auditor is applying himself both to an art and a science. He is at all times only human and whilst he applies his skills with integrity and without bias the element of judgment is always present and with it its own limitations.

In calling for more enlightenment of the auditors' role there would appear to be a strong case for more user 'education' and explanation by the profession.

In the UK all limited liability companies are governed by the legislative requirements of the Companies Acts 1948, 1967 and 1976. To this extent the accountability of companies via management to their shareholders and other users of financial statements is laid down by statute. Although these Acts refer to accounts, the UK accountancy profession has produced its own accounting standards and the first of its auditing standards is in the course of preparation. Nevertheless there is much progress to be made on the UK form of corporate report. In July 1975 the Consultative Committee of Accountancy Bodies, representing the major UK accountancy bodies, suggested that the fundamental objective of corporate reports is to communicate economic measurements of and information about the resources and performance of the reporting entity useful to those having reasonable rights to such information. Therefore the corporate report should be relevant, understandable, reliable, complete, objective, timely and comparable. We therefore agree that the auditor has a vital role in reporting as to the validity of the statements prepared and presented by management.

The suggestions that 'the audit function requires a confidential relationship between auditor and management' and 'that the auditor cannot assume that management is dishonest' are welcomed. The principle of being a 'watchdog' and not a 'bloodhound' is still tenable. The objective should be one of mutual respect and confidence to the benefit of all.

SECTION 2

In our opinion it is impossible to provide standards for every contingency, circumstance or event and we consider that there is merit in expecting the auditor to be able to exercise his judgment in situations hitherto unknown.

The principles enunciated for analysing the underlying facts to determine which alternative presentation is more in accord with the substance of an event is accepted.

We concur with the opinion that the ultimate objective of any audit must be to ensure that notwithstanding the application of accounting and auditing standards the overall result is not misleading.
In our view the exercise of prudent judgment by the auditor should safeguard against these dangers.

ECTION 3

In the Report the statement that 'the auditor normally evaluates whether financial information presented by management conforms with appropriate standards' is contrasted with the situation in respect of uncertainties in regard to which the auditor is required to be a reporter and interpreter of financial information as well.
The Report suggests that these aspects of the auditors' role are contradictory.
In our opinion it is by no means clear why there should be a contradiction. In so far as uncertainties may affect the auditors' report the auditor ensures as full a disclosure as possible of the uncertainty and reports thereon. In reaching a conclusion as to whether to qualify his report he will exercise his judgment as in any other case.

We do not agree that the 'subject to' qualification is confusing and ambiguous. The 'subject to' qualification is considered an essential tool to be protected by the auditor in all cases where an unqualified report cannot be given. The auditor is seeking to alert all users of financial statements that all is not well and to explain why through the medium of explanatory notes and his own report. It is therefore not considered desirable to dispense with 'subject to' reports.

It is acknowledged and agreed that independent auditors are in no way better able to predict business success or failure than they are able to predict the outcome of other uncertainties. The auditor should therefore take care to ensure that any relevant information that will assist in explaining uncertainties should be disclosed in the notes to the accounts. Care must be exercised at all times to ensure that a reference to a particular uncertainty does not as a result of undue publicity precipitate that happening of an event that might otherwise not occur, e.g. loss of confidence by creditors. As in many other instances the auditor must maintain a reasonable balance and apply his skills and intellectual honesty to the task.

It is not clear why the present requirements for qualifying an opinion because of uncertainty do not provide desirable legal protection for the auditor. Possibly this is peculiar to the American scene.

SECTION 4 We agree with the statement that the public expect that auditors will concern themselves with the detection of fraud and we consider that in planning the audit programme the auditor should bear this in mind.

In our opinion it is obvious that the detection of management fraud is of prime importance to the auditor, and he should therefore look into the possibility of such fraud in considering whether the accounts on which he is reporting show a 'true and fair' view. However, we do not think that the detection or prevention of fraud are the chief objects of the audit. In our opinion the auditor should satisfy himself that the system of internal check provides adequate safeguards. We agree with the observation that an audit in depth with a view to detecting possible fraud would be prohibitively costly.

We agree with the the suggested explanation of the auditors responsibility for the detection of fraud.

SECTION 5 We concur with the view that auditors should assume more responsibility for the detection and disclosure of illegal or questionable acts by management.

We consider that the following statement is of major importance:

> 'Auditors are primarily accountants, trained and experienced in activities that are basically financial. They are not lawyers nor are they criminal investigators and they do not presently possess the training or skills of either group.'

We therefore agree entirely with the proposals for increasing the role of lawyers in respect of corporate legal accountability.

SECTION 6 We have no specific comments to make on this section of the Report.

SECTION 7 We would reiterate our views regarding the suggested elimination of references to 'fairness' in the auditors' report. (See our comments on Section 1, above.)

We would also reiterate our views regarding the 'subject to' qualification and we believe that a case for reporting by exception, as is the manner in the UK at present, can be supported. (See our comments on Section 3, above.)

SECTION 8 This section is mainly applicable to the American situation and we have no comments to make.

SECTION 9 We are generally in agreement with the contents of this section insofar as they are applicable to the accountancy profession in the United Kingdom.

However, with reference to the effect of time pressures we should like to see a recommendation that the auditor be protected by legislation in respect of a claim by a client if any penalty is incurred by the client for late filing or registration of accounts, when the reason for the late filing is attributable to disagreement between management and auditor as to the audit opinion.

SECTION 10 This section is mainly applicable to the American situation and we have no comments to make.

SECTION 11 This section is mainly applicable to the American situation and we have no comments to make.

ooOoo

SHELL OIL COMPANY
ONE SHELL PLAZA
P.O. BOX 2463
HOUSTON, TEXAS 77001

June 10, 1977

A-37

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, NY 10036

Dear Mr. Carmichael:

Shell Oil Company appreciates the opportunity to comment on the Report of Tentative Conclusions published by the Commission on Auditors' Responsibilities. The Commission and its staff are to be complimented on the quality and scope of the Report, and especially for the decision to expose the tentative conclusions for comment by all interested parties.

Shell endorses a substantial number of the Commission's conclusions and recommendations. We disagree with others, particularly those recommendations dealing with significant expansion of the audit function, because they would not serve the best interests of shareholders and other financial statement users.

The Commission's "forty" recommendations were somewhat difficult to identify. Shell suggests the Report would be improved by specifically denominating each recommendation within the body of the appropriate sections, listing the relevant recommendations at the conclusion of each section, or listing all recommendations in an appendix to the Report.

Although we would have preferred more time in which to develop comments on the Report and recommendations, we wish to express again our appreciation for the opportunity provided by the Commission. Should clarification or additional information be desired with regard to our comments, we would be happy to cooperate.

Very truly yours,

For: J. C. Jacobsen

Attachment

SHELL OIL COMPANY

Comments Submitted to the Commission on Auditors' Responsibilities
With Respect to the Report of Tentative Conclusions

SECTION 2 - FORMING AN OPINION ON FINANCIAL PRESENTATIONS

Recommendation: Reference to "fairness" should be eliminated and an increased emphasis placed on the description of the judgments and decisions required of auditors by (1) improving guidance for evaluating the appropriateness of accounting in the absence of detailed accounting principles, (2) improving guidance for evaluating the appropriateness of alternative accounting principles, and (3) improving guidance for evaluating whether financial statements as a whole are biased or misleading.

The phrase "present fairly...in conformity with generally accepted accounting principles" is not truly meaningful and is subject to varying interpretations or, in some instances, misinterpretation. Therefore, Shell concurs that reference to "fairness" should be eliminated and that the description of the judgments and decisions required of auditors be emphasized. The recommendations for providing improved guidelines as the basis for auditors' judgments and decisions should improve the quality of financial statement audits and, just as importantly, provide the auditor with a sounder basis for providing advice and counsel to management. Further, such guidelines could foster improved understanding by users of the auditor's role and responsibility.

Improved guidance for auditors in the three identified areas must be established with great care, particularly the evaluation of proper alternative accounting principles. With respect to the auditors' responsibilities for evaluating the appropriateness of accounting alternatives determined by management, we wish to emphasize that management has an overriding responsibility--the integrity and completeness of financial reports based on an in-depth knowledge of business operations, conditions and plans. Auditors cannot be expected to be as knowledgeable as management in such areas.

SECTION 3 - REPORTING ON SIGNIFICANT UNCERTAINTIES IN FINANCIAL PRESENTATIONS

Recommendation: The existing requirement that an auditor express a "subject to" qualification for material uncertainties should be eliminated.

It is suspected that the existing requirements are often interpreted differently and that other equally competent auditors might have rendered an unqualified opinion with respect to the Armstrong Cork Company example shown in the Report. Further, "subject to" qualifications might be detrimental to the reporting entity simply because some users are confused about the reason for the qualification. These reasons coupled with those presented in the Report provide strong and valid arguments for support of this recommendation.

Recommendation: A separate note, similar to the Accounting Policy note, should be required for uncertainties; to include disclosures generally contemplated by FASB No. 5 for each material uncertainty.

Shell disagrees with this recommendation because it stresses form over substance by congregating and relocating disclosures presently required. The content and definition of disclosures are promulgated by the FASB. The auditor's function, in Shell's opinion, should be to determine that disclosures of material uncertainties are complete and provide users with enough information to make their own risk evaluations. It is conceivable, indeed probable for many entities, that a company may not have material uncertanties to disclose every year. Would a company in that position have to provide a negative disclosure note if the Commission's recommendation was adopted?

Recommendation: If uncertainty about a company's ability to continue operations is adequately disclosed, the auditor should not be required to call attention to that uncertainty in his report. Considerable improvement is required in the disclosure of going-concern uncertainties and if the auditor does not believe disclosure is sufficient to portray the company's financial position, he should express an adverse opinion.

The recommendation and supporting discussions are not clear. In essence, it appears the Commission is recommending that auditors be responsible for evaluating whether management disclosures adequately reflect "going concern" uncertainties, the relationships among uncertain matters disclosed individually, and the estimated effects of resolution of uncertainties on the viability of the enterprise. Without better audit guidelines and more definitive disclosure requirements under GAAP, such general evaluations introduce too great a degree of subjectivity on the part of the auditor.

SECTION 4 - CLARIFYING RESPONSIBILITY FOR DETECTION OF FRAUD

Recommendation: Auditors should establish a systematic client investigation program; prospective clients with untrustworthy management or deficient internal controls should not be accepted and existing clients which develop such characteristics should not be retained.

An unwarranted rejection by an auditor based on subjective judgments made without full knowledge of all pertinent facts could cause irreparable harm to a business entity's reputation. Therefore, investigative programs leading to possible resignation from an existing engagement or rejection of a prospective client should be instituted only with very specific guidelines and controls. The guidelines should preclude other factors, such as account profitability, from influencing a decision which might be interpreted by outsiders as a client rejection based on questionable actions of management.

Rejection of audit engagements based on inadequate or deficient internal controls should be governed by guidelines different from those for investigating client honesty. Is is certainly possible for deficient internal controls to coexist with an honest management and with financial statements of the highest caliber. An honest management, of course, would be expected to discuss implementation of improved controls with the auditor and to pay higher fees commensurate with the additional tests and procedures required for a satisfactory audit.

SECTION 5 - CORPORATE ACCOUNTABILITY AND THE LAW

Recommendation: Corporations should adopt and distribute to employees detailed policy statements on illegal or questionable acts along with procedures to monitor compliance with the policy. The statements should be available to shareholders and others.

It is agreed that the first responsibility for meeting the demands for corporate accountability belongs to management. Adoption of detailed policy statements and compliance measures relative to illegal or questionable acts is, therefore, appropriate. Distribution of the policy statements to outsiders should not be necessarily discouraged or prohibited, however, Shell is not persuaded that outside distribution should be mandatory.

Recommendation: Additional guidance on the meaning of "professional skill and care" is needed by auditors for detection of illegal or questionable acts.

Development of such guidance for auditors is critical if the independent auditor is to fulfill his responsibilities both to financial statement users and to management. Shell shares the Commission's view that immediate steps should be taken in this regard because the subject of illegal and questionable acts is evolving rapidly. However, our company cautions that costly "overkill" provisions might result if auditor guidance was developed without input from user groups and from the business community.

Recommendation: The auditor's responsibility for detecting illegal or questionable acts must be distinguished from his responsibility for taking action when such acts are detected or discovered...The need for public disclosure must be considered if the board of director's response to the situation is inadequate.

Shell agrees with the general thrust of these recommendations. As previously stated, however, the primary responsibility for corporate accountability rests with management. Public disclosure in the auditor's opinion should be permitted only when the magnitude of the situation might materially compromise the validity of the financial statements. If public disclosure of illegal or questionable acts of a material nature is considered necessary by the auditor, the disclosure should be limited to a factual description of the situation and management's actions thereon.

Recommendation: Greater responsibility for the disclosure of legal matters should lie with management in consultation with its corporate lawyers and outside counsel. The auditor should be responsible for reviewing the information and representations of management and counsel to determine that the financial statements properly reflect the information.

Corporate accountability encompasses the responsibility for disclosure of legal matters, and it is agreed the auditor should not be expected to assume responsibilities in those areas where he lacks training, knowledge and experience. However, it does not necessarily follow that lawyers should assume an auditing function with respect to such areas. The role of lawyers in this area should be consultative, consistent with the lawyers' obligations to their clients. Unlike the auditor, a lawyer is not an independent third-party intermediary and in accord with existing public policy lawyers are expected to maintain the traditional lawyer-client relationship. In specific cases or situations where it is appropriate to refer to opinions of counsel on specific matters, opinions could be provided and mentioned in footnotes, similar to that practice sometimes followed in SEC registration statements.

Certainly corporate and outside counsel should provide full professional assistance to management to enable it to fulfill its corporate accountability and disclosure responsibilities. However, it is inappropriate to suggest or impose obligations or responsibilities inconsistent with the traditional role and responsibilities of lawyers. Shell believes SAS No. 12 is essentially valid in that primary reporting responsibility rests with management and the lawyers' traditional role is maintained.

SECTION 6 - THE BOUNDARIES OF THE AUDITOR'S ROLE AND ITS EXTENSION

Recommendations: Auditor's association with interim information, other financial information in the annual report, or earnings forecasts should not be approached as separate services; rather as the total reporting process.

The audit function should not be limited by the annual financial statements. Auditor association should be limited to information of an accounting and financial nature; the accounting system establishes the most important audit function boundary.

The audit function should be expanded to include all accounting and financial information produced by the accounting system that management has a responsibility to report; limited only by auditor competence relevant to verification.

The audit should be considered a function to be performed during a period of time rather than an audit of a particular set of financial statements:

- Financial statement audits should be expanded to include more elements of the financial reporting process.

- Annual financial statements, while the most important, should be only one audit element.

- Audit function should expand to include all important elements of the financial reporting process.

- Audit expansion should begin with the accounting system and its controls.

- Add a new aspect to independent auditing - the need to examine and report on the functioning of the accounting process and its controls during the year.

These related recommendations are examined as a group. Shell believes the Commission proposes to extend the boundary of audited financial information not only beyond what is needed by financial statement users, but beyond what is desired by most users. Even if there was a need for the recommended expansion of the auditor's function and if public accounting firms had the staff capability and competence to adequately discharge those responsibilities (both being doubtful hypotheses), the increased costs to the shareholder would far outweigh the benefits. Undoubtedly, the recommendations would generate sizable increases in audit fees. More importantly, perhaps, the increased involvement of auditors in day-to-day operations would place an inordinate demand on management's time--time needed to properly conduct and control business operations. Time taken to apprise auditors of business conditions and plans, and to justify the correctness of business judgments would detract from management's ability to meet other more important responsibilities.

Too little is known about the quantification of increased costs and the measurement of attendant benefits to users. The fact that the Commission concluded that benefit-cost analyses could not be conducted at this time was dismissed with the rationalization that the public accounting profession should provide the new services needed by society. There was no clear demonstration, however, of society's need for new services.

The assertion that financial statement users need assurance on financial information not presently audited is not persuasive. There is no question but what users are demanding greater corporate accountability and a higher level of professionalism in the public accounting profession. Shell believes these demands can be better achieved by improving existing reporting and auditing standards rather than by extending the auditor's role into other provinces. Further, we believe user confidence in financial reporting is far more dependent upon confidence in management and its record of consistent and honest reporting rather than on the comfort and assurance provided by an auditor's opinion.

Shell agrees that auditors should be involved with the accounting process and controls throughout the year in order to fulfill their primary role of auditing and providing an opinion on the financial statements prepared by management. However, continuous involvement does not extend to auditing all or even more of the financial reporting processes. There is, already, considerable involvement by auditors with interim reports and other financial reporting throughout the year.

Recommendation: After gaining experience with the expanded study of accounting system controls, the auditor should be required to review the financial reporting process for interim reports as part of a single on-going audit. The review would be similar to but more extensive than the "limited review" contemplated by SAS No. 10. The auditor's interim report should emphasize the review of the accounting process rather than providing assurance related to the interim information.

Shell believes the vast majority of interim financial reports are already responsible representations by management of operating performance. It is doubtful that users would accept a review letter on the accounting process as the basis for appreciably improved confidence. Regardless of the report language, we believe the distinction between a review of the accounting process and an audit would not be understood by many users. A careful evaluation of the substance of the proposed reporting format leads us to the conclusion that the prudent and well-informed user would find little value in an auditor's interim review of the accounting process. Shell does not agree with suggestions that significantly greater involvement by auditors in the financial reporting process is needed to improve the process and the preparation of financial information.

Recommendation: The auditor should be familiar with the company's earnings plan and should relate that plan to his knowledge of its annual and quarterly budgets and its operating activities.

Earnings plans are tools for guiding future management actions and are subject to frequent change and revision. Auditors do not need access to confidential future plans in order to fulfill their responsibility for auditing statements of financial condition and results. In fact, time taken to review such plans could detract from the auditor's ability to satisfactorily conduct the audit in a timely manner. Shell agrees the auditor needs familiarity with budgets and operating activities to assist in his role as auditor of financial statements and information.

Recommendation: The audit function should be extended to include other annual report information (outside the financial statements) which is derived from the accounting system.

Shell agrees. Management's responsibility for accurate and consistent reporting of other financial information in the annual report is no less than that required for the financial statements.

Recommendation: The audit function should evolve to include information bearing on the efficiency, economy, or effectiveness of corporate programs, including social programs, that is produced by the accounting system and is required to be disclosed in public releases of financial information.

As in other areas the auditor's role should not be extended beyond normal verification and audit of information produced by the accounting system which is included or associated with annual financial statements or securities registrations which require an auditor's opinion.

SECTION 7 - THE AUDITOR'S COMMUNICATIONS WITH USERS

Recommendations: The auditor's report in the annual report should be more descriptive of his role and findings.

Chief financial officers should present a new report with financial statements acknowledging management responsibilities and describing programs and actions having a bearing on the financial statements and the accounting process.

Generally, Shell agrees with these proposals. A great deal of work would be required of standard-setting bodies to establish guidelines; however, several aspects of the Commission's suggested report examples have merit. The fourth paragraph of the proposed auditor's report is weak because it requires subjective judgements that would tend to confuse rather than enlighten statement users. We believe financial statements users are far more interested in the auditor's opinion as to the factual presentation of financial results in a complete and honest manner. It is likely some users would view the latter part of the paragraph as a protective disclaimer by the auditor just in case something was wrong in the statements. The corresponding second paragraph of the proposed management report has basically the same weaknesses. Further, both paragraphs could project an image of auditor-management conflict on procedural matters that could easily be misunderstood by the user.

In the suggested management report the fourth paragraph might raise more questions and problems than it dispenses with. As suggested in our comments on Section 5, it might be appropriate to refer to opinions of legal counsel on some specific cases or situations in footnotes to financial statements. Absent special circumstances, we do not believe it is appropriate to specifically mention outside experts, including auditors, in a report by management. Basically, Shell believes such a report should be limited to setting forth the policies, procedures and controls exercised by the company's management, board of directors and committees thereof.

SECTION 10 - THE PROCESS OF ESTABLISHING AUDITING STANDARDS

Recommendation: AudSEC should be replaced by a smaller full-time Auditing Standards Board, appropriately compensated.

In Shell's opinion the full range of recommendations in this section are appropriate. The Commission suggested two possible methods of providing for formal participation by outsiders. We believe aspects of both methods should be formally incorporated in an Auditing Standards Board's organizational and procedural documentation. While we believe outsider representation on the

Board and an advisory committee would be highly desirable, we do not believe in specific membership quotas for either AICPA members or for members representing other groups or organizations. To achieve the best possible Board and advisory committee requires selection of the most qualified persons available on the basis of ability, knowledge, experience and interest without regard to association with the accounting profession, private industry, academe or any other group.

LUKENS STEEL COMPANY

COATESVILLE, PENNSYLVANIA 19320

A-38

J. LEE LEDBETTER
Vice President-Finance and Controller

June 10, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

SUBJECT: The Commission on Auditors' Responsibilities
Report on Tentative Conclusions

Dear Mr. Carmichael:

We have reviewed the report and offer our comments, most of which are noted on the enclosed "Response Sheet." Our comments are directed to the list of 39 recommendations as worded by the AICPA staff for the Member Forum Program. Instead of indicating our response by checking the appropriate "yes" or "no" blank for each recommendation, we have instead inserted the staff's recommendation number in the appropriate space. Since there does not seem to be specific provision for a response to Recommendation 7, we have inserted a comment on page 5, marked as C under Section 4.

The list of recommendations worded by the AICPA staff was especially helpful. We request that the Commission's final report specifically identify and highlight each of its recommendations, rather than just weave them into the text without special notice.

In view of the fundamental nature of the Commission's recommendations, we are shocked and disappointed that their tentative report was not promptly distributed to all AICPA members as well as non-member preparers and users of financial statements. Since the sweeping recommendations could impact all of those groups for many years, the topic of auditors' responsibilities deserves extensive consideration. We were not among those invited to the Member Forum Discussions. Upon learning of the significance of the Commission's recommendations, we requested a copy of the report. Since its receipt, we have devoted many hours to its study and consideration. We look forward to the timely receipt of a copy of your final report and hope that it will reflect our several comments.

Respectfully submitted,

J. Lee Ledbetter

J. Lee Ledbetter

WPT/JLL/mct

Enclosure

RESPONSE SHEET

MEMBER FORUM DISCUSSION

"Commission on Auditors' Responsibilities: Report of Tentative Conclusions"

Section 1: The Independent Auditor's Role in Society

A. Should AICPA encourage closer cooperation between audit committees of Boards of Directors and auditors? Should Boards regularly require a report from the auditor on the accounting system and controls over it?

Yes 1 No ______

Comments:

Section 2: Forming an Opinion on Financial Presentations

A. Should the auditor's reporting role be clarified as recommended?

Yes 2, 3 No ______

Comments:

If you need additional space for comments, please use back of page

Section 3: Reporting on Significant Uncertainties

A. Do you agree that the auditor's report should be revised as recommended?

Yes 4 No

Comments:

B. Should AICPA urge the FASB to adopt a standard that requires a separate note on uncertainties?

Yes 5 No

Comments:

Section 4: Clarifying the Auditor's Responsibility for the Detection of Fraud

A. Do you agree that the application of the recommended guidelines would benefit both third parties and auditors?

Yes 6 No

If you need additional space for comments, please use back of page

Comments:

B. Should guidelines cover recommended requirement:

a. Yes 6 a No

Comment:

b. Yes 6 b No

Comment:

c. Yes 6 c No

Comment:

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d. Yes 6 d No

Comment:

e. Yes 6 e No

Comment:

f. Yes 6 f No

Comment:

If you need additional space for comments, please use back of page

g. Yes 6 g No

Comment:

h. Yes 6h No

Comment:

C. Should Recommendation 7 be adopted?

Yes 7 No.

Comment: We suggest changing the phrase "of fraud" to "of material fraud", to emphasize that regular audit work is limited to major instances of fraud.

Section 5: Corporate Accountability and the Law

A. Should AICPA urge the SEC or the stock exchanges to implement this recommendation?

Yes 8,10,11,12,13 No 9

Comments:

Recommendation 8 - Since all publicly-owned corporations should be required to adhere to the same standards of corporate accountability, we propose that a uniform statement of such policies be developed through the coordinated efforts of the principal professional organizations representing preparers (including lawyers, actuaries and others who contribute to the preparation), auditors and users of financial statements. Such an effort should be funded by the participating organizations.

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(OVER)

Section 6: The Boundaries of the Auditor's Role and its Extension

A. Should the profession support the expansion of the auditor's role as recommended in Recommendation 14?

Yes 14 No ______

Comments:

B. Should the profession support the expansion of the auditor's role as recommended in Recommendation 15?

Yes ______ No 15

Comments:

The auditor should not be required to comment on his review of management's description of the controls over the accounting system unless there are material weaknesses which management has not adequately disclosed.

See also Comments for Section 7, Item A.

C. Should the profession support the expansion of the auditor's role as recommended in Recommendation 16?

Yes ______ No 16

Comments:

We do not believe that auditors should be required to report publicly on quarterly financial information unless that information has been subjected to the same auditing standards as annual audits. If the information were

If you need additional space for comments, please use back of page (OVER)

Section 7: The Auditor's Communication with Users

A. Should the auditor's standard report be revised to provide for an expanded flexible report?

Yes______ No 17

Comments: Although we agree that the current standard audit report could be clarified, we cannot accept the logic that a new standard audit report with standard alternatives will be read as much or more carefully than the current report. Sophisticated users will first look for the standard buzz words to see which standard paragraphs have been used and then for the standard buzz words which identify the standard alternative used. Unsophisticated users may notice that the report is there but will not change their habit of skipping it.

The audit report should be as short as possible and as non-technical as possible while meeting all of the professional and governmental regulatory requirements and highlighting exceptions. We suggest a standardized (OVER)

B. Should the report reflect the recommendations concerning:

1. Consistency

Yes 18 No______

Comments:

2. Reliance on work of another auditor

Yes______ No 19

If you need additional space for comments, please use back of page

Comments:

The principal auditor should not duplicate the work of another auditor just to avoid relying on the work of another auditor. Such a requirement could lead to higher than necessary audit fees, expecially in years where a merger or acquisition occurred after auditors of each organization had begun their work for the year. This proposal would also tend to favor larger CPA firms at the expense of smaller ones when clients of smaller firms establish operations distant from their principal operations, especially if the expansion were overseas.

3. Unaudited information associated with audited information

Yes_____ No 20

Comments:

The auditor should not report on unaudited data with which he is associated unless management has not reported the data appropriately. See Comments for Item A.

C. Should AICPA urge the SEC or the stock exchanges to require that corporate management present a report as recommended?

Yes_____ No 21

Comments:

Although we approve of Recommendation 21 as written, the illustration on page 79 of the Commission's report should be modified in several respects:

a. The comments in the second paragraph on the correction of material weaknesses in the accounting and control system should be excluded unless there is a weakness at the statement date or a weakness was eliminated during the year. See Comments for Item A.

b. We also propose deleting the second and fourth sentences of the third paragraph. These report that the board members who serve on the audit committee are neither officers nor employees and mention meetings of the audit committee. If such information is meaningful at all, perhaps it would be more appropriate in the proxy statement.

If you need additional space for comments, please use back of page (OVER)

D. Should AICPA urge the stock exchange to implement the recommendation that auditors be required to be present at the company's annual meeting to answer questions of shareholders?

Yes 22 No ______

Comments:

Section 8: The Education, Training and Development of Auditors

A. Should AICPA's goal be a four-year undergraduate and three-year graduate program of entrance education?

Yes ______ No 23

Comments:

While we agree that public accounting must be able to attract to the profession enough persons with adequate training and skills to meet the requirements of society, we cannot justify such a requirement for entry-level auditors in the foreseeable future. Certainly, we would encourage accounting students to seek as much education as they desire. However, we would be reluctant to recommend doctoral programs to them if they wish to enter the accounting profession. Possibly the reason so many of those with Ph.D. degrees in accounting have remained in academia is that the market for their services in the business world is very limited. We are also concerned about the economics of such a general educational requirement from the standpoint of the individual students and ability of industry to afford

(OVER)

B. Should AICPA work toward separate schools of professional accounting or place principal emphasis on graduate degree programs in professional accounting regardless of organizational structure?

Yes ______ No ______

If you need additional space for comments, please use back of page

Comments:

Although we do not oppose separate schools of professional accounting, we feel that principal emphasis should be placed on making educators at both the graduate and undergraduate levels more aware of the profession's needs and assist them in developing courses with appropriate content. This should alleviate the burden of entry-level training which has fallen on public accounting firms by default of the educational system.

C. Should AICPA provide a form of membership for non-CPA accounting educators?

Yes 24 No ____

Comments:

D. Should AICPA encourage state societies to provide similar forms of membership?

Yes 24 No ____

Comments:

If you need additional space for comments, please use back of page

Section 9: Maintaining the Independence of the Auditor

A. Should AICPA urge the SEC or the stock exchanges to implement Recommendation 25?

Yes 25 No______

Comments:

B. Should AICPA urge the SEC or the stock exchanges to implement Recommendation 26?

Yes 26 No______

Comments:

If board's of directors are to determine if other services performed by auditors pose an independence problem, then some technical group, such as the AICPA, should establish guidelines so that well-informed non-accountants who serve on boards can adequately monitor relationships.

C. Should AICPA urge the SEC or the stock exchanges to implement Recommendation 27?

Yes 27 No______

Comments:

If you need additional space for comments, please use back of page

D. Should AICPA adopt a Rule of Conduct to implement Recommendation 28?

Yes______ No 28

Comments:

We believe it is impossible to administer this proposal in a way that would avoid the appearance of conflicts of interest. A placement that would comply with this recommendation at the time it was made could very possibly not comply within a short time as a result of changes in circumstances not contemplated at the time of the placement. The cases referred to on page 99 of the Commission's report do not, in our view, represent conflicts of interest so much as they appear to be (OVER

E. 1. Should AICPA urge the SEC or the stock exchanges to implement Recommendation 29?

Yes 29 No______

Comment:

2. Should AICPA adopt a Rule of Conduct which would require a successor auditor to insist on such disclosure?

Yes 29 No______

If you need additional space for comments, please use back of page

Comment:

F. Should AICPA support Recommendation 30?

Yes 30 No

Comments:

G. Should AICPA implement Recommendation 31 through its Quality Control Review Program?

Yes 31 No

Comments:

If you need additional space for comments, please use back of page

H. Should AICPA implement Recommendation 32 through its Quality Control Review Program?

Yes 32 No ____

Comments:

I. Should AICPA adopt a Rule of Conduct to implement Recommendation 33?

Yes 33 No ____

Comments:

Section 10: The Process of Establishing Auditing Standards

A. Should an Auditing Standards Board of full-time members be established?

Yes 34 No ____

Comments:

If you need additional space for comments, please use back of page

B. Should AICPA implement the recommendation that more attention be directed to the needs of firms involved with non-publicly-owned companies?

Yes 35 No____

Comments:

Section 11: Regulating the Profession to Maintain the Quality of Audit Practice

A. In re Recommendation 36, should AICPA publish the names of all members involved in Trial Board actions and name all those against whom action is taken?

Yes 36 No____

Comments:

B. In re Recommendation 37, should AICPA initiate action in support of this recommendation?

Yes 37 No____

If you need additional space for comments, please use back of page

Comments:

C. In re Recommendation 38, should AICPA urge CPA firms to experiment with the type of reporting suggested?

Yes 38 No

Comments:

D. In re Recommendation 39, should AICPA regularly conduct studies and publish findings about cases involving significant audit failures, as it did in the Equity Funding case?

Yes 39 No

Comments:

If you need additional space for comments, please use back of page

Seidman & Seidman
CERTIFIED PUBLIC ACCOUNTANTS

OFFICE OF GENERAL COUNSEL
15 Columbus Circle, New York, New York 10023 · (212) 765-7500

A-39

June 14, 1977

Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Attn: Mr. Douglas R. Carmichael
Research Director

Dear Sirs:

Enclosed are this firm's comments on the Commissions' Report of Tentative Conclusions. I know that it is a day late, but I would respectfully request that you still consider the comments set forth.

Very truly yours,

Richard A. Meyer
General Counsel

RAM:s
encls.
(Hand Deliver)

A-39

Seidman & Seidman

15 Columbus Circle, New York, New York 10023 · (212) 765-7500

CERTIFIED PUBLIC ACCOUNTANTS

June 14, 1977

To: Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Attn: Mr. Douglas R. Carmichael
Research Director

Re: Comments on Commissions' Report
of Tentative Conclusions

Dear Sirs:

On behalf of my firm, I wish to offer certain comments on the Commission's recently issued Report of Tentative Conclusions. First, however, I would like to extend our congratulations to the Commission on its substantial efforts. The Report is well written and evidences a significant investigation into the various aspects of auditors' responsibilities.

We have one general criticism. Many of the items in the Report seem sketchy compared to the overall Report, and offer little guidance to auditors. For example, in Section 4, on auditors' responsibility for detecting fraud, the middle item on page 39 involves the study and evaluation of internal controls. This is an important area. In fact, the Report deals with it again in Section 6, and makes certain recommendations. However, the discussion on page 39 consists of two short paragraphs. Without further guidance, the Report suggests "...a study and evaluation of internal control beyond that now required," and that the auditor should be concerned with "...all controls that have a significant bearing on the prevention and detection of fraud." We do not believe such, summarial recommendations are helpful.

We understand the Commission's role, and that the procedures for implementing its recommendations are left to the profession and other appropriate bodies. However, we believe that the circumstances surrounding a Commission recommendation should be fully discussed, the recommendation explained and reasonably defined, as has been done in many cases. Vague or general suggestions raise questions, but do not provide the necessary guidance to the profession or those charged with standard-setting.

We are especially concerned with two areas of the Report: responsibilities with respect to fraud; and competition among firms. We feel that the entire discussion on the auditors' responsibility for detecting fraud is too summarial and general, and includes some dangerous comments. Section 4 contains a useful discussion of the background to the problem--expectations of users, concepts of fraud, etc. It also contains some interesting recommendations. Too much of this Section, however, appears to be a recap of material previously published elsewhere. It does not seem to reflect the fresh thinking evident in other parts of the Report.

