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Edited transcript of roundtable discussion of auditors' responsibilities and capital markets, May 11, 1976: Section II

Ross Institute

American Institute of Certified Public Accountants. Commission on Auditors' Responsibilities

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Draft
1/25/77
T. McR.

SECTION II

EDITED TRANSCRIPT

OF

ROUNDTABLE DISCUSSION ON AUDITORS' RESPONSIBILITIES AND CAPITAL MARKETS, MAY 11, 1976

SPONSORED BY

THE ROSS INSTITUTE

AND

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ROUNDTABLE DISCUSSION ON AUDITORS' RESPONSIBILITIES AND CAPITAL MARKETS

MAY 11, 1976

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ROUNDTABLE DISCUSSION ON AUDITORS' RESPONSIBILITIES AND CAPITAL MARKETS

May 11, 1976

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MANUEL F. COHEN (MFC)
ROLAND E. DUKES (RD)
ROBERT ELLIOTT (RE)
ANN GABRIEL (AG)
MARTIN GRUBER (MG)
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MICHAEL SCHIFF (MS)
LEE SEIDLER (LS)
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DAVID SOLOMONS (DS)
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JOHN J. VAN BENTEN (JvB)
CHARLES WERNER (CW)

IMPLICATIONS OF PORTFOLIO MANAGEMENT MODELS FOR INDEPENDENT AUDITS

Chairman of Session, Douglas R. Carmichael

Marty Gruber has prepared an outline on implications of portfolio management. Marty, do you want to start.

Outline Prepared by Martin Gruber

I. BACKGROUND. There are three theories of general approaches to theory which make alternative assumptions about the degree of perfection in security markets.

A. The Capital Asset Pricing Model (GAPM). Equilibrium exists in the capital markets—deviations from equilibrium are non-predictable—all investors should hold the "market portfolio" at all times.

B. The Single Index Model. Popularly called the Beta model. If investors have (or believe they have) some forecasting ability, they should (will) hold a portfolio which is very widely but less than fully diversified. The risk in investors' portfolios that is not market related approaches zero and so investors should only be concerned with the sensitivity of their portfolios to market movements (the Beta coefficient). In this model, the user is concerned with forecasting the return from each stock and the Beta for each stock.

C. Full Variance-Covariance Models. Holders of small portfolios must be concerned with non-market related risk as well as market related risk. They must estimate expected returns, the uncertainty of returns for each stock (variances) and the co-movements between the returns on all stocks (correlations).

The CAPM makes horrendous assumptions about investor behavior, e.g., homogeneous expectations, the ability of investors to lend and borrow unlimited amounts of money at the riskless rate, etc. Nevertheless, it seems to provide a good approximations to the behavior of security markets. Furthermore, large institutional investors are starting to act as if they believed in the CAPM model, as evidenced by the establishment of an increasing number of index funds.

The Single Index Model seems appropriate for those investors who wish to act on forecasting ability and still take advantage of the benefits of portfolio diversification.

Despite the implications of theory, empirical evidence indicates that most individual investors still hold portfolios consisting of two to three stocks. For these investors, the Full Variance-Covariance Model is appropriate.

SOME POINTS FOR DISCUSSION

A. If the CAPM is a good description of reality, then relevant information is being supplied to investors, either by the accounting profession or by others. Auditing still has a role, for the cost of funds to users is a function of perceived risk. To the extent that the auditing process can lower perceived risk, it can lower the cost of funds.

B. If the CAPM does not hold, then the investor must forecast:

   1. The expected level of future returns.

   2. Risk—measured either by the relationship between returns and the market (Beta), or the variability of returns and the co-movement between securities.

C. Expected Returns. Evidence shows that 85%-90% of the information contained in annual earnings announcements is incorporated in stock prices before the announcement is made. This implies that information is leaked (signaled) to the market earlier than the report. Should the auditor be responsible for the accuracy of this information, or for at least seeing that it is not leaked to special groups? Should the auditor be responsible for making sure that relevant information that will bear on future returns be made available to the public at the time that audited reports are made available (or even more frequently)? To what extent should non-accounting economic information be reported and audited? For example, planned advertising and R & D expenditures, contracted changes in wage costs, managers' estimates of future earnings, planned changes in financing policy.

   Empirical evidence indicates that the market, in setting stock prices, can see through alternative accounting methods. Nevertheless, the cost of "seeing through" accounting changes or alternative accounting methods is not costless. Might not costs be reduced (returns increased) if the cost of restating financial data is borne once by the accountant, rather than individually by each user?

D. Risk. Very little has been done to link accounting data to risk. Some work has been done on the prediction of Betas from accounting data. While most of the variables used as input to the prediction process are already reported, two are not:

1. The past level of Beta itself.

2. The insensitivity of the firm's earnings to the average level of earnings in the economy (earnings Betas).

Should the auditor see that these measures are included in company reports?

To what extent should the auditor help the investor assess risk by reporting probabilistic information when data is subject to uncertainty?

To what extent should the auditor be responsible for reporting major uncertainties in the company's future?

Since the tendency of the returns of a firm to change with the returns in other companies is a major input to many portfolio models; to what extent should audited statements contain measures of the extent to which the returns of a firm vary with its industry and other industries or economic sectors?

Discussion Leader, Martin Gruber

I guess I should start with a disclaimer. When Mike first asked me to talk about this topic, I found it an interesting one. My background is in financial theory rather than in accounting. In fact, before this morning, I'm not sure I knew what the job of the auditor was; perhaps, I still don't know what the job of the auditor is.