The summarial nature of the discussion leads to troublesome statements, such as that the auditor "...has a duty to search for fraud..." (p. 36). While this is tempered somewhat by other comments, it is too broad and vague by itself. "An auditor cannot be expected to detect all frauds" (p. 37) does not explain the scope of the duty to search for it , nor give an indication of those frauds one can expect to be detected. While the recommendations help somewhat in this regard, they are often too general and insufficiently explained. We also note that the Report does not substantially address certain considerations, with respect to the detection of fraud, such as: the tailoring of audit programs; communications between predecessor and successor auditors; communications with the SEC; and data processing matters.

The auditor's duty with respect to fraud is relevant. If the matter is to be discussed, it should be thrashed out and brought down to some reasonably definitive conclusions. If the subject is too complex for the Commission to deal with fully, which would be understandable, it should say so and possibly set forth some recommendations in that context.

One disturbing suggestion by the Commission is that the AICPA should regularly issue reports on frauds, such as its report on the Equity Funding matter (pp. 39-40). We disagree, and the suggestion is inconsistent with the recommendations made in Section 11. Reports analyzing individual fraud cases as they move through the courts, as suggested on page 145, may well be useful. However, the Equity Funding report was not of that nature.

The Equity Funding report was a critical discussion of the audits, inexcusably issued during the course of litigation, before any trial, and was a disservice to the AICPA and the profession. The report was ill-conceived in an emotional atmosphere after the Equity scandal arose. It was based to a large extent on material supplied by persons who were suing the auditors, and on press reports. The investigation was more a witch-hunt than a careful analysis. Auditors who were involved were not interviewed; many workpapers were not reviewed. The report was issued in the midst of complex litigation over the objections of at least two members of the report committee and other responsible persons. The report provided no substantial answers to the questions raised by the Equity fraud; its principal accomplishment was to bolster the plaintiffs' arguments against the auditors in the settlement negotiations, to the eventual detriment of the whole profession.

The Equity report then is not the type of communication by the profession which should be encouraged. It represents an arbitrary, unproductive effort which should be discouraged. Of much greater benefit to the profession and society would be a thorough, careful analysis of a problem, such as Equity Funding, providing guidance for future situations. This may be the type of report the Commission envisions on page 145, and could be useful.

We agree with most of the Commission's other recommendations in Section 4, but have the following comments.

Extending study of an evaluation of internal control: This recommendation, of extending the study and evaluation of internal control beyond that which the auditor believes necessary to perform his audit, would add substantially to the cost of an audit, particularly for smaller clients. We do not feel that the Commission has provided sufficient rationale to justify this recommendation in view of its additional cost to society. If there is to be an expanded study of internal control, we suggest the requirement be limited to publicly-held companies.

Developing and disseminating information on frauds and methods of detecting frauds: While we agree that auditors should be generally knowledgeable about the latest methods of perpetration of fraud, we do not think there should be a higher responsibility imposed on the auditor for the detection of fraud. For example, there should not be a responsibility in a normal audit to expand audit procedures simply to ascertain whether the type of frauds perpetrated in other situations have occurred.

Awareness of deficiencies in individual audit techniques and steps: The AICPA should pay continuous attention to the effectiveness of conventional auditing techniques and develop new ones as the need arises; but the individual auditor should not have to assume the burden of developing other auditing procedures unless he is aware that a step he is performing has little validity on a particular audit.

We are also concerned with the discussions on competition among accounting firms appearing on pages 106-118, in Section 9 on Independence. We are happy that the Commission has addressed what we perceive to be a serious problem within the profession, and we agree with many of the conclusions and recommendations. However, we do not feel the Commission has dealt adequately with the problem and find that it has too cryptically dismissed items as not being of concern.

In our practice, my firm has experienced many questionable and undesirable practices in competing with large national firms. I will limit my present comments to irresponsible price competition and related questions. These activities are not only harmful to smaller firms, but are dangerous to the entire profession.

Unfair competition with respect to engagements for publicly-held companies is a very real problem. The Commission has properly concluded that "...the profit motive, competition among firms, and the need to attract new clients and keep existing ones are...emphasized too much." (p. 113). We also agree with the Commission's view that accepting engagements at a loss, to be offset by future fees, may create an independence problem, a matter the AICPA should consider.

Yet, the Report does not fully come to grips with the problem. Indeed, the discussion of the concentration of public company audits in large national firms (pp. 109-110) appears to be a defense of the large firms' activity, not a thoughtful analysis of the matter. For example, the Commission too cryptically concludes that there is no evidence to support the presumption that concentration might result in poor audits. We agree the big firms are making efforts to improve the quality of their work. All firms are. However, that is not a complete answer.

"Concentration" cannot be viewed as a bare concept, but should be viewed in light of the present excessive price competition (Report, pp. 107-9). Fee-cutting appears a normal practice of some large firms for obtaining and maintaining engagements for large public companies. This obviously encourages the trimming of audit procedures, shortcutting and hurried work. We have heard reports of such practices being employed, as cost-reducing devices. Such inappropriate practices result in bad audits. Thus, concentration, in conjunction with excessive price competition, does encourage substandard work. Further, such a system has the unfortunate habit of enforcing itself, and encouraging further, undesirable cost-saving practices.

The concentration of publicly-held clients in the big firms tends to create other problems. However, it is the fact that such concentration is based in part on inappropriate price competition that must be of major concern to the profession, and to society. It encourages cost-reducing practices and discourages objective professional performance.

Another cryptic, self-serving comment, on page 110, is: "Concentration may also hold the promise of benefits to users." There follow, in the discussion on pages 109-110, unfounded suggestions that only the big firms can adequately audit large public companies, that concentration reduces costs to users, and that the performance of such audits by smaller firms is undesirable because the fees may be material as to the smaller firm. The Commission should not be a party to such statements, which are misleading and promotional of the big firms' activity. Such statements seem to support an argument that only big firms should audit public companies of any size.

Smaller national firms like ours, with international affiliations, are equipped to audit most public companies, even international entities, as efficiently as the large firms. The fees of such clients would not generally be material to a firm such as ours. Many regional firms, too, are equipped to audit smaller public companies, and would not have a materiality problem on the fees.

Further, the big firms, like other firms, must serve their large public clients through one primary office. That office must be concerned with retaining that client and making a profit. The fees may well be material to that office. Viewed in this manner, such engagements pose as much a potential independence problem to the big firms as to smaller ones.

The Commission has not dealt with the affect on smaller firms of the concentration of public company audits in the large firms. Many smaller firms like ours depend in part on public-company business. The increasing concentration will destroy some smaller firms, stymie the growth of others, and reduce our ability to compete with the larger firms. The problems stemming from concentration, discussed above, will then be greatly intensified. It will also create an even greater domination of the profession by the larger firms. On pages

109-110, the Commission states that, because of price competition, "there is no reason to condemn concentration on the basis of costs to the users of financial statements." This ignores the fact that the solidifying of such concentration will reduce competition and enable the large firms to charge greater fees to public company clients. The users will be the ultimate victims of those larger fees.

There are other problems involved with big firms securing engagements on the basis of low initial fees, and with the concentration of the public company practice in such firms. We do not feel the Commission has adequately analyzed this area or dealt with it completely, as we think it should. We do not know all the answers to the problems of price competition and concentration. Treating fee-cutting, with contemplated recoupment, as an independence problem is one answer. There must also be stronger sanctions against unethical practices in securing audit engagements, and more attention to this area by the proper authorities. In any case, we feel the Commission should have taken a stronger stand, and come up with more recommendations, in this area.

Outside of the main concerns above, we have certain other comments on the Report, which I will set forth in the same order as that of the Report.

Section 1

We agree with most of the Commission's comments and recommendations in Section 1. However, while we agree that auditors should have a closer working relationship with a company's board of directors, we do not feel that the Report provides enough guidance in this area. For example, it would be helpful if the Commission made further and more definitive recommendations with respect to interaction between the auditors and a company's audit committee, and with respect to other communications between the auditors and the board of directors.

Section 2

Evaluating the appropriateness of accounting in areas in which there appear to be acceptable alternative accounting principles: The Commission's discussion of the selection of accounting principles from alternatives should not deal with accounting for transactions in accordance with their substance. To account for them otherwise would not be in conformity with GAAP; therefore, there is no alternative involved. We believe that, absent a conceptual framework for financial reporting or an objective basis in accounting literature, the auditor cannot form a professional judgment as to appropriateness without introducing personal bias; this would result in the auditor superimposing his personal bias for that of the management. In the case of most accounting alternatives there is rationale for each of the alternatives and therefore it's a question of degree - i.e. how much weight should be given each reason - pro or con - for a particular accounting alternative. In practice, this evaluation is very difficult if not impossible for the auditor to make, and at the same time preserve the character of financial statements as being those of the company. Moreover, auditor evaluation in these circumstances would encourage the unhealthy practice of "shopping around" for accounting principles. Therefore, the thought of extending the requirement for the auditor to judge preferability of acceptable accounting alternatives when there are no objective standards is ludicrous in those cases where there is not even a switch from one accounting principle to another. In fact, some of the "free-choice" alternatives mentioned in the report, although characterized as extremely few, are those that have a very significant impact on financial reporting. Moreover, those alternatives that are not "free-choice" normally have objective criteria to determine preferability and, therefore, in those cases we would agree that the most appropriate accounting method should apply regardless of whether there is an accounting change.

<u>Evaluating whether financial statements taken as a whole have been prepared in a biased manner or are otherwise misleading</u>: We think it would generally be very difficult, if not impossible, for the auditor to evaluate whether the cumulative effect of the selection

and application of accounting principles produces a misleading picture. Our feeling is that as long as the basic underlying accounting principles are described (which they are not under existing literature), the reader would be in a position to evaluate the risk factors involved.

Section 5

Responsibility for detecting illegal or questionable acts: If a corporation adopts a policy on corporate conduct and procedures to monitor compliance with the policy, the auditor in a separate engagement could review the policies and procedures to determine whether there are material weaknesses in them. However, we do not believe it necessary for the normal audit under generally accepted auditing standards to be expanded to have the auditor plan his examination to search for illegal acts. Because of a lower materiality threshold for illegal acts, it would unnecessarily add significant costs to the ordinary audit.

Reporting on corporate codes of conduct: We do not think the auditor should report publicly on corporate codes of conduct because of the cost involved in making such a mandatory review and the false expectations that the public might receive from that kind of a report, in view of the inherent limitations involved in any system and procedures to prevent or detect illegal or questionable acts.

Increased involvement of lawyers on illegal or questionable acts: The Commission is correct that the conformity of a corporation's actions with laws and regulations is properly within management's and the lawyers' scope of responsibility, not the auditors'. However, the Commission would still impose on auditors inappropriate duties, such as requiring them (p. 48) to publicly disclose questionable or illegal acts when management or the board of directors makes "an inadequate response." We feel the Commission's conclusions would leave auditors in substantially the same, uncomfortable position as at present. The conclusions do not reflect the shifting of most responsibility on illegal and questionable payments to management and the lawyers as suggested by the Commission.

Section 6

Expanding study and evaluation of internal control: Because this would substantially add to the cost of an audit and because the perceived need for this service is largely in the public sector, we do not think it should be extended to all companies. If expanded at all, it should be limited to publicly-held companies. Even with respect to publicly-held companies, we doubt that management's discussion of its controls would have any meaning to the public and, in fact, such controls may appear to others to be more impressive than they actually are. Users would have more of an interest in knowing of material weaknesses, than of being in a position to evaluate the controls from the description given by management. Also, before the auditor will be in a position to report all material weaknesses in controls, a framework would have to be developed as to the objectives of internal controls and what would constitute weaknesses in the system.

More extensive involvement in the financial reporting process review: We believe the SAS No. 10 type of review would be sufficient, and need not be expanded for this purpose.

Extension of the auditor's role re other annual report data: We disagree with the recommendation for the auditor to immediately extend the audit function to other information in an annual report and modify his report accordingly. While we agree with the idea of communicating better in a report, that communication should, at least initially, relate to the financial statements and not to matters with which auditors are not traditionally associated in the public's mind.

Section 7

A new approach to reporting: We agree that there needs to be better communication in the auditor's report. Moreover, we generally agree with the idea of a report by management, and with the idea of expanding upon the auditor's report, to better communicate. However, we have concerns about some of the substance of the auditor's report, which concerns are set forth above in response to other recommendations.

Section 8

Professional schools for accounting: We agree with the recommendation.

Professional society affiliations for academics: We do not think that non-CPAs should be permitted to join the AICPA. While we agree with the desirability of improving interaction between academicians and practicing accountants, such interaction can be encouraged by the AICPA through other means, without admitting academicians to membership in the AICPA.

Section 10

Retain standard setting in the private sector and with the AICPA: We heartily agree.

Replace AudSEC with a full-time Board: We agree, provided there are safeguards to assure adequate consideration of the impact on smaller clients and smaller accounting firms. We feel AudSEC has performed well, but the need for more attention to this area would be better served by a full time group.

<u>Participation from outside the profession in setting standards</u>: While we agree with the recommendation of greater outside participation, these outsiders should not serve directly on the new standards-setting Board because of their lack of practical knowledge and experience in auditing.

* * * * *

We appreciate this opportunity to comment on the tentative Report of the Commission, and we would be happy to expand on any of our comments at the Commission's request. We wish the Commission success in its further deliberations and the conclusion of its substantial and difficult task.

Respectfully submitted,

Bernard Z. Lee
Managing Partner

BZL:s

A-40

THE New York Stock Exchange

Robert M. Bishop
Senior Vice President
(212) 623 5250

June 13, 1977

Mr. Douglass R. Carmichael
Research Director
The Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, NY 10036

Dear Mr. Carmichael:

The Regulation and Surveillance Group of the New York Stock Exchange, Inc. is pleased to submit its commentary on the AICPA's Independent Commission Report of Tentative Conclusions on Auditors' Responsibilities. Generally, we endorse the tentative conclusions and recommendations and offer our congratulations to the Commission for the fine job it has done.

Please don't hesitate to call on us for any assistance or support that you feel may be helpful in reaching your stated objective.

Very truly yours,

THE New York Stock Exchange

AUDITORS' RESPONSIBILITIES

A New York Stock Exchange, Inc. Regulation and Surveillance Group Commentary Submitted to the American Institute of Certified Public Accountants' Independent Commission on Auditors' Responsibilities.

This paper represents a commentary on the Report of Tentative Conclusions of the Commission on Auditors' Responsibilities, an advisory commission established by the American Institute of Certified Public Accountants (AICPA). The commentary represents the position of the staff of the Regulation and Surveillance Group of the New York Stock Exchange, Inc. Because of the uniqueness involved in broker/dealer auditing and regulating, our report briefly discusses the group's operating functions and responsibilities before addressing the Commission's conclusions.

THE EXCHANGE'S ROLE AS A SELF-REGULATOR

The Regulation and Surveillance Group regulates and monitors the financial and operational condition and sales practices of 374 member firms who, in the aggregate handle 85% of our nation's securities business. In performing these responsibilities, the Exchange is subject to the jurisdiction and oversight of the Securities and Exchange Commission (SEC), which designated the Exchange as the primary self-regulator of its broker/dealer members. In order to effectively regulate the broker/dealer community, the SEC and the Exchange adopted a series of financial responsibility and reporting rules.

REQUIREMENTS FOR AUDITS OF BROKER/DEALERS IN SECURITIES

The financial responsibility rules are concerned with broker/dealer financial viability and operational integrity and the protection of customers' assets. The reporting rule, SEC Rule 17a-5, provides the framework for the comprehensive monitoring system which is supplemented by examinations conducted by the Exchange's personnel. Since the audited financial statement required by SEC Rule 17a-5 is to be presented in a form similar to the financial reports submitted to the Exchange by broker/dealers during the year, the annual audit - by virtue of its confirming characteristic - is the cornerstone of the broker/dealer reporting system. Because our commentary is based on our experience with broker/dealer audits, a copy of the relevant sections of the SEC Rule 17a-5 pertaining to the audit function is included in the appendix of this paper.

Basically, the reporting rule mandates that each broker/dealer doing a public business be subject to an annual audit. As such, it defines a series of minimum requirements as to the conduct of the audit and the content of the resulting audited reports.

In addition, the audit rule requires that the independent accountant express an opinion on the financial statement and on the computations of Net Capital and Customer Protection Reserves under the financial responsibility rules. This is especially relevant in that SEC Rule 15c3-1, the Net Capital rule, makes it unlawful for a broker/dealer to do business if they are not in compliance with this rule. Furthermore, the auditor is required to issue a letter identifying any material inadequacies that were found in the accounting system, internal control, and procedures for safeguarding securities, etc. Consequently, the Exchange views the statements and reports on which independent auditors' render opinions as critical to the effectiveness of its regulation and surveillance efforts.

Examinations of member firms conducted by Exchange personnel are not reaudits. Accordingly, the Exchange relies on the integrity and professionalism of independent accounting firms and expects professional presentation characterized by full and complete disclosure of material adverse matters.

The degree of disclosure and comprehensiveness of the opinion are required by the rule with the express purpose of assisting the designated primary self-regulator in fulfilling its surveillance responsibilities under the Securities and Exchange Act of 1934. In effect, the self-regulator is the primary user of financial reports and statements audited by independent public accountants. In our case, the Exchange is the primary user of the auditors' reports concerning 374 member organizations. It is in this role that we offer our commentary to the Commission. The major section of this paper discusses our experiences with the gap that we perceive to exist between auditors' performance and our expectations.

THE GAP BETWEEN PERFORMANCE AND EXPECTATIONS

Before the formation of the Securities Investor Protection Corporation (SIPC), the New York Stock Exchange, through its Special Trust Fund, assumed responsibility for the protection of customers' accounts at certain liquidating member organizations that were unable to meet their obligations to their customers.

During the liquidation process, numerous material accounting and operational deficiencies were discovered by Exchange staff members. In some instances, these deficiencies indicated that audits were not conducted in accordance with generally accepted auditing standards (GAAS). Most often in such instances, adequate disclosure of material information had not been made. In some instances, rather than submit to a legal proceeding, some of the accounting firms involved acquiesced to the Exchange's claims of material deficiencies in auditing procedures and reporting requirements and entered into monetary settlements with the Exchange. In other instances, the Exchange refrained from legal action because the monetary damages arising from such inadequacies were not large enough to justify legal proceedings.

Following, are five examples of deficiencies discovered by the Exchange staff during the liquidation process. The deficiencies which were found to have been in existence from several months to several years were of such a material nature that, if properly disclosed and comprehended in the capital computation, they would have resulted in violations of the financial responsibility rule then in effect. We should point out that these deficiencies were encountered when the securities industry was undergoing a severe "operations backlog". Although some would view this as mitigative in circumstance, the Exchange feels that this period demonstrated a classic need for quality audits.

1. General ledger accounts were out of balance for unreasonable time periods on numerous occasions. These difference or suspense items, related to security positions as well as money balances, were not audit-verified, not disclosed and not comprehended as a charge in the net capital computation. In addition, subsidiary ledger trial balances were found to have been out of balance for unreasonable time periods. The reports did not disclose these out-of-balance conditions and the accountants rendered unqualified opinions in their submitted reports.

2. Bank reconciliations had not been prepared and cash accounts had not been adjusted for material debit or credit items on many occasions. The Exchange staff also noted that material adjusting entries had not been made to correct the books and records. In some instances, bank reconciliations had not been prepared by the member organizations for unreasonable time periods. Disclosure of these deficiencies was not made in the auditor's report.

3. Stock records - the records that list each security with detailed information about its ownership and physical location - had been materially out of balance as of the audit date. Capital computations did not properly comprehend charges for these out-of-balance conditions. Disclosure was not made, and unqualified opinions were rendered.

4. Omnibus account balances with other broker/dealers, for material money balances and securities positions, were not reconciled for unreasonable time periods by the member organizations and the accounting firms did not prepare proper reconciliations.

Confirmation responses were not reconciled with the money balances and security positions. Correcting journal entries were not made. In one instance, these out-of-balance conditions continued for at least two consecutive annual audits. The submitted reports, which were accompanied by clean opinions, did not disclose any deficiency or problem in this area.

5. Money balances due from customers were presented as being "bona fide" (current and collectible) cash accounts or as fully secured accounts. However, some material customers' account balances were not collectible and were either unsecured or partly secured. Capital computations were incorrect since the computations did not comprehend these incorrect classifications. In one instance, a customer's account with a material balance was classified as a bona fide cash account for two successive audits when, in fact, it was unsecured.

In recent years the Exchange has not supervised the liquidation of any broker/dealers. Consequently, while we have seen no evidence casting doubt on the quality of most current audits we are not in a position to determine the extent to which the aforementioned audit inadequacies have been eliminated.

Today, our differences with auditors are more fundamental. However, any differences of opinion are much more difficult to resolve. Generally, our dissatisfaction lies with the area of limited disclosure and the profession's general unwillingness to recognize that designated self-regulators are the prime users' of the audit report and, consequently, accept the attendant responsibility the auditors have to those users'.

For example, some accounting firms issue a confidential "management letter" to member organizations that, in effect, is a critique of a member's accounting system, operations department and internal controls. Recommendations are made to improve any disclosed deficiencies of the aforementioned areas. Accountants will not provide the Exchange with a copy of this management letter, claiming a confidential client relationship.

As a result of this practice, the following questions arise: How can the Exchange determine whether there are any <u>material weaknesses</u> inherent in the member's accounting system, operations or internal controls, if the Exchange, as the designated primary self-regulator, is not privy to this confidential letter? Does the confidential management letter contradict the material inadequacy letter which may have stated that no material weaknesses were disclosed? Has full disclosure been made to the Exchange regarding the <u>material</u> aspects of the critique? If the accountants' role is interpreted to be that of an impartial party, how can this be reconciled with the need for a confidential report to the client? Does the preparation of a confidential management letter place the accountant in the position of being an advocate of the member organization (client) and, in turn, an adversary of the Exchange or any user relying on the accountant's opinion? Is the confidentiality concept of management letters appropriate in broker/dealer audits in view of the requirements of SEC Rule 17a-5?

As long as the practice continues, these questions will linger with us as a self-regulator.

Recently, certain audited financial statements were submitted that reflected management's opinion on pending legal actions, although an independent legal opinion had been obtained from the client's outside counsel. In some cases, management's opinion concerning contingent liabilities, or the resolution of pending litigation differed from that of the outside counsel. The Exchange believes if outside legal opinion has been obtained, the footnote to the financial statements should contain the substance of such an opinion.

In another situation, footnotes in the submitted reports were stated in vague, deceptive and misleading language. In one instance, an accounting firm stated that sufficient information and adequate disclosure had been submitted to the Exchange relative to a material problem. However, the Exchange's examination disclosed that the information referred to was indicated in a four-word parenthetic statement which contained misleading information. In essence the parenthetic statement commented on the currency of certain items in terms of being outstanding longer than 40 days. We subsequently learned that such items were in fact outstanding for at least three-to-five-years and should have been considered in the firm's capital computation. The eventual outcome of this situation was the decision by the member firm to liquidate its business.

A RECOMMENDATION TO
OVERCOME COMMUNICATIONS BARRIERS

Currently, if a specific difference of opinion exists between the Exchange staff and an independent accountant or his client, there is no vehicle to reach an ultimate mutual understanding. Although the Exchange has regulatory authority over its membership, it does not have jurisdiction over the accountants.

In numerous instances, the accountants have dismissed our concerns with the statement that the items under discussion are not "material" and that the professional judgment exercised by the accountant is final. When users such as the Exchange and auditors disagree, there should be recourse for resolution other than legal action, which can be costly, time-consuming and embarrassing.

The Exchange believes that if the AICPA established a vehicle -- i.e., a forum to stimulate discussion where differences of opinion exist -- hopefully, a reconciliation of such differences could be achieved.

In addition, a component of this vehicle should explore the professional accountability of individual Certified Public Accountants. Recently, we informed the AICPA's Committee on Professional Ethics of a situation where we questioned the independence of an auditor vis-a-vis his client. Although the Committee investigated the matter, it was not empowered to inform us of its final disposition. Consequently, we were provided with no response or perspective with which to arrive at our own determination on the position we should take relative to the audit. It seems to us that the AICPA, as the professional authority for CPAs, ought to consider designating its staff to act for the Institute in enforcing professional standards and establishing a hearing process whereby such questions can be decided, with public disclosure of penalties for inadequate, substandard or negligent observance of auditing standards. The Exchange's own disciplinary process may furnish an example of a balance of fairness with due process, privacy for persons found not guilty, and public notice of disciplinary penalties. We feel that some change is necessary in the governance of the professional accountants. The alternative is the imposition of complex rules of conduct by regulatory authorities or Congress.

The issues that must be faced in deciding how auditors should meet the audit requirements entail many fundamental value judgments. In exercising such judgment the independent accountant must give consideration to the underlying purpose of the audit. The auditor can be aided in his considerations by referring to the objectives stated in SEC Rule 17a-5. Because one of the major functions of the audit is to provide users with the financial information necessary to fulfill their responsibilities, the accountants' should place greater importance on the regulatory establishment as a prime user of the auditor's report and be guided accordingly. In short, we do not expect the accounting profession to regulate the securities industry but, rather, look for their professional cooperation so as to allow us to meet our overall regulatory objectives.

Considering the importance of these objectives, we are greatly encouraged by the AICPA's Independent Commission's report and the tentative conclusions reached. We believe the report represents a substantial effort and offers the profession a meaningful and practical blueprint for today and the future. Although we commend the conclusions and tentative proposals for change made, we especially endorse the Commission's recommendations in reporting on significant uncertainties; boundaries and extension of the auditor's role; auditor's communication with users'; and regulation of the profession to maintain the quality of audit practice. Finally, we applaud the conclusion that the gap which exists between the users' expectations and the auditors' performance must be considerably narrowed.

To this end, the staff of the Regulation and Surveillance Group of the Exchange would be pleased to assist the Commission in any way which may be helpful.

June 13, 1977

RELEVANT SECTIONS* OF SEC RULE 17a-5: REPORTS TO BE MADE BY CERTAIN EXCHANGE MEMBERS, BROKERS AND DEALERS

(d) Annual Filing of Audited Financial Statements.

(1)(i) Every broker or dealer registered pursuant to Section 15 of the Act shall file annually, on a calendar or fiscal year basis, a report which shall be audited by an independent public accountant. Reports pursuant to this paragraph (d) shall be as of the same fixed or determinable date each year unless a change is approved by the Commission.

(ii) A broker or dealer succeeding to and continuing the business of another broker or dealer need not file a report under this paragraph as of a date in the fiscal or calendar year in which the succession occurs if the predecessor broker or dealer has filed a report in compliance with this paragraph as of a date in such fiscal or calendar year.

(iii) A broker or dealer who has not transacted a business in securities directly with or for other than members of a national securities exchange, and has not carried any margin account, credit balance or security for any person who is defined as a "customer" in paragraph (c)(4) of this rule, shall not be required to file a report under this paragraph.

(2) The annual audited report shall contain a Statement of Financial Condition (in a format and on a basis which is consistent with the totals reported on the Statement of Financial Condition contained in Form X-17A-5, Part II or Part IIA), a Statement of Income, a Statement of Changes in Financial Position, a Statement of Changes in Stockholders' or Partners' or Sole Proprietor's Equity, and a Statement of Changes in Liabilities Subordinated to Claims of General Creditors. Such statements shall be in a format which is consistent with such statements as contained in Form X-17A-5, Part II or Part IIA.

[As amended in Release No. 34-11935, March 19, 1976, 41 F.R. 12638.]

(3) Supporting schedules shall include, from Part II or Part IIA of Form X-17A-5, a Computation of Net Capital Under Rule 15c3-1, a Computation for Determination of the Reserve Requirements under Exhibit A of Rule 15c3-3 and Information Relating to the Possession or Control Requirements Under Rule 15c3-3, and shall be filed with said report.

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* Note: Sections e and f are not included.

(4) A reconciliation, including appropriate explanations, of the Computation of Net Capital under Rule 15c3-1 and the Computation for Determination of the Reserve Requirements Under Exhibit A of Rule 15c3-3 in the audit report with the broker's or dealer's corresponding unaudited most recent Part II or Part IIA filing shall be filed with said report when material differences exist. If no material differences exist, a statement so indicating shall be filed.

(5) The annual audit report shall be filed not more than sixty (60) days after the date of the financial statements.

(6) The annual audit report shall be filed at the regional office of the Commission for the region in which the broker or dealer has its principal place of business, the Commission's principal office in Washington, D.C., and the principal office of the designated examining authority for said broker or dealer. Copies thereof shall be provided to all self-regulatory organizations of which said broker or dealer is a member.

(g) Audit objectives.

(1) The audit shall be made in accordance with generally accepted auditing standards and shall include a review of the accounting system, the internal accounting control and procedures for safeguarding securities including appropriate tests thereof for the period since the prior examination date. The audit shall include all procedures necessary under the circumstances to enable the independent public account to express an opinion on the statement of financial condition, results of operations, changes in financial position, and the Computation of Net Capital Under Rule 15c3-1, the Computation for Determination of Reserve Requirements for Brokers or Dealers under Exhibit A of Rule 15c3-3, and Information Relating to the Possession or Control Requirements Under Rule 15c3-3. The scope of the audit and review of the accounting system, the internal control and procedures for safeguarding securities shall be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination in (a) the accounting system; (b) the internal accounting controls; (c) procedures for safeguarding securities and (d) the practices and procedures whose review is specified in (i), (ii), (iii) and (iv) of this paragraph would be disclosed. Additionally, as specific objectives, the audit shall include reviews of the practices and procedures followed by the client:

(i) in making the periodic computations of aggregate indebtedness and net capital under Rule 17a-3(a)(11) and the reserve required by Rule 15c3-3(e);

(ii) in making the quarterly securities examinations, counts, verifications and comparisons and the recordation of differences required by Rule 17a-13;

(iii) in complying with the requirement for prompt payment for securities of Section 4(c) of Regulation T of the Board of Governors of the Federal Reserve System; and

(iv) in obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3.

(2) If the broker or dealer is exempt from Rule 15c3-3, the independent public accountant shall ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to his attention to indicate that the exemption has not been complied with during the period since his last examination.

(3) A material inadequacy in the accounting system, internal accounting controls, procedures for safeguarding securities, and practices and procedures referred to above which is expected to be reported under these audit objectives includes any condition which has contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to (i) inhibit a broker or dealer from promptly completing securities transactions or promptly discharging his responsibilities to customers, other broker-dealers or creditors; (ii) result in material financial loss; (iii) result in material misstatements of the broker or dealer's financial statements; or (iv) result in violations of the Commission's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described in parts (i), (ii), or (iii) of this subparagraph (3).

(h) Extent and Timing of Audit Procedures.

(1) The extent and timing of audit procedures are matters for the independent public accountant to determine on the basis of his review and evaluation of existing internal controls and other audit procedures performed in accordance with generally accepted auditing standards and the audit objectives set forth in paragraph (g) above. In determining the extent of testing, consideration shall be given to the materiality of an area and the possible effect on the financial statements and schedules of a material misstatement in a related account. The performance of auditing procedures involves the proper synchronization of their application and thus comprehends the need to consider simultaneous performance of procedures in certain areas such as,

for example, securities counts, transfer verification and customer and broker confirmation in connection with verification of securities positions.

(2) If, during the course of the audit or interim work, the independent public accountant determines that any material inadequacies exist in the accounting system, internal accounting control, procedures for safeguarding securities, or as otherwise defined in subparagraph (g)(3), then he shall call it to the attention of the chief financial officer of the broker or dealer, who shall have a responsibility to inform the Commission and the designated examining authority by telegraphic notice within 24 hours thereafter as set forth in paragraphs (d) and (f) of Rule 17a-11. The broker or dealer shall also furnish the accountant with a copy of said notice to the Commission by telegraphic communication within said 24 hour period. If the accountant fails to receive such notice from the broker or dealer within said 24 hour period, or if he disagrees with the statements contained in the notice of the broker or dealer, the accountant shall have a responsibility to inform the Commission and the designated examining authority by report of material inadequacy within 24 hours thereafter as set forth in paragraph (f) of Rule 17a-11. Such report from the accountant shall, if the broker or dealer failed to file a notice, describe any material inadequacies found to exist. If the broker or dealer filed a notice, the accountant shall file a report detailing the aspects, if any, of the broker's or dealer's notice with which the accountant does not agree.

(i) Accountant's reports, general provisions.

(1) Technical requirements. The accountant's report shall: (i) be dated; (ii) be signed manually; (iii) indicate the city and state where issued; and (iv) identify without detailed enumeration the financial statements and schedules covered by the report.

(2) Representations as to the audit. The accountant's report shall: (i) state whether the audit was made in accordance with generally accepted auditing standards; (ii) state whether the accountant reviewed the procedures followed for safeguarding securities; and (iii) designate any auditing procedures deemed necessary by the accountant under the circumstances of the particular case which have been omitted, and the reason for their omission.

Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required under this rule.

(3) Opinion to be expressed. The accountant's report shall state clearly the opinion of the accountant: (i) in respect of the financial statements and schedules covered by the report and the accounting principles and practices reflected therein; and (ii) as to the consistency of the application of the accounting principles, or as to any changes in such principles which have a material effect on the financial statements.

(4) Exceptions. Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given.

(5) Definitions. For the purpose of this rule, the terms "audit" (or "examination"), "accountant's report", and "certified" shall have the meanings given in Rule 1-02 of Regulation S-X.

(j) Accountant's report on material inadequacies.

The broker or dealer shall file concurrently with the annual audit report a supplemental report by the accountant describing any material inadequacies found to exist or found to have existed since the date of the previous audit. The supplemental report shall indicate any corrective action taken or proposed by the broker or dealer in regard thereto. If the audit did not disclose any material inadequacies, the supplemental report shall so state.

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MEMBER
AMERICAN INSTITUTE OF
CERTIFIED PUBLIC ACCOUNTANTS
CANADIAN INSTITUTE OF
CHARTERED ACCOUNTANTS

June 10, 1977

Dr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York, 10036

Dear Sir:

Re: Report of Tentative Conclusions

In response to the request for suggestions for change in the Report of Tentative Conclusions, I wish to complement the Committee on the report in general, but would suggest reconsideration of the following subjects:

1 PUBLIC REPORTING ON INTERNAL CONTROL

It seems that from time to time various hot proposals spearhead the current wave of reform. Sometimes they fade, as unfortunately appears to have happened with proposals for published forecasts. I believe, for the following reasons, that public reporting on internal control is a proposal which should also be permitted to fade.

(A) The external auditor is an integral part of the overall system of control. If a company has no internal controls, but a complete external audit of all transactions, it still has adequate controls. The overall control system is only inadequate if the external auditor is prevented from extending his audit to the extent neccessary to supplement lack of internal controls. He is already required to report if this occurs. I agree with the SEC position on detection of fraud on pages 31-32 of the report. If the auditors' clean certificate means that the accounts are not materially distorted, then it is implicit that the overall controls, inclusive of the external audit, have functioned adequately.

In many smaller companies the external auditor is expected to perform the functions that are performed by internal auditors in larger concerns. It would seem to be a matter of management prerogative to determine whether certain functions should be performed by an internal audit staff or by external auditors. It is impractical to draw an arbitrary line and say that controls are inadequate if not performed by an internal staff. Requirements for reporting on inadequacies in <u>internal</u>

control will result in a multitude of exception reports for companies which have adequate overall control.

(B) As stated in the sample audit report on page 78 of the report, "control procedures can be circumvented by collusion or overridden". Management can always override internal controls. In an analysis of computer fraud at the recent AICPA Computer Conference in Chicago, it was noted that by far the largest average loss per fraud occurred in management frauds and that a significant percentage of computer fraud was perpetrated by people in management positions. To paraphrase the comments from ACCOUNTANCY on page 32 of the report; it is absurd to say that controls are all right subject to the possibility that they may have been circumvented. Public reports can only lull the lay reader into unwarranted reliance on controls and open the profession to further litigation.

(C) Public reporting on controls will tend to harness the profession to the current approach of reliance on "internal controls". It may be found in the future that alternative audit approaches prove more effective. Modern management now controls through budgets, not through extensive review of detailed documents as used to be the practice. It is desireable that the profession have flexibility to change without having any particular audit technique set in cement by requirements for public reporting. "Internal Controls" is the current panacea for all ills. We may find in the future that alternative app-roaches are more cost effective.

2 MANAGEMANT SERVICES PRACTICES

In my opinion, current trends in management services are adversely affecting audit performance. This is not because of its effects upon independence, but because of the organizational trend to segregation of separate management services departments.

In most major firms the management services function is handled in a separately staffed department. Development of accounting systems, EDP consulting and all business oriented analysis goes to this department. As a result, the audit staffs tend to be lacking in experience in accounting systems, particularly EDP systems, and in understanding of the businesses they audit. The greatest internal problem facing the profession at the present time is the question of how to co-ordinate the various specialists and bring their composite knowledge to bear on the professions primary function of auditing. Whatever the theory, the practical fact is that auditors and management services staff tend not to speak to each other and that cost and other considerations tend to inhibit use of MAS specialists on an audit.

It is noticeable that the Metcalf report, and also one of the major accounting firms, believe that public accountants should restrict their activities to auditing, accounting and accounting systems. The practice of offering a supermarket full of of financial services, based upon specialties in which the partners of accounting firms are not trained, is questionable. Auditors cannot function adequately without being experts in accounting systems and it is desireable to limit approaches which tend to remove this training from their experience. I believe that accounting firms should stick to their area of expertise and understand that an auditor must be a systems expert as well as auditor and accountant.

In conclusion, let me again complement the Committee on a very comprehensive report and trust that these suggestions will receive consideration.

Very truly yours,

William A. Bryden.

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OWENS-ILLINOIS

Kenneth E. Tigges
Vice President and
Comptroller

June 13, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Sir:

We are pleased to take this opportunity to comment to you on the report of tentative conclusions of the AICPA Commission on Auditors' Responsibilities.

Owens-Illinois is one of the world's leading manufacturers of packaging products with sales of $2.6 billion annually. The Company manufactures and sells products including glass containers, metal containers, semi-rigid plastic containers, metal and plastic closures, containerboard, corrugated and solid fiber shipping containers, composite cans, multiwall paper and plastic shipping sacks, plywood and dimensional lumber, disposable paper and plastic cups, tubs, lids, and plates. In addition, an important part of Owens-Illinois' business consists of specialized glass products, such as glass television bulbs, scientific and laboratory glassware, and glass tumblers and stemware for household and institutional use. The operations of Owens-Illinois are international in scope. In the United States, the Company employs nearly 50,000 persons and has more than 100 manufacturing and related facilities in 27 states and extensive administrative, research, and marketing facilities. Owens-Illinois has investments in 21 other countries. We are enclosing a copy of our 1976 Annual Shareholders' Report which will provide further information on our Company.

As background for the following specific comments on the report, we believe it is important to point out that Owens-Illinois has long been a proponent of good and complete financial reporting. We also have been strong supporters of the concept that financial statements of a company are the prime responsibility of management and that is the auditor's responsibility to attest as to whether the statements presented represent within reasonable parameters the condition and results of the company. Also, in accordance with our commitment to good financial reporting and control, we have a comprehensive and, we believe, sophisticated internal audit function.

While, as stated in the previous paragraph, we believe in full and good disclosure, we have become increasingly concerned that the vast amounts of additional information, much of it of a technical nature now being required by the FASB and SEC, has significantly reduced the readability and understanding of such reports for all but a few sophisticated users. The addition of a statement regarding management's acknowledgement of its responsibility for the reports together with its assessment of the company's accounting system and controls (which could run several pages) appears to us to be one additional step in the wrong direction. Once again, additional information is being used as a substitute for correction of the real problem as further discussed under auditor's responsibilities.

While there have been some instances where auditors failed to fulfill what sophisticated readers would consider the auditor's responsibility, the number of these cases has been relatively few in comparison to the total number of companies audited annually. The publicity given them has distorted the reputations of both management and the public accountants far beyond the importance of these few situations. This is not to imply that both professions do not have a responsibility for improved quality of audits and financial reporting, but rather to reflect that no matter how stringent the rules, there will be human failures in the accounting profession as in any other way of life. We believe that as compared to some of the detailed recommendations in the report, a more satisfactory solution might well be an educational program on the part of the Institute to better educate users as to realistic expectations from audits. Such educational program could reach professional users through organizations such as Financial Accounting Foundation, Credit Managers Association, American Bankers Association, American Bar Association, etc. This could be accomplished by direct mail literature, their periodicals and/or conferences. Most other users could be reached through articles in the various business publications.

While the commission included representatives of the legal, educational and financial analysts professions as well as industry and research, there was a strong flavor also of public accountants. This may, in part, explain the principal emphasis on curing the problem through reducing auditors responsibility while increasing audit time and thus fees. In a period when operating margins are being squeezed (despite reported record earnings by many companies each year), the great number of additional requirements by the SEC, FASB, and now this proposal, causes audit fees to be one of the fastest rising costs of companies at least on a percentage basis.

We believe firmly that the public accountant, particularly as to larger clients, should maintain a continuing interest in the company and, in fact, have involved our public accountants in consulting on major financial matters long before it was a requirement. However, the expansions in the audit function proposed in your report and summarized below appear to provide an open-ended opportunity for the public accountant to run up considerable additional time without adequate justification.

> "<u>Audit Function</u>
>
> "--The audit function should be expanded to include other information of an accounting and financial nature that management has a responsibility to report--in addition to periodic finan-

cial statements--provided that it is produced by the accounting system and the auditor is competent to verify the information.

"--The audit function should include greater involvement in a company's financial reporting process on a more current and continuing basis.

"--The auditor's report on the audit function, issued annually, should include an evaluation of management's description of controls over the accounting system, and should disclose material uncorrected deficiencies not disclosed by management.

"--The audit function should gradually expand to include all important elements of an entity's financial reporting process."

In fact, with the degree of involvement suggested, we even question whether the auditor can retain an independent viewpoint.

As to questionable acts of clients, we concur that auditors should be subject to the concept of due professional care and concur that they cannot reasonably be expected to detect all frauds. Here, again, however, we believe that a primary requirement is to educate users as to what can reasonably be expected rather than great expansions of the audit function. As to the specific steps that management should take, we believe that each individual management can more appropriately judge what is appropriate to its style rather than having specific documents required.

While we concur with the guideline for selection and appointment of auditors and have followed this procedure, as well as the ratification of the selection by our shareholders, we are concerned that the setting of fees be centered in the Board of Directors or its Audit Committee. While we have a dedicated and active Audit Committee, they cannot be as well informed as to the specifics of audit time as can the financial management of the company. We believe that a better practice is to allow management to continue to set fees with the auditors, but allowing the auditors to advise the Audit Committee and/or full Board as necessary if they feel that the setting of fees has placed undue restrictions on them. This can readily be accomplished during the portion of the Audit Committee meeting where management representatives are not present. We have a concern that there might be a growing philosophy that audit fees, no matter how high, are "good for the country".

The report states in part, "Management of public accounting firms should take steps to reduce pressures on independence which arise from time budgets that are too stringent and cost constraints that are too restrictive, and arbitrary deadlines imposed by clients should be resisted when they threaten audit quality." We believe the real answer here is for public accounting firms to make the decision to abandon a client if they feel the above creates a problem. In due respect to its responsibility to the shareholders, management must work in a cost-conscious manner and report on a timely basis. Proper scheduling and a coordinated effort between the auditor and the company is essential. If deadlines set for certification happen to make the auditors concentrate on those issues necessary for certification and spend less time on unimportant matters, the shareholders interest has been served.

We heartily concur with the recommendation that the establishment of auditing standards remain in the private sector and that the AICPA or some associated body is probably the best vehicle to establish such standards. We strongly encourage some outside participation in the standards setting body particularly representation from the business community to insure a degree of practicality in the process.

In summary, we believe that the public accounting profession should take such steps as are necessary to insure quality audits. These should not necessarily include significant expansions of audit time but rather redirection to important matters. The expectations of users have become so great in many areas because of a lack of understanding that even great expansions of the audit would not serve this purpose. An educational program by the Institute may well have a significant impact in this area.

Perhaps a paragraph could be inserted in the auditor's certificate to the extent that the audit is intended to verify the reasonableness of the representation but is not intended to insure against fraud may well alert the uninformed reader. In closing, we would not want the Commission to believe that the comments above should necessarily reflect pro or con on our experience with our public accountants. They are the combined thoughts of a number of people whose experiences include time in public accounting and with other companies as well as O-I.

Once again, we appreciate having the opportunity to comment on your report.

Sincerely,

R. Wiggins

rp

Enclosure

cc: Mr. J. A. Bohland, Owens-Illinois, Inc.
Mr. R. H. Kohring, Owens-Illinois, Inc.
Mr. W. D. Reed, Owens-Illinois, Inc.

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CHEMICAL NEW YORK CORPORATION

20 Pine Street
New York, NY 10005

George C. Deecken
Controller

June 13, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Sir:

Comments on Tentative Conclusions of
The Commission on Auditors' Responsibilities

Chemical New York Corporation appreciates this opportunity to offer comments in response to the Report of Tentative Conclusions prepared by the Commission on Auditors' Responsibilities, an independent group established by the American Institute of Certified Public Accountants.

The Commission's report is probably the most herculean effort yet attempted to analyze the multitude of issues now confronting the auditing profession. It is well-reasoned and well-timed. The eventual resolution of the independent auditors' responsibilities could have an important impact on certain related responsibilities of management.

Accordingly, from management's viewpoint,we wish to draw the attention of the Commission to two sensitive issues which we feel require further coordination with statement preparers and the legal profession. These issues are:

1) A proposed new report by management for inclusion in the annual report.

2) A proposed separate footnote, similar to that on accounting policies, commenting extensively on "uncertainties."

These issues are more fully developed below.

New Report by Management

The Commission's report furnishes a well-balanced analysis of the distinctions between the responsibilities of management and those of independent auditors with respect to published financial statements. This clarification is long overdue and should help clear up existing confusion in the public's mind.

Chemical views this as a first step. Subsequent research, we believe, should include a full assessment of the legal profession's position with respect to these newly-defined areas of responsibility.

As to the example of a "Report by Management" furnished on page 79, we restate, for reference purposes, the paragraph suggested by the Commission with regard to the position of the company's legal counsel:

> "The company's legal counsel has reviewed the company's position with respect to litigation, claims, assessments, and illegal or questionable acts; has communicated that position to our independent auditors; and is satisfied that it is properly disclosed in the financial statements."

Strong resistance to the above all-inclusive statements should be anticipated from the legal profession on the grounds that the suggested text is overly simplistic.

Accordingly, we recommend that before finalization of this proposed report by management, full coordination be effected between the accounting and legal professions.

Uncertainties

The Commission's proposal to include, as a separate footnote to financial statements, a comprehensive commentary and evaluation by management of the company's uncertainties is by far, we believe, the most important and controversial issue in this report. Research in the reporting of uncertainties (and unusual risks) must, we feel, include an assessment of the Securities and Exchange Commission's Accounting Series Release No. 166, dated December 23, 1974, on "Disclosure of Unusual Risks and Uncertainties in Financial Reporting." The point of departure from this Accounting Release must be clear if the constituency is to measure properly the extent of the additional reporting disclosure on uncertainties being suggested.

The apparent open-endedness of the proposal is fraught with difficulties in practical compliance. Of particular significance is the fact that all footnotes must be covered by the accompanying opinion of the independent auditors. No mention is made in the report of the extensive additional audit work which would be required, no less the cost thereof, to enable the independent auditor to have such a footnote covered by his opinion.

Because the very nature of any discussion of uncertainties (or unusual risks) involves important legal considerations for both the independent auditor and the preparer of financial statements, we recommend the final report of the Commission include a complete discussion of the legal issues involved.

In a similar vein, we believe the Commission should give cognizance to the satisfactory progress already made between independent auditors and members of the bar regarding legal counsels' responses to auditors' inquiries concerning uncertainties. Any new footnotes on uncertainties should avoid upsetting unnecessarily the existing arrangements in this respect between the two professions.

Self-Regulation

We understand that the American Institute of Certified Public Accountants has established a special committee for the sole purpose of evaluating the Commission's report and recommending appropriate courses of corrective action. Further, it is expected that the Senate Subcommittee on Reports, Accounting and Management (the Metcalf Subcommittee) will, when reconvened in early 1978, consider such proposed corrective actions.

Both the Commission's final report and the corrective actions to be recommended by the AICPA's special committee should be of the greatest importance in demonstrating that the private sector is capable of prompt and effective self-regulation.

Very truly yours,

George C. Deecken

George C. Deecken
Controller

G. C. D.

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KIMBERLY-CLARK CORPORATION

June 13, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

RE: Report of Tentative Conclusions - The Commission on Auditors' Responsibilities

Dear Mr. Carmichael:

Kimberly-Clark Corporation appreciates the opportunity to comment on the tentative conclusions and recommendations contained in the above subject report. Our comments are directed specifically at those recommendations which appear to most directly affect management's role in the accounting and reporting process, its communication with investors and with those recommendations which will increase audit fees while not commensurately increasing the benefits of independent auditor review and examination to investors and creditors.

Forming an Opinion on Financial Presentations (Section 2)

We agree with the Commission that management has the responsibility to select and apply accounting principles that are appropriate in the circumstances. We further agree with the Commission that the auditor has responsibility to determine whether management's judgments were appropriate.

However, we do not agree with the Commission's conclusions with respect to auditors' responsibility for judging the appropriateness of accounting principles when alternatives exist in the absence of direction in authoritative pronouncements.

First, the Commission states that the auditor should not be expected to judge the choice among alternatives in the instances when (a) authoritative bodies have considered the alternatives and have not been able to conclude as to the preferability of one of several generally accepted alternatives or (b) when all of the generally accepted alternatives are equally arbitrary.

Second, the Commission states that present standards require justification by management that change to a new principle is preferable.

Finally, the Commission states that an auditor's responsibility to evaluate management's choice among alternative principles should not be different simply because there has been a change. The auditor, it says, should have the same obligation to analyze the underlying facts and circumstances for accounting principles for which alternatives exist even in the absence of a change.

This series of observations indicates that the auditor has no duty with respect to preferability in the two instances cited regardless if such principles are changed or not. In our view, consistent application of accounting principles is important and preferability should be a criteria when change is contemplated.

By contrast, for those principles where an objective basis for their selection does exist, the Commission directs the auditor to assess preferability of the principle regardless of whether or not change is contemplated. In our view, this charge will have the effect of requiring all such principles to be continually assessed as to preferability in the circumstances and could result in a misdirection of audit effort. As previously stated, consistent application of a principle is an important aspect of financial accounting and reporting. Furthermore, consistent application of an appropriate generally accepted principle, while perhaps not the preferable one, is likewise important. To interject the auditor into a constant assessment of the preferability of generally accepted accounting principles is inappropriate when no change in principle is contemplated or no change in circumstances has occurred. Assessment of preferability of accounting principles is properly the role of the Financial Accounting Standards Board.

We wish to emphasize again that management has the responsibility to select and apply accounting principles appropriate in the circumstances, and when circumstances change management has an obligation to change the accounting principle if the one they are currently following is no longer appropriate.

In Section 7 of the report, the Commission recommends deletion of the auditor's reference to "consistency" in his report. We disagree with that recommendation for the reasons stated above. In addition, the deletion of the reference to consistency in the auditor's report will not be in the best interest of investors and other users of financial statements. Readers noting a "consistency" exception are alerted that certain changes in accounting principles or their application have been made during the period, that non-comparability may exist and that further analysis is often required. We, therefore, urge that the reference to "consistency" be retained in the auditor's report.

We agree with the Commission that removal of "fairly" from the auditor's report and substitution of "appropriate in the circumstances" will result in an improvement of the auditor's communication with financial statement users.

Reporting on Uncertainties (Section 3)

We agree with the Commission that the auditor's role with respect to reporting on uncertainties requires clarification. In addition, we see merit in management's obligation to report to investors and other statement users on significant uncertainties. However, we do not agree with the Commission's recommendation that a separate note to the financial statements describing the significance of all material uncertainties will necessarily be in the best interests of investors unless the auditor's "subject to" opinion is retained and truly major uncertainties are separately discussed in other notes to the financial statements. Our concern stems from the fact that truly major uncertainties (those which in the past would have resulted in a "subject to" opinion by the auditor) will be obscured by other less significant uncertainties described in the note.

Otherwise, investors will be required to rank uncertainties as to likelihood of adverse effects on the earnings and financial position of the enterprise. It is unlikely that all investors will sufficiently understand the uncertainties to enable them to rank them in a consistent manner.

Although we agree with the Commission's logic with respect to exclusion of the "subject to" qualification from the auditor's report, we believe that the needs of investors to have the most significant uncertainties highlighted by means of a "subject to" qualification report should override the limitations on the auditor's ability to predict the future of uncertainties. In addition to the auditor's reporting on major uncertainties by means of a "subject to" opinion, uncertainties involving litigation or going concern problems are typically discussed thoroughly in a separate note to the financial statements - such note being clearly the responsibility of management. We do not, therefore, see merit in repeating such items in a note entitled "uncertainties."

Clarifying Responsibility for the Detection of Fraud (Section 4)

Most of the recommendations contained in this section will aid in clarifying the auditor's role in fraud detection and will provide guidance with respect to minimizing instances of undetected major fraud. We support their adoption. However, on page 36, the Commission states that the auditor "...has a duty to search for fraud...". An expansion of detail testing by a significant extent in order to "search" for fraud would result in prohibitively costly audits, the benefits of which would be of minimal value in most instances.

In our view, the auditor's responsibility for the detection of fraud should be encompassed in an increased awareness of the possibility of fraud and a charge to the auditor to perform a more thorough and penetrating examination of the propriety of transactions otherwise selected for audit test and, as the Commission recommends, to study and evaluate internal control systems as to prevention and detection of fraud.

Accordingly, we urge the Commission to clarify the intended meaning of the phrase "search" for fraud.

Corporate Accountability and the Law (Section 5)

On page XIX in the summary of conclusions and recommendations, the Commission states that the "auditor has a duty to search for illegal or questionable payments." However on page 47, under the subtitle of <u>Detecting Illegal or Questionable Acts</u>, the Commission states that it has no specific recommendations similar to those for the auditor's responsibility for the detection of fraud. We find the two statements in opposition to one another.

If the Commission believes that the auditor has a duty to "search for illegal or questionable payments," we believe that it has an obligation to clarify just what is intended by the phrase. In our comments in Section 4, we recommended what we believe to be the intent of the phrase "search for fraud." We believe that a similar meaning should be given to the phrase "search for illegal or questionable payments" in Section 5.

We support the Commission's recommendation that management should bear the primary responsibility for corporate accountability and that it should adopt and distribute to employees detailed policy statements indicating specifically the conduct that will not be tolerated. In addition we agree with the Commission that adoption of a compliance monitoring system is highly desirable. However, we disagree with the Commission's recommendation that such statements of policy should be distributed to shareholders and others. We see no compelling need to distribute this policy to the exclusion of other policies, such as goals, strategies, conduct, labor relations and social and legal ethics, which may have a much greater effect on a company. We are not suggesting that these other policies be made available to shareholders and others - we see no useful purpose which would be served. In our view, reporting in a general manner the existence of these policies, their aims and the existence of compliance procedures, when appropriate, should be sufficient.

Section 5 of the report also contains a discussion of the Commission's views on increased involvement of lawyers. The Commission claims that because an elaborate procedure involving the auditor, the client and the lawyer now exists for determining which legal claims need to be disclosed, such procedures and division of responsibilities are inefficient and ineffective. To overcome the inefficiency and ineffectiveness, the Commission recommends that greater reliance be placed on corporate or outside legal counsel in management's responsibility to disclose significant legal matters. It suggests that legal matters be disclosed in the uncertainties note to the financial statements described in Section 3 of the report and that auditors have materially decreased reporting responsibilities for such matters.

In our view, a significant reduction in the auditor's reporting responsibilities with respect to legal matters will not be in the best interest of informing investors and other users of financial statements. Our comments under Section 3 set forth the reasons why we hold this view.

The Boundaries of the Auditor's Role and its Extension (Section 6)

This section of the report contains the Commission's recommendations with respect to future extension of the auditor's role into the entire financial accounting and reporting process.

We do not take exception to the Commission's suggestion that the first step in the expanded role is for the auditor to become more involved in the study and evaluation of the internal accounting control system. We view the expanded role of the auditor in the review of the internal accounting control system to be a logical reaction stemming from the publicized corporate accountability problems experienced by certain corporations. However, we believe the thrust of such a review should still be directed toward significant parts of the internal control system and those aspects which may have a potential material effect on the enterprise's financial statements. We do not believe that the Commission intends that the auditor should loose sight of the cost/benefit aspects of internal control systems.

The Commission states that the next step in the expanded role is for the auditor to become more involved in the review of the company's financial reporting process for preparing quarterly information released to the public. In addition, the Commission suggests that the limited review procedures of Statement on Auditing Standards (SAS) No. 10 be expanded.

We are not convinced that the present involvement of auditors in the quarterly reporting process needs expansion. At present, registered companies are required to have auditor involvement with quarterly data either on a timely basis or on a retrospective basis. We believe the present system is operating effectively. Those registrants wishing timely involvement may have it; those who do not are not required to have it. In either case, the quality of the quarterly reporting process is subject to limited review by the auditor on a reasonably current basis. We believe that expansion of the auditor's role in the quarterly reporting process should not be made until a stronger case for it can be demonstrated.

The Commission recommends an immediate extension of the audit function to other information in an annual report, such as the financial highlights section, management's analysis of changes in earnings, comments on financial statements in the president's letter and similar information. We believe that the auditor's role with respect to such other information is adequately covered in SAS No. 8. In addition, expansion of the auditor's role over that now prescribed could frustrate the efforts of certain management's in providing interpretive and qualitative information of a subjective nature in the annual report. Subjecting such information to attestation and verification by independent auditors could inhibit this important means of communication of relevant information to investors.

The Auditor's Communication With Users (Section 7)

In this section the Commission makes two major recommendations - a new approach to auditor reporting and a report by management.

A New Approach to Auditor Reporting

We agree with the Commission that the communication between the auditor and the users of his work is unsatisfactory. The Commission offers many sound reasons for supporting revision in the present auditor's report. We believe that the goal of the auditor's report should be to describe in precise and unambiguous terms, the auditor's function and the results of his examination. The direction of change is shown in the Commission's illustration of a revised auditor's report. In general, we have no important objections on the first three paragraphs of the report shown on page 77. However, we believe that the next paragraph dealing with the internal control system is too negative and will likely create the wrong impression with investors who are not familiar with the limitations of such systems. We suggest that the paragraph is directed more at protecting the auditor than informing the reader. We believe that the limitations of any attestation as to the effectiveness of an internal control system can be conveyed without the recitation of a list of observations that the system may be circumvented, deteriorate or otherwise fail.

The final four paragraphs of the illustrative report convey certain messages as to what the auditor has specifically performed in discharging his duties under generally accepted auditing standards. We do not believe that such a listing is appropriate within the larger context of the auditor forming an opinion and reporting on the financial statements taken as a whole. In fact, we see the list of messages growing as new issues arise in the evolution of business activities and reporting thereon. We urge the Commission to delete the enumeration of selected tasks performed by auditor's in its final report and conclusions.

We have previously commented on our support for removing "fairly presents" from the auditor's report and why we believe that reference to "consistency" is important to retain in the auditor's report.

Report by Management

In general we support the concept of a report by management. Although the entire annual report is a report by management, we do see a useful purpose served in communicating with investors by specifically addressing the issue of management's responsibilities, as differentiated from the auditor's, in the preparation of financial statements in accordance with generally accepted accounting principles. We believe, however, that flexibility in language and subject matter should be permitted in any final recommendation by the Commission. Only by permitting flexibility will "boiler plate" language be avoided and investor understanding improved.

Maintaining the Independence of Auditors (Section 9)

We strongly support the Commission's conclusion that transfer of the approval, assignment or compensation function to the government sector or to have audits performed by a corps of governmental auditors is not warranted or necessary.

Similarly, we support the Commission's arguments for rejecting the notion that auditors be compensated from a pool of funds to be created by an assessment against all audited companies.

The Commission recommends that the board of directors or its audit committee take a more active role in establishing audit arrangements, including matters of fees and timing of audit work. We agree that exercise of an oversight role by the board of directors or its audit committee is important in maintenance of auditor independence.

We support the Commission's views against adoption of a policy requiring the manditory rotation of auditors.

Conclusion

In conclusion, we have supported the Commission's recommendations when a clear need for change has been demonstrated. We have expressed reservations when the need for change has not been so demonstrated. We look forward to the Commission's final report and would be pleased to discuss our views with the Commission if it wishes.

Sincerely,

D. W. Dusendschon
Assistant Controller

DWD:dt

A-45

GENERAL ELECTRIC

GENERAL ELECTRIC COMPANY
3135 EASTON TURNPIKE
FAIRFIELD, CONNECTICUT 06431

T. O. THORSEN
VICE PRESIDENT-COMPTROLLER

(203) 373-2171

June 15, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

We have studied the Report of Tentative Conclusions by the Commission and appreciate the opportunity to offer some brief comments.

It is our view that the Report points a viable way for the auditing profession to evolve in an orderly manner in these tumultuous and trying times. The more significant recommendations in the Report will probably require a considerable number of specific actions such as changes in the Code of Ethics, development of new auditing standards, and revisions of SEC regulations and practice. These activities obviously will take some period of time, will require considerable educational effort, and may result in actual implementation somewhat different than the tentative conclusions in the Report. Therefore, we urge the AICPA to act promptly by adopting immediately the recommendation in Section 10 to establish a full-time Auditing Standards Board with adequate procedures for considering diverse views of interested parties. The Board's charter should include assignment of priorities to the Report's conclusions and recommendations, determination of appropriate implementation procedures, and commencement of actual work as soon as possible.

Please be assured of our support for this effort, and we look forward to participating constructively as the work progresses.

Very truly yours,

T. O. Thorsen

TOT:ck

A-46

NEMA

National Electrical Manufacturers Association
2101 L Street, N.W., Suite 300
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June 14, 1977

Mr. Douglas R. Carmichael
Research Director
AICPA Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

NEMA(1) endorses the creation of a full-time Auditing Standards Board. We are not now commenting on the specific paragraphs and sections of these tentative conclusions. Presumably, when this Commission's recommendations in final form are presented to the AICPA, each of the action recommendations will be subject to formal implementation procedures within the AICPA. It seems to us that all of this Commission's action recommendations would be subject to due process deliberation by such a full-time board. Even if the recommendations were to be acted upon by a continuation of the Accounting Standards Executive Committee, we confidently expect that due process implementation would include solicitation of comments. Since we view both the form and content of implementation as the most important elements, we expect to respond to the solicitation for comments during those deliberation processes. Our response will include an assessment of the benefits vs. costs of eventually implemented recommendations.

We express agreement with the intentions supporting the reforms recommended, but submit that unless implementation proceeds with due process and with dispatch the Commission's efforts will have been wasted.

Sincerely yours,

T. B. Fauls

Thomas B. Fauls
Vice President - Statistical
and Financial Services

(1) The National Electrical Manufacturers Association (NEMA) is the principal national trade association of the electrical manufacturing industry. The electrical products within NEMA's scope are used either as components or as end-equipment in the generation, transmission, distribution, control and utilization of electrical energy. The association has some 550 member manufacturing companies who are affiliated with one or more of our 70 product sections; each section, in essence, representing a separate and distinct industry. Over 90 NEMA member firms are represented in the Fortune 500 list, with others varying in size down to many small businesses.

This comment letter, as are all others from NEMA on accounting issues, has been written under the direction of the NEMA Advisory Committee on Financial and Accounting Issues, which is a subcommittee of the NEMA Financial and Accounting Council. All comment letters are approved in final form before release by the Advisory Committee, the Council and the NEMA President.

TBF:msp

A-47

FARMLAND INDUSTRIES, INC.

post office box 7305/kansas city, missouri 64116

June 17, 1977

Dr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Dr. Carmichael:

We have reviewed the Report of Tentative Conclusions of the Commission on Auditors' Responsibilities. The objectives of the Commission of securing absolute clarity and honesty in presentation coincide precisely with the views of our organization. We are in general, however, concerned as to whether the implementation proposed will in many cases accomplish the objectives.

Rather than generalizing about the entire report, we would like to select several parts of the report with which we most strongly disagree and comment on them, saving our general remarks for the last.

Specifically, we are most concerned with Section 5, "Corporate Accountability and the Law," Section 6, "The Boundaries of the Auditor's Role and Its Extension," and Section 7, "The Auditor's Communication With Users."

<u>Section 5 - Corporate Accountability and the Law</u> - Many organizations, including our own, already have policy statements intended to clarify those areas which might be considered "grey", for example, conflict of interest. We agree that these areas need to be clearly stated by employers and clearly understood by employees. We have no objection to auditors using these company policies as guidelines for investigation. What we are concerned about is the apparent intent to use the suggested "detailed policy statement" as the only measurement upon which the auditor is required to comment.

We feel that there are two types of policy statements that a company might consider appropriate. The first is the type of statement earlier mentioned, one that clarifies company policy on those "grey" or difficult to legally define areas. The other, far more broad ranging and completely general in nature, is a simple statement expressing that the employer expects honesty and legality in the acts of the employee.

It is our opinion that in the case of these few "grey" or difficult to define areas, the auditor should exercise professional discretion and indicate in the final audit report the extent to which the business has been carried out in line with the policies issued by management.

In the case of the many areas which can only generally be defined, we have to be like Moses. The Lord gave Moses Ten Commandments, but if Moses had asked for a statement of specific detail on every way in which those Ten Commandments could have applied, he'd still be on the mountain waiting. Business is in somewhat the same position. Employees are to be honest and not commit illegal acts, but to anticipate in advance when, where and how each act requiring discretion should be handled is simply impractical. However, we believe that the judgment of management on the character of its employees when coupled with the checks and controls normal to an accounting system and the professional audit will catch most material activities that would be detrimental to meaningful financial statements.

To summarize, we agree that a policy statement should contain specific and detailed policies for easily misunderstood areas, but suggest that a general policy that anticipates honesty, integrity, and legality is the only practical way to handle the balance of any rulemaking. Management should exercise all possible control to see that the general actions of its employees fall within the scope of its policy statement. The auditors, on the other hand, should assist management by the examination of records to make sure that honesty, integrity and legality have been observed.

Section 6 - The Boundaries of the Auditor's Role and Its Extension - In our comments on Section 5, we indicated that the scope of the auditor's responsibility be relaxed. In this Section 6, we find ourselves confronted with the proposed expansion of auditor's responsibilities to the extent that an audit function would be performed on practically every financial report released outside the company.

We see in this a contradiction, as it is extremely difficult for us to understand how an auditor could approve a financial report and still not have reviewed the books with a responsibility to judge the honesty and legality of their various entries. Additionally, the recommendation ignores what would become an unbelievable cost resulting from maintaining a high level, full-time audit staff on the premises that possessed the necessary level of understanding of the company.

It also ignores the time involved with auditing and disregards the fact that there are financial statements which an outside user, such as a bank, might properly be perfectly willing to accept on an unaudited basis.

Here again, as in the case of Section 5, we have a conflict between objectives and the implementation of programs to attain those objectives. The implementation is again impractical, and in this case, also involves a cost which would be prohibitive.

Section 7 - The Auditor's Communication With Users - We agree with the provisions concerning materiality in the management statement. However, we see some severe problems in the management statement when it touches the area of responsibility of the legal counsel. Many additional guidelines beyond those thus far stated will be required to avoid conflicts of responsibility created by the problems resulting from the anticipated outcome of a pending lawsuit, the uncertainty of damages expected to be awarded in litigation and the lack of guidance as to whether the same standards of materiality apply in the legal area as apply in the accounting and auditing area. The problems in this legal area are so great that we can visualize attorneys feeling it is not legally possible to be a party to such a "Mother Hubbard" statement. If a management statement that includes conclusions concerning legal counsel's disclosures is to be required, we feel that much more guidance must be given on the legal problems that follow such a requirements.

General Comments - The objective of the auditing function, the promulgation of accounting principles, and the regulation by government of public financial statements is to avoid information which might be misleading to users outside the company.

The function of the auditor was established in recognition of the fact that honesty and integrity cannot be legislated or created by a standardized control system. The auditor performed a third party function of impartial judging recognizing the difference between different companies engaged in different enterprises and attempted to ensure that the information that was material was presented in an acceptable manner.

We see this proposal in general as removing the auditor from a judgment position and introducing instead what in effect is the legislation of rules, checklists, forms, and shifted responsibility so that it undermines the original need for which auditing was created.