But I would like to start with a few words about portfolio theory in general. I might note that there are three widely accepted texts on portfolio theory which have come out in the last few years. Not one of those texts mentions accounting data or financial data at all.

There are three theories of portfolio management, which make different amounts of assumptions about the perfection of capital markets. The capital asset pricing model really states that equilibrium exists in the capital market at all points in time and that all investors should hold the market portfolio of stocks, should not trade, should not try to make any judgments on information. The single-index model, another model which has gained wide acceptance in recent years, is popularly called the Beta model. It holds that if investors have, or believe they have, some forecasting ability, they will hold a portfolio which is widely diversified, but not perfectly diversified. This portfolio will tend to mirror market movements, and the only risk in the portfolio is that concerned with how sensitive are movements of stock prices to market movements. We can capture the risk and return by looking at the forecasted returns for each stock, plus the relationship of each stock to the market. And finally, there is something we call the Full Variance/Covariance Model, which says that holders of small portolios must be concerned with non-market related risks as well as market related risk. They have to look at the uncertainty associated with the return on each stock, and the way stocks tend to move together, the co-movement between each security.

The Capital Asset Pricing Model makes a set of very strict assumptions about the way the capital market works. It assumes things like homogeneous expectations, and the fact that investors can lend and borrow at a riskless rate of interest. However, despite these horrendous assumptions, it appears to be a very good approximation to the way capital markets really behave. Furthermore, in the past few years, we have seen institutional investors act to an increasing extent as if they believed in this model, the increasing use of index funds for example, which are basically funds that are meant to replicate the market portfolio, the total group of stocks out there. Several pension funds now run index funds and invest part of their money in the market portfolio. Private institutions are offering index funds to customers.

The other extreme is this model that says you have to look at the risk between all securities. Recent empirical evidence on investment behavior by individuals has suggested that the bulk of individuals that hold stocks hold portfolios that consist of two or three stocks, which would suggest, at least in terms of behavior, that there is some reason to measure the relationship between stock prices.

Even if we believe in the Capital Asset Pricing Model, this doesn't say that there is no role for the auditor, because the price of funds in this model is a function of perceived risk.

(PAGES 157-166 INADVERTENTLY OMITTED IN TYPING)

To the extent that auditing lowers the perceived risk in holding securities, it lowers the cost of funds to corporations and can lead to a better allocation of funds in the economy. When we talk about any of these models, we have to tie back into the efficient market hypothesis.

Let me, more to provoke you than anything else, tell one of my favorite efficient market stories. I recently had occasion to run some seminars in Europe on the state of capital markets in Europe. One of the more interesting speakers came from Austria. He described the Austrian stock exchange. The Austrian Stock Exchange consists of 24 stocks. Ninety eight percent of the outstanding stocks are owned by two banks. The whole stock exchange consists of 3 clerks who keep transactions in large ledger books by hand. Every stock is traded every day, because if the stock isn't traded, naturally the subsidiary of a bank will sell a share back to the parent of the bank. So we have a recorded price each day. The law requires that annual reports be reported to the public within 3 years from the close of the fiscal year. However, it specifies that if there is any reason for not reporting it, such as the director is out of the country or one of the directors is ill, you can have an extension of from 3 to 5 more additional years before the information is made public. There seems to be a large incidence of sickness among directors in Austria, so, a typical time lag between the time the fiscal year closes and the time the information is reported is somewhere between 5 and 8 years. (WN: Does that system work any worse than ours?) Well, the efficient market tests show that that market is totally efficient. We have run the full set of efficient market tests, and we concluded that that is a perfectly efficient market.

There are other anomalies going on in the economy such that once a year the banks are valued and they are valued according to the market value of the securities they hold. The timing of the valuation is random, and prices usually double immediately before the valuation process. Again, we get efficient market tests. So, that while I believe in efficient markets, I think we have to be careful in what we mean by efficient markets. Markets are efficient with respect to the information that is reported in the economy. That does not imply that markets could not be made more efficient by making the information flow to those markets more efficient. I would suggest that the standards in Austria do not represent perfect accounting standards, even as little as I know about accounting. So, I guess I would, having listened to the proceedings this morning, caution against believing that, because we find efficiency tests in the United States, the auditor's job is done perfectly and that all information which is of potential use to investors is already there.

Another point that struck me had to do with the cost of processing information. We have a certain amount of evidence in the literature that the investor is able to see through different accounting methods, providing we footnote, and make known what is going on. There are costs to seeing through alternative accounting methods, and it is not clear to me that some of these costs are not better borne once and for all by the accountant than many, many times by each of the 300,000 investors who are sitting out there in the market.

Finally, I return to risk and perhaps make two points. One is that I see one of the key roles of the auditing function as attempting to decrease risk and make the market more efficient in that sense. And second of all, I wonder about the possibility—and I may be wandering from the auditor's role to the accountant's role—but I wonder about the possibility of making probabilistic information available to investors. That is, it seems to me that a lot of work goes into taking a certain amount of events, which are at best uncertain in nature, and trying to reduce those to a single number and throwing away all the information that we had to absorb and work with in reducing that to a single number. It seems to me that this information that we are dealing with in portfolio analysis is extremely valuable to investors.

Well, I have listed some more points in my outline, but I have covered the ones that I find interesting at this point.

GENERAL DISCUSSION

Chairman (DRC): Could you explain to us what you mean by decreasing risk?

Discussion Leader (MG): In a portfolio sense, if we are holding small portfolios, what we ideally like to be able to ascertain or be able to hold are stocks whose price movements do not move in unison. If we buy a— in very simplistic terms— if we buy a company that runs ski resorts in New England, we would also like to buy a company that operates a summer resort in New England, to protect ourselves from the variances of weather. Gold stocks are typically held out as examples of stocks that tend to move counter to other stocks in the economy. If we buy a portfolio that is composed totally of automobile stocks and companies that sell products which are related to automobile sales, we are exposing ourselves to one type of risk in the economy.

(RK): How can auditors reduce this kind of risk?

Discussion Leader (MG): I'm not sure that they can reduce it, but I believe they can supply information on it. (MS: Like what?) Well, in recent years, out of the accounting profession has come, for example, a lot of attempts to measure the sensitivity of a company's earnings to the sensitivity of earnings in the economy. That is a valuable piece of information reported upon in the economic-financial literature. It might be worthwhile thinking about and incorporating that information in accounting statements.

(RE): That is an accounting question now, not an auditing question.

Discussion Leader (MG): Well, I guess I view the role of an auditor as saying, not just, has the accountant done his job, but what job would I like the accountant to do. Not being an auditor, I can't make that distinction.

(RE): On an individual job basis? In other words you think...

Discussion Leader (MG): No, set standards across companies for what type of information do I think is relevant for investors, and I will be concerned with investors, because that is my thing to look at.

(MS): Well, I think it is fair game if we are looking at the problem of what extensions of auditing might be useful, as we have the whole day. If we constrain ourselves to what is the current standard in accounting then we narrow our objective. I think what is being inferred here is a kind of analysis of a sort of a profit variance, based on externalities, macro economic factors, perhaps, versus the industry versus the micro.

(RK): That is based on publicly available information. I could go home and in a week could publish a list of the accounting Betas for all publicly traded companies. So, I'm not sure that that is a particularly interesting question to focus on, because it is basically operating on publicly available information.

Discussion Leader (MG): Well, it is publicly available information. I could walk into Merrill Lynch, for example—

Merrill Lynch sells rate of return Betas— I could walk into Merrill Lynch and I can buy rate of return Betas. If I'm an institutional customer, I can purchase an evaluation service and pay $80,000 a year in commissions to get that service. The question is whether the auditor, who can make that service available at considerably less than $80,000 a year per customer, should make some of that information available to the public.

(EH): I guess we would agree that that is a question.

Discussion Leader (MG): Yes, I'm putting it forth as a question; I don't have an answer.

(CW): I have an answer. How much credibility do you want to attach to what Merrill Lynch publishes, to those accounting Betas of all those companies? Do you want our certificate on it? Do you want the public to really believe that stuff, that those accounting Betas are all alright? What was the accounting Beta on Equity Funding?

Discussion Leader (MG); If you are talking about replicable, historical information, you have a piece of replicable, historical information, now. Do you want to make a value judgment that that information is nonsense, and shouldn't be reported on by the accounting profession? I don't believe that it is nonsense.

(CW): You missed my point. Let me just come around one more time. One of the things we all hold precious, I think, as auditors is the attest function that we are involved in. If we get involved in things where we are not expert but would reflect on our general credibility and get us tangled up in things that we really aren't able to do very well, it is going to reflect on the attest function. That is one thing. Now, so long as we are involved with the attest function, if we put our name on something like the Merrill Lynch accounting Betas, what is that going to do to our credibility and the other work we are supposed to be doing in the public interest? I guess there is an implied answer to my question.

(MSh): I don't think Marty is saying that you should do that. I think—and maybe I'm adding a little something to you Marty, and you may disagree with me, correct me if that is the case—I think the substance of Marty's remarks for auditors is the following: estimation of Betas is a problem outside the realm of auditors, but estimation of Betas may depend on accounting information, which could be made more reliable by auditors. So that the auditor's role lies in that.

(EH): I guess that isn't what we heard.

(MSh): Okay, what did you mean to say, was it something like I threw back at you now or something different?

Discussion Leader (MG): It is something that perhaps I can make clear in this sense. Perhaps I'm expanding the role of this group beyond the role that they want to play, but it seems to me that the important thing that we have hinted at a lot this morning, and haven't really gotten to is, what is the value—we are going to talk about cost-benefit analysis, perhaps in a more restricted sense—but what is the value of information to the users of information? We can say we believe in the efficient market hypothesis, and it doesn't really matter if we expand the information set that is provided. But I think a key role that we should be looking at is supplying information that is valuable to the users of that information. And if I were an auditor, I would want to have some sense of value when I looked at what I put my time and costs into replicating. If a piece of information isn't valuable to users of information, I wouldn't be terribly concerned with making sure that I measured that to the penny, whereas if information is extremely valuable, I would be concerned with it.

(EH): Would you believe that we attach a tremendous sense of value to placing our signature on that single piece of paper in which we express an opinion on a set of financial statements? Would you believe also that we have no overwhelming desire to compete with Merrill Lynch in reporting Betas nor do we see a need to do that just because we can do it cheaper?

(JR): I go along with Mel in saying that this highlights that portfolio constructors, people who construct portfolios, the first party investors, want to estimate the expected return on a stock and the risk, the systematic risk. Now, not much attention—in fact, no attention at all—was paid to the uncertainty of information used in making these estimates. and I think what follows, within the efficient market findings, within the portfolio model, is that the auditor's role would be—the auditor would fulfill a beneficial social function by—reducing, improving or enhancing the accuracy of that accounting information which goes into the formulation of expected returns and risk.

(CW): Yes, but see what you want to do—what you want to do—is to change our role. I didn't go into public accounting to become an investment advisor. If I had wanted to do that, I would have joined Bill Norby's group. I went into this profession thinking that what I would do is be engaged in the attest function on historial financial statements, and suddenly find that I am being asked to get involved in a whole predictability process and that I'm supposed to make all kinds of normative judgments, some of which—listening to what has gone on here today—aren't even in the financial area. They have to do with management performance, best use of assets, etc.