A company management which seeks to intentionally mislead will have no more concern about making a misleading statement about its integrity than it will in issuing a misleading financial statement comprised of improper figures. The function of the auditor is to prevent the dissemination of misleading information and not to set up a better mechanism by which it can be proven that the misleading information was deliberately presented. However, it seems that that is the direction in which this entire proposal is headed.

In conclusion, the stated objectives of the Commission and the management of our company are absolutely identical; the presentation of accurate information which will inform and not mislead. We should all be agreeable to changes which will accomplish that objective. Our objections to the report are based upon the probability that what has been proposed will mislead the public into thinking that steps have been taken to accomplish this objective, when in fact little of a preventive nature has been done. We feel the public user could be mislead even more than he was before.

We appreciate this opportunity to express our comments on the Commission's report. We would be happy to answer any questions you have concerning our position on these matters.

Sincerely,

J. P. Blair

J. P. Blair
Vice President
Corporate Development and Control

JPB:ds

A-48

FINANCIAL EXECUTIVES INSTITUTE
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June 20, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

The Committee on Corporate Reporting (CCR) of Financial Executives Institute appreciates the opportunity to comment on the "Report of Tentative Conclusions," by the Commission on Auditors' Responsibilities. The CCR supports the basic objectives of the Commission as embodied in the tentative conclusions, and we commend the members and staff on the quality of their work and the foresight demonstrated in the report. While our following comments reflect concern about particular aspects of some of the specific conclusions, we offer these views in the spirit of constructive dialogue, and with our endorsement of the report.

The Commission's undertaking is timely, in view of the increasing litigation and public attacks on the independent public accountant and corporate management. The need for a reappraisal of the role of auditors and their responsibilities has recently been underscored by the pointed questions being asked by Congressional committees and others as to the ability of the private sector to serve properly the needs of investors and other users of financial statements. Nevertheless, while we can agree that there is room for improvement in the present system, we should not overlook the fact that the corporate financial reporting system in the United States is the most informative and advanced in the world. We also recognize that our superior capital formation accomplishments in the past may not have been possible without this system and an effective balance between the functions and responsibilities of corporate management, the independent public accountant, and government agencies.

In our view, however, the existing structure has well served the public interest and, while it must be adaptable to the changing environment, the present structure should not be radically changed unless there is evidence to suggest that such change is necessary or desirable. In this regard, we believe it is unfortunate that the Commission's report creates the impression that management in general needs the constant vigilance of the auditor in order to protect the users of financial statements from the negligent or abusive actions of the few. Since the overwhelming majority of corporate managements discharge their responsibilities with integrity and high ethics, we believe the report overemphasizes the need to expand the auditor's responsibilities in this regard.

We recognize the need for independent verification; however, we believe management's representations should be accorded a high degree of trust and credibility. In this context, our specific comments on certain of the tentative conclusions are as follows:

Section 1 - The Independent Auditor's Role in Society

The CCR agrees with the Commission that the auditor's primary responsibility is to the users of his work. Also, by defining his primary responsibility and limiting the other expectations for which he may presently be held responsible, as more fully developed in subsequent sections of the report, all parties would be better served if the CPA is not held accountable for "all things to all people." That is, more reliance should be placed on management and its other experts, such as lawyers, engineers, actuaries, geologists, etc.

Section 2 - Forming an Opinion on Financial Presentations

We accept the fact that the auditor has, and will continue to have, responsibility for evaluating management's choice of accounting principles. However, the auditor's responsibility should be limited to commenting on the appropriateness of those principles in the circumstances, and the cumulative effect of their application on the financial statements.

We also believe that the criteria for judging preferability should result from authoritative accounting standards or pronouncements, rather than from auditor interpretations. As stated in the report (page 19), there exist widely divergent opinions among qualified professional accountants as to which accounting treatment is appropriate under a given set of circumstances. It is, therefore, reasonable to expect that such differences will continue to exist in areas which have not been addressed in authoritative accounting pronouncements. Thus, we believe the auditor's role should continue to be to exercise professional judgment in commenting on the results of management's interpretation and application of accounting principles, rather than to express opinions as to preferability.

The designation of financial accounting standards is, and should remain, in the Financial Accounting Standards Board's province. Where alternatives do exist within generally accepted accounting principles (GAAP), management has the responsibility to select the most appropriate accounting method in the circumstances. Preferability is a controversial "standard," about which there have been sharp disagreements, and the auditor, therefore, should not be expected to superimpose his judgment as to preferability on issues for which there is no general agreement.

Accordingly, we believe that when a new situation arises requiring the selection of an accounting principle from among possible alternatives, or when the underlying circumstances change to the extent that an accounting change is warranted, the auditor should, in his opinion, either express his agreement with management's choice or take exception to the change or principle selected. Further, we believe that, in addition to the disclosure of significant accounting policies and principles in the notes to the financial statements, any significant change in accounting, with the effect of said change, should be disclosed in the notes and, again, the auditor should express his agreement or take exception in his opinion. Thus, we believe that consistency is important to the users of financial statements, and it should continue to be commented on in the auditor's report.

The CCR agrees with the Commission's reasoning and supports its recommendation to remove the word "fairly" from the auditor's report on the basis that "appropriate in the circumstances" is more objective and better understood. However, as stated above, we do not support the Commission's reasoning for this change as a vehicle to address the preferability issue.

<u>Section 3</u> - <u>Reporting on Significant Uncertainties in Financial Presentations</u>

The CCR supports the Commission's basic conclusions about the need to clarify the auditor's role in reporting on uncertainties, and a majority of CCR members agrees with the Commission's recommendation to eliminate "subject to" qualifications in auditors' opinions and to include footnote disclosure of material uncertainties. However, a significant minority of CCR members disagrees and believes that "subject to" opinions should be retained because the "subject to" represents a useful means of attracting attention to truly material uncertainties.

We believe the disclosures in the proposed standardized note on uncertainties would be largely repetitive and would not improve disclosure. Also, a standardized note would tend to obscure material uncertainties.

<u>Section 4</u> - <u>Clarifying Responsibility for the Detection of Fraud</u>

Most of the recommendations in this section will aid in clarifying the auditor's role in fraud detection, and they should provide guidance with respect to minimizing instances of undetected major fraud. Accordingly, we support these recommendations, with the following exception:

On page 36, the Commission states that the auditor "has a duty to search for fraud." We are concerned that this assertion could cause auditors to expand substantially their audit tests and detailed reviews of transactions over the customary audit procedures followed in the examination of financial statements, and to go well beyond the effort required to establish "reasonable assurance that the financial statements are not affected by material fraud." Since a significant expansion in detail testing in order to "search for fraud" could result in prohibitively costly audits, the benefits of which would be of minimal value in most instances, we urge that this language be clarified.

We suggest that the auditor's responsibility for the detection of fraud should be encompassed in an increased awareness of the possibility of fraud, perhaps with a more penetrating examination of transactions selected for audit tests and, as the Commission recommends, the study and evaluation of internal control systems, including the work of the internal auditors.

Section 5 - Corporate Accountability and the Law

We are concerned with the apparent contradiction wherein, on page XIX in the summary of conclusions and recommendations, the Commission states that the auditor "should search for illegal or questionable acts," while on page 47, the Commission states that it has no specific recommendations similar to those for the auditor's responsibility for the detection of fraud. Our comments in Section 4, relative to the intent and clarification of the phraseology "search for fraud" are equally applicable to the Commission's admonishment that the auditor should search for illegal or questionable acts.

The CCR endorses the Commission's recommendation that corporations adopt codes or statements of policy detailing the ethical conduct expected of its employees and the distribution of the statements to all employees. We further believe that a program for monitoring compliance is a desirable, if not necessary, feature of the ethical conduct policy.

While we believe it should be unnecessary to make the policy statement on ethical conduct available to the public, companies should be encouraged to report a general description of the policies adopted, the existence of monitoring and compliance procedures, and the fact that the company's compliance will be subject to periodic or annual review by the independent auditor.

The CCR accepts the Commission's logic that the timing and extent of disclosures of pending and potential legal claims should be the responsibility of management and its legal counsel. We further believe that the auditor's responsibility for reviewing legal matters should be no different from his responsibilities in reviewing other areas of expertise, such as actuaries, geologists, etc. In our opinion, a logical extension of the Commission's recommendation is for management to address other areas for which it relies on experts, and for the investment community to abandon their expectation that the independent auditor is their surrogate expert in all matters which might have an impact on the company's financial statements.

Section 6 - The Boundaries of the Auditor's Role and Its Extension

The introduction to this section indicates that it presents a framework for the evolution of the auditor's role to accommodate changing business and investment needs. We do not question that there will be a continuing evolution of the auditor's role; however, we agree with the Commission's conclusion that management is the originator and interpreter of financial information, and the auditor's role is to provide an objective evaluation of management's presentations. Accordingly, we do not agree with the Commission's recommendation that the present boundary of the "annual financial statements" on the auditor's role be expanded to include the more abstract concept of "information of an accounting and financial nature that is produced by the accounting system."

As part of its framework for the evolution of the auditor's role, the Commission recommends requiring the auditor to expand his review and evaluation of the company's controls over its accounting system and to form a conclusion on the functioning of the system. Financial Executives Institute has publicly endorsed the principle that corporations should establish and maintain internal accounting control systems in recent letters to the Securities and Exchange Commission and the United States Senate. Auditors of the larger companies presently rely on the company's internal accounting controls. Accordingly, we anticipate few, if any, implementation problems with respect to the larger companies. However, we are concerned that the recommendation could involve significant implementation problems with respect to smaller, closely-held, and/or non-public companies, and the smaller audit practitioners. We urge the Commission to include an assessment of these implications in its final report.

The Commission also recommends that auditors become involved in the quarterly financial reporting process on a timely basis, and that they expand their present "limited review" procedures. We do not agree with this recommendation because the need for this magnitude of auditor involvement has not been demonstrated. Indeed, the SEC requirements that the auditors become "associated with" the reporting of quarterly financial results were only recently adopted and, while a number of companies do have their auditors conduct timely "limited reviews," we are not aware of any strong criticisms of, or pressures to expand, the new procedures. Unless it can be demonstrated that mandatory timely involvement would add meaningfully to the present requirements, we believe the Commission should drop this recommendation.

Also, we are not aware of any supportable need to expand the existing "limited review" procedures. In our opinion, the Commission's objective of having the auditors obtain an understanding of the process used by the company to prepare quarterly financial information and to evaluate its ability to prepare reliable interim information is achieved by the existing limited reviews under SAS 10.

The Commission's recommendation would also extend the auditor's role beyond the annual financial statements to include other financial presentations in the annual report, such as the financial highlights, management's analysis of changes, and the President's letter. We believe the extension is unnecessary, since the auditor's present procedure in reviewing all financial information in the annual report is sufficient to safeguard the interests of investors, and that it is understood by reasonably well-informed users of the reports. We further believe that this would involve the auditor in areas which have not been standardized as to the information required to be disclosed and the format to be used. In our opinion, the annual report is an important means by which management can provide information outside the financial statements which it deems relevant to investors, but which involves a degree of subjectivity not susceptible to independent attestation. We are also concerned that this extension of the auditor's responsibilities would result in substantially higher audit costs and, since the Commission has not demonstrated that any resulting benefits would warrant the additional cost, we suggest that this recommendation be dropped or, at least, clarified in the final report.

Section 7 - The Auditor's Communication with Users

The CCR concurs in this section's opening sentence which states "evidence abounds that communication between the auditor and users of his work ... is unsatisfactory." We likewise believe that resolutions to this problem have to involve more than the message contained in the audit certificate. Thus, while emphasis on a clearer audit message by auditors is needed, the more basic need is for users to have a clear understanding of an auditor's work and his function, including both the benefits and the limitations.

A program to educate users on the meaning of "generally accepted auditing standards" would be a good starting point; however, we do not believe that the auditor's opinion on the financial statements is a proper forum. The illustrative report describes certain procedures, but necessarily omits many others, and those which are described have negative implications which reflect unfavorably on the credibility of the entire reporting process. Accordingly, we believe that the accounting profession should conduct a continuing educational program through other media. We also believe that corporate management and Financial Executives Institute should cooperate and assist in this effort, since the objective of the program - increased credibility - would benefit everyone.

The Commission has offered compelling reasons for revising the auditor's "certificate;" however, we are concerned that some of the suggested changes will not accomplish the stated goals. For example, the final four paragraphs dealing with information in the annual report, other than the financial statements, appear to be the beginning of an expanding listing of messages about what the auditor does to "check up on management." Because we believe this kind of information is not conducive to the users' need to grasp the auditor's opinion of the presentation of the financial condition of the company, it should be excluded from the audit report. We urge that efforts to improve the users' understanding of the scope of procedures which become generally accepted auditing standards be conducted through the educational program discussed above.

On the other hand, we believe the explanation in the first paragraph of who prepared the financial statements and notes, the addition of "in all material respects" and "appropriate in the circumstances" in the second paragraph, and the addition of remarks on internal controls in the third paragraph, appear to be meaningful steps to enhance an understanding of the auditor's certificate.

The Commission's recommendation regarding auditors' attendance at annual meetings has considerable merit; however, since it may not be practical in all cases, such as smaller or closely-held companies, we urge that this be encouraged, but not required at this time.

The CCR endorses the principle of a separate report from management. Even though there could be some confusion, since the entire annual report is from management, there are possible advantages in a separate report directed to accountability. We agree that such reports should be along the lines suggested by the Commission, so management could better communicate matters of substantial interest and concern to investors and other users. However, we caution against any "standardization" of subject matter or format which might soon deteriorate to boilerplate language.

We agree that the present method of referring to other auditors' reports and unaudited data are problem areas, but we believe the audit firms can best offer comments on these questions.

<u>Section 8 - The Education, Training, and Development of Auditors</u>

The CCR believes the Commission has overstated the need for professional schools of accounting to overcome deficiencies in the education of auditors. While professional schools of accounting may ultimately be desirable, we do not foresee them as the only route for entry into the accounting profession. We are concerned that the movement toward separate schools of accounting, apart from business administration, could weaken the business education for accountants and the accounting education for business students.

Likewise, we are concerned about the proposal that the AICPA and the state CPA societies develop an associate membership to permit non-CPA educators to participate in their activities. Rather than lower the professional standards for CPAs to accommodate those who are unwilling or unable to meet the standards, non-CPAs should be encouraged to pass the CPA examinations, obtain the experience, and meet the other requirements in these organizations.

Section 9 - Maintaining the Independence of Auditors

The CCR does not find it surprising that the Commission found little or no empirical evidence to support the presumption that the performance of "other services" compromises an auditor's independence. We believe that independence is primarily a state of mind in situations where one party is not under the "control" of the other. The concept of economic control is an important reason why we do not share recent concerns that the growth of large accounting firms has been an adverse development. We believe it is clear that the audit fees billed to even the largest corporations do not individually represent a significant percentage of their audit firm's revenues and, in that sense, the firms are not economically dependent on individual clients. The principal asset of an audit firm is its good name, and we perceive that audit personnel are mindful of this economic fact, as well as the importance of their personal reputations, when confronted with particular factual situations.

In view of this, and for other reasons noted in the Commission's report, it is our perception that audit personnel are as objective regarding areas in which their firm has performed other services as they are in general. We further agree with the Commission's conclusion that the performance of other services often puts the auditors in a better position because they can become more knowledgeable of the client's operations. We, therefore, support the recommendation that there be no bar to offering such services, including financial executive placement services. As to the latter, audit firms can be particularly qualified to help fill the need of offering highly qualified candidates for important positions, often with candidates who are known quantities to the client and/or the firm. We do not believe, due to the aforementioned considerations, that an independent attitude of either the audit personnel or the financial executive is compromised in the ongoing relationship. Also, for the above reasons, we agree with the Commission that payment by the client for the firm's services does not cause the audit firm to be less independent, given the economics of a large firm's practice.

We also support an oversight role by audit committees of the board of directors in appointing auditors and arranging the audit scope and fee. However, we emphasize "oversight role" here because we believe that management is best qualified to work out the many details of audit arrangement and to assess the scope from a requirement and cost/benefit viewpoint. Management and the auditors should then present these arrangements to the audit committee for its concurrence. We believe this is already the procedure in a majority of large public companies. In this same connection, we agree with the Commission's conclusion against mandatory rotation of audit firms for the reasons stated in the report.

Finally, on independence, we believe the Commission has overstated the effect of time and budget pressures on an auditor's independent state of mind. Certainly, there are time deadlines - but they are most often real and not arbitrary as stated in the Commission's report. A financial report must be timely to be useful, not to mention a company's filing obligations to the SEC, stock exchanges, and to the shareholders in connection with annual meeting requirements. And, certainly, there are budget pressures to keep total time and charges to a reasonable level. No business has the luxury of being unconcerned with the pricing of its product or services. The ingredients of any business success must normally include efficiency in offering the best quality at a price related to the usefulness and need of the product. For expenditures of the magnitude of annual audit costs, it is not at all unreasonable to agree beforehand on the expected time and fee requirements. To do otherwise would expose clients to open-ended charge commitments even for gross inefficiencies, and to remove administration of its own practice from an audit firm's management. Assuming that a firm would not knowingly commit to uneconomic or impossible arrangements, we can see a need for good planning and scheduling, and efficient performance of the audit work with full cooperation of the client's personnel, but we do not agree that running a "tight ship" in this regard bears on independence. It has more to do with keeping the cost commensurate with use and benefit, especially with the need of firms to offer compensation at a professional level to continue to attract and hold high quality individuals to the profession.

Section 10 - The Process of Establishing Auditing Standards

The CCR fully supports the Commission's rejection of the idea that a government agency should set auditing standards. However, we endorse the concept of a full-time auditing standards board, within the private sector, appropriately compensated, and staffed with qualified personnel.

We are not in agreement with the Commission's conclusion that the establishment of auditing standards "does not need to operate to the fullest extent practical in public." This view seems contrary to the "sunshine" concept and to the stated purpose of the Commission's report, namely, improved communication to users of the auditor's work.

We note that the Commission has cited corporate personnel as participants in the process of setting auditing standards (page 133). We agree that the standards-setting body should solicit the views and comments of financial executives and others who have a direct interest in the effective functioning of the body and its pronouncements as a source of constructive advice in its deliberations.

Finally, we urge the AICPA to take immediate action to adopt and implement the proposed full-time auditing standards board.

Conclusion

We reaffirm our endorsement of the Commission's report and our support for its basic objectives. While we have expressed some reservations on certain of the specific recommendations, we believe it is timely for the AICPA to begin the process of assigning priorities and developing the means to implement the Commission's final conclusions and recommendations. The CCR looks forward to the Commission's final report, and would welcome the opportunity to cooperate in its implementation on a continuous basis.

Sincerely,

J. A. Sciarrino

Joseph A. Sciarrino
Technical Director

JAS:dmd

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HARVEY V. GUTTRY, JR.
Vice President and Controller

June 17, 1977

Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Attention: Douglas R. Carmichael

Gentlemen:

The Times Mirror Company appreciates the opportunity to comment on the Report of Tentative Conclusions of the Commission on Auditors' Responsibilities. We congratulate the Commission on the objectivity, insight and thoroughness of its tentative conclusions. By exposing its views in a preliminary, yet very readable form, the Commission has undoubtedly increased the impact of its work.

In responding to the urgent need for clarification and possible modification of the auditors' responsibilities, the Commission's study is an integral component of the private sector's responsiveness to the major conceptual issues confronting those who are involved with financial reporting. Out of the Commission's work and that of the Financial Accounting Standards Board, which is examining the very basis of financial statements, has come a great deal of helpful study and dialogue as well as increased understanding.

In the present environment of responsiveness and ongoing evaluation, there should be continued open-mindedness of the type that has obviously characterized the Commission's efforts to date. In particular, the discussion on the conceptual framework should not be hampered by any set positions taken in the Commission's report. At the same time, we encourage the Commission to be generally unequivocal in its conclusions and recommendations.

The FASB's final conclusions on the objectives of financial statements will certainly have a significant impact on the auditor as well as the financial statement preparer. In our response to the FASB, we are urging the Board to recognize that formal financial statements do not, by themselves, give sufficient information to meet the principal need of a user, which we perceive to be the assessment of cash flow prospects. We believe that the most useful information to investors is obtained via the system of informal disclosure -- including press releases, management's discussion and analysis of operations, and the financial review section of annual reports. We are asking the FASB to consider following the example set by the Securities and Exchange Commission in recognizing the use of the informal disclosure system for disclosing subjective, predictive or uncertain information.

The Committee on Corporate Reporting of the Financial Executives Institute, with which we have worked closely, is proposing a modification of the alternative objectives of financial statements suggested by the FASB in its tentative conclusions. In recognition of the full spectrum of financial information provided to users, the Committee on Corporate Reporting has developed a definition of the objectives of financial reporting for business enterprises which we endorse. We have asked the Financial Executives Institute to provide the Commission with a copy of the Institute's forthcoming response to the FASB.

In its report, the Commission presents an excellent discussion of the trend to "hardness" in accounting measurement where substantial uncertainty is involved. The Commission appears to accept as a necessary compromise "the tradeoff between the hardness of a measure and the accuracy of measurement." While recognizing that the auditor has major difficulties with uncertainties (a form of "soft" data) and that more of the responsibility for reporting on uncertainties should be visibly shifted to management, the Commission is proposing that more information on uncertainties be included in the audited financial statements. The Commission is apparently suggesting that all material uncertainties be disclosed in the formal financial statements. Strictly interpreted, the recommendation would seem to encompass all risks of varying degrees that face the enterprise, including the general business risks presently disclosed in the unaudited portions of the Form 10-K.

The Commission has zeroed in on perhaps the major inadequacy of financial statements and the auditor's relationship to financial statements -- the current handling of significant uncertainties. As is skillfully explained by Robert J. Runser in the June 1977 issue of Financial Executive magazine, uncertainties about the future are a central focus of the economic decision-making process and are perhaps the predominant concern of the financial statement user. Under any conceptual framework, we believe management cannot properly and fully report on uncertainties within the confines of the audited financial statements. If users are persuaded to rely primarily on the formal financial statements, such items as research and development costs that have been expensed but which have considerable future cash flow prospects will further widen the credibility gap for both management and the auditors. We foresee a sharp increase in the amount of crucial, essentially soft information which, if included in the audited statements, will be calling for the auditors' attestation but will be generally unverifiable. Out of such incompatability of the reporting framework to deal with the range of predictive data to be communicated, there is little hope for meaningful and useful disclosure. Both management and the auditors may find themselves in the vicious circle of legal liability considerations.

Times Mirror believes that the solution to the uncertainties question is for the FASB to participate in the establishment of standards for all aspects of financial reporting. If recognition is given that only limited data can be presented in audited financial statements and that there are informal disclosures with which auditors can be "associated," the financial community can unify the subject of financial disclosure without being restricted by auditability.

The implication of this broadening of the FASB's role is that, in many cases, such as those dealing with values, changes in values, unrealized gains and losses, meaningful business segment reporting and so forth, unauditable data will be provided. Users, we believe, if given a choice, would rather have a range of predictive data than disclosures limited to that which is precise.

Auditors generally are uncomfortable with imprecision. In some cases, they do not have the expertise to deal with uncertainty and, in other cases, the accounting and reporting framework is not equipped to deal with it. Corporate management, as well as the outside investor and creditor, constantly contend with imprecision. While there is a role for the precision and confidence-building which an independent audit provides, it should be recognized that unauditable data may be more useful.

Having alerted the Commission that Times Mirror, and probably other companies, will be asking the FASB to consider the full sphere of financial reporting and the limits of the attestation function, we will make the rest of our comments generally in the context of the traditional emphasis of the FASB and AICPA on formal, audited financial statements.

Section 1 -- The Independent Auditors' Role in Society

Times Mirror agrees that a board of directors has an oversight responsibility with respect to the company's accounting and financial reporting system. Directors must take an active interest in the adequacy of internal controls and the propriety of the company's financial statements. In these areas, the independent auditors are a principal means for the board of directors to monitor management's performance, and the board should regularly require a report from the auditors on the accounting system and the controls over it. In turn, the active interest of the board of directors, in the Commission's words, "can go a long way toward balancing the auditor's relationship with management."

The active interest of Times Mirror directors has been concentrated through the board's audit committee established several years ago and made up of outside directors. Times Mirror's independent auditors meet regularly with the audit committee to review and approve fee arrangements, the scope of the audit work, and the auditors' principal findings.

We endorse the Commission's suggestion that the board of directors be made up of a significant proportion of outside directors. While there is a practical need for a sufficient number of inside directors, we believe that the outsiders must have clear authority and the votes to support that authority.

Both the auditors and management of our company have sought ways to further improve the independence and quality of the auditors' performance. For example, at the suggestion of management, the audit committee of the board of directors recently took the initiative of insisting that our company's independent auditors implement the following:

1. Rotation every three years or less of audit partners, managers and supervisors assigned to audit Times Mirror operating units.

2. Annual review of the audit by a partner from a different district of the audit firm and rotation of this review partner every three years.

3. Rotation periodically of the partner-in-charge of the Times Mirror audit and rotation of the manager and/or supervisor not less frequently than every three years.

Times Mirror strongly believes in the value of continuing audit by its external and internal auditors. Extensive coordinated audit work is a necessary part of Times Mirror's approach to quality financial reporting. This joint effort in no way infringes on the independence of the auditors, yet it does illustrate that the auditor can function effectively without assuming the role of being an adversary to management.

Section 2 -- Forming an Opinion on Financial Presentations

We agree that the word "fairly" as used in the standard auditor's report is highly ambiguous and should be replaced with "appropriate in the circumstances."

We concur with the general thought that more guidance must be developed for the selection of the most appropriate accounting principles when there are alternatives or when there are no applicable accounting pronouncements. Additional guidelines for evaluation of the cumulative effect of the application of alternative accounting principles should also be considered. This guidance should, however, come from the FASB rather than the accounting practitioners. Based on past experience, we would not rely on the AICPA to reach an effective consensus on the delicate issues of preferability. Our fear is that the result of any audit standards designed to handle preferability would unnecessarily restrict management's efforts to make meaningful financial disclosure. Requiring the independent accountant to declare one acceptable method as preferable to another equally acceptable method forces the accountant to make a determination that hinges on business planning and judgment, rather than accounting judgment.

The need for additional guidelines should be considered in the light of the "efficient market" research findings that users of financial statements are not confused or misled by alternative accounting treatments. This lack of confusion is partially the result of disclosure requirements mandating the exposure of accounting methods employed.

Section 3 -- Reporting on Significant Uncertainties in Financial Presentations

As stated earlier, Times Mirror believes that the present accounting and auditing framework is unable to properly handle uncertainties. We support the Commission's reasoning and proposal that the "subject to" qualification be eliminated from the auditor's opinion.

We question the value of a requirement for a separate note on uncertainties. Regardless of the limitations given in any new accounting standard, financial statement users would expect a separate note entitled "uncertainties" or the like to cover all material uncertainties, up to and possibly including general business risks. We cannot imagine how such disclosures could be effectively handled in the formal financial statements.

Section 4 -- Clarifying Responsibility for the Detection of Fraud

We agree with the Commission's observation that users of financial information and the public have generally had higher expectations concerning the independent auditor's role in detecting fraud than has been traditionally acknowledged by the profession.

SAS No. 16, "The Independent Auditor's Responsibility for the Detection of Errors or Irregularities," did respond to public expectation by mandating that "...under generally accepted auditing standards the independent auditor has the responsibility...to search for errors or irregularities that would have a material effect on the financial statements, and to exercise due skill and care in the conduct of that examination." The requirement that an auditor search for material fraud is explicit in the statement in SAS No. 16 that "an independent auditor's standard report implicitly indicates his belief that the financial statements taken as a whole are not materially misstated as a result of errors or irregularities." In our opinion, the adoption of SAS No. 16, combined with SAS No. 6, "Related Party Transactions," indicates that the profession has moved sufficiently to codify that frame of mind which the Commission aptly characterizes as "healthy skepticism."

In our opinion, a pragmatic definition of materiality must be developed before any additional audit procedures to uncover fraud are instituted. In the absence of such a standard, we are concerned that the Commission's recommendation of a "search" for fraud might lead to additional audit work beyond that which is necessary to provide audit assurance to financial statement users. Where the independent auditors are satisfied with a company's internal controls and the fraud detection work of the internal auditors, the independent auditors should concentrate on top management fraud.

Section 5 -- Corporate Accountability and the Law

We concur with the Commission's position that management has an obligation to adopt and disseminate policies setting forth the company's standards of conduct. Management also must ensure that the company's accounting system and the controls over it provide a cost effective opportunity to detect violations of company policy. As the Commission has properly suggested, a company's internal audit staff should play a major role in the attainment of optimum "corporate legal accountability." It is our hope that if a corporation has an effective approach, its independent auditors will, with minimal incremental cost, be able to obtain assurances that any illegal and questionable acts are being detected and disclosed.

As part of the ideal corporate accountability framework, Times Mirror proposes the use of internal letters of representation. Two years ago, we instituted a required procedure of quarterly representation letters from each of our company's operating units executed by the respective Chief Operating Officer and Chief Accounting Officer. In addition to covering normal financial representations, these letters require representations covering compliance with public laws and our company's policies in the following areas:

1. Conflict of interest.

2. Related party transactions.

3. Improper or illegal payments, including payments of a political nature.

4. International boycott.

5. Recognition that the unit management is responsible for the financial statements of the unit.

While these letters merely emphasize long-established company policy, they do continually remind the operating unit management of the company's requirements.

The Commission has set forth a well-reasoned description of the manner in which the auditor should respond to detected illegal or questionable acts. The auditor should consider detected illegal or questionable acts "without regard to traditional standards of materiality."

We strongly endorse the Commission's suggestion that the responsibility for legal disclosures should be placed squarely on management and its legal counsel. We support the study and development of improvements in the manner in which legal matters are disclosed. In particular, a solution to the auditor-lawyer impasse over the disclosure of unasserted claims needs to be found.

<u>Section 6 -- The Boundaries of the Auditor's Role and Its Extension</u>

Times Mirror involves its independent auditors in the quarterly financial reporting process on a timely basis. Our internal auditors also play an active role in the review of subsidiaries' quarterly results while the corporate policy and control section, which is independent of the consolidation process, performs quarterly overview procedures. We have found that the benefits of this coordinated review program exceed the costs involved.

The focus of the quarterly work of our independent and internal auditors is on internal controls. Both the independent auditors and management are pleased with the results of this more frequent involvement. On this basis, we endorse the Commission's proposal for timely involvement by independent auditors in the financial reporting process.

Times Mirror supports the concept that management should make explicit representations covering the adequacy of the corporation's accounting system and the internal controls over it. This representation should extend to disclosure of uncorrected material deficiencies.

We also endorse the expansion of the audit function to include a more comprehensive study and evaluation of controls over the accounting system. The auditor's report, we agree, should include a conclusion on the functioning of the system and comment on inadequacies in management's disclosures on internal controls. Although we would envision that this expansion will not result in a significant increase in the annual cost of auditing services, there should be further dialogue and research among interested parties to assess the benefits and costs of the additional audit work.

In reviewing the annual report information outside the audited financial statements, the auditor should "extend his procedures to include a comparison of the other information in the financial statements and his audit work papers" and "when necessary...recompute information stated in percentages or combined in a manner different from that in the financial statements." It is unfortunate that SAS No. 8, "Other Information in Documents Containing Audited Financial Statements," did not contain this additional guidance. Nevertheless, it is our impression that most major accounting firms are performing these procedures. While we do endorse these "limited review" procedures, we strongly disagree with the recommendation of the "extension of the audit function to other information in the annual report." Any suggestion that the other information should be audited will give the auditor serious problems since he will find that much of the other information is nonverifiable. We believe there must be a generally understood boundary for the audit responsibility, and the audited financial statements are the limit of the information susceptible to the auditor's attestation.

Section 7 -- The Auditor's Communications with Users

Times Mirror strongly endorses the concept of the "report by management" acknowledging management's responsibility for the financial statements, and the auditor's opinion stating his satisfaction or dissatisfaction with management's representations. Logically, management should make the representations pertaining to the propriety of financial statement presentation and the status of the accounting system and internal controls.

In keeping with the concept that management has the responsibility for the financial statements, management rather than the auditors, should be making consistent representations. Accordingly, we agree with the omission of the consistency comment from the revised auditor's report. We do, however, believe that significant accounting changes should be highlighted in the report by management and then discussed in detail in the notes to the financial statements.

While calling its example of a report by management an "illustration," the Commission comments that a "standardized format" should be developed through "substantial cooperation...between auditors and management." If the Commission is suggesting that customized reports by management should be developed by individual corporations and that an authoritative body need not promulgate a rigid universal format, we heartily support the Commission's proposal in its entirety. Even before the distribution of the Commission's tentative conclusions, Times Mirror management was using an abbreviated report by management in internal financial statements and in 10-Q filings.

Because we believe that the typical financial statement user should not be expected to comprehend the essence of the expression "generally accepted accounting principles" or to understand the other intricacies of the present standard auditor's report, we endorse the Commission's proposal for a more explanatory auditor's report. A new report should be devised to include a series of paragraphs with standardized alternative wordings, noting all significant aspects of the audit function. While we do share the concern of others that the expanded report, by referring to the auditor's monitoring of management activities, could unnecessarily imply that management is not to be trusted, we have faith that interested parties will be able to develop balanced language.

Section 8 -- The Education, Training and Development of Auditors

Times Mirror agrees that there is a need for significant improvement in the education of entrants to the accounting profession. Practitioners, accountants in industry and educators should interface more to resolve deficiencies in current curriculums.

However, we do not believe that there is a demonstrated need for background and skills beyond what universities should be able to arrange into a four or five year program. It is doubtful that a seven year higher level education will help prevent "the exercise of poor judgment under conditions of stress and pressure" cited by the profession. It is our observation that "good" judgment in an auditing context is the result of practical and sufficient audit experience; it is gained not in the classroom, but rather in the field by exposure to accounting and auditing problems under actual conditions of stress and pressure.

In addition, the kind of specialized training gained in a seven year program would be unnecessary for individuals who decide to pursue careers in private industry and government. It would also tend to eliminate the enriching interchange of professional personnel among public accounting, private industry and government.

The Times Mirror Company does support measures which would enhance both the technical skills and integrity of the entrant. We suggest consideration of the following proposals:

1. The background of the CPA candidate should be broadened to require effective courses in economics, statistics, electronic data processing and written communication, to name a few.