(LL): Chuck, if 10 years from now, the investor is placing 90% of his reliance upon forecasts instead of historic statements, we don't want to be like the guy who was shoeing horses when the automobile was coming in.

(CW): We are already doing that, according to the empirical accounting research studies. These guys can demonstrate that that is already the case. All the annual report does is confirm what has gone before. We don't provide all the information which is of value; we just provide some little part of that that is attested to and confirms what happened in the past. That is what I want to do, and I think we can do it well. If you make me get into the rest of that, you are going to destroy my basic function and my credibility probably.

(MSh): When people cease to believe that you are supplying information which is substantially valuable for their decision, you won't get paid. That is why, before we can answer the question about what auditors do, we have to think about the uses to which the information is put, that is, we have to think about the decision models of users of information. Marty is saying, here are some decision models; one of the models deals with estimation of these Betas. He thinks, perhaps, that Betas can be estimated using accounting data. If that is the case—so so far, you are not in the picture at all yet as an auditor—if that is the case, though, where does he get the accounting data? Well, presumably he uses data which has been audited, and hence the quality and reliability of that data is better than if it wasn't audited when it is used and Betas are chosen and decisions are made. So, you are an important guy because you are supplying the right information upon which the rest of the decision process follows.

(JR): Otherwise, what is the objective of the attest function?

(RE): Let me take another crack at it.

(CW): It is to confirm the historical results, period. I don't visualize my function as analyzing them, giving you a predictability quotient, or anything of the sort.

Discussion Leader (MG): I'm not asking you to analyze them, and I'm not asking you to predict in this one instance. There may or may not be value there. That is a separate issue. What I'm saying is that you should—what I'm asking for is—ascertain what aspects of the historical information are important to investors.

(GB): What if the answer is none? What evidence would you be satisfied with if the answer is yes?

Discussion Leader (MG): Well, I guess I don't believe that the answer is none, and I will use your own argument, George. If the answer is none, we wouldn't have auditing firms.

(GB): You go back to what was just said. The function of the auditor, at least in part—I personally believe it is almost the whole—is the attest function, namely, to confirm what people otherwise know, and further than that, to uncover mal-uses of resources. And I completely agree that it is an extremely difficult and important function.

Discussion Leader (MG): It is not clear to me that if we didn't have auditors, if we didn't have accountants, that they would know that. And one of the reasons people know it, one of the reason things are made public, is because that auditor's statement is going to come out.

(WN): You could have nonaudited statements, and the information of a sort would be out.

Discussion Leader (MG): It might not be out as accurately as it would be in the presence of auditors.

(WN): Okay, that is the marginal value of the audit, per se.

(GB): Shall we move to a situation where we audit every other year? Is that enough of a discipline on the system?

(MSh): That is a matter of costs and benefits. In other words, I think that the big point which Marty is making is the tradeoff Betas and that kind of thing. The big point, if I can generalize this a little bit,is this: that it is important for auditors to be aware of how users make use of audited information, that is, be aware of what are the decision models, the decision processes. You don't have to invent the decision models, but you should be aware of them. Aware of what is going on. And if these in fact are the decision processes being used, and if you supply—as I believe auditors do supply—key information which is part of that process, then you are playing an extremely important role. The attest function is probably very important

(EH): Excuse me, can I interrupt a minute? I think it is fair to say that we auditors do not believe we supply any information except information as to the credibility of information supplied by somebody else. Is there any auditor here who disagrees with that?

(MSh): That is worth a lot, though

(EH): Fine, but that really, I think, is not the way in which you were using the expression, "supply information."

(JR): "Supply information on the accuracy of that information," what does it mean otherwise to confirm?

(WN): When you look at the accounting profession, which includes auditing and accounting standards, the accounting standards are certainly having a lot to do with the kind of information being supplied.

(LL): We have some small practitioners who don't understand what you just said.

(EH): Setting accounting standards is a job which we all recognize has been delegated to the Financial Accounting Standards Board, which is not part of the accounting profession. We are talking here today about auditors as auditors, but not always. More often we slip over and talk to the question of what the accounting principles should be, what information should be provided by financial statements? And this is at the heart of a great deal of the difficulty we have.

(JR): Are you saying a different thing? You are confirming historical results. You would agree to that definition? Now, what does that mean to "confirm?" To confirm means that you are providing, as far as I'm concerned, to me, as an investor, information on the accuracy of that information. Now, if that is the case, and if...

(EH): Right, but not as to the content of that information.

(JR): Well, I find it difficult to talk about accuracy of information devoid or regardless of content.

(EH): I'm sure you find it difficult, yet it is necessary.

(JR): But if that information is purely historical, then investors will not need any information on accuracy. The only reason that investors need that historical information is because it is of value to future decisions and therefore to prediction.

(MFC): This may be a digression, but what you said raises the point for me. You said that the auditor doesn't supply information. Well, I suppose, when he writes the "subject to" opinion, he may be supplying some information.

(EH): Well, he is supplying information about information.

(MFC): Right, exactly. And to choose another example I know we have Sandy Burton saying that the auditor is a partner, at least, in the sense of determining the form in which information is provided. Would you accept that view? If you accept that view, then there is an auditing role.