2. A separate course covering the legal and ethical responsibilities of the auditor.

3. The business schools should place a greater emphasis on auditing. Courses in auditing which focus on fraud detection and particular industries and are oriented, perhaps, toward the AICPA Industry Audit Guides should be considered by the schools.

We are disturbed by the trend, described by the Commission, that accounting teachers are coming "directly through the educational process, without a period of experience." Interested parties should study this detrimental development for ways to arrest it. However, the entrance standards for the CPA's professional societies should not be diminished for the sake of more communication with academics. We do believe it is incumbent upon educators and CPA's to find and fully utilize other means of regular contact between the two groups.

Section 9 -- Maintaining the Independence of Auditors

We believe that the Commission has advanced sufficient grounds to support its conclusion that accounting advice, accounting advocacy, income tax consultation, and similar services not directly related to the audit do not affect the independence of the auditor. On the other hand, we disagree with the Commission in that we believe management services work and "peripheral services" can possibly conflict with the auditor's independence and, perhaps more importantly, can damage the public credibility of the auditor. The feeling that public accountants should not perform the latter types of services for their audit clients is too wide-spread to be ignored. We foresee that the trend for increased disclosure will lead to the requirement that publicly-owned enterprises report the details of all transactions with their auditors. Such a requirement is inevitable, we believe, because there is no sustainable basis for opposing it. In anticipation of the disclosure requirement, some corporations will avoid criticism, even if refutable, by discontinuing the use of the peripheral services of their auditors.

We believe that the Commission should explicitly note that a high proportion of boards of directors and managements had already been scrutinizing the nature of services received from their auditors and have not retained them for services that could be reasonably viewed as counter-productive to the auditors' independence. On this point as well as others throughout the Commission's tentative conclusions, the report has failed to describe measures already in practice which serve to demonstrate the integrity of the vast majority of the nation's business leaders. In recent times, the ethical and law-abiding behavior of this majority has been overlooked in the concern over a relatively few instances of gross misconduct. This perspective, we hope, will be reflected throughout the Commission's final conclusions.

The Commission has used its survey of individual audit personnel as the basis for strong charges regarding the effect of time pressures and cost restraints on auditor performance. We are deeply disturbed by the indicated incidence of substandard performance. As the information is presented in the tentative conclusions, however, we have the impression that, due to the fogging of the data-gathering process, the survey results do not show that some of the omissions were supportable although the auditor did not document this support or was too inexperienced to recognize that the omission was supportable. In any event, the accounting profession must seriously study the survey and its results and take prompt action to resolve any significant problems indicated by the survey results and the subsequent dialogue.

We do not believe that relaxing deadlines or increasing audit fees will significantly improve audit quality. In the isolated instances where audit firms have agreed to unconscionable fees or deadlines, they have a duty to resign if they are unable to satisfactorily perform the audit. The peer review process should help identify and bring pressure for reform of poor management practices and other shortcomings of individual auditing firms.

Section 10 -- The Process of Establishing Auditing Standards

We strongly endorse the Commission's recommendations for prompt private sector action in the improvement of the auditing standard setting process. We have faith that the current momentum of independent accountants and industry will be sufficient to produce effective solutions to significant deficiencies. In the revision of standard setting structures and the standards themselves, the Securities and Exchange Commission should be consulted; however, only after the profession has failed to act promptly and adequately should it be advocated that the Government intervene. A full-time Auditing Standards Board within the American Institute of Certified Public Accountants should be seriously considered. This board should open up the standard setting process to greater participation by interested parties, including industry accountants serving in advisory capacities. The business of the new board should be conducted in public forum to the maximum extent practical to reveal the objectivity and fairness of the standard setting process.

Recognizing that non-publicly-owned companies and small practitioners have legitimate complaints, we support recommendations to give their needs more consideration in the standard setting processes for both accounting and auditing standards.

Section 11 -- Regulating the Profession to Maintain the Quality of Audit Procedures

While agreeing with critics that the accounting profession has, in the past, not taken prompt, effective action to respond to deficiencies, including the need for peer reviews, we believe that recommendations from certain quarters for direct Government action are premature. The profession should be given a limited, although reasonable, amount of time to establish a mechanism for periodically evaluating the work of auditing firms.

Yours truly,

Harvey V. Guttry Jr.

HVG:pc

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Corporation
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J. W. OSTREM
GROUP VICE PRESIDENT
FINANCIAL CONTROLS

June 20, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

The Report of Tentative Conclusions by the Commission on Auditors' Responsibilities is a thoughtful and balanced presentation which could well result in an improvement in the performance of independent auditors. Many of the recommendations can be accepted as stated. I am noting below only those points which we wish to emphasize or which we recommend be changed.

FORMING AN OPINION ON FINANCIAL PRESENTATIONS (Section 2)

We agree that the word "fairly" should be eliminated from the auditor's report. With the heavy emphasis on compliance with rules, the judgmental decision as to whether or not the financial statements are "fair" has taken a subordinate position.

REPORTING ON SIGNIFICANT UNCERTAINTIES (Section 3)

The elimination of the "subject to" qualification in the auditor's opinion has merit, and any uncertainty could best be described in a note to the financial statements. However, the Cohen Commission recommendation is that "the note should describe all material uncertainties, not only those that might have resulted in a qualification." The problem with this recommendation is that clear standards of such note disclosure must be established in order for both the company and its auditors to satisfactorily determine those uncertainties which should be considered material. Uncertainties could be quite lengthy and, therefore, burdensome if the threshold of materiality is too low.

CLARIFYING RESPONSIBILITY FOR THE DETECTION OF FRAUD (Section 4)

The Cohen Commission recommendation is that the auditor should "search for material fraud" and that he should make certain that the "financial statements report and explain the nature and effects of material frauds that are discovered."

In this case, two standards need to be established: (1) A standard must be carefully defined as to what represents "due professional care" for use as a guide by the auditor in determining how far to take his search for material fraud and (2) a standard must be set to determine what level of frauds or defalcations must be reported in the financial statements. For instance, in financial organizations, where many people are handling cash or its equivalent, it is not uncommon for there to be small defalcations by employees. The threshold of materiality must be sufficiently high to safeguard against the financial statements being cluttered with the listing of small "frauds."

CORPORATE ACCOUNTABILITY AND THE LAW (Section 5)

The Cohen Commission recommendation properly makes it a management responsibility for meeting society's demands for corporate accountability. I would also agree that management should adopt publicized and detailed policy statements indicating the correct conduct of its officers and employees. I am concerned, however, that the independent auditor not expand unduly the scope of his audit in monitoring compliance with corporate policies as laid down by management. I believe it would be proper for the independent auditor to note any failures in compliance, but they should not have as one of their primary missions the monitoring of the policy in all its aspects. The cost and time consumption involved would be totally uneconomic. I would agree that any detected illegal or questionable acts be brought by the auditor to the attention of management without regard to traditional standards of materiality.

BOUNDARIES OF THE AUDITOR'S ROLE AND ITS EXTENSION (Section 6)

This entire set of recommendations is too broad and sweeping. First of all, it would encompass all "information of an accounting and financial nature that management has a responsibility to report." This could expand the auditor's scope to almost limitless bounds. Further, it is indicated that the auditor's report on the audit function should include an evaluation of management's description of controls over the accounting system. It is not clear to whom the report should be issued but presumably it would be made public. If so, this could be considered objectionable inasmuch as at any one time there are control problems which any company is working on and which it would not care to have made a part of the public record.

The scope of this set of recommendations is so broad that there would need to be established a very well-defined set of standards by which they would be made to operate.

THE EDUCATION, TRAINING, AND DEVELOPMENT OF AUDITORS (Section 8)

I am in enthusiastic agreement with the recommendation that an educational program similar to that of the legal profession should be instituted over a period of time. Four years of undergraduate work plus a graduate program in a professional school of accounting would be a major step in elevating accounting to true professional status and help to insure a level of competence adequate to meet the financial and accounting problems in the next generation. I would question whether a three-year graduate program might not be overlong, at least initially; a full three-year graduate program might require greater time and experience to develop.

MAINTAINING THE INDEPENDENCE OF AUDITORS (Section 9)

These recommendations would result in removing management's effective control over audit costs and for this reason are not supportable.

Further, the recommendations would result in steps being taken to reduce the pressures which arise from time budgets and also would remove deadlines. I don't know of any business or profession which is not confronted with deadlines and time budgets. Further, there is no instance of which we have knowledge in which it has been alleged, much less proven, that independent auditors have "missed" because of deadlines or time budgets. It is the responsibility of any auditor to withdraw from the engagement if the time requirements make it impossible for him to perform an adequate audit.

* * * * *

Despite the specific disagreements noted above, we believe the Cohen Commission's report is worthwhile and is a step in the right direction. Further, it is tangible evidence that the private sector acting on its own initiative can continue to improve its procedures and techniques without the intrusion of Congress or Federal regulatory agencies.

Very truly yours,

J. W. Ostrem

JWO:cc

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RESPONSE OF ALEXANDER GRANT & COMPANY
TO THE REPORT OF TENTATIVE CONCLUSIONS BY
THE AICPA COMMISSION ON AUDITORS' RESPONSIBILITIES

I. Introduction

This paper presents the views of Alexander Grant & Company on the Report of Tentative Conclusions of the AICPA Commission on Auditors' Responsibilities. On the whole, we are impressed with the Report of Tentative Conclusions, and, as will be set out hereinafter, there are a number of specific conclusions which we think the profession would do well to implement. The Report also presents a few conclusions with which we do not agree and such conclusions are also discussed in this paper.

II. Principal Points of Agreement

AICPA Auditing Standards Executive Committee

We agree with the fundamental thrust of the Commission's recommendations about restructuring the AICPA Auditing Standards Executive Committee (AudSEC). The present Committee of twenty-one part-time voting members is plainly too large to be effective. Moreover, the fact that one-third of the Committee members are new each year causes problems of updating and efficiency. As we noted in our testimony before the Subcommittee on Reports, Accounting and Management of the Committee on Government Affairs of the United States Senate, "a number of (AudSEC's) recent pronouncements have appeared to us to be ill-considered and awkwardly drafted."

We concur in the finding of the Commission that many AudSEC "pronouncements could usefully provide more specific guidance." All too frequently the pronouncements use language which is not understood by the average practitioner in the field and key issues are either ducked or finessed.

Our recommendations for changes in AudSEC as set forth in our testimony before the U.S. Senate Subcommittee are as follows:

> The Committee should be reduced in size -- to five or seven members. Some of the "Big Eight" and other larger firms would thus have to forego their permanent representation. Terms should be increased from three to at least five years. AudSEC should be given adequate staff, including counsel and assistants who can communicate in plain English. Meetings should be conducted in the open, allowing all who wish to attend or send observers to do so. AudSEC could also continue to be assisted by special task forces drawn from the accounting profession and elsewhere.

We do not believe, however, that it is necessary or desirable for AudSEC to become a full-time body. Practitioners who are involved with practice problems on a day-to-day basis can make a better contribution to setting the rules for conducting audits than those who are removed from practice. Also, it seems to us that before the cost -- which would be substantial -- of a full-time AudSEC is incurred, we should test whether a part-time AudSEC comprised of a smaller number of practicing professionals would be effective.

Audits of Non-Public Companies

We concur with the Commission's conclusion that "there are two distinct types of audit practice within the profession." We were also pleased to see the Commission's comment that "the users of audited statements of non-public companies differ significantly enough from investors in public companies to suggest that not all the requirements of every Statement on Auditing Standards should apply."

We believe that not only do the users of financial statements of non-public companies differ from users of financial statements of public companies, but that the audit approach for the non-public company must itself be different in many cases. For example, it is not uncommon in non-public companies to find that accounting departments are of insufficient size to permit a full separation of functions and, hence, an adequate system of internal accounting controls in the classical sense. Nonetheless, these companies frequently have excellent controls over their day-to-day operations and accounting records because the personnel performing the accounting functions are experienced, intelligent and closely supervised by the top management (likely including the owners) of the enterprise.

It is frequently more efficient to audit the financial statements of such enterprises by applying substantive tests to the account balances rather than concentrating on review of the system of internal accounting control and test of compliance. This distinction is already recognized in the present literature in Section 320.55 of Statement on Auditing Standards No. 1.

We know that some professional accountants will argue that "an audit is an audit is an audit." While we agree that the end product of an audit examination of financial statements should be the auditor's opinion about the client's financial statements, the procedures applicable in various circumstances -- to various sizes of companies -- will not necessarily be the same. In short, the nature of procedures applied to a public company's financial statements may differ from those applied in the case of a non-public company; but the end result should be the same -- an opinion on the client's financial statements.

Uncertainty Qualifications and Statement of Uncertainties

We agree with the Commission's recommendation about elimination of the requirement in the present literature that auditors qualify their reports (or deny an opinion) for material uncertainties. It seems clear to us that financial statements which adequately present and disclose the effects of uncertainties are in conformity with generally accepted accounting principles and, accordingly, no qualification of the auditor's report is necessary. We have no problem extending this principle to the so-called "going concern" situation. Even if the auditor has significant doubts about the entity's ability to continue as a going concern, as long as the client's problems relating to going concern uncertainties are adequately disclosed and emphasized, the financial statements should be regarded as presented in conformity with generally accepted accounting principles. Of course there can be circumstances where it is clear to the auditor and to management of the enterprise that preparation of financial statements in accordance with the going concern assumption is not warranted. In these latter situations the auditor should be careful to see that the financial statements present information in accordance with the facts.

We also agree with the Commission's suggestion that each set of audited financial statements should contain a separate "statement of uncertainties." A separate statement would serve to emphasize uncertainties about the financial statements and help to reduce the communication problem with users of such statements who may believe that the financial reporting process is more precise than it actually is.

We think a great deal of work will have to be done on developing standards for the content of a statement of uncertainties within the context of generally accepted accounting principles and adequately distinguished from statements of "risk factors" included in prospectuses. For example, most CPAs today would qualify their audit reports for material uncertainties about the collectability of accounts receivable but would not qualify their reports for uncertainties about the useful lives selected by management for the depreciation of property, plant and equipment. We think that, properly conceived, a statement of uncertainties could open the way toward frank discussion of all material uncertainties about the financial statements of an enterprise without attempting to make the artificial distinctions caused by the present literature and practice on auditors' reports.

Consistency Exceptions

We agree with the Commission that the present auditing standard requiring the auditor to take an exception in his report letter for changes of accounting principles should be revised. A clear-cut note to the financial statements describing accounting changes should be sufficient to adequately communicate the information needed to users of financial statements. In this regard, the matrix set up by the present auditing literature is so complicated that only technicians inside the profession can hope to understand what the standard short-form report intends to communicate. For example:

1. Certain accounting changes involving the inseparability rule (paragraph 11 of APB Opinion No. 20) may be treated as changes in accounting estimate but will be treated as involving the consistency standard on accounting principles changes for the purposes of the auditors' report letter.

2. Major reclassifications in financial statements will usually not be considered as affecting the consistency standard but changes which relate to an adjustment of the presentation of the statement of changes in financial position will be considered to involve the consistency standards (paragraphs 420.14 and 420.15 of Statement on Auditing Standards No. 1).

3. Even the periods to which the consistency standard is applied are interpreted in a highly technical and somewhat confusing manner. For example, if the auditor "reports only on the current period, he should report on the consistency of the application of accounting principles in

relation to the preceding period, regardless of whether the financial statements for the preceding period are presented" (paragraph 420.20 of Statement on Auditing Standards No. 1). But if the auditor reports on two or more years he reports only on consistency among those years and not on consistency with any year prior to such years reported on unless financial statements of such prior periods are presented.

Management Acknowledgement of Its Responsibility

We agree with the Commission's suggestion that management acknowledge its responsiblity for the financial statements in a formal written report to be attached to each set of audited financial statements. We believe that some additional work will have to be done on the suggested form of the management responsibility statement, but think that matter can be resolved.

Management Advisory Services

We believe that the Commission's discussion of management advisory services is extremely well done. We agree that while providing such services to clients poses "an obvious potential threat to the auditor's independence," "the evidence contradicts the theory."

However, we do believe that the practice of public accounting must stop somewhere, and, accordingly, our firm has not chosen to provide an unlimited range of management advisory services to audit clients. One specific area where we have chosen not to provide non-accounting consulting services to our clients is that involving actuarial services. As we said in our testimony before the Subcommittee on Reports, Accounting and Management of the Committee on Government Operations, United States Senate, actuarial services place "the auditor in the troublesome position of appearing to audit his own work." We acknowledge that this problem may be more one of appearance of independence rather than fact of independence, but we believe that actuarial services are exactly the type of services which the profession would do well not to perform for its audit clients.

We also concur with the Commission's suggestion that non-audit services performed for audit clients ought to be disclosed.

Professional Discipline

We agree that removal of some of the secrecy from the profession's present disciplinary processes is advisable. Undoubtedly this will have to be handled carefully as a professional's reputation can be severely injured by the mere indication that he is being considered for disciplinary action. Nonetheless, subject to proper control, we think removal of secrecy may be a good idea.

We agree that there is a problem regarding deferral of disciplinary action where litigation is pending. However, we think that the AICPA and the State Boards of Accountancy have little choice but to defer their proceedings in such situations. In the case of complicated litigation, it is useful to wait so as to have the benefit of the record developed in discovery and at trial. The important thing is that there be follow-through on disciplinary action at a later date after pending litigation has been concluded. All too often, it appears to us that when the cases drag on for years, disciplinary action is eventually not taken simply because the matter has become "yesterday's newspaper."

Information About Audit Failures and Fraud

We agree with the Commission that dissemination of information about "audit failures" and fraud would be helpful to the practicing profession. Because of the legal difficulties which may be involved (which we understand caused problems for the AICPA special committee on the Equity Funding matter), we suggest that the information disseminated be written up in a "case study" format without reference to a specific matter which has actually occurred. Such case studies may even be more instructive than lengthy descriptions of actual "audit failures" and frauds.

III. Principal Points of Disagreement

Revised Auditor's Report

We are very troubled by the revised auditor's report letter recommended by the Commission. Our concerns may be summarized as follows:

1. We doubt that the suggested revised report really communicates the fundamental audit responsibility on the financial statements better than the present short-form report. This is not to say that we believe the present report communicates adequately either.

But we do believe that the first three paragraphs of the Commission's suggested report letter will leave the public in the continuing position of wondering what it all means. Phrases such as "in all material respects" and "generally accepted accounting principles appropriate in the circumstances" are still not sufficiently clear to really result in help for the user of financial statements.

2. Until the concept of a fair presentation is fully incorporated in generally accepted accounting principles we would be reluctant to remove the phrase "presents fairly" from the short-form report. Indeed, in the present state of the art where authoritative literature does not exist for the selection among various accounting principles, we believe that the auditor should be required to give his opinion both on fair presentation of the financial statements and on their conformity to generally accepted accounting principles.

3. At page 20 of its Report the Commission states the following:

> The mere absence of authoritative literature specifying how the choice among alternatives should be made is not sufficient grounds for the auditor to accept management's selection (of accounting principles).

We agree with this statement by the Commission but are unable to discern how the Commission would have the auditor cope with a situation where he does not agree with management's selection of principles from among alternatives permitted by generally accepted accounting principles. We also note with interest that the Commission has stated that accounting principles appropriate to individual circumstances may be selected and applied properly, yet the resulting financial statements as a whole may be biased or misleading." We agree that in the present state of the art this can sometimes happen, but we believe that the best answer lies in adopting a uniform set of accounting principles tied to a conceptual framework -- not in imposing a further audit reporting requirement. Moreover, what the public really wants -- it seems to us -- is the auditor's overall view of the integrity of the financial statements, not just his view about alternative principle selection. For this reason dropping of the phrase "presents fairly" from the auditor's report would in our view be a step backward.

4. We doubt that non-public companies will need or desire in all cases for the auditor to be involved with quarterly information. Accordingly, reporting on the quarterly information of non-public companies should not be mandatory. We also wonder whether timely quarterly involvement of the auditor is sound from a cost/benefit standpoint for smaller, and less actively traded SEC registrants.

Reporting on Internal Accounting Control

The new auditor's report letter proposed by the Commission also contains a paragraph reporting on the client's internal accounting controls. We are gravely concerned about this recommendation.

To us it appears that the profession (with a push from the SEC) is moving headlong toward foisting on the public another idea which will not serve the purpose for which it may be intended. Every auditor knows that a good system of internal accounting control does not necessarily result in correct financial statements. All that a system of internal accounting control can mean to the auditor is possible adjustment of the nature, timing and extent of his audit procedures. The public will inevitably believe that if the auditor makes no negative comment about the client's system of internal accounting control that there is little or no possibility of fraud. This is plainly not so. In some of the more significant cases of "audit failure" management has overridden the system of internal accounting control for its own purposes -- whether fattening the financial statements, fattening its own pockets or both. We know the Commission's suggested report says this -- but who will remember or understand?

We also believe that it will prove to be virtually impossible to define an "adequate system of internal accounting control." The SEC has tried; AudSEC has tried -- each without success.

As we have noted above in our discussion of auditing non-public companies, the system of internal accounting control in one enterprise may differ significantly from that in another enterprise simply because of the size or nature of the company being audited. When viewed in a cost/benefit context the internal accounting control systems of many smaller clients are perfectly adequate even though they may not match up well against some absolute concept of an "ideal system." For such smaller companies, we believe the Commission's suggestion that the auditor report on "material weaknesses" could lead to lengthy -- and silly -- lists of weaknesses which have no effect whatsoever upon the reliability of the financial information presented because of the substantive tests which the auditor has applied in making his examination.

Outside Directors and Independence

The Commission has said that "an active Board of Directors with a significant proportion of independent, outside directors to whom the auditor reports is necessary to help sustain his independence." In principle, we agree that it is desirable to have knowledgeable and outside directors on any board, but we believe the Report of the Commission has overstated the issue. Indeed, an appropriate audit committee staffed with outside directors has proven to be helpful in many public company situations. However, we really doubt whether it is necessary to have outside directors on the boards of non-public companies across the country. We also doubt whether a requirement for outside directors could be adopted by the profession in the face of the varying business corporation laws of all of the states and serious questions about cost/benefit which would likely be raised at the state level.

Education of Auditors

We think the Commission's discussion about the education of auditors misses a very significant point. It is not the length of the education that matters (seven years under the Commission's suggestion) but the quality of education and the nature of the material taught. Increasingly, the major business schools throughout the country have begun to emphasize sophisticated management information and computer systems which are encountered only in large companies. Many new auditors appear to lack knowledge of how a basic set of accounting records works. In short, as one practitioner put it recently -- "many don't know the debits from the credits."

It is true that the profession itself presently bears a very heavy educational burden discharged by each of the firms providing lengthy training courses of their own. In part, however, such costs have been escalated because the firms have not chosen to cooperate through the AICPA by sharing their educational efforts. If the Commission were to analyze the success of the Institute program to exchange educational materials (the so-called "EDMAX Program") they would learn that the major firms have been singularly reluctant to support the program. Is it really necessary that all of the firms develop their own materials on accounting for leases, for example?

Materiality for Illegal Acts and Social Control

We are concerned by the manner in which the Report deals with illegal or questionable acts, and its abandonment of materiality as an insufficiently "powerful" concept for application by an auditor once he has discovered or believes he has discovered such an act.

Our concern is more fundamental. It appears to be a major premise of the Report that a principal purpose of the auditing function is societal control over corporate enterprise, and that the auditor and his function are perhaps best viewed as agencies of social control. If that premise is accepted, then, of course, materiality is not a sufficiently powerful concept, because it is not responsive to the interests society may have in controlling corporate enterprises. In our own society, the Equal Employment Opportunity Commission, the Occupational Health and Safety Administration, the Department of Defense, and even the Central Intelligence Agency and the Federal Bureau of Investigation may well be vitally interested in or curious about matters which are of no concern to the average investor or shareholder in making investment decisions. Public interest groups and private citizens may have other areas of interest or curiosity -- all without limit.

We do not accept the premise. We believe that materiality is an important concept in the preparation and auditing of financial statements. We believe that materiality is a prerequisite to keeping financial statements within usable and understandable dimensions.

As for societal control in general, and as for disclosure of questionable acts as a more particular but still vaguely defined application of such control, we urge that the matter be dealt with apart from the preparation and audit of financial statements. If particular corporations or classes of corporations should be required to report upon their conformity or non-conformity with prescribed norms of corporate conduct then let them do so in a report clearly intended for that purpose. We are not ducking responsibility.

We are willing to assist in exploring how we, and other accountants, directors, counsel and management might play a role in the preparation of and attestation to such reports. But we object to cluttering and confusing the auditing of financial statements with new and still undefined notions.

IV. Conclusion

In conclusion, we repeat that on the whole we are impressed with the Commission's recommendations. We trust that those points with which we disagree will be carefully considered by the Commission in its further deliberations. We look forward to the Report of Final Conclusions.

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The Dayton Power and Light Company
Courthouse Plaza Southwest, Dayton, Ohio 45401

John R. Dill
Comptroller

June 23, 1977

Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

RE: Tentative Conclusion on Auditors' Responsibilities

Dear Sir:

In response to the Commission's report of tentative conclusions on Auditors' Responsibilities, The Dayton Power and Light Company ("the Company") submits the following comments.

The Company does not agree with the Commission that an overriding need exists to expand the audit function and its reporting process on annual financial statements. If these expansive recommendations are adopted, the cost will become quite an added burden on industry, and the benefits to be derived are not substantially assured. Once the novelty of the new audit report and management's report fade, they too may become an "unread symbol." If the auditor's expanded role adds clarity as to what an auditor does, as the Commission contends, the Company questions the propriety of industry absorbing this additional cost created by the independent accounting profession which in actuality is public relations. On the whole, these recommendations would not accrue sufficient benefits to justify their added cost.

The Company agrees with the Commission's suggestion to do away with "subject to" qualifications on annual reports by reporting the uncertainty which might cause such an opinion. Full disclosure of uncertainties is essential in an era of corporate distrust. The best way to eliminate the confusion of a "subject to" qualification is to allow the user of financial statements to evaluate the uncertainties for himself. The need to disclose "other" services of independent auditors in the proxy statements in order to safeguard independence is not seen. Presently, auditors affirm their lack of material relations with the Company in the proxy statements. To fully disclose any normal management advisory service which auditors perform is unnecessary.

The effects of time pressures on auditors as well as on internal company staff are inevitable. A certain level of time pressure is tolerable, but most excessive time pressures can be avoided by careful time budgeting by management. However, at times, these pressures are unavoidable, and for an auditor to simply refuse to accept these pressures, as the Commission suggests, is unworkable. The Company believes that some allowance should be arranged ahead of time to deal with these type of occurrences.

The Company approves of the Commission's recommendation for a professional school of accounting. Such a school will result in a better quality audit because time will not be spent training untested new employees. Graduates of such a school would be more professional, more knowledgable, and more efficient than persons who have gone through the traditional method of training.

The importance of maintaining the regulatory function of accounting and auditing within the private sector cannot be understated. The Company agrees with the Commission that the government should not assume the role of determining auditing and accounting principles. The Company also agrees that the standards board should include some input from industry. The Commission should further study specific means of including industry in the decision process.

The Company appreciates the opportunity to submit its comments in regard to auditors' responsibilities and thanks the Commission for its consideration thereof.

Respectfully submitted,

THE DAYTON POWER AND LIGHT COMPANY

J. R. Dill

J. R. Dill
Comptroller

TK/rrp

A-53

ASSOCIATION OF GOVERNMENT ACCOUNTANTS
NATIONAL OFFICE: 727 SOUTH 23RD STREET, SUITE 100, ARLINGTON, VA. 22202 (703) 684-6931
FORMERLY FGAA

June 20, 1977

Mr. Douglas R. Carmichael
Research Director, Commission
on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

The Financial Management Standards Board of the Association of Government Accountants has reviewed the Commission's "Report of Tentative Conclusions." The views expressed represent a consensus of the Board, speaking for the Association, and do not necessarily represent the views of individual members or their employers.

The Board agrees with the report. In our opinion, the conclusions are adequately supported and the recommendations sound. Hopefully, the final report will reinforce the conclusions and recommendations and would serve as a master blueprint for the profession to follow in realigning its relationships with clients, regulatory bodies, recipients of financial statements and the public.

The opportunity to review and consider the report was appreciated.

Sincerely,

John T. Crehan

John T. Crehan
Chairman, Financial Management
Standards Board

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NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

nysscpa

600 THIRD AVENUE, NEW YORK, N.Y. 10016 ■ (212) 661-2020

June 23, 1977

Dear Doug:

It was necessary to make several revisions in the report of our committee on the recommendations of the Cohen Commission. Accordingly, we enclose a revised copy.

Bob

Robert L. Gray
Executive Director

Douglas Carmichael, CPA
Managing Director of
Technical Services
American Institute of CPA's
1211 Avenue of the Americas
New York, NY 10036

RLG:bb

The Committee on the Future of the Profession of the New York State Society of Certified Public Accountants is pleased to offer the following comments and recommendations to The Commission on Auditors' Responsibilities on its Report of Tentative Conclusions.

RE: THE INDEPENDENT AUDITOR'S ROLE IN SOCIETY (SEC. 1)

Our committee concurs in the Commission's views on this subject. Regarding the role of auditors in serving non-public companies, with which the Commission admittedly does not deal, we urge the earliest possible attention to this subject.

On page xvii, last paragraph, the report states that "Audits are designed to assure..." We suggest the use of "reasonably assure."

The paragraph continues with "Audits are designed...to help safeguard the assets..." Our committee could not unanimously concur in this position since some feel that safeguarding a company's assets is solely management's responsibility.

RE: FORMING AN OPINION ON FINANCIAL STATEMENTS (SEC. 2)

We accept with some concern the Commission's position that the independent auditor should undertake the responsibility for judging the preferability of the accounting principles employed by a company in the preparation of its financial statements.

The concern arises from the foreseen difficulties in reaching a judgment in some, perhaps many, situations. It is therefore essential that the Commission recommend the development of guidelines for judging preferability in order that a frame of reference be available to assist auditors and to help achieve such uniformity as is possible.

As to the recommended exclusion of the word "fairly" from the term "presents fairly" in the auditor's report, our committee was evenly divided on the advisability of this action.

RE: REPORTING ON SIGNIFICANT UNCERTAINTIES IN FINANCIAL PRESENTATIONS (SEC. 3)

I. Approximately half the committee agreed with the primary recommendation in Section 3 that "subject to" qualifications should no longer be required in accountants' opinions with respect to uncertainties. The remainder of the Committee was not prepared to endorse this recommendation for the following reasons:

A. <u>The need to obtain more data as to the possible legal consequences to the auditor.</u> The courts may not accept a pronouncement of the profession that uncertainties do not require reference in the auditor's opinion even if there is adequate disclosure in the financial statements. This is an area that should be investigated thoroughly before any change in reporting standards is adopted.

B. <u>The need to educate the public prior to implementing such a significant change in reporting practice.</u> The Commission's Report points out that presently many users may believe that there are no uncertainties in financial statements if the auditor's opinion is "clean." They are more likely to believe this even if, as recommended, material uncertainties would not be cited in the auditor's opinion but would be disclosed in a footnote.

C. <u>The practical desirability of retaining "subject to" qualifications to ensure adequate emphasis in financial reports having material uncertainties.</u>

II. The support for the premise that auditors cannot evaluate the outcome of most uncertainties any better than users of financial statements should be improved. This is a concept that many people outside the profession may disagree with since, as indicated in the Commission's Report, financial statements contain numerous estimates (also see IV below). The profession should be prepared to undertake a public relations effort to clarify this misconception.

If "subject to" opinions are eliminated, the responsibility for evaluating material uncertainties would rest almost entirely with the user. There is some doubt that the user (with some exceptions) is as qualified to evaluate uncertainties as is the independent auditor. Accordingly, the recommendation that "subject to" be eliminated deserves further study.

III. Further, if "subject to" is eliminated, a standard should be promulgated to set forth the requirements for disclosure of uncertainties in financial statements. Particular attention should be given to unasserted claims and other actions.

If it is intended that <u>all</u> material uncertainties should be disclosed, a statement from the FASB should set forth in great detail the nature of the items that should be included and the information that should be given about each, though this may prove to be a most difficult task. A single footnote which purports to include all uncertainties, which, in fact, does not deal with all the uncertainties that face a business enterprise, could be more misleading than useful. Companies and their auditors might innocently overlook some of the uncertainties which should be disclosed even if there is extensive guidance in this area. In addition, without adequate guidance, serious disagreements may occur between auditors and clients over some disclosures of uncertainties.

The need for disclosure guidelines for "going concern" uncertainties is acute. Because such a disclosure can be a self-fulfilling prophecy, the auditor confronts a most agonizing dilemma -- to disclose or not to disclose. In periods of economic distress many such cases may exist, making the development of guidelines an urgent matter.

IV. There is a need to develop cautionary expressions to accompany an uncertainty disclosure. Illustrative of such a caveat is that appearing in the disclosure in 1976 financial statements pertaining to replacement cost data. Such cautionary expressions might also relate to estimates of the provisions for bad debts, obsolescence in inventories, outstanding warranties and other estimates.

V. The use of a middle paragraph in the auditor's report, to emphasize a situation affecting the financial statements, is suggested in paragraph 27 of Statement on Auditing Standards No. 2. The committee feels that the Commission should deal with whether this provision of SAS No. 2 would be appropriate for the disclosure of uncertainties in the absence of a "subject to" qualification.

In suggesting that "subject to" opinions be eliminated, the Commission should also address itself to the use of a disclaimer where there is a material uncertainty (see footnote 8, paragraph 25 of SAS No. 2). Further, in addressing the appropriateness of adverse opinions, the Commission should also deal with the propriety of "except for" qualifications where there is inadequate disclosure of material uncertainties.

RE: CLARIFYING RESPONSIBILITY FOR THE DETECTION OF FRAUD (SEC. 4)

The committee supports the Commission's desire to clarify the auditor's responsibility. It believes that SAS No. 16 adequately defines the responsibility of the independent auditor for the detection of errors and irregularities. As stated in SAS 16, the independent auditor has the responsibility to plan his examination to search for errors and irregularities that could materially affect the financial statements, and to exercise due professional care in the conduct of that examination. While we agree with the recommendations proposed by the Commission to further expand on the general concept of due professional care, we do not believe that the concept of due professional care can be reduced to a detailed list of steps and procedures because, in our view, auditing involves a considerable amount of professional judgement.

RE: CORPORATE ACCOUNTABILITY AND THE LAW (SEC. 5)

We agree with the Commission that the independent auditors should take steps to improve corporate accountability. However, as indicated by the Commission, accountants are not trained to detect violations of law; therefore, we support the need for a clear definition of prohibited corporate conduct.

We also agree with the Commission's conclusions that management has the primary responsibility in this area. Corporations should adopt statements of policy and monitor compliance with such policy. Companies should be encouraged to disclose the existence of the policy in public documents.

The auditors should report any questionable or possibly illegal activities noted during their audit to the Audit Committee or the Board of Directors. The Audit Committee or the Board of Directors should seek the advice of legal counsel on these matters.

We do not agree with the Commission that auditors should disclose confidential information to government agencies or publicly disclose any questionable activities without regard to materiality. We believe that a reasonable standard of materiality should be adopted for disclosure in the financial statements.

The committee supports the Commission's view that better assistance and involvement by the legal profession should be sought by management to enable them to fulfill their responsibility for disclosure of litigation and illegal or questionable acts. A report by management covering accounting systems and internal control and their discussions with legal counsel with respect to accounting for and disclosure of legal matters, would be desirable. We agree with the Commission that the auditor's responsibility should be to review the information and the representations of management and counsel to determine that the financial statements properly reflect the information provided.

RE: THE BOUNDARIES OF THE AUDITOR'S ROLE AND ITS EXTENSION (SEC. 6)

We concur in the Commission's proposal for a continuing involvement by the auditors in a company's accounting and reporting process. We also concur with (1) the concept of the fundamental separation of the roles of management and the auditor, and (2) limiting the auditor's association to information of an accounting and financial nature which is verifiable.

However, we believe that before new areas of auditor involvement are mandated, further study should be recommended in order to provide for the orderly evolution of the audit function. Specifically, the study should focus on (1) the question of the auditor's independence as a result of his assumption of a new responsibility; (2) the auditor's inability to provide assurance on matters with which he is associated; and (3) the benefits of extending the auditor's responsibility against the cost of such extension.

We recommend that independent auditors be required to communicate internal control weaknesses to the Audit Committee or the Board of Directors. This same cost-benefit analysis should be made before mandating a comprehensive review of internal control for the purpose of detecting all deficiencies. We do not agree, however, that a brief summary of such weaknesses would be meaningful to the public because of the difficulty of communicating inherent limitations in internal control.

An agreement could not be reached on the suggested form of "negative assurance" to the public with respect to quarterly financial statements. Further study is necessary of the auditor's ability to convey to users the degree of assurance which can be expected from limited reviews.

RE: THE AUDITORS' COMMUNICATION WITH USERS (SEC. 7)

While we agree with the Commission's conclusion that many users instinctively view the auditor's report as a seal of approval with respect to the financial soundness of a company, we question whether the Commission's suggested revised auditor's report and report by management should be implemented at this time. Rather, the Commission should recommend research and study of the feasibility and implications of an expanded auditor's report and of a management report.

We are concerned with the suggestion that the auditor's report cover such matters as internal controls, association with quarterly information, corporate codes of conduct and meetings with the Audit Committee. The auditor may not be able to convey, and the user may not be able to comprehend, the extent of the auditor's involvement in such matters. If reporting of this information is deemed valuable to users, such communication should be channeled through the company's Audit Committee rather than public reporting.

The committee could not reach a consensus as to whether "fairly" should be eliminated from the auditor's report with the substitution of "in all material respects". A material number of committee members urge that this matter be further studied.

Although the committee endorsed the concept of the report by management, it was divided on the need for a statement by management with respect to its communicating with legal counsel regarding litigation. Outside legal counsel may not be qualified to make a determination on the disclosures required in financial statements. Management's statement on the efficiency of internal controls should eliminate the need for an additional statement on illegal and unethical activities.

RE: THE EDUCATION, TRAINING AND DEVELOPMENT OF AUDITORS (SEC. 8)

The committee concurs in the Commission's conclusion that there is a need for improvement in the educational process. However, it could not agree on the optimum method to achieve this objective.

The committee agrees that in the last decade the academic accounting community in graduate B-schools with executive training motivation has increased its emphasis on managerial accounting and financial analysis with a heavy mathematical emphasis. However, it is only the degree to which this has been done that should be of concern to those engaged in educating public accountants.

We also agree with the Commission that the emphasis on the attainment of the Ph.D. degree, generally following directly after undergraduate work, most often precludes the completion of any significant amount of audit experience (which is, incidentally, also a basic prerequisite for the CPA certificate in many states). The result is that such academics lack the professional background necessary to a full understanding of the needs and problems of a public accounting practice.

It is agreed that possession of a Ph.D. Degree and a CPA certificate, coupled with professional experience and scholarly attainment will remain the optimum type of academic preparation. However, we recognize the difficulty of attaining this optimum combination of credentials.

The mere establishment of a professional school of accountancy will not in itself solve this type of faculty problem. Rather, a solution, not suggested by the Commission, is to accept an approved MBA degree plus a CPA certificate, supplemented by high-level practical experience and an acceptable record of scholarly writings in lieu of the Ph.D. degree.

As noted before, the Commission states that "formal education does not now adequately prepare students to meet the demands and risks of professional practice" and that "at present it usually does not instill in them an appreciation of the legal and ethical obligations assumed by independent auditors." The study conducted by Professor John G. Rhode, described in Appendix B (pp. 167-174), summarizes the reasons why the respondents believed their education was insufficient.

It is submitted that neither the inadequacies in auditing instruction nor the substandard audit performance cited in detail by the Commission will be corrected unless the accounting curriculum (in the first instance) and the accounting firms' policies (in the second) undergo substantial change. Merely spinning off the educational vehicle as a separate professional school of accounting would not, of itself, cure the cited defects.

The Committee believes that what is needed is a major reorganization of existing collegiate schools of business along lines that would recognize all other student career goals than that of executive administration. Accounting (as well as the other departments) should be free to develop and control its own curricular offerings according to preceived professional needs within the appropriate time frame, as well as to prescribe the criteria for the appointment and advancement of its own personnel. The instruction would be more responsive to professional needs, students would have less cause for complaint on this score, and the professional identity of a public accountant would be greatly enhanced.

The Commission also proposes an internship program as a curriculum requirement. This proposal may be desirable but it would be difficult for business schools to administer properly if at all. If it is to be a curriuclar requirement, every student must be provided with an opportunity to enjoy substantially the same extent and level of exposure to actual practice, which is a virtual impossibility.

Thus the committee believes that the solution of the educational problems cited by the Commission is not necessarily to be found in the establishment of separate professional schools of accounting regardless of whatever other merits they may have, but rather in the reorganization of existing collegiate schools of business.

The report recommends the gradual extension of the educational process with a four year liberal arts under-graduate program followed by a three year graduate professional program as the ultimate goal. The committee was divided on the necessity for more than a bachelor's degree as preparation for a professional accounting career.

RE: MAINTAINING THE INDEPENDENCE OF AUDITORS (SEC. 9)

In general, the Commission's conclusions on problems involving independence appear sound and are based on reasonable and impartial evidence. Our committee endorses them, with one exception. Rather than prohibit a specific management services activity (i.e., certain executive recruitment and placement services) the committee feels that all management services activities should be authorized and approved by a committee of outside directors of the client being served.

RE: THE PROCESS OF ESTABLISHING AUDITING STANDARDS (SEC.10)

The committee is in general agreement with the recommendations in respect to the establishment of auditing standards. However, we believe that auditors are the best qualified to set auditing standards -- that outsiders should be encouraged and invited to participate and to contribute their views in task force and subcommittee deliberations, particularly in their field of expertise, but they should not be members of an official standard setting body.

RE: REGULATING THE PROFESSION TO MAINTAIN THE QUALITY OF AUDIT PRACTICE (SEC. 11)

We are in general agreement with the Commission's recommendations with respect to regulating the profession to maintain the quality of audit practice.

However, we question the Commission's recommendation for moving more expeditiously in disciplinary matters when litigation is involved. Unleashing the disciplinary mechanism prior to conclusion of the litigation clearly could have an adverse effect on the defendant's right to "due process." Nevertheless, we believe that the profession, in response to public expectations, should re-evaluate the practice of waiting until litigation is concluded before commencing its investigations.

The Commission suggests that users of audited financial information rely heavily on the name and reputation of the particular accounting firm performing the audit. From this, it concludes that experimentation with disclosure of information by a firm about itself would be useful. Although unstated, it is clear that this recommendation implies that the information include financial information. We believe this is a questionable recommendation which, as the Commission acknowledges, is not supported by a demonstrated user need. Absent such a demonstrated need, we believe it is the right of a private partnership to limit distribution of its financial information to its partners. Recognizing that the public has an interest in the reputation of an accounting firm, we believe that one of the best ways to provide it with meaningful information about the firm's professional standing is through publication of the results of the AICPA peer review program.

A-55

George L. McCalla
2 Gap View Road
Short Hills, N. J.
07078

June 29, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Sir:

Comments on Tentative Conclusions of
The Commission on Auditors' Responsibilities

We appreciate this opportunity to submit in the attached memorandum our thoughts on the Commission's tentative conclusions, which are underlined therein.

The report of the Commission comes at a time when the accounting profession is under critical review by the Subcommittee on Reports, Accounting and Management of the Senate Committee on Government Operations (the "Metcalf Subcommittee"). The Subcommittee has reported that the accounting profession should make many changes to eliminate a number of alleged bad practices, conditions, etc., but members of the Subcommittee have said they prefer to give the private sector an opportunity to eliminate the reported weaknesses rather than propose new legislation to correct the weaknesses. Senators Metcalf and Percy said at the recent public hearings of the Metcalf Subcommittee that the Subcommittee should meet early next year and review the actions taken by the AICPA in response to the conclusions of the Cohen Commission.

We trust that the Commission's final report and the corrective actions to be recommended by the AICPA's committee will demonstrate conclusively that additional legislation is not required.

Yours very truly,

G L McCalla

George L. McCalla

Enclosure

COMMISSION ON AUDITORS' RESPONSIBILITIES

COMMENTS OF GEORGE L. MCCALLA ON THE COMMISSION'S TENTATIVE CONCLUSIONS

SECTION 1

NEED FOR OUTSIDE DIRECTORS

Boards of directors should have a significant proportion of independent, outside directors.

We agree that this composition is necessary to sustain the independent accounts' independence. We believe that not less than two thirds of the board should be composed of independent, outside directors.

SECTION 2

DELETE "FAIRLY"

The word "fairly" should be eliminated from the auditor's report.

We disagree on two grounds. "Fairly" expresses the element of estimation which pervades most financial statements, yet is rarely discussed or disclosed in annual reports. In fact, the quantitative content of financial statements contributes unfortunately to the apparent existence of exactitude, which is usually unobtainable. In addition, "fairly" emphasizes the need for management and auditors to consider the general over-all view presented by the financial statements notwithstanding technical compliance with the accounting standards applicable to the individual amounts contained in the statements.

SECTION 3

REPORTING ON SIGNIFICANT UNCERTAINTIES

(a) Users do not sufficiently recognize the degree of uncertainty that affects all financial statements, and present reporting does not adequately emphasize uncertainty. A separate note in financial statements should be required on uncertainties similar to that required on accounting policies. The note should explain the significance of the uncertainties for earnings and financial position.

(b) The note would identify material uncertainties for users, which is the purpose of the auditor's "subject to" qualification, and the requirements for the "subject to" qualification should be eliminated. The note should describe all material uncertainties, not only those that might have resulted in a qualification.

(c) The most significant uncertainty that can cause a "subject to" qualification under present reporting requirements is doubt about a company's ability to continue to operate as a going concern, but there is no reason to believe that independent auditors are better able to predict continued business success or failure than they are able to predict the outcome of other uncertainties. The auditor's responsibility for "going concern" and other uncertainties should be to evaluate whether the disclosure presented by management includes all the available material information on the potential effect of the uncertainties on the entity's earnings and financial position.

(a) We are dismayed by the Commission's recommendation that there is need for a footnote on uncertainties similar to that on accounting policy in view of the fact that the latter note is comprehensive, required every year, and largely repetitive. We fear that the footnote recommended by the Commission would have to include such diverse matters as the economic and political conditions in the industry and in the countries where the company has its offices, supply sources, production facilities, customers, or investments. The type of information to be covered appears to be limitless and might pose an unsurmountable auditing problem.

Under ASR 166 issued by the SEC in December 1974, registered enterprises must report their unique or unusual circumstances so that investors will be made aware of unusual risks and uncertainties. We believe this disclosure should be required by generally accepted accounting principles, and that with this information plus the reporting of contingent liabilities arising because of litigation, assessments, claims, etc., which has been required for many years, the users of financial statements would be adequately informed of the uncertainties applicable to the reporting company.

(b) (c) We agree that "subject to" qualifications should be eliminated by requiring disclosure in the footnotes of all material uncertainties in sufficient detail to enable users of financial statements to evaluate the possible impact of uncertainties on the future earnings, financial position, and viability of the enterprise.

However, if the auditor is not to issue "subject to" opinions, we believe the footnote on uncertainties should include a prominent statement expressing the import of the contingencies on management's ability to report on the financial position and results of operations of the enterprise. This requirement is necessary because the footnote must not only describe the contingencies and their possible effects, but it must also serve as an adequate substitute for the warning now expressed emphatically by the unusual, additional paragraph(s) contained in the auditor's report.

SECTION 4

MATERIAL FRAUD

(a) An audit should be designed to provide reasonable assurance that the financial statements are not affected by material fraud. The auditor should search for material fraud. The auditor should also see that financial statements report and explain the nature and effects of material frauds that are discovered.

(b) <u>The profession should develop and disseminate information on frauds and methods of detecting them</u>.

(c) <u>Individual auditors should be more aware of the limitations of certain audit procedures</u>.

(a) We agree. However, we believe that most major frauds were made possible by the collusion of corporate personnel and that it is extremely difficult for an auditor to detect frauds perpetrated by collusion, particularly if those colluding include one or more members of the enterprise's top management.

Accordingly, to hold audit costs to a level where they are commensurate with the possible benefits to be obtained, we recommend that the auditors should be held responsible for performing audit procedures with professional skill that can be reasonably expected to detect major frauds, which might be defined as those which are of major consequence to the future of a business enterprise, that is, having an effect of possibly 20% to 25% of the enterprise's net assets or $5,000,000, whichever is less.

(b) (c) We agree. We believe that major fraud cases should be studied at length during the training of persons entering the accounting profession and that there should be periodic courses for experienced auditors (partners, managers, and seniors) to enable them to keep abreast of developments in the procedures being used in fraudulent activities.

<u>SECTION 5</u>

<u>CORPORATE ACCOUNTABILITY</u>

(a) <u>Management should bear the primary responsibility for corporate accountability and should adopt and publicize detailed policy statements indicating the conduct that will not be tolerated and develop appropriate compliance procedures</u>.

(b) <u>The independent auditor should search for illegal or questionable acts and should be expected to detect those acts that the exercise of professional skill and care would normally uncover</u>.

(a) We agree that management should announce publicly its primary responsibility for endeavoring to eliminate and for detecting illegal and questionable acts, that its detailed statement of policy should be widely disseminated within its organization and, if appropriate, to those with whom it has business dealings. (We do not believe that inclusion of a detailed policy statement in the annual report to stockholders would serve a useful purpose.) We also agree that management should develop effective procedures to enforce compliance.

(b) We disagree if adoption of this conclusion would require the independent accountants to search for immaterial illegal or questionable acts because we believe that the additional cost of such expansion of audit scope would be far greater than the possible benefits.

The accounting profession is undoubtedly fully aware at the present time of the public's rejection of illegal or questionable acts. We believe strong steps should be taken to continue this awareness, with implementation via appropriate audit procedures, including particularly the review and testing of management's procedures to assure detection and compliance. However, we also believe that generally accepted auditing standards should have as one of their basic elements that of materiality, and that materiality should not be excluded here in determining the audit scope of the independent accountants.

SECTION 7

THE AUDITOR'S REPORT

The independent accountants should revise their standard report as indicated in the Commission's report so that it would be expanded and flexible, with a paragraph on each major element of the audit function.

We agree with this change as a valid effort to improve the public's understanding of the role and function of the independent accountant.

However, we are pessimistic on its likelihood of being successful because the accounting profession can be expected to standardize the various paragraphs so that the signing accountants and their legal counsel would be able to know the exact meaning of the report being issued. As a result, the users of financial statements will continue to be confronted with paragraphs which are boiler-plate. We believe this standardization will minimize any increase in the public's understanding of the auditor's work.

ANNUAL REPORT BY MANAGEMENT

Corporate management should present a report that acknowledges their responsibility for the representations in the financial statements, that states the information is presented in conformity with generally accepted accounting principles appropriate in the circumstances, and that states that legal counsel has communicated the company's position with respect to litigation, claims, and assessments to the independent auditor and is satisfied that it is properly disclosed in the financial statements. The report should also present management's assessment of the company's accounting system and controls over it and describe the response of the company to material weaknesses in controls identified by the independent auditor.

We agree with this conclusion except that we recommend deletion of reference to legal counsel because legal counsel is rarely, if ever, so well informed of all aspects of a business enterprise that they are able to state with reasonable assurance that management's statement of its position regarding litigation, claims and assessments is adequate. Only management is competent to make a statement of an enterprise's contingent liabilities.

We believe that the present system of lawyers' responses to auditors' inquiries, which was only recently developed, should be tried for a longer period before any radical change is considered.

REPORT ON CONSISTENCY

Reference to consistency in the auditor's report should be deleted.

We agree. The quality of consistency from one reporting period to the next is required by generally accepted accounting principles.

Further, because of the importance of consistency, we recommend that its application be mentioned prominently in management's footnote on significant accounting policies.

WORK OF OTHER AUDITORS

The method of referring to the work of other auditors should be revised.

We agree. The report of the independent accountants in which the work of other auditors is mentioned should name the other auditors and give a clear indication of the materiality of the accounts (assets, liabilities, revenues, net income, etc.) which are included on the basis of their opinion.

AUDITORS AT ANNUAL MEETINGS

The independent accountants should be present and available to answer questions at the annual meeting of stockholders.

We agree. Their attendance might well be made a requirement of generally accepted auditing standards

GRADUATE SCHOOLS OF ACCOUNTING

An educational program similar to that of the legal profession should be gradually instituted, which would include a four-year undergraduate and a three-year graduate program in a professional school of accounting.

We believe this conclusion has merit if the graduate program would include several actual working periods, each of which are of five or six months' duration. Further, the program should stress the auditor's need for individualistic, imaginative thinking, possibly by use of the case method of study. The course should also feature a number of lectures by practicing independent accountants on current accounting and auditing problems and developments.

In order that the course might be thoroughly up-to-date, there should be relatively little use of textbooks. Much of the reading matter in the field of accounting and auditing might well be publications issued by authoritative bodies such as the AAA, AICPA (including AcSEC and AudSEC), CASB, FASB, NAA and SEC.

OPEN THE PROFESSIONAL SOCIETIES

The AICPA and state societies should make it possible for the increasing proportion of accounting educators who are not CPAs to join those organizations and take part in their professional activities.

We agree for two reasons. The participation by educators would be most helpful in increasing the educators' knowledge of current events in actual accounting practice so that such knowledge might be drawn upon in designing courses for the graduate accounting program.

In addition, addition of educators to the society memberships would broaden the base of understanding within the societies. This broader understanding should improve the work of the operating committees of the societies and lead to a better acceptance by the business community and the public of the actions of the groups who set accounting and auditing standards.

Section 9

AUDIT COMMITTEES

The board of directors should evaluate the relationship between the auditor and management, review and approve all arrangements for the audit, including the fee, scope and timing, and recommend the appointment of independent auditors to shareholders.

We agree and believe that this function can be performed most effectively (in fact and in appearance) by an audit committee drawn from the outside directors. The committee should include one well qualified attorney, one well qualified professional accountant, and one businessman with wide, diversified experience. As a practical matter, we fear that such persons would be in short supply and might require additional staff and fees to handle the expanded workload.

The scope of the committee should cover the work of the internal auditors as well as that of the independent accountants. The importance of internal auditing would be greatly expanded if the Commission's tentative conclusions are put into effect since they would undoubtedly be the main instrument by which the company would exercise surveillance over its programs regarding investigation of possible internal fraud or predispositions to management fraud and its search for illegal or questionable acts. The internal auditors would continue as in the past to evaluate management's controls over the accounting system and management's correction of deficiencies found in that system by the internal auditors and the independent accountants.

The audit committee should keep minutes of its meetings with the independent accountants and the internal auditors, should circulate or distribute these minutes to the other directors, and should issue a summary report each year on its activities and recommendations.

AUDITORS OFFERING OTHER SERVICES

Individual auditing firms should consider the potential impact (on their independence) of the services they offer.

We agree with this conclusion.

OTHER SERVICES BY AUDITORS

Boards of directors or their audit committees should determine if the nature and extent of other services performed by their auditor pose a problem. The nature and extent of other services provided by the auditor should be disclosed in proxy statements.

We agree. The proposed action by the directors is an integral part of the actions required to fulfull their role of protecting the interests of the stockholders. The disclosure in the proxy statement should add to the stockholders' understanding of the various roles played by the independent accountants. This disclosure should, of course, include the non-audit services, if any, performed by other auditors if any are referred to in the independent accountants' report.

RECRUITMENT BY AUDITORS

Audit firms should neither recruit for management positions which carry discretion over the selection or retention of the auditors nor place former employees in those positions.

We agree with this conclusion.

CHANGE OF AUDITORS

The disclosure now required by the SEC when auditors are changed should accompany all audited financial statements.

We agree with this conclusion.

Section 11

INFORMATION ABOUT AUDITORS

Public accounting firms should voluntarily experiment with public reporting of information that would increase understanding of their organization and operation.

We disagree with this conclusion on the belief that such reports will give little, if any,practicable information to investment advisers, investors, and creditors (this group of three include those who are most likely to read them carefully) and none to the general public.

ANALYSIS OF AUDIT FAILURES

The AICPA should regularly publish analyses of cases involving significant audit failures.

We agree. These analyses should be made as deeply as possible and reported as fully as possible. They would fill a long-felt need of management, independent accountants, and internal auditors.

June 29, 1977

A-56

ARTHUR YOUNG & COMPANY

277 PARK AVENUE
NEW YORK, N. Y. 10017

July 5, 1977

Mr. D. R. Carmichael, Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

This letter supplements our letter to the Commission on Auditors' Responsibilities dated June 17, 1977 and our oral presentation at the Commission's public meeting on June 22, 1977. We are writing now in response to Professor Lee Seidler's request for a more explicit description of the internal accounting control procedures on which we have suggested it would be feasible for auditors to report.

The control procedures we had in mind are those whose purpose is to provide reasonable assurance that:

a. Transactions are executed in accordance with management's general or specific authorization.

b. Transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (2) to maintain accountability for assets.

c. Access to assets is permitted only in accordance with management's authorization.

d. The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

The control procedures identified above imply appropriate segregation of functions. You will recognize them as the ones listed in Paragraph 320.28 of the AICPA's Statements on Auditing Standards. In our letter of June 17, we referred to these procedures, for simplicity, as "the record-keeping activities." These are the procedures whose operation can be tested and thus can be determined with reasonable assurance. Consequently, they are the procedures on which auditors could reasonably report.

We suggest that it is important for the Commission, in discussing the controls on which auditors could report, to emphasize two categories of controls on which auditors would not report. The first category encompasses the control procedures that have to do with how a company runs its business. These procedures, sometimes called "administrative controls," include such matters as production control procedures, budgets, and the processes by which management decides on the general or specific authorizations for transactions. For the most part, the procedures in this category deal with matters that are not within the competence of most auditors.

The second category of controls on which it would not be feasible for auditors to report encompasses the aspects of the accounting process that we have referred to as "the financial reporting activities" -- the estimates, evaluations, decisions and disclosures that management must make in preparing financial statements (for example, What is the proper amount for a reserve for uncollectible accounts? Or: Is part of the inventory obsolete; and, if so, by how much should the carrying amount be reduced?). No amount of testing can assure that judgments will be exercised without bias, that all relevant facts will receive adequate consideration, or that objectives other than informing the users of financial statements will not unduly influence decision-makers.

We trust that the foregoing will help the Commission to identify those controls on which auditors could reasonably report. If you have further questions, please do not hesitate to contact us.

Very truly yours,

Fred L. Tepperman

Fred L. Tepperman

Copy to: Professor Lee Seidler

To – Brian Zell – Please ... to ...

A-57

FREDERICK B. HILL AND COMPANY

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FREDERICK B. HILL, C. P. A.
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NORFOLK, VIRGINIA
PORTSMOUTH, VIRGINIA

MEMBERS
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
VIRGINIA SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

JUNE 23, 1977

MR. DOUGLAS R. CARMICHAEL
RESEARCH DIRECTOR
COMMISSION ON AUDITORS' RESPONSIBILITIES
1211 AVENUE OF THE AMERICAS
NEW YORK, NEW YORK 10036

RE: ORIENTATION TOWARD AUDITING OF PUBLICLY HELD COMPANIES

DEAR MR. CARMICHAEL:

THE COMMISSION ON AUDITORS' RESPONSIBILITIES HAS MADE A RECOMMENDATION THAT SEPARATE CONSIDERATION BE DEVOTED TO THE PROBLEMS OF SMALLER PRACTICE UNITS WITH PRINCIPALLY NON-PUBLIC CLIENTS. IT WOULD HAVE BEEN MUCH BETTER IF THE ISSUE HAD BEEN MET HEAD-ON, INSTEAD OF SIDESTEPPING THE MATTER AS HAS BEEN DONE SO OFTEN IN THE PAST. UNFORTUNATELY, STANDARDS, ONCE ADOPTED, GENERALLY TEND TO BECOME REQUIRED FOR ALL REPORTING UNITS, NOT JUST THOSE FOR WHICH THEY WERE ORIGINALLY AND PRINCIPALLY INTENDED.

BEFORE ADOPTION OF THE RECOMMENDATIONS IN THIS REPORT IT SEEMS IMPERATIVE THAT GUIDELINES FOR APPLICATION TO SMALLER PRACTICE UNITS AND NON-PUBLIC CLIENTS BE CLEARLY DEFINED. THE EFFECTS OF THIS REPORT WILL BE FAR-REACHING AND THE INSTITUTE SHOULD BE CAREFUL NOT TO CREATE MORE PROBLEMS THAN ARE SOLVED.

VERY TRULY YOURS,

Pat S. Callahan

PATRICK S. CALLAHAN

Seab E DuVall Jr.

SEAB E. DUVALL, JR.

PSC/LLC:VM

National Association of Accountants

William M. Young, Jr., *Executive Director*
919 THIRD AVENUE
NEW YORK, N.Y. 10022
(212) 754-9700

A-58

July 11, 1977

Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibility
1211 Avenue of the Americas
New York, N.Y. 10036

Dear Dr. Carmichael:

The Management Accounting Practices Committee of the National Association of Accountants is pleased to offer its comments on the Commission's Report of Tentative Conclusions. We hope that our remarks will be useful despite their late submission.

From a broad perspective, we believe the report has raised questions that are timely and important. In general, our committee is in accord with the Commission's recommendations. The comments that follow address specific aspects in the 11 sections of the Report, although in one case so noted, we have combined sections as seems appropriate.

Section I - The Independent Auditor's Role In Society

To be effective, in both reality and in the perception of others, auditors must be truly independent of management. We think the proper mechanism to promote such a relationship is the corporate audit committee composed of outside directors. The audit committee should be empowered to hire and to dismiss the outside auditor.

We believe, however, that recognition should be given to the audit committee's potential for establishing adversary relationships between auditors and management. Such a situation must be avoided because of the desirability for cooperation between auditors and management so as to maximize potential benefits from the audit process.

On another matter affecting independence, we think the practice of periodically rotating partners in charge of audit engagements is desirable.

Section II - Forming an Opinion on Financial Presentations and Section VII - The Auditors Communication with Users.

We agree that the standard audit report is not especially useful to readers. Moreover it is reasonable to assume that an expanded, flexible report containing more information about more items would be a definite improvement. We would, however, like to point out certain considerations that should be weighed.

For one thing, there is a practical problem in such a conversion. There exist a significant precedence in law that is based on what auditors' responsibilities have been determined to be. There would have to be a redefinition of responsibilities based on the new reporting plan. This is not to imply that we are locked into the present short-form report, but rather to note potential problems.

Another matter is of concern to us. With the use of a flexible reporting system, there exist the risk of readers' attributing significance to circumstances that may or may not be significant. For example, one auditing firm may insist on mentioning some uncertainty about its client in the report. A reader may assume that, because the report of another company does not refer to that type of uncertainty, it does not exist as concerns this other company. In fact, the same uncertainty may well exist with respect to both companies but the two auditing firms are exercising differing levels of judgement. Conversely, standardized audit reports cause a risk of failing to recognize differences among companies because of the uniformity of the reports. Somehow, a middle ground must be found between both extremes.

Section III - Reporting On Significant Uncertainties in Financial Presentations

This section expresses our feelings very well. The reporting of significant uncertainties really is a matter of disclosure rather than being a part of the auditor's report. We agree that the "subject to" qualification is inappropriate.

The auditor should not be in the position of assessing the likelihood of uncertainties occurring; his (or her) responsibility is the revelation of the basic facts and reasonable potential consequences of the facts.

Our only concern with this section is the possibility of ignoring an uncertainty because of lack of timely knowledge that it was indeed an uncertainty. It obviously is not feasible to address directly all possible uncertainties that may affect an enterprise. Only hindsight may reveal at some point in time that some circumstance was in fact an uncertainty that significantly affected the organization. Furthermore, there are all sorts of problems in defining the uncertainty.

For example, assume a division of a company, for a brief period engaged in an activity that reasonably could be construed as being in violation of an anti-trust statute. Then, upon discovery of the act by corporate officials, the activity is discontinued. Certainly continuing potential liability exists for the past act. Should disclosure be made in such a circumstance, thus inviting suits?

The foregoing example is cited to illustrate the difficulties inherent in reporting uncertainties.

Section IV - Clarifying Responsibility for the Detection of Fraud

We think that, in general, auditors would not have difficulty in accepting a concept of expanded responsibility for the detection of fraud---on a prospective basis. They might as well learn to live with the greater responsibility already assumed by the public at large. Of course, it should be recognized that certain well executed frauds perpetrated by several parties in collusion with each other could likely escape detection by any auditor regardless of the diligence exercised.

With, however, the added responsibility must come some reasonable statutory limitation of liability, as is recommended in the paragraph titled, Statutory Limitations to Damages on page 146 of the Commission's Report.

There is another question we would raise in connection with this section. Auditors are expected to be alert for evidence of dishonesty on the part of management. It is not certain to us that "honesty" is susceptible to clear-cut definition when applied to particular circumstances. For example, many executives have the use of a company vehicle. It is undoubtedly true that, in many cases, the vehicles are not used 100% for business purposes and the personal portions are not reported as additional compensation to the employees. If an auditor encounters such a situation, should he take it as an indication of an untrustworthy management? Or, assume an auditor becomes aware that a member of management is associated in a totally different activity with a person having an unsavory reputation. Should this affect the auditor's perception of management's honesty?

Section V - Corporate Accountability and the Law

The recommendation that management assume the responsibility for adopting policy statements dealing with permissible conduct and that the auditor monitor for compliance has considerable merit. We wonder, though, whether the emphasis on ignoring a concept of materiality would not impede its implementation. As noted in our comments on Section IV, questions regarding illegality and dishonesty often cannot be approached in simplistic fashion.

Another concern of ours is the competence of auditors to monitor compliance in certain areas such as, for example, possible violation of the Robinson-Patman Act. We feel that a greater burden must be assumed in such matters by companies' attorneys; they would have to abandon their roles of acting predominately as advocates in favor of enhanced responsibilities to the general public.

Section VI - Boundaries of the Auditors' Role and its Extension

We support the concept that an auditor should examine the events in a period of time rather than a set of financial statements. Again, a number of questions arise which we should like to see addressed specifically.

One problem relates to timing. Significant events considered reportable arrive irregularly throughout the course of the year. We are not certain how the Commission would propose that auditors go about ensuring appropriate disclosure. What would be the vehicle for accommodating the auditor's responsibility in this respect? It is not clear that audited quarterly financial statements are the desired instrument for such disclosure.

We are concerned that the level of knowledge about clients' industries that apparently would be required to assure the effectiveness of such monitoring would place a severe, if not impossible, burden on many auditing firms and perhaps particular offices of even the major accounting firms.

Furthermore, we are concerned about the extension of auditors' responsibilities beyond the realm of professional auditors' expertise and into other professional areas such as law, engineering, appraisal, chemistry, and architecture.

Section VIII - Education, Training and Development of Auditors

We recognize and concur with the need for an enhanced level of education to enable auditors to effectively cope with the changing environment. We are not convinced, however, that any unique institutional framework, such as the four year undergraduate school and three year professional school of accounting is required at this time.

It is not clear that auditing firms presently assume an inordinate burden of training. Auditing is one skill that must be honed to a considerable extent outside the classroom.

There does not appear to be evidence that anything beyond a five, or possibly six, year combined program is warranted at present, especially in light of the soaring cost of collegiate education.

Section IX - Maintaining the Independence of Auditors

We support the present system of a private profession with the combination of private and governmental regulation as superior to the alternative considerations. As we commented under section I, we believe that the existence of independent corporate audit committees is critical to the maintenance of auditors' independence.

We see no evidence that the performance of management advisory services by accounting firms compromises their independence vis-a-vis the auditing function. Conversely we believe that the knowledge gained during MAS engagements may well be helpful in conducting audits.

Recruiting services do, however, represent problems with respect to the appearance of independence. Whereas the problems may exist only in the perceptions of others, we would recommend that auditing firms avoid that activity--- there is little to gain but much to lose from its continuation.

Our committee strongly supports the Commission's recommendations that auditing firms take steps to reduce the pressure on independence that arises from unrealistic time constraints for doing audit work. In this regard, audit committees could be useful in assuming responsibility for helping to define the scope and expected cost of audits.

Section X - Process of Establishing Audit Standards

We agree with the proposal that audit standards be established by a full-time board within the province of the American Institute of Certified Public Accountants. We think, however, that all members of this board should have substantial audit experience.