(EH): Not necessarily. I may not sound this way, but I'm willing to see the auditing role expanded in any reasonable direction and to any reasonable extent. I'm also insistent that, as we do that, we gear our thinking to a distinction between, on the one hand, the identification of the information that is to be presented and the question of what we are proceeding under, as companies present that information, and, on the other hand, the obligation of the auditor in the attest function, which is not to decide what has to be presented but rather to decide whether that which is presented meets certain identified standards of accuracy or whatever.

(JR): How do you make materiality decisions?

(EH): With great difficulty. We hope that in the fullness of time we will have some advice from the FASB under its current project.

(GS): Well, in the meantime, we have the obligation to decide what fairly present is.

(EH): "Fairly present" means in conformity with GAAP.

(GS): I understand, but there are many gaps in GAAP, so that we have to make the decisions. The decisions that we generally make are not those that GAAP specifically identifies but those that fall within the cracks of GAAP. And in that sense, let's just explore what Marty says, it may have certain implications for auditing. And I don't know but I'm just raising that as a question, in the following sense. It may have implications in the sense of what we as auditors are willing to allow to be lumped together, to be aggregated together, or what we insist is reported separately. And there I think that we could decide that, for instance, an assessment of how things vary in relation to the industry or the economy would lead to certain suggestions, namely, that things that vary in—certain activities—that tend to vary differently in relation to the economy and the industry must be separately set forth and can't be lumped together with those things that vary in the same general way as the economy or industry which can be lumped together. I would say that if that is an important thing, then by lumping all different things that vary in different ways in terms of the industry—and let's not talk about Betas or anything else—we say now that really wouldn't fairly present. Can that give us some guide as to the level of classification or disaggregation which we are going to insist upon or which we are going to allow and so on? That is not far beyond our role as auditors.

(EH): I really can't respond to that, because it was much too long a question, but my friend Mr. Werner apparently understood it. So I will defer to him.

(CW): What George is suggesting, for example, is that we take a part public companies' earning statements and disaggregate the data, for example, on discretionary costs, and provide that information—just so the academics understand what it is we are saying as auditors. But what I don't want to do is come up with a value judgment at bottom. I think that Betas are out. I'm perfectly willing to break this data a part and report as facts.

(GS): Chuck, I agree with you 100 percent, because essentially the financial statements are only part of the information about a company and they are the part about the actual activities of a concern which you really can't pick up from other—well, not as effectively—from other sources. But, I think, we must pay some attention to how these are packaged, how they are aggregated, how they are disaggregated, and what fairly presents about those—that limited set—and thus, I think, we must pay some attention to these issues that Marty raised.

(CW): Yes, I agree; I will go this far with you. We do package in the earnings statement uncertain income, uncertain revenues. Things that are very close to a cash term we package with things that are very far from cash, and I think, indeed, that we should start to disaggregate those things. But if you want from me predictability and interpretation, that is what I don't want to do; I don't think that is my business.

(WN): Well, the president of the AICPA is suggesting that maybe that is the next role of the auditor.

Chairman (DRC): No, he didn't, not in his last speech. In his last speech, he said that management should furnish the interpretation and that the auditor might read and review that but would not interpret the data.

(WN): My statement was accurate with respect to a certain point in time.

(EH): Bill, maybe somebody talked to him in the meantime.

Chairman (DRC): The speech that was published in the last issue of the Journal, the last one he made.

(RE): May I ask a question that I think is about what Marty is talking about? If you look at the way information comes in to the prices reflected in the market and so forth, we have a situation here where accounting represents only a small part of the information that goes into the valuation of securities. The question is one that hasn't been addressed except by Chuck and then in the negative sense of saying that he didn't want to go beyond the historical information that is disclosed. Let's say that, on a scale of 0 to 100, 100 percent of the information enters into security prices and that we auditors are now working on 10 or 20 percent of it or whatever percentage you care to use to reduce the uncertainty connected with that. That is fine; if that is what we do today, let's forget that. The questions that I think you have to ask are: Is there a role for the auditor in reducing the uncertainty connected with the other 80% of the information which enters into market prices? And if the auditor is the most efficient way to reduce uncertainty with respect to one part of the information set—that is, he can do it once for the benefit of all stockholders—is there theoretically any reason why he shouldn't be exercising the same type of efficient reduction of uncertainty with respect to the rest of the information set? Now, Chuck has expressed clearly his view that he as an auditor doesn't want to get beyond the part of the information that he deals with but I as a practitioner would like to state that I represent, maybe a different constituency among practitioners who feel not only that they would like to get involved with the rest of this information set but also that the financial information is becoming less and less relevant and that I, personally—I'm fairly young, as you can see—am not interested in being in a buggy-whip industry. I think that our future is in the rest of the information set. I think that that is implicit in this whole market pricing question, and we haven't really addressed that.

Chairman (DRC): You have to perceive it properly because now in the current moral climate, S and M are coming in and whips are coming back.

(RE): Well, I don't think it's going to be as big a market as...

(RK): One of the problems we are encountering here is called the "kinky" demand curve

Chairman (DRC): That was really a lead into a break; we need a break. Let's take a five-minute break.

Chairman (DRC): I promised to allow a couple of people to comment, before we move to cost-benefit analysis. Bob, do you want to say something?

(RH): The reason I wanted to get it in here was that it ties in with portfolio context in the sense that if we do look at the auditor as someone who is trying to minimize the possibility of a report being issued that is fraudulent or something such as that, individuals, in a portfolio context, may be able to diversify away from that same type of risk. Although I know of no research looking into that question, it would seem to be a very logical way to approach the issue. In the same sense that in the portfolio context, as far as the underlying business risks to the firm are concerned, we can diversify away from a lot of that. If we have a sufficient spreading and the same kind of context for the risk of reporting errors, we may not have as big a problem as we think, if we can find diversification to reduce that risk.