Section XI - Regulating the Profession

Our only comment is that the Commission's proposals for improving the self-regulatory efforts by the auditing profession are appropriate and should be implemented.

We commend the Commission for its well-prepared document and we wish to express appreciation for the opportunity to make our views known.

Sincerely,

Martin V. Alonzo

Martin V. Alonzo LB
Chairman
Management Accounting Practices Committee

MVA/sg/6513

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CALIFORNIA SOCIETY CPA

THE CALIFORNIA SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS

California CERTIFIED PUBLIC ACCOUNTANTS
FOUNDATION *for Education & Research*

A-59

July 13, 1977

Dear Lee:

Enclosed is a report summarizing comments of 544 California Society members on the tentative recommendations of the Commission on Auditors' Responsibilities. The Society conducted 30 Member Forum Discussions throughout the State during the month of June to provide the Commission with the views of CPA practitioners in this State.

The Society members are very interested in learning how the Commission uses this report in its deliberations. We would appreciate knowing at the earliest possible date the conclusions reached by the Commission.

The Society appreciates the interest of the Commission and the AICPA in seeking the views of California Society members. We hope these views will assist the Commission in reaching its conclusions.

Best regards.

Lou

LOUIS G. BALDACCI
Executive Vice-President

Mr. Lee J. Seidler

cc. Mr. Michael N. Chetkovich
Mr. Samuel A. Derieux
Mr. Wallace E. Olson
Mr. Douglas Carmichael
Mr. Lorin H. Wilson
Mr. James E. Jensen

LGB:pb
Enclosure

COMMENTS ON THE TENTATIVE RECOMMENDATIONS OF THE COMMISSION ON AUDITORS' RESPONSIBILITIES

July, 1977

The California Society of Certified Public Accountants
1000 Welch Road Palo Alto, California (415) 321-9545

BACKGROUND

In response to The Commission on Auditors' Responsibilities Report of Tentative Conclusions, the California Society of Certified Public Accountants conducted 30 member discussion sessions throughout California. The purpose of the Member Forums was to obtain members' views regarding the 39 recommendations of the Commission.

This report summarizes the response received from 544 participants at the close of the Member Forums. An outline of the Commission recommendations and the related questions is presented preceding each response section of this report to facilitate reading without reference to other materials. The yes and no answers were tabulated from all 544 responses received, with a percentage distribution of replies to each question shown in parentheses. The comments of participants presented in this report are remarks extracted from a representative sample of comments. Individual response sheets received from the participants have been transmitted to the AICPA in cooperation with its program to provide assistance to the Commission in reviewing responses.

The short exposure period provided by the Commission did not permit sending participant materials in advance of the discussion session. Most participants believed the sessions were meaningful; however, discussion leaders reported that participants would have preferred an opportunity for advance preparation. A longer exposure period would have allowed for a more careful review of the Commission recommendations.

The majority of Member Forum participants were from small CPA firms. Many felt that the Commission recommendations were primarily germane to CPA firms with large publicly held clients and expressed concern that adoption of the proposed standards would result in requirements inappropriate for the local practitioner.

The Society appreciates the opportunity to report the views of its members and will be glad to further assist the Commission.

MEMBER FORUM RESPONSE SUMMARY

(Total member responses = 544)

SECTION 1: THE INDEPENDENT AUDITOR'S ROLE IN SOCIETY

Recommendation:

1. Boards of Directors, with a high proportion of independent, outside directors, should assume a more active role in evaluating internal controls and management's supervision of them. The role of the independent auditor in improving corporate accountability can be significantly strengthened by closer cooperation between Boards and auditors. For example, directors should regularly receive a report on the company's accounting system and controls over it from the independent auditor.

Question:

A. Should AICPA encourage closer cooperation between audit committees of Boards of Directors and auditors? Should Boards regularly require a report from the auditor on the accounting system and controls over it?

Response:

Yes: 409* (90%) No: 46* (10%)

*Note: 81 additional responses split the reply into separate answers to each sentence in the question:
1) Yes: 78 (96%) No: 3 (4%)
2) Yes: 44 (54%) No: 37 (46%)

Comments:

Pro:
- need strong, independent, more involved directors
- auditor should meet with the board before and after issuing report
- need a separate set of rules for public and non-public companies, apply to public only
- auditors should attend board meetings
- AICPA should prepare a fact sheet explaining the significance of the accounting and control system to the directors
- apply only to larger companies with audit committees
- should apply to all boards
- smaller companies are problem because owners and directors are the same
- apply only where management and board are independent
- auditor should only be responsible for material weaknesses in informal controls

SECTION 1: THE INDEPENDENT AUDITOR'S ROLE IN SOCIETY

Comments: (Continued from previous page)

Con:
- -regular reporting becomes too burdensome
- -who should be advised when board is not independent?
- -reporting requirement should not be adopted without waiver of accountant's liability
- -reports would not be used
- -reports too costly
- -places responsibility on auditors instead of management
- -cooperation not defined
- -SEC should require audit committees for publicly held companies
- -impractical due to large variation in internal controls

SECTION 2: FORMING AN OPINION ON FINANCIAL PRESENTATIONS

Recommendations:

2. The word "fairly" should be eliminated from the auditor's report.

3. The auditor should make an objective appraisal of the accounting principles used by management. Additional guides should be developed for evaluating 1) the choices made by management among the alternative principles, 2) the appropriateness of principles applied in the absence of formal or detailed accounting pronouncements and 3) the cumulative effect of management's decisions concerning selection and application of accounting principles.

Question:

A. Should the auditor's reporting role be clarified as recommended?

Response:

Yes: 300 (57%) No: 228 (43%)

Comments:

Pro:
- -auditor should be required to review and recognize the thrust of management decisions, if they are detrimental to the interests of a third party
- -audit principles should require the disclosure of cumulative effects of differences of applying accounting principles
- -"fairly" is confusing, vague, ambiguous, meaningless
- -"fairly" is more difficult to defend than "compliance with guidelines" or "compliance with GAAP"

SECTION 2: FORMING AN OPINION ON FINANCIAL PRESENTATIONS

Comments: (Continued from previous page)

Pro:
- -the guides referred to in paragraph 3 should be made available to management
- -substitute "reasonably" or "not misleading" for "fairly"

Con:
- -proposal is asking auditor to outguess management as to the propriety of each principal in use
- -auditor can't make an "objective" appraisal of accounting principles used by management, especially in small businesses where the auditor is often responsible for the selection of GAAP
- -"objective appraisal" not quantifiable
- -"cumulative effect" is too vague
- -"fairly" describes the impressions and uncertainties which accompany any financial statement, avoids an implication of 100% accuracy, and keeps accounting from becoming an "exact science"
- -user must be made to realize that judgement is involved
- -eliminating "fairly" puts the auditor in a precarious position in today's legal climate
- -independence and flexibility would be impaired
- -will tend to increase audit costs - how far will the auditor have to go?
- -impractical or impossible to implement
- -will place auditors in an adversary position with management, and will encourage "shopping" for auditors who favor certain accounting principles
- -will change auditor decisions from accounting judgement decisions to market decisions
- -who will determine guidelines, and who will pay? enough are produced already

SECTION 3: REPORTING SIGNIFICANT UNCERTAINTIES

Recommendations:

4. The requirement to express a "subject to" qualification for significant uncertainties should be eliminated.
5. A separate note on uncertainties should be required. The note should include a description of all material uncertainties, not only those that require a qualification. It should include "going concern" uncertainties.

Questions:

A. Do you agree that the auditor's report should be revised as recommended?

SECTION 3: REPORTING SIGNIFICANT UNCERTAINTIES

Questions: (Continued from previous page)

B. Should AICPA urge the FASB to adopt a standard that requires a separate note on uncertainties?

Response:

A. Yes: 267 (51%) No: 259 (49%)

Comments:

Pro:
- remove auditors from the business of judging "going concern" problems
- user would be given the opportunity to use his own judgement more in reading the report
- auditor only has the responsibility to identify uncertainties, not evaluate them
- standardized footnotes are desirable, used in conjunction with the opinion
- if auditor really adequately discloses uncertainties, "subject to" can be eliminated
- important to change the impression of unfailing accuracy
- generally agree with any proposal to increase disclosures
- uncertainties are better bundled in footnotes
- if "subject to" is eliminated, opinion must refer specifically to certain footnotes

Con:
- proposal is a "cop-out" that forces an unsophisticated reader to form an opinion on uncertainties
- no one knows "all going concern uncertainties"
- not all readers look at notes - so uncertainties may go undetected
- notes are those of management, so if they don't want to disclose uncertainties, what should the auditor do? disclaim? qualify?
- seems to require too much expertise on business matters of clients
- opens up more answers for legal action against CPAs
- significant uncertainties are a management problem, and shouldn't be passed to CPAs
- major uncertainties should be footnoted and mentioned in the opinion paragraph
- opinions belong to auditors - notes to management - responsibilities shouldn't be mixed
- the specific wording (e.g. "subject to") is not the important issue - a red flag is raised in the opinion paragraph that shouldn't be relegated to footnotes
- revision of definition of "clean opinion" would be a better approach

SECTION 3: REPORTING SIGNIFICANT UNCERTAINTIES

Response: (Continued from previous page)

B. Yes: 373 (74%) No: 132 (26%)

Comments:

Pro:
- -only for major uncertainties
- -follow by publicizing the idea that understanding financial statements is impossible without a careful reading of the footnotes
- -this will place burden properly, on management
- -if adequate assistance by corporate attorneys in assisting management can be obtained
- -assuming the latitude of uncertainties is more closely defined
- -although immaterial uncertainties shouldn't be disclosed, since they detract from the more important material ones
- -but limited only to questions of "going concern"

Con:
- -present practice is adequate
- -"material" needs defining
- -a heavy burden for auditor to be responsible for "all uncertainties"
- -footnotes can be just as confusing as the opinion paragraph
- -will confuse and weaken a qualification and will expand liability
- -obligation to find "all uncertainties" would result in an ever expanding list of audit procedures

SECTION 4: CLARIFYING THE AUDITOR'S RESPONSIBILITY FOR THE DETECTION OF FRAUD

Recommendations:

6. Auditors have a duty to search for material fraud and should be expected to detect those frauds that the exercise of professional skill and care would normally uncover. Explicit guidelines for auditors on the exercise of professional skill and care should be developed. The guidelines should include requirements that the auditor:

   a. establish an effective client investigation program;

   b. take immediate steps if evidence indicates that management is untrustworthy, including, if necessary, resigning from the engagement;

   c. observe conditions suggesting predispositions to management fraud;

SECTION 4: CLARIFYING THE AUDITOR'S RESPONSIBILITY FOR THE DETECTION OF FRAUD

Recommendations: (Continued from previous page)

d. maintain an understanding of a client's business and industry;

e. extend the study and evaluation of internal controls to all controls that have a significant bearing on the prevention and detection of fraud;

f. seek, through a formal procedure developed by the profession, information on methods of perpetrating, concealing and detecting fraud;

g. be alert for possible deficiencies in audit techniques and steps;

h. understand the limitations of incomplete audits.

7. If auditors adhere to a standard of professional skill and care that covers detection of fraud, they should not be held liable for failure to detect all material frauds.

Questions:

A. Do you agree that the application of the recommended guidelines would benefit both third parties and auditors?

B. Should guidelines cover recommended requirement a,b,c,d,e,f, g,h?

Response:

A. Yes: 365 (71%) No: 148 (29%)

Comments:

Pro:
- will take pressure off auditors, causing more objectivity
- as long as requirements are not unreasonably complex
- the study of the problem of fraud would be an education for most auditors
- but educate the public regarding inevitable cost increases
- except if management is untrustworthy, then the investigation should be expanded
- "due professional care" to detect fraud is expected of every auditor

Con:
- would imply too much credibility on audited statements
- costs would exceed benefits

SECTION 4: CLARIFYING THE AUDITOR'S RESPONSIBILITY FOR THE DETECTION OF FRAUD

A. Comments: (Continued from previous page)

Con:
- -formal client investigation programs may be inappropriate for smaller firms
- -liability isn't escaped by having a "guidelines list"
- -no substitute for common sense and judgement
- -places too much responsibility on the auditor, by making him a guarantee that no fraud exists
- -will create more litigation
- -recommendation goes beyond SAS-16, which should be the limit
- -financial statements really belong to management, so automatically incorporate fraud auditing is to say that management is inherently fraudulent
- -auditors don't have the duty to "search for" and shouldn't be "expected to detect" fraud - a better wording would be "aware of the possibility of material fraud"
- -proposal merely substitutes a procedure for a judgement
- -auditor's responsibilities for detecting fraud should be spelled out in auditor's reports
- -regarding item 7, the courts must have the right to determine if the standard of professional skill is covered in the guidelines - which must be sufficiently clear to insure that material fraud <u>will be</u> detected
- -duty of CPA is to exercise "due professional care", not to actively search for wrongdoing
- -the term "reasonable effort" should be emphasized - no one can do everything

B. <u>Response and Comments</u>:

a. establish an effective client investigation program

Yes: 333 (72%) No: 129 (28%)

Pro:
- -proposal is fine, although "know your client" is a basic rule that really is practiced currently by quality professionals
- -client investigations should be discreet
- -this should be publicized as an AICPA request of auditor procedures

Con:
- -there is a danger of this leading to gestapo-like investigations
- -would be impossible for small firms to cover the loss this could produce

SECTION 4: CLARIFYING THE AUDITOR'S RESPONSIBILITY FOR THE DETECTION OF FRAUD

B. Comments: (Continued from previous page)

a. establish an effective client investigation program (continued)

Con: -will raise client costs and have dangerous legal implications
-in large cities a client investigation program may be appropriate, but in smaller cities reputations are generally well enough known
-"effective" and "untrustworthy" are vague and subjective
-no assurance that these steps will have any effect

b. take immediate steps if evidence indicates that management is untrustworthy, including, if necessary, resigning from the engagement

Yes: 402 (88%) No: 56 (12%)

Pro: -good idea but already being done by competent auditors
-would need very clear guidance on the applications of this

Con: -"untrustworthy" is difficult to define and harder to evaluate
-difficult to establish formal steps
-auditor should probably more properly withdraw from the engagement upon discovering major management dishonesty, or upon significant suspicion that it exists
-guidelines cannot replace judgement

c. observe conditions suggesting predispositions to management fraud

Yes: 382 (86%) No: 64 (14%)

Pro: -important to check internal controls - if they are loose, the auditor should be doubly vigilant

Con: -court defense would be extremely difficult

d. maintain an understanding of a client's business and industry

Yes: 408 (91%) No: 40 (9%)

Pro: -good, although this is really already a standard, and should be happening presently

SECTION 4: CLARIFYING THE AUDITOR'S RESPONSIBILITY FOR THE DETECTION OF FRAUD

B. Comments: (Continued from previous page)

d. maintain an understanding of a client's business and industry (continued)

Con: -how does one get the first audit - what is the availability of industry information?
-almost impossible to maintain a knowledge of diverse industries
-large companies make this idea impractical

e. extend the study and evaluation of internal controls to all controls that have a significant bearing on the prevention and detection of fraud

Yes: 339 (78%) No: 96 (22%)

Pro: -although it should be spelled out that this should not result in a duplication of work by internal and external auditors
-adequate guidance must be supplied
-really should be happening presently
-recent illegal political contributions make this an obvious necessity

Con: -should not extend to all controls, but only those that might materially affect firm position
-only if existence of fraud is actually suggested

f. seek, through a formal procedure developed by the profession, information on methods of perpetrating, concealing and detecting fraud

Yes: 361 (82%) No: 77 (18%)

Pro: -the more information the auditor has, the better fraud can be detected
-a great training project for auditors
-should be a board to publish and disseminate data on frauds, similar to that of aircraft and marine accidents

Con: -auditors should not be enforcers
-professional jealousy makes dissemination difficult
-should be done through continuing education, rather than through required procedures which would be prohibitively costly
-proposal is ambiguous

SECTION 4: CLARIFYING THE AUDITOR'S RESPONSIBILITY FOR THE DETECTION OF FRAUD

B. Comments: (Continued from previous page)

g. be alert for possible deficiencies in audit techniques and steps

Yes: 400 (92%) No: 35 (8%)

Pro: -the AICPA should prepare some standard programs that can be customized for each client
-absolutely necessary, since "professional skepticism" isn't strong enough
-audit procedures should constantly be updated
-although no list or guide is really sufficient
-proposal is just common sense

Con: -where is one to obtain "all" information regarding new procedures, etc.?
-canned audit programs should be minimized

h. understand the limitations of incomplete audits

Yes: 403 (93%) No: 30 (7%)

Pro: -the conscientious auditor is always aware of the limitations of incomplete audits
-the engagement letter should specify exactly what won't be done in the audit

SECTION 5: CORPORATE ACCOUNTABILITY AND THE LAW

Recommendations:

8. Management should adopt and publicize policies on illegal or questionable acts and develop appropriate compliance procedures.

9. The auditor should monitor compliance with the policies and describe his review of the procedures and his conclusions on them in his report.

10. Detected illegal or questionable acts should be considered by the auditor without regard to traditional standards of materiality. The auditor must consider each illegal or questionable act in light of the circumstances. This involves three steps:

a. determination of the extent to which the item might affect the financial statements

b. comparison of the act with the standards of corporate conduct established by the corporation's Board of Directors

c. consideration of the need for public disclosure

SECTION 5: CORPORATE ACCOUNTABILITY AND THE LAW

Recommendations: (Continued from previous page)

11. The auditor should have responsibility for seeking out illegal or questionable acts, but he should be expected to detect only those that the exercise of professional skill and care would normally uncover.

12. Additional guidance is necessary on the meaning of the appropriate "exercise of professional skill and care" in this area. (Because the subject of illegal and questionable acts is evolving rapidly, the Commission has no specific recommendations for guidelines as it did for detection of fraud.)

13. Principal responsibility for assurance on legal claims and litigation against clients should lie with management acting in consultation with their lawyers.

Questions:

A. Should AICPA urge the SEC or the stock exchanges to implement these recommendations?

Response:

Yes: 226 (64%) No: 128 (36%)

Comments:

Pro:
- would protect company employer and assist the auditor as well
- guidelines for case, when owners of closely held companies are perpetrators of fraud and no higher Board of Directors exist should be included
- recommendation should apply to all companies - public and non-public
- except that trivial departures need not be reported
- fine provided that only generalities are covered
- management will need guides as to what constitutes an illegal act
- specific criteria must be established to evaluate management controls
- may help to improve bad image of business

Con:
- long term public mores and goals should be arrived at before the profession attempts to radically change standards
- assumes inherent management dishonesty
- government regulation generally end up making the auditor responsible for more than originally intended
- will intensify current litigation environment

SECTION 5: CORPORATE ACCOUNTABILITY AND THE LAW

Comments: (Continued from previous page)

Con:
- -places unreasonable demands on auditors, to assume roles of policeman and lawyer
- -CPAs should not become involved in trying to codify morality
- -"monitoring compliance" is too broad a concept
- -small firms are not familiar enough with SEC work
- -another type of professional and another audit is needed to cover these areas - suggest consultation with an independent attorney or require a "legal compliance audit" to be conducted by attorneys
- -"questionable" is poorly defined
- -disclosure should be limited to items over a specific dollar amount or percentage of income, etc.
- -public disclosure is not necessary - disclosure to boards should be necessary
- -illegal acts must be material for the auditor to be expected to detect them using "due profesional care"
- -many transactions are borderline - illegality is difficult to determine

SECTION 6: THE BOUNDARIES OF THE AUDITOR'S ROLE AND ITS EXTENSION

Recommendations:

14. The audit function should be expanded to encompass all information of an accounting and financial nature that management has the responsibility to report, provided that it is produced by the accounting systems and that the auditor is competent to verify it.

15. The audit function should include a more comprehensive study and evaluation of controls over the accounting system. The auditor's report on the audit function, issued annually, should include an evaluation of management's description of the controls over the accounting system and should disclose uncorrected material deficiencies in a company's internal control that are not disclosed by management.

16. The audit function should gradually expand to include all important elements of an entity's financial reporting process and should provide assurance on management's accountability over a period of time. To achieve this the auditor of a publicly-owned company must be continuously associated with a client's financial reporting process. The auditor should review the process used by the company to prepare quarterly financial information and should give timely assurance on his review in an interim report on the audit function. (The Commission suggests that this recommendation be adopted after experience with implementing recommendation No. 15 has been gained.)

SECTION 6: THE BOUNDARIES OF THE AUDITOR'S ROLE AND ITS EXTENSION

Questions:

A. Should the profession support the expansion of the auditor's role as recommended in Recommendation 14?

B. Should the profession support the expansion of the auditor's role as recommended in Recommendation 15?

C. Should the profession support the expansion of the auditor's role as recommended in Recommendation 16?

Response:

A. Yes: 250 (58%) No: 185 (42%)

Comments:

Pro:
- the recommendation should be directed at various statistical information required in SEC reporting
- good but a definition is required for "information management has the responsibility to report"
- with emphasis on, and confined to, "produced by the accounting systems"
- assuming information is objectively verifiable
- should be limited to public companies
- limitations should be established regarding reports to governmental units
- a good step if fees charged will cover the work done

Con:
- will involve CPAs in areas beyond training
- not applicable to small companies who do not publish annual reports
- "auditor competent to verify it" needs defining
- confusion results as to what information is unaudited
- definition of "field" is too broad
- what exactly will management be required to report?
- additional cost of interim reporting not juctified
- proposal is too general - not clear as to what "expansion" means
- seems to nullify the concept of materiality
- "all information" needs defining
- what if management produces reports beyond those necessary, e.g. reports intended only for internal use?
- will make policemen and watchdogs of auditors

B. Yes: 262 (60%) No: 178 (40%)

Comments:

Pro:
- study of the controls over the accounting system is always part of the audit function

SECTION 6: THE BOUNDARIES OF THE AUDITOR'S ROLE AND ITS EXTENSION

B. Comments: (Continued from previous page)

Pro:
- -report should be given to boards but not made part of a public report - that is a management decision
- -proposal acceptable within the confines of cost-benefit analysis

Con:
- -management will oppose inclusion in annual reports
- -will tend to make outside auditors full-time, in-house auditors
- -too many small companies don't have good internal control due to staff size
- -who would determine material deficiencies?
- -controls and procedures are too fluid for spot analysis
- -proposal is broad, vague, and could get out of hand
- -could create libelous situations

C. Yes: 222 (53%) No: 201 (47%)

Comments:

Pro:
- -ongoing familiarity with the company is essential
- -should be limited to public, SEC-listed companies
- -fees must cover expanded work
- -must be strictly limited to areas of competence of the auditor
- -good idea but would the requirement be for the accountant with a new client?
- -may be accomplished over a period of years

Con:
- -might present the implication of a "lock" on engagements
- -unreasonable financial burden for small firms
- -what is meant by "gradually"?
- -case where the same auditor is not continuously associated with a company over the years makes this impractical
- -will destroy or at least call into question the independence of the auditor
- -additional cost without additional benefit
- -legal exposure is increased
- -may be inconsistent with the requirement that CPAs not let the company set audit guidelines, etc.

SECTION 7: THE AUDITOR'S COMMUNICATIONS WITH USERS

Recommendations:

17. The auditor's standard report should be revised. The new report

SECTION 7: THE AUDITOR'S COMMUNICATION WITH USERS

Recommendations: (Continued from previous page)

should consist of a series of paragraphs with standardized alternative wordings, describing all major elements of the audit function.

18. The reference to consistency in the auditor's report should be deleted and the responsibility of disclosing changes should be reserved to management.

19. The principal auditor should do enough additional work so that he does not need to rely on the work of another auditor. If this is not possible, management should present the reports of the other auditors who audit material components of the reporting entity.

20. The auditor should report on all unaudited financial information with which he is associated, including that which appears in a document containing audited information. Additional clarification and guidance is needed in this area.

21. The Board of Directors should require management to issue a detailed complimentary report that acknowledges management's responsibility for the representations in the financial statements. The report should 1) state that the information is presented in conformity with GAAP appropriate in the circumstances, 2) discuss the company's accounting system and internal control system, and 3) state that legal counsel has communicated the company's position with respect to litigations, claims and assessments to the independent auditor.

22. Auditors should be present and available to answer questions at annual stockholder meetings.

Questions:

A. Should the auditor's standard report be revised to provide for an expanded flexible report?

B. Should the report reflect the recommendations concerning:

   1. Consistency

   2. Reliance on work of another auditor

   3. Unaudited information associated with audited information

C. Should AICPA urge the SEC or the stock exchanges to require that corporate management present a report as recommended?

D. Should AICPA urge the stock exchange to implement the recommendation that auditors be required to be present at the company's annual meeting to answer questions of shareholders?

SECTION 7: THE AUDITOR'S COMMUNICATION WITH USERS

Response:

A. Yes: 295 (63%) No: 177 (37%)

Comments:

Pro:
- -the report will be more meaningful to the reader, as current report is difficult to understand
- -descriptions of inherent limitations in audit procedures should be included
- -a less "canned" approach could induce more people to read the report, increasing understanding and eliminating disputes
- -should be revised because "clean" opinion letters are largely meaningless
- -greater education is the key, regardless of the wording used
- -must be implemented within strict limitations, so attorneys won't have to be engaged
- -standardized responses must be developed

Con:
- -this is reminiscent of "piecemeal" reports
- -result will be the opposite of what is intended - reader reliance will increase
- -additional verbiage will only further confuse the reader, and make the basic element of the opinion more difficult to discern
- -will increase potential legal problems
- -is simply a political response to consumerism
- -too idealistic for small practitioners
- -currently a standard is at least implied, while the alternative allows for too much variation
- -emphasizing that the report was "prepared" by management is false and it must be remembered that preparing the report "for management" doesn't reduce management's responsibility for it

B. Comments:

1. Consistency

Yes: 241 (52%) No: 221 (48%)

Pro:
- -long felt that consistency per se was not necessarily a virtue
- -provided that management states that consistency exists between periods

Con:
- -"consistent application" of GAAP too important to delete
- -hiding changes in footnotes is not the answer - they need to be highlighted in opinion letter

SECTION 7: THE AUDITOR'S COMMUNICATION WITH USERS

B. Comments: (Continued from previous page)

Con: -average reader understands consistency
-disclosure will become a question of optional usage

2. Reliance on work of another auditor

Yes: 209 (46%) No: 244 (54%)

Pro: -principal auditor has primary responsibility and it is hard to feel comfortable relying on the work of another auditor

Con: -cost to companies would be prohibitive, in that two audits are required
-virtually impossible to do enough work to not rely on another auditor
-whether or not to accept the work of another auditor is an individual decision
-will be seen as a self-serving concept
-concept will confuse readers
-will eliminate use of other auditors - soon only large firms will be able to audit large companies
-end result will be to eliminate the small firm

3. Unaudited information associated with audited information

Yes: 242 (58%) No: 176 (42%)

Pro: -clarifies the exact position of the auditor to the reader
-care must be expressed so the reader can distinguish between audited and unaudited information

Con: -mixing kinds of information confuses users
-SAS is adequate
-proposal not acceptable until profession decides the fate of unaudited information
-if you examine material you are auditing it, and audited and unaudited material should not be missed

C. Yes: 329 (74%) No: 116 (26%)

Comments:

Pro: -would help clarify the primary responsibility for the financial statements, and separate the responsibilities of management and the auditor
-imperative because public often forgets that financial statements belong to management
-only for large, publicly held companies
-except for discussion of system and controls, where too much "boiler plate" will make it meaningless

SECTION 7: THE AUDITOR'S COMMUNICATION WITH USERS

C. Comments: (Continued from previous page)

Con: -financial statements are management reports
-management reports add nothing to audit reports and don't lessen CPA liability
-new system is mostly "boiler plate"
-would eventually become the responsibility of the small practitioner in non-SEC audits
-smaller companies couldn't and wouldn't comply

D. Yes: 317 (71%) No: 130 (29%)

Comments:

Pro: -for publicly held companies only
-assuming that auditor participation can be strictly limited to its proper function

Con: -there is a danger of disclosing information management doesn't want disclosed
-places auditor in the position of umpire
-unreasonable burden upon auditor since material may not be available to answer specific, detailed questions
-this is ineffective since auditors really aren't independent enough to be publicly critical of clients
-shouldn't be mandatory but option should be available to auditor to attend if something significant can be contributed

SECTION 8: THE EDUCATION, TRAINING AND DEVELOPMENT OF AUDITORS

Recommendations:

23. An entry-level educational program should be gradually instituted which would include a four-year liberal arts program and a three-year graduate program in a professional school of accounting.

24. The AICPA and state societies of CPAs should allow accounting educators who are not CPAs to become associate members and participate in the progessional activities of those organizations.

Questions:

A. Should AICPA's goal be a four-year undergraduate and three-year graduate program of entrance education?

B. Should AICPA work toward separate schools of professional accounting or place principal emphasis on graduate degree programs in professional accounting regardless of organizational structure?

SECTION 8: THE EDUCATION, TRAINING AND DEVELOPMENT OF AUDITORS

Questions: (Continued from previous page)

C. Should AICPA provide a form of membership for non-CPA accounting educators?

D. Should AICPA encourage state societies to provide similar forms of membership?

Response:

A. Yes: 158 (35%) No: 300 (65%)

Comments:

Pro:
-broader undergraduate education is necessary to develop professionals, not merely technicians
-give individuals the choice between graduate training or experience
-suggest a well rounded undergraduate business program with a three year accounting specialty
-only if the AICPA finally recognizes specialties within the profession

Con:
-better education is necessary, not more education
-expanded liberal arts curriculum is irrelevant to an accounting career
-experience is infinitely more valuable than formal education, so two years experience plus continuing education is preferable
-too much schooling for the amount of pay available at the entry level
-salaries would be increased to unacceptable levels small firms couldn't accept such a graduate
-non-accounting courses teaching the value of independent thinking and logic would help eliminate the tunnel vision of auditors
-proposal coupled with the high cost of education will restrict access to the profession
-would require students to select from public and private industry with no opportunity to switch later
-a 4-5 year graduate program plus 2-3 years in professional school would be best
-would be discriminatory unless financial aid were available

B. Yes: 210 (53%) No: 190 (47%)

Comments:

Pro:
-emphasis of AICPA direction should be on content, not form
-four year accounting programs are adequate

SECTION 8: THE EDUCATION, TRAINING AND DEVELOPMENT OF AUDITORS

Response: (Continued from previous page)

C. Yes: 232 (53%) No: 205 (47%)

Comments:

Pro:
- may help foster better education
- desirable to expose educators to real-life situations
- will allow for a greater distribution of material and information and create a filtering down effect
- may help to add theory and objectivity
- without communicating with educators complaints about their products are unfair
- any non-CPA should be welcome if interested
- will help remove self-serving image
- as associate members
- either adopt the proposal or consider something like the "Illinois Plan"

Con:
- educators should pass the CPA exam and use educational experience to fulfill the experience requirement
- should be required experience for educators
- same standards should apply to educators and practitioners
- AICPA would degenerate into a trade organization
- non-practicing educators produce impractical recommendations
- will probably lead to other non-CPAs getting into the AICPA

D. Yes: 228 (54%) No: 197 (46%)

Comments:

Pro:
- students in many cases eventually become local practitioners and this would help make them aware of local problems and conditions
- as associate members
- may cause accounting theory to be brought into line with real life situations

Con:
- educators should have to pass the CPA exam to qualify for membership
- state societies should be free to reach their own conclusions on this

SECTION 9: MAINTAINING THE INDEPENDENCE OF THE AUDITOR

Recommendations:

25. Corporate Boards of Directors or their audit committees should review and approve all arrangements for an audit, including the fee, scope and timing and selection of auditors.

26. Boards of Directors or their audit committees should determine if other services performed by auditors pose an independence problem.

27. The nature and extent of other services provided by auditors should be disclosed in proxy statements.

28. Audit firms should neither recruit for management positions which carry discretion over the selection and retention of the auditors nor place former employees in these positions.

29. The disclosure now required by the SEC when a change of auditors is made concerning disagreements on accounting methods and disclosure should be required in all audited financial statements.

30. Professional standards should be expanded to provide guidance on the independent auditor's responsibility when he has knowledge of deficiencies in unaudited financial information released by an audit client.

31. Management of public accounting firms should take steps to reduce pressures on independence which arise from too stringent time budgets and too restrictive cost constraints.

32. Management of public accounting firms should revise their policies relating to fees (and the related pressure on staff to reduce time and costs), arbitrary deadlines and other factors which place unnecessary stress on the auditor's independence.

33. The practice of accepting an audit engagement for an unprofitable fee with the expectation of offsetting early losses with higher fees to be charged for future audits should be prohibited.

Questions:

A. Should AICPA urge the SEC or the stock exchanges to implement Recommendation 25?

B. Should AICPA urge the SEC or the stock exchanges to implement Recommendation 26?

C. Should AICPA urge the SEC or the stock exchanges to implement Recommendation 27?

SECTION 9: MAINTAINING THE INDEPENDENCE OF THE AUDITOR

Questions: (Continued from previous page)

D. Should AICPA adopt a Rule of Conduct to implement Recommendation 28?

E. 1. Should AICPA urge the SEC or the stock exchanges to implement Recommendation 29?

2. Should AICPA adopt a Rule of Conduct which would require a successor auditor to insist on such disclosure?

F. Should AICPA support Recommendation 30?

G. Should AICPA implement Recommendation 31 through its Quality Control Review Program?

H. Should AICPA implement Recommendation 32 through its Quality Control Review Program?

I. Should AICPA adopt a Rule of Conduct to implement Recommendation 33?

Response:

A. Yes: 362 (84%) No: 71 (16%)

Comments:

Pro:
- -particularly if the audit committee works closely with the audit
- -boards and audit committees must be independent of management
- -SEC should establish a Board of Standards that would hire auditors
- -except for scope, which is at discretion of auditor, and may restrict the audit if it is determined by someone else
- -only outside directors should be involved with the auditor
- -providing that the AICPA is to do the implementing

Con:
- -implies too much government control
- -idea is good but may prove excessively costly to small firms
- -puts too much power in directors - stockholder participation should be more encouraged
- -however AICPA should encourage boards to use more care in selecting auditors, perhaps disclosing how the selection was made

SECTION 9: MAINTAINING THE INDEPENDENCE OF THE AUDITOR

Response: (Continued from previous page)

B. Yes: 293 (73%) No: 109 (27%)

Comments:

Pro:
- boards and audit committees should be only one party to this determination
- doesn't, however, relieve the auditor from making an evaluation of independence, and exercising his ultimate responsibility to withdraw if he is not independent

Con:
- auditor alone should make this determination
- without specific guidelines, boards can't make this determination
- criteria should be standardized and formulated by AICPA or it will vary from company to company
- SEC committee should determine independence
- independence is more a matter of attitude than observation by others

C. Yes: 267 (65%) No: 134 (35%)

Comments:

Pro: NO MEANINGFUL POSITIVE COMMENTS WERE RECEIVED ON THIS QUESTION

Con:
- vague and will confuse users on independence question
- places too much responsibility on reader
- will suggest to the public that independence is a problem

D. Yes: 238 (59%) No: 168 (41%)

Comments:

Pro:
- the appearance of independence is crucial
- yes regarding outside recruitment, but not regarding placing a firm's own people - where are accountants leaving public pracitce to go?
- proposal is good, but it should be noted that it may amount to a reduction of independence

Con:
- not practical for small firms

SECTION 9: MAINTAINING THE INDEPENDENCE OF THE AUDITOR

Response: (Continued from previous page)

E. Comments:

1. Should AICPA urge the SEC or the stock exchanges to implement Recommendation 29?

Yes: 295 (72%) No: 116 (28%)

Pro:
- -expand to unaudited information also
- -not in financial statements, but in attachments
- -good although an integral 10-K would do the job
- -AICPA should consider it, rather than SEC

Con:
- -will inhibit changes for valid reasons
- -creates too much legal exposure for slander
- -assumes the new auditor can resolve the original conflict or won't issue the report
- -the successor auditor will determine if the conflict was material or not

2. Should AICPA adopt a Rule of Conduct which would require a successor auditor to insist on such disclosure?

Yes: 296 (73%) No: 109 (27%)

NO MEANINGFUL COMMENTS WERE RECEIVED ON THIS QUESTION

F. Yes: 343 (85%) No: 61 (15%)

Comments:

Pro:
- -only if the CPA is associated with the unaudited statements

Con:
- -adequate standards currently exist

G. Yes: 309 (79%) No: 82 (21%)

Comments:

Pro:
- -quality of work is increased by the CPAs judgement of what is material
- -but, at same time eliminate competitive bidding

Con:
- -fees will become excessive
- -unworkable in today's business environment

H. Yes: 282 (72%) No: 110 (28%)

Comments:

Pro:
- -these policies are usually dictated by the client, not the firm
- -price competition lowers quality - large firms are especially guilty

SECTION 9: MAINTAINING THE INDEPENDENCE OF THE AUTHOR

Response: (Continued from previous page)

I. Yes: 258 (65%) No: 136 (35%)

Comments:

Pro:
- no firm should be allowed to work for less than direct cost plus reasonable return
- assuming a provision is made for non-recurring start-up costs, which probably can't be charged to the client
- an attempt to create a client relationship based upon dollars rather than professionalism
- how would "unprofitable fee" be defined?
- an important goal but difficult to enforce
- will be a real change for some large firms
- buying-in should be prohibited

Con:
- unenforceable, silly, hard to detect
- disadvantageous to client
- auditor should have control over his fee
- client may rotate faster with a low initial fee, and its difficult to justify an increase in fee after first "loss" year

SECTION 10: THE PROCESS OF ESTABLISHING AUDITING STANDARDS

Recommendations:

34. The Auditing Standards Executive Committee should be replaced by an Auditing Standards Board within the American Institute. This board should be composed of five to nine full-time members.

35. Auditing standards should be restructured to give more attention to the needs of public accounting practice involving non-publicly-owned companies.

Questions:

A. Should an Auditing Standards Board of full-time members be established?

B. Should AICPA implement the recommendation that more attention be directed to the needs of firms involved with non-publicly-owned companies?

Response:

A. Yes: 265 (64%) No: 151 (36%)

SECTION 10: THE PROCESS OF ESTABLISHING AUDITING STANDARDS

A. Comments:

Pro: -members should be rotated so no one misses work for extended periods

Con: -looks like something that was changed years ago
-would move standards even further away from those who do the auditing
-would be incapable of dealing with local practitioner problems
-would give standards to "ivory-tower" types
-SEC and FASB currently have enough of third type of influence
-need actual practitioners on the Board

B. Yes: 380 (94%) No: 26 (6%)

Comments:

Pro: -should be done immediately because unless there are specific requirement separations between public and non-public companies, courts will adopt recommendations pertaining to publicly held companies
-this is where most firms work and they need help
-should be expanded to governmental entities as well as companies
-small firms and companies have very different needs than larger ones
-too much latitude currently exists because of uncertainties over reporting requirements

Con: -will cause greater rift between large and small firms
-is a simple revisiting of "BIG GAAP-LITTLE GAAP"-problem of GAAP must be solved first
-might cause a "two class" system for both firms and financial statements
-the less attention paid to small firms, the less they will be given "ivory-tower" directives

SECTION 11: REGULATING THE PROFESSION TO MAINTAIN THE QUALITY OF AUDIT PRACTICE

Recommendations:

36. Secrecy should be removed from disciplinary actions and from the penalties imposed. Action should not be deferred pending the outcome of litigation except when the accused demonstrates that the litigation is directly related to the charges. Action should rarely await the outcome of appeals.

SECTION 11: REGULATING THE PROFESSION TO MAINTAIN THE QUALITY OF AUDIT PRACTICE

Recommendations: (Continued from previous page)

37. The AICPA should support attempts to change the legal system that would:

    a. give the courts additional discretionary authority to assess costs against unsuccessful plaintiffs.

    b. establish a statutory limit to damages.

    c. increase the use of court-appointed masters.

    d. grant temporary "safe harbors" when auditors' responsibilities are significantly extended, for instance, in areas such as forecasts and various forms of current value. A safe harbor rule places the burden of proof that a specified standard was not met on the person seeking to establish liability.

38. Public accounting firms should voluntarily experiment with reporting information aimed at increasing understanding of their organization and operation by users of financial statements.

39. AICPA should regularly publish analyses of cases involving significant audit failures.

Questions:

A. In re Recommendation 36, should AICPA publish the names of all members involved in Trial Board actions and name all those against whom action is taken?

B. In re Recommendation 37, should AICPA initiate action in support of this recommendation?

C. In re Recommendation 38, should AICPA urge CPA firms to experiment with the type of reporting suggested?

D. In re Recommendation 39, should AICPA regularly conduct studies and publish findings about cases involving significant audit failures, as it did in the Equity Funding case?

Response:

A. Yes: 199 (54%) No: 167 (46%)

Comments:

Pro:
- if there is full disclosure by both sides, and the final outcome is included
- fine if the results are also published
- public right to know is more important than the individual's right to secrecy

SECTION 11: REGULATING THE PROFESSION TO MAINTAIN THE QUALITY OF AUDIT PRACTICE

A. Comments: (Continued from previous page)

Pro: -if the profession doesn't get tougher, the government will step in

Con: -should be published only for those found "guilty", as a person later proven innocent could be branded
-should depend on the reason for the action
-is a legal question that should be resolved by lawyers

B. Yes: 325 (86%) No: 54 (14%)

Comments:

NO MEANINGFUL COMMENTS WERE RECEIVED ON THIS QUESTION

C. Yes: 253 (71%) No: 106 (29%)

Comments:

Pro: -a profession task that should be taken on by AICPA and state society joint effort
-limited to large firms of significance to the financial community

Con: -will distort comparability and significance of auditor's reports for the experimental period
-should be done on a wider basis, similar to the AICPA effort regarding the Quality Control program
-would create chaos and financial statements are difficult enough for readers to understand now.
-would be solely a sales document for large firms

D. Yes: 354 (94%) No: 23 (6%)

Comments:

Pro: -could be of great value and produce educational benefits
-proposal is good but names of those involved should be withheld

Con: NO MEANINGFUL NEGATIVE COMMENTS WERE RECEIVED ON THIS QUESTION

A60

GENERAL MOTORS CORPORATION

July 8, 1977

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibilities
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

We welcome the opportunity to respond to the Report of Tentative Conclusions ("Report") of the Commission on Auditors' Responsibilities ("Commission").

We commend the Commission for a document which appears to be comprehensive in scope and relevant as to issues exposed. By contrast with lengthy, complex documents appearing regularly on a variety of accounting issues, the Report is presented in an easy-to-read and understandable style, yet fortified with enough background and reasoning material that the Commission's position on the several dozen issues are readily discernible and, thus, conducive to comment.

Before we comment on specific issues, we would like to make the following general points:

> The summary on page xvii states in the fifth paragraph that the recommendations number forty. It has not been possible for us to determine these forty exactly. However, Appendix A to this letter contains fifty recommendations and conclusions we gleaned from the Report. To facilitate our response, we have indicated our approval or disagreement with each issue and have cross-referenced those issues on which we have expanded in our written response.
>
> Several of the recommendations could result in more audit work to be performed by auditors (and management) with consequent increases in audit fees. We strongly recommend that the Commission be completely satisfied that the expected benefits of the increased work are reasonably attainable and cost justified.

We are concerned with the frequent references to what management should or should not do in a report on "auditors' responsibilities" wherein management had minimal representation on the Commission. We, of course, realize that an audit is a joint task which has to bring to bear the talents, patience, understanding, and cooperation of all parties involved to accomplish, among other things, the stated purpose of the Report -- namely, to improve communication between provider and user of audited and other financial information. We believe that accomplishing the goal can be enhanced if a section in the final report recognizes this and suggests means for gaining management compliance with the recommendations addressed to it.

The task of setting sound auditing standards and improving the needs and expectations of users of financial information is exceptionally difficult. Accountants, management, and users view differently not only the end result of a financial statement audit, but also the extent to which each should participate in the overall goal as stated in the Report. Auditors stress the visibility which management must show because its financial statements are being audited; management reacts that an auditor through his opinion belongs in the forefront; the user is confused as to each party's role because, among other things, he does not understand the complex audit process. In addition, the user is expected to have a reasonable understanding of business activities and financial reporting and auditing if he is to receive the message intended through the audit process -- no matter how seriously the party tries to communicate effectively.

We caution the Commission not to expect the proposed audit certificate and management report alone to solve the audit communication problem. Basically, while emphasis on developing a clearer message by auditors and management is worthy of support, and we do support this as explained on page 5, its significance must be viewed within the limitations of any written words and within the potential of other media sources to accomplish the desired objective.

Finally, we believe the format of the final report should enumerate in a more concise manner the Commission's conclusions and recommendations in order to foster more prompt action on the final results of its study. An appendix explaining the reasoning behind each point, with reference to respondents' comments, is also suggested.

Following are specific comments on selected recommendations and conclusions included in the Report.

Section 1 - The Independent Auditor's Role in Society

This Section provides a framework for studying specific issues and covers not only what the auditor does, but what his relationship is to those interested or affected by his work. Thus, the social implications of accounting and auditing are identified and evaluated.

We essentially agree that an auditor's primary responsibility is to the user of his work. We caution the Commission, however, not to expect that the full range of his responsibilities can be conveyed through either his certificate or management comments. Other media sources must be exploited. The Financial Accounting Standards Board (FASB) received a recommendation from its Trustees to improve its public relations programs. This, we believe, is worthy advice also for the auditing profession.

Section 2 - Forming an Opinion on Financial Presentations

We concur in the Commission's reasoning to eliminate the word "fairly" in the opinion paragraph of this report. The use of "appropriate in the circumstances" and of "in all material respects" are better alternatives to raising the importance of judgments and decisions which auditors make in forming an opinion on financial statements.

We have difficulty in accepting the Commission's recommendation for providing auditors with more guidance in evaluating the preferability of alternative accounting principles. Auditors, of course, have a responsibility to counsel management on the selection of an accounting alternative. However, in the final analysis, we believe that management is in the position, unattainable by auditors, of having a personal, in-depth awareness of its business and, therefore, is best qualified to decide on the preferable alternative.

Section 3 - Reporting on Significant Uncertainties in Financial Presentations

The reasoning behind eliminating "subject to" in auditors' opinions is noteworthy. Simply put, the Commission is recommending that standards be adopted to require management to disclose a broad range of uncertainties and auditors to certify as to the adequacy of the disclosure. Users are then expected to qualify the financial presentations on the basis of this information. We are disturbed, however, by the emerging, changing emphasis on roles of the parties involved because an auditor's ability to objectively draw to a user's attention a potentially significant uncertainty is being traded for a clean opinion (or adverse opinion to a lesser degree). This further burdens the already under-educated user by requiring him to know even more about the audit/opinion process.

Perhaps a better solution lies in not redefining the roles of auditors, management, and users, but rather in maintaining the status quo to the extent that the auditor's opinion includes words different than "subject to" to convey his qualifying opinion. We could support this alternative since adoption of an "uncertainties" note in place of "subject to" can only lead to both more and confusing disclosures. In many cases, it may be written in symbolic, boiler-plate, hedged language about the inherent difficulties every business faces in today's litigation-laced environment. The FASB's current exposure draft on objectives of financial statements may set the standard as to how much data must be disclosed since the draft proposes that users at least have an awareness of, as well as an interest in, understanding the financial reporting process.

Section 4 - Clarifying Responsibility for the Detection of Fraud

We concur in the theme of this Section. However, the Commission should answer the following questions to make its recommendations most effective:

1. What is meant by the words "search" and "material" as used in the sentence "the auditors should search for material fraud" (page xviii, Section 4, second sentence)? We believe these words need clarification to avoid extensive auditing beyond either a reasonable cost-benefit measure or outside the scope expected of a reasonable standard of professional care and skill.

2. What is meant by the word "management" in the discussion of "management fraud" beginning on page 32? This needs clarification to help frame the scope of an auditor's testing procedures.

Section 5 - Corporate Accountability and the Law

As in Section 4, the Commission uses the word "search" to describe how an auditor should test for illegal or questionable acts. The scope of the work being recommended should be defined for the reasons mentioned above.

We are concerned that the Commission has singled out a corporation's policy on employe conduct for publication in detail when comment on other policy statements may be as important. To publicize to employes is acceptable; to publicize to the non-employe public is neither acceptable nor reasonable. The standard we believe which makes sense is to report externally that employe conduct policies, as well as other policies exist; that controls exist to require compliance; and that internal and external auditors assist in assuring management that compliance is being monitored.

The last subject entitled, "A Proposal for Increased Involvement of Lawyers", (Page 49) disturbs us, particularly the first sentence in paragraph 4 which reads in part that "the present structure and division of responsibilities in this area are (not) efficient or effective". We realize that the struggle over disclosure amongst management, auditor, and lawyer, may not always be cordial, but then SAS #12 on lawyer inquiry has been in existence only since January 1976. It represents a major step forward towards defining the "rules" of inquiry, investigation, opinion, and disclosure and has not, to our knowledge, made the inquiry process less productive or unduly strained. After all, the auditor always has had the advantage of opining on the sufficiency of disclosure including requiring management's and/or his lawyer's opinion(s) to be published regarding the outcome of a contingency. We recognize that the Commission is only "orbiting a balloon" with this suggestion, but we react that, until proven otherwise, the idea may be more form than substance. The substance, we think, is in place and working.

Section 6 - The Boundaries of the Auditor's Role and its Extension

We, at General Motors, are in accord with the Commission's recommendation that the auditor be involved with the financial reporting process. In our opinion, any auditor should strive for such a relationship -- even if it should mean only reading his client's periodic financial statements to be aware of changing conditions.

We believe, however, that the final report should contain some guidelines as to how extensive an auditor's involvement should be with data other than financial statements "produced by the accounting system". Specifically, this means clarifying what the Commission means by the sentence "(It) recommends an immediate extension of the audit function to other information in an annual report" (page 68, 3rd full paragraph, second sentence). As to non-annual report areas, does the Commission envision that speeches by corporate personnel on financial activities, public interest reports, and new product press releases must be "audited" before being disclosed?

Section 7 - The Auditor's Communication With Users

We concur in the opening sentence in this Section which states that "evidence abounds that communication between the auditor and users of his work ... is unsatisfactory". We also believe that this problem must be solved by more than updating the audit certificate. Thus, while emphasis on a clearer audit message is important, its significance must be viewed within the limitations of written words and within the potential of other media sources.

While we have already remarked about eliminating "fairly", and adding "appropriate in the circumstances" and "in all material respects", and now indicate a general agreement with expanding the work scope and internal control remarks in the third and fourth paragraphs, respectively, we think that brevity of expression in the audit certificate is still the best approach. This means that the term "generally accepted auditing standards" is preferable over a reversion to the "long form report" wherein the standards (and only some of them) are described. On balance, we believe the profession can best revise its own report and thus limit our remarks as above.

We concur in the concept of a "management report". However, we would prefer that the final report offer guidelines for subjects which can be discussed in public reports vs. the structured example on page 79. Ultimately, management must decide on how extensively it will discuss its role in the financial reporting and audit process.

Section 8 - The Education, Training, and Development of Auditors

The concept that "more and better education can develop more qualified CPA's of the future" is support worthy. We caution the Commission, however, on holding to the premise that extended education is only for entry into public accounting. In many respects, the same preparation is required for entry into professional accounting positions in industry. The end result could be an undesirable trend towards CPA's being only qualified for public accounting and not for both public and private accounting as is the present working status.

We don't believe that weakening present standards for admission of accounting educators into a state society of CPA's is wise. The experience element of most professionals holding a certificate is not obtained other than in practice. Educators, of course, should continue to be encouraged to share their knowledge and viewpoints through professional activities.

Section 9 - Maintaining the Independence of Auditors

We support any reasonable recommendation which fosters auditor independence. In particular, we champion the benefits which can and do accrue from an independent audit committee as cited by the Commission. We urge the Commission, however, to emphasize the Audit Committee's role as that of a reviewer when it comes to arranging the audit scope and fee. The Committee can be a resource of valuable guidance if it acts on management's recommendations after management has explored the details of these two issues.

Though we agree that auditor rotation is not desirable, we recommend that audit personnel assigned to an engagement be rotated periodically.

As to the recommendation that audit firms not recruit from within their own ranks for positions which can influence the hiring of auditors, we question the value of this when obviously other important benefits may accrue to companies. We do not believe the Commission's recommendations on independence are enhanced by this suggestion.

Section 10 - The Process of Establishing Auditing Standards

We endorse the concept of a full-time auditing standards board, within the private sector, appropriately compensated, and fully staffed with qualified personnel. We also suggest that membership be open to non-AICPA personnel.

If the Commission makes this recommendation in its final report, we urge the AICPA to adopt it immediately. The Board's charter should be written to assign priorities to the other final conclusions and recommendations, to determine how to implement them, and to begin the process.

While we agree with the suggestion for improving the standard-setting process, we disagree with the conclusion that this process "does not need to operate to the fullest extent practical in public". This viewpoint would appear to be contrary to the stated purpose of the Commission's Report, namely, better communication with the user of the auditor's work. We suggest that the Commission adopt Finding #14 which the Trustees of the FASB made in their recent report on "The Structure of Establishing Financial Accounting Standards". This Finding encouraged the Board to educate its constituency by explaining its ideas, conclusions, and recommendations.

We are disappointed that the Commission did not cite qualified corporate financial personnel as individuals who should participate in the process of setting standards (6th full paragraph - page 133). Since corporations, through their financial staffs, are showing an increasing awareness and concern for accounting, these people represent a major source of constructive advice for the Board to use in its deliberating and deciding process.

Section 11 - Regulation of the Profession to Maintain the Quality of Audit Practice

We generally concur with the recommendations made in this Section which we believe are worthy of the accounting profession's insight, review, and response.

We appreciate the opportunity to comment on this report and urge the Commission to consider our remarks in its final report.

Very truly yours,

A. M. Long
Comptroller

Attach.

The Commission on Auditors' Responsibilities: Report of Tentative Conclusions

	A	D	X
AUDITOR'S ROLE			
1. An auditor's function in society is represented by his position as a third party intermediary between issuer and user of financial statements. His primary responsibility is to the user.	X		2
OPINIONS			
2. The word "fairly" should be eliminated from the auditor's report.	X		3
3. More guidance is needed in evaluating:			
a) appropriate accounting principles in areas when none exist;	X		
b) preferability of choice made by management among alternative principles; and		X	3
c) cumulative effect of principles selected and applied.	X		
SIGNIFICANT UNCERTAINTIES			
4. "Subject to" qualifications in opinions should be abolished.		X	3
5. More uncertainties should be disclosed by management in a standard note to its financial statements.		X	3
FRAUD DETECTION			
6. Auditors should search for material fraud.	X		4
7. Audits should be designed to provide reasonable assurance on the accountability of management.	X		4
8. Auditors must continually assess management's integrity (existing and prospective clients).	X		
9. Auditors must act on evidence showing management to be untrustworthy.	X		
10. Auditors must be alert to situations conducive to management fraud.	X		4
11. Auditors must maintain a better understanding of the client's business and industry.	X		

Notes:
A = Agree
D = Disagree
X = Page number in letter containing explanatory comments on answer, or qualifying language.

	A	D	X
FRAUD DETECTION (continued)			
12. Auditors must expand the study and evaluation of internal control.	X		
13. Information regarding frauds and methods of detecting them must be developed and disseminated.	X		
14. Auditors must constantly assess limitations of audit procedures.	X		
15. Clients must understand limitations of incomplete audits.	X		
ACCOUNTABILITY AND THE LAW			
16. Corporations should publicize <u>in detail</u> their policy statements re: accountability to society.		X	4
17. Auditors should monitor compliance with policy statements.	X		4
18. Auditors should search for illegal or questionable acts without regard to traditional materiality standards; they should detect only those which "professional skill and care should uncover".	X		4
19. Information on legal claims and litigation, including assurances on policies on illegal payments, is <u>without</u> the purview of financial statements; lawyers should assume this responsibility.		X	4
BOUNDARIES OF AUDITOR'S ROLE AND ITS EXTENSION			
20. The audit function should not be viewed as confined to a set of financial statements but rather as an examination of the financial reporting process.	X		4
21. Expansion of the audit function will require expanded study and evaluation of internal control and more timely involvement in the financial reporting process, including other financial information included in an annual report.	X		5
22. A public report should be issued by the auditor on internal control.		X	
23. A public report should be issued by the auditor on the process used to prepare interim financial information.		X	

Notes:
A = Agree
D = Disagree

X = Page number in letter containing explanatory comments on answer, or qualifying language.

		A	D	X
	AUDITOR'S COMMUNICATION WITH USERS			
24.	The present auditor's report is deficient and should be replaced by a new, flexible, greatly expanded report.		X	5
25.	Management should report on its role as being responsible for the financial statements and related disclosures.	X		5
26.	Reporting on consistency in the auditor's report should be eliminated.		X	
27.	Present method of referring to other auditors in the auditor's report is inadequate and should be revised.	X		
28.	Auditors should be present at the annual stockholders' meeting to answer questions.	X		
29.	The auditor's reporting requirement for unaudited information which is associated with audited information should be better clarified and expanded.	X		
	EDUCATION, TRAINING, AND DEVELOPMENT OF AUDITORS			
30.	A long-range goal for proper education would be a 4 year liberal arts program and a 3 year graduate professional program.	X		5
31.	The AICPA and state societies should develop better educational programs; non-CPA educators should be invited to participate.	X		
	AUDITOR INDEPENDENCE			
32.	MAS, tax and other non-audit services are generally compatible with the client-audit relationship. This excludes engagements to testify about or prepare accounting information as an advocate.	X		
33.	Audit committees should evaluate nature and extent of other than audit services.	X		
34.	Guidance is needed on action an auditor should take when, performing non-audit services, he learns of deficiencies in disclosed unaudited information.	X		
35.	Guidance is needed on how the auditor should give advice on selection and application of appropriate accounting principles.	X		

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D = Disagree
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	A	D	X
AUDITOR INDEPENDENCE (continued)			
36. Other than audit services performed should be disclosed in proxy statements.		X	
37. Auditor rotation is not advisable to maintain independence.	X		
38. The public sector should not become involved in auditor approval, assignment, or compensation process.	X		
39. Responsibility for selecting and evaluating auditors, establishing scope of work, and setting fees should rest with an audit committee whose members are independent; if auditors are changed due to disagreements, disclosure should be made in <u>all</u> audited financial statements.	X	X	6
40. Auditors should not influence auditor retention or selection by recruiting (externally or from within own ranks) for positions which may influence the decision.		X	6
41. Clients should not cause undue pressures by setting arbitrary deadlines or releasing unaudited earnings information "early".	X		
42. Auditors should examine their "excessive price competition actions" if this causes undue time pressures on staff.	X		
43. Auditors should review their time budget processes to make sure lower quality audits are not resulting from present policies.	X		
44. Auditors should adopt policies on accepting favors or gifts from clients.	X		
PROCESS OF ESTABLISHING AUDITING STANDARDS			
45. Setting standards by a government agency or outside the AICPA is not recommended. However present AudSEC should be replaced by a full-time (5 to 9 members), appropriately compensated committee, provided with improved staff support.	X		6
46. Auditing standards should be restructured to recognize change in audit function. Participation in the standard setting process should come from within and without the profession.	X		6
REGULATION OF THE PROFESSION			
47. Present set-up (private profession with private and public overseeing) does not need drastic change.	X		

Notes:
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D = Disagree

X = Page number in letter containing explanatory comments on answer, or qualifying language.

	A	D	X
REGULATION OF THE PROFESSION (continued)			
48. Secrecy regarding how the profession undertakes disciplinary actions and the outcome of the actions should be removed; process of resolving violations of professional ethics should be revised.	X		
49. Public accounting firms should experiment with public disclosure of their organization and operation.	X		
50. AICPA should publish details of audit failures and take steps to change legal system by, for example, establishing statutory limitations for damages and granting temporary "safe-harbors" when auditors' roles are extended.	X		

Notes:
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D = Disagree
X = Page number in letter containing explanatory comments on answer, or qualifying language.

A 61

GENERAL MILLS, INC. · EXECUTIVE OFFICES · 9200 Wayzata Boulevard · Minneapolis, Minnesota

June 30, 1977

E.K. SMITH
Vice President and Controller

Mr. Douglas R. Carmichael
Research Director
Commission on Auditors' Responsibility
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

We are pleased to have the opportunity to review and comment on the tentative conclusions and recommendations of the Commission on Auditors' Responsibility, established by the American Institute of Certified Public Accountants. We hope that the following comments will assist in finalizing your report and recommendations.

In general, we agree with most of the conclusions and recommendations presented in the Summary of the report.

We are, however, concerned with some of the detailed conclusions and recommendations. Some of these appear to be mostly self-serving for the public accounting profession - almost to the point of the public accountants walking away from the problems.

Our detailed comments are as follows:

1. Section 6 - The Boundaries of the Auditor's Role and its Extension

   We generally agree with the summary provided for Section 6. We encourage both management and the public accountants to expand their interaction to provide the public accountants with greater and continuous knowledge of the ongoing business and transactions of the company.

   At General Mills, we have established a good, ongoing, relationship with our public accountants. We involve them in all major new and unusual transactions or situations on a continuous basis. We feel that this assists both of us in assuring that a proper decision is reached before the fact and does not create dispute or confusion at a later date. We would encourage this type of "continuous involvement" by all managements and public accountants.

However, the detailed comments included in Section 6 of the report, includes inferences and possible ramifications which we strongly disagree with.

a. References (page 64) to an understanding of the company's budgeting system and earnings plan with subsequent comparisons to actual results sounds good but we seriously doubt budgeting is a skill that public accountants can develop with good cost/benefit balances.

   To understand a budget or profit plan, it is necessary to have much on-going operating knowledge of the assumptions, strategies and action plans which were used by management in developing the numerical data. We do not feel that these discussions should include our public accountants.

   Secondly, the explanation of the variances, not only requires knowledge of the above, but are also analytical, interpretive explanations. We do not feel that public accountants can be or should be expected to interpret these extremely complex situations.

b. Reference (on page 58) of possible extension of the accounting system to include data on backlogs of sales and purchase orders infers that the auditor should investigate 1) the accuracy of the data; and 2) the reasons for fluctuations. A logical result of the above would be an attempt to interpret the meaning of such fluctuations, with subsequent disclosure of the data and interpretations.

   Again, we do not think that public accountants can adequately assess backlog positions and the implications of the fluctuations. This is true for no other reason than the fact that they are not associated with the business and the industry on a day-to-day basis.

c. The discussion on pages 61-63 relating to disclosure of internal control weaknesses appears to be self-serving to the public accountants while rendering a great disservice to the financial community.

   Internal control and systems weaknesses are often quite complicated and technical. Any written explanation of the weakness in the financial statements would, generally, inadequately describe the true situation.

Similarly, the total financial community should not, and probably cannot, be expected to understand the implications of the disclosures. The financial community has the right to expect the paid, professional public accountants to make these assessments and inform them whenever the weaknesses make the financial statements unrealiable.

It is our opinion that the public accountants have this responsibility today. To the extent that internal control and systems weaknesses are so material that the public accountants cannot attest to the fairness of the financial statements, a qualified opinion should disclose this fact.

The on site public accountants should make this determination, and not expect the remote financial community to be able to understand the implications of an inadequate description in the financial statements.

In our opinion, this recommendation does nothing but limit the liability of public accountants (if a fact is disclosed, how can I be held accountable?) while serving a great disservice to the financial community.

d. While the Commission report implicitly implies advance reviews of press releases, speeches, etc., by the public accountants, we strongly object to requirements of this type in most all instances.

   Existing securities laws have adequate sanctions to deal with improper/misleading information without inserting the public accountants in this role.

2. Section 5 - Corporate Accountability and the Law

   We agree that Corporate accountability and adherence to all laws is a must requirement of all corporations and managements. At General Mills, we have strict policies and guidelines on illegal or questionable acts which all levels of management are held accountable to.

   We agree with the public accountants' role in assessing management's actions to monitor compliance and extending their efforts to uncover such actions.

   We disagree, however, with the position taken in the report (page 49) relating to disclosure of litigation. In our opinion, the position taken in the report, which would require the increased involvement of outside attorneys, simply restates the public accountants' position on legal matters which created the recent impasse with the legal profession.

While acknowledging, but without commenting on the merits of either professions' position, we believe that the compromise previously reached was acceptable and workable. We do not believe that this compromise should now be unilaterally broken because one of the parties has discomfort with the arrangement.

3. Section 9 - Maintaining the Independence of Auditors

We generally agree with most of the conclusions reached in the discussion of maintaining the independence of Auditors.

At General Mills we have attempted to enhance their independence through the use of a strong audit committee of outside directors. The public accountants have direct access to the directors at all times and have regularly scheduled meetings with them.

Additionally, we follow the practice of having the full Board of Directors recommend the auditors for the next year with the shareholders voting on this recommendation.

Internally, we follow the practice of not restricting access to any information and encourage their independence with our operations and subsidiaries.

However, while we agree that time pressures have often affected the quality of the audit, we cannot agree that the reasons are completely client imposed.

It had been our experience that the public accountants have self imposed time inefficiencies which should also be examined along with recommendations to increase time budgets.

a. Too often, inexperienced personnel are not adequately supervised. (We will comment more on this in our discussion of more education for accountants.)

b. Many procedures and specific workpaper format appears to be more related to form than to the substance of auditing. Too often, one gets the impression that auditors are more interested in completing good looking workpapers as opposed to in depth auditing of the function.

c. Reluctance to supplement the work of public accountants with the work of independent internal auditors.

In most large corporations, especially those with decentralized operations and a corporate controlled internal audit function, the internal auditors are truly independent of the operations and subsidiaries of the corporation.

Public accountants have traditionally been reluctant to rely on the work of the internal auditors and have generally relegated the work done to an additional feature of internal control. We feel that much can be done in many companies to increase the overall efficiency of the total audit effort by better coordinating the two groups. The public accountants, however, must change their insistence on doing all of their own work and be willing in appropriate circumstances, to place more reliance on the work of the internal audit staffs.

4. Section 8 - The Education, Training, and Development of Auditors

The major conclusion reached in this section is that public accountants should be required to attend professional schools of accountancy patterned after the legal profession and that public accounting firms have been required to do too much training of recent graduates.

The inference in the above is that the additional training would alleviate the public accounting firms' need to train their people and would automatically insure better auditing because of better trained personnel.

We disagree with this recommendation and conclusion. It has been our observation that the reason for the failure of auditing has not been the technical training of the individual, but rather the lack of realistic on-the-job experience which the individual has. Experience cannot be learned in school.

In our opinion, the primary failure of the public accounting profession has been to develop and retain experienced qualified, people at the <u>auditing</u> level.

We feel that this has been caused by, or accentuated by, two major factors:

a. The relatively low experience requirement needed to obtain a CPA certificate.

In many states, the passing of the CPA examination is the only requirement for obtaining a CPA certificate. To our knowledge, the most experience required by any state is two years.

This requirement is insufficient to develop the total skills needed by a CPA to properly perform his profession. With the recognition given to a CPA certificate by industry and others, the low experience requirement encourages graduates to enter public accounting for the minimum time needed. This in turn creates turnover and inexperience at the basic, on site, auditor levels and diminishes the professional status of the CPA certificate.

In our opinion, the CPA profession should be encouraging all states to increase the experience level needed to obtain a CPA certificate to a minimum of four to five years.

b. Secondly, the "up or out" attitude of most public accounting firms leaves no place for the individual who does not have adequate qualifications for partnership but who would like to remain in public accounting.

In any industry, comparable individuals can be found in middle management positions performing a wide variety of functions in an important, fulfilling role. In most instances, these "staff sergeants" are vital to the total functioning of the business and they are rewarded, both monetarily and in prestige, accordingly.

To our knowledge, there are no comparable positions within public accounting. In our opinion, this contributes to the "void" of experience between the partner on the engagement and the on-site people, and to the supervision which is given to the actual auditing of the engagement.

In many cases, this inadequate supervision of the "Juniors" allows many items to go unchallenged, and contributes to recent problems of the public accounting profession.

We feel that instead of first looking at the "easy" answer of a "professional school of accounting", the public accounting profession should also look inward at its own management practices and structure. Long-term solutions to the difficult problem of obtaining professional auditing at the "<u>auditing</u>" level cannot be achieved through additional education.

Any changes in the educational process should include work/study programs and faculty members with actual, meaningful, industry experience.

Sincerely,

EKS:ii