Discussion Leader (MG): Individuals can diversify away reporting errors. At the same time, although that takes some of the bad effects away from reporting errors, it doesn't mean that we are as well off whether we have reporting errors or not, because in that capital asset pricing is the amount of risk in the market and the market price of risk. If we have more errors across the economy, we don't worry about them. What you are doing is changing the amount of risk.

(RH): I guess what that would seem to convey, then, would be that we would want to look at the average level of risk instead of looking at specific firms. Much like portfolio analysis suggests that we shouldn't be spending a lot of money looking for underpriced stocks, maybe we are spending too much money looking for the Equity Funding, looking for those kinds of frauds, when we should concentrate more on specifying some average level of risk that we want to exist in the economy for reporting errors and designing auditing standards that should try to accomplish the realization of that average level of risk.

Discussion Leader (MG): I think this gets into the cost-benefit analysis, and perhaps one point I did not make as well as I would have liked to, which is the fact that the auditor really has a scarce resource to allocate, namely, his time or the amount of money he has to work with. I meant my brief talk in part to be a plea for trying to discover where that scarce resource was best spent, the areas in which we are most concerned with eliminating errors.

THE COST BENEFIT ASPECTS OF THE AUDIT FUNCTION

Outline of Issues: Prepared by Robert K. Elliott

I. Background

   A. The cost-benefit aspect of the auditing function has not been clearly defined.

   B. Research on this subject is badly needed.

      1. Benefits have not been fully identified, much less quantified.

      2. Nonauditee users, who constitute the bulk of the consumers of the audit product, rarely in today's audit practice contribute directly to the payment for the audit.

II. Further research is necessary to precisely define cost-benefit relationships, but the following specific items are readily identifiable:

   A. Costs

      1. Auditors' salaries, fringe benefits, overhead, and profit, which are typically paid by auditees.

      2. Disruption in normal routines of audited entities, which are typically absorbed by auditees.

      3. Additional records and systems that are required to satisfy auditability requirements, which are incurred by auditees.

      4. Litigation costs (as distinguished from awards) arising as a consequence of audits, which may be incurred by both auditors and auditees. (Litigation awards may wind up being costs to auditors and auditees and benefits to users.)

      5. Losses incurred by information users that result from reliance on information because it had been audited but nevertheless was erroneous.

B. Benefits

1. Improvement in decision outcomes that result from the increased usefulness of information that has been audited, which accrues to information users.

2. Improved allocation of economic resources, which accrues to all members of society.

3. Motivational impacts of an audit. Auditee personnel may make greater effort to avoid intentional or unintentional errors if they know their work will be audited. This benefit, which involves both the improvement in the accuracy of information and reduction in losses from defalcations, is shared by the information users and auditees.

4. Professional advice provided by auditors. During the course of audits, auditors often assist auditees by identifying ways to improve the efficiency and effectiveness of the audited entities. Assuming that action taken as a result of auditors' advice causes no impairment of auditors' independence, this benefit accrues to auditees with no cost to information users.

Chairman, Douglas R. Carmichael

Bob, can you give us a brief background on your work on cost-benefit analysis?

Discussion Leader, Robert K. Elliott

Well, I feel that I have a definite advantage here over the three individuals who led the previous sessions, in that in each case, there was a body of research and there were facts established by the research. I'm in an area where there has basically been nothing done, and therefore almost anything I say is, at least, plausible. That is a part of my problem. So many of the discussions that have come up today at one point or another, we get back to the question of the cost of having audit involvement in these areas versus the benefits. So, my section here is to look a little bit more explicitly at this question of costs and benefits.

The costs to some extent are defined, and I have got them listed here under costs, at least some of the ones that you can clearly think of. There may be other costs, too, that aren't so obvious. There are costs that companies have, for example, when by divulging more and more information, they give their competitors advantages over them, and those costs, opportunity costs and so forth aren't captured here. But at least the direct costs are here, and these include auditors' salaries and fringes, and so forth, in the form of fees. Although this audit benefit is really for the benefit of not only the present owners of a company but also future owners and, in some respects, society at large, the fee is nevertheless borne on behalf of all those people by the company itself. Now I understand that one of the issues under consideration is the way in which this function should be financed, but at least presently, auditees pay these fees. So that is one of the costs.

Another one, which is not negligible, is disruption in the work routines of the auditees, because we come in and ask a lot of questions and disturb the general routine. There is some cost there, which I suppose, if you wanted to investigate, you could get an order of magnitude estimate on that. There are systems that companies maintain that they probably wouldn't maintain at all if they didn't know that we were going to come along and audit them, so, these are costs which are imposed. There may be offsetting benefits there, too, because management may get some benefit in terms of better information internally, but at least there is a cost in maintaining these systems. There are litigation costs, which may be borne by the auditors, may be borne by some of the others, but these are certainly some of the quantifiable costs involved because of the attest function.

There are losses that information users incur, because they rely on information that they thought the auditor had gotten the imprecision out of but in fact had not. Those costs are getting into the realm where they are pretty difficult to measure. For example, let's say that through an audit error in a very simple case, the financial statements were wrong and I, as one owner of a company made \$10,000 that objectively I shouldn't and Doug lost \$10,000 because he was on the other side. What is the cost involved there? It is not necessarily \$10,000 because to the rest of you there was no cost or benefit. It is only between the two of us and the distribution of our resources, so it is a little difficult to put a number on that cost that means anything relative to the broader picture of how society costs out this audit function. Well, those are some of the costs.

On the benefits side, the benefits are more nebulous than the costs in general, I suppose, if you want to get down to a quantification. But there is the improvement in decision outcomes that comes from having better quality of information available through the audit process, and this benefit goes to the owners of the securities, basically, present and potential, as they get into it. There is the improved allocation of economic resources because, after all, the grand total of all the individual investment decisions represents the macro-economic investment decision and to the extent that that is a better decision in the aggregate, that benefit accrues to all the citizens, whether or not they are stockholders. There are motivational impacts of an audit which I have referred to earlier today as a deterrent effect. In many cases, management will behave differently because they know that their actions are subject to review annually, and any discrepancies will be publicized, and that is a very significant benefit which is shared by really the information users and to some extent the companies being audited themselves.

Then there is the fourth one, which is a side benefit, and that is that the auditors are experienced because they go around and see many different companies and typically what they do when they look at an individual entity that they are auditing, if they see inefficiencies or poor business practices, they will point these out. There is very little additional cost involved in doing this, but there may be a significant benefit to the auditees in terms of the efficiency of their operations, assuming that the auditor doesn't in some way lose some independence by this—by making suggestions which then later put him in a position of having to report on the implementation of his suggestion. And you have all these independence questions, which most of us who are in auditing feel do not significantly detract from independence, but nevertheless, the perceptions of outsiders are also important here and have to be considered. So, there is that possibility there.

Really, these costs and benefits are different enough to quantify, but even if we could quantify them, we might not be able to answer all of these audit questions, because we can't really make decisions here unless we have some set of values that we are trying to work to as a society. Now, let me give you an example. In a socialist economy, where all the resources are owned by the government for the benefit of the people, the resource distribution question—who owns the resources—is not even a question that comes up because there are no shareholders, per se, no trading going on. So, the information errors don't really distribute assets erroneously between Doug and myself at all. So, that aspect doesn't even come up in a socialist economy, whereas in a capitalist economy that is a significant aspect of it. Obviously, in those two different types of economies, you would be paying for different purposes for having audits. Now, most types of economies do have an attest function, an audit function, but they are there for different reasons.

So, really, there are basically these two outcomes of having audits, as I see it, at least. The first is the question that the improved reliability of information results in better resource allocation over the whole economy, and those benefits go to everybody. The second is that auditing reduces the misallocation of income and wealth between individuals, that just come up because of either random or deliberate fraudulent errors in reporting by companies. If you are going to make cost-benefit choices, you have got to decide between the two of those, because in some cases, they are inconsistent.

Let me give you an example which already came up today, and that is the question of: should the auditor act as insurer against investment risks? The basic concept here is that the auditor is in a position to indemnify those who made wrong decisions based on information errors in the financial statement—let's say he has got to pay out X dollars per year for that purpose. So, all the auditor has got to do is divide that up, add it to his fee as in effect, an insurance premium on top of the fee, charge it, and he will act as a sort of the Blue Cross of the investment world. He will collect from everybody and distribute to those who suffer a loss. Well, that has been seriously proposed, I guess, by some people. But what you have to look at is that that view of things really very much goes toward the second of the functions that I have outlined, that of minimizing irrational redistributions of wealth based on bum accounting data. The other side of it, if you look at the resource allocation question across the economy, is that if the auditor is an insurer against investment risks, such that all investment risks are reduced, in fact, if they are ultimately insured against all risk, all securities would sell at the same price as Treasury Bills, because they would all have virtually no risk. In this type of case, where all investments sell at the same risk level, there is no incentive to people to invest in things which are socially beneficial or which maximize—whatever you want to maximize, GNP, or whatever—and so therefore if we insure it to too great an extent against investment risk, which helps them on one side of this equation, we may in fact degrade the performance of the economy as a whole in terms of the way in which it allocates resources. And so therefore, you have to decide, when making the cost-benefit trade-offs, which of those two is more important to you.

If you look at the way the courts and the SEC are operating, it is clear that they prefer to minimize individual investment risks. In other words, if you look at all the litigation here, you find that it is between people who feel that they have been had. In most cases, a plaintiff is coming in and saying," I lost money because of bad information, so I want to recover it from somebody." All of this legal activity really is to minimize this random redistribution of wealth because of accounting errors, and we really don't see much activity in the legal sense aimed at the resource allocation question. But, given that we have to make some choices in this area, we really can't do it in the absence of some societal goals and values.

So, it just seems to me that in answering these questions about what is the proper role of the auditor, we can't ask them in a vacuum, but we have to ask them with respect to some defined goals that we have within the economy as a whole. It depends on how those choices come out, and I really don't think that it is the proper role of auditors to make those choices. I think that that is the political process, as to what are the important things going on, and it is based on that process that the proper role of auditing, among many other things, has got to be determined.

So, about all I have done here is to list off some of the costs and benefits in a qualitative sense as a basis to get the discussion rolling, but there has been very little work done in this area that would help us to quantify these at the present time.

General Discussion

(MSh): Bob, I think that you presented a pretty clear statement about some things that we have talked about this morning and kind of dropped. For one thing, I think you are saying that we really have to look at the whole economic system, given that we will never make it all the way from that up until what the auditor should do, within say, the life of this Commission. Even that being the case, I still think we would do better in terms of anything the Commission might come out with at this point, if we keep that in mind. Because just because we don't have a strong handle on this whole economic process, that is not to say that we don't know something about it. We do know quite a bit about, at least in terms of an outline, how information is, or could be plausibly used. We can't prove it; we can talk about how information may well be plausibly used in the overall question of resource allocation in the national economy. We have to keep that in mind because, as soon as we talk about the auditor's role, we are starting to compartmentalize.

Let's look at the total flow of information because you can't completely ignore the question of what is happening in the overall system when you are an auditor. Nobody is going to tell you that this is what you are supposed to do, and you wouldn't be content in simply doing it, because nobody is smart enough to tell you what you should do. On the other hand, I don't think an auditor would want to be totally relegated to that situation. The plain fact is that the boundaries of auditing cannot be precisely defined anymore than the total understanding of the overall system can be defined. But, having said on the one hand that we can't do it, on the other hand, I think we can, because I think we do know enough about the overall economic process I think we can trace—certainly conceptually—and I think we can slowly begin to quantify. We can trace the flow of information. We can talk about how firms make capital budgeting decisions. We can talk about how capital markets provide capital through efficient terms. We can talk about the role of information in this process. Then, we can talk about, how do we insure the reliability of this information, which is getting closer to what the auditor is after.

But I think that in order to talk very practically about what the auditor really does, we really can't ignore the overall process. That is one of the things I read in your statement and that is that whatever comes out about what the auditor does, unless it tries, even imperfectly, to relate this to the question of the overall resource allocation in the economy, we are not going to be able to make our best efforts at this definition. At least we should feel that it is consistent with whatever understanding we have about resource allocation in the economy.

Discussion Leader (RE): You can't do that without some reasonably explicit statement about what you are trying to accomplish.

(MSh): Well, you can do that. Let's say you want to maximize GNP, then you talk about how is GNP generated and it is a long chain.

Discussion Leader (RE): Let's take the assumption that what you want to do is maximize GNP. Therefore, you are interested in optimal resource allocation; you really don't care who owns the resources. That is what you said; that is your only objective. You really don't care who owns them.

(MSh): Suppose you list several objectives. You might list maximize GNP, and you might talk about...

Discussion Leader (RE): You might but that is my point. You can't make these decisions unless you are willing to state what you are trying to maximize or optimize.

(MSh): Right, you have to list all your goals. You are saying, okay, that the minimum goals have to do with generation of total wealth and distribution of wealth.

Discussion Leader (RE): They are two that you can think of pretty quickly.

(MSh): Yes, but as you and I have talked privately on other occasions, the question of distribution may be of less importance if everybody holds a diversified portfolio.

Discussion Leader (RE): That is right. You can diversify away the risk, but the whole legal system acts as if we were doing exactly the opposite. It is holding us accountable for individual risks—when the market—when all this information we are talking about--George and Bob and Marty all bring up information—which tells us that, as a public policy matter, that is probably misdirected.

(MSh): Well, maybe you can convince everybody to get off the hook and say: "Look, everybody should have diversified portfolios. That being the case, don't sue us when we go wrong on one company, as long as we apply the reasonable principles that have been agreed to."

Discussion Leader (RE): Well, one of the things I think that would be okay in some sense is to say that it is up to people to diversify away their risk, but, on the other hand, I think the auditor has to be faced with some possible penalties to give him the incentive to do a good job. Now, maybe what you want to say is, that instead of having this random system where plaintiffs, if they happen to prevail in court, can collect from the auditor and that provides the incentives, maybe you ought to say, "the hell with it, investors can never collect" but we will set up a fine system--the government will collect a fine if they find auditors misperforming. Now, there are other ways to structure this, and although the Cohen Commission does not have the authority—at least it is not obvious that they have the authority—to change the legal system in this country, at least if they make observations along these lines, presumably that might have an impact on future developments. But if they don't make any observations at all in this regard, then there is no hope that they would have that type of influence on future developments. This is to some extent, I guess, a little too abstract.

The problem—getting back down to the decisions that the Commission has within their range—the problem is this. They have identified a group of issues: Should the auditor be responsible to detect management fraud? Should the auditor address himself to interim financial statements? and so on and so forth. There is a group of issues, and they are outlined in that booklet. The problem is that if you look at these things strictly from a standpoint of moralistic reasoning, you could say: "well, fraud is bad, objectively bad in our value-system; we don't want it, so the auditors ought to find it. So, let's vote, and we find that the vote is 7 to nothing on the Commission that the auditor is responsible for fraud." Now, that could be done; and they could resolve all the issues like that and probably could dispense with them in one long meeting. But, does that make any sense without at least considering, what are the costs associated with finding this? So, it is in that sense that I think you have to address this cost problem. What does it actually cost? Chuck mentioned a figure, that we spend a billion dollars on auditing a year. I think that that is a lower limit, certainly. (CW: Public Companies) Well, I think that is low, even for public companies. We spend a hell of a lot of money on this. Suppose we said, "let's get into quarterly auditing, finding fraud and so forth," and to do this, we would have to spend another 2 billion dollars a year, which would imply, if Chuck's figure is right, that we would have to go out and buy another quarter of a million auditors. There is nothing too difficult about that; we could do that in about six months.

(JR): Relative to the Defense budget, this is nothing.

(CW): A quarter of a million competent auditors?

Discussion Leader (RE): No, just the same as today. My point is that it is too easy to resolve these questions on a moralistic basis without considering whether the cost is justified to do this, and if we could only get our hands on some of these costs and benefits, maybe we could at least make decisions that, although they weren't scientific, were reasonable.

(MS): We have danced around one thing quite a bit here today, and I think this might be a time to get to it. Forget the fraud, let's get back to the illegal payment bit. We sort of touched on it and left. On the cost-benefit notion, recognizing, I think we hear, that the securities market and their model is unaffected by disclosure of illegal payments, at least, so I heard. So, the benefit to the security holder is almost zero. You certainly have costs in pursuing this. How do you resolve this issue on what involvement the auditor should have in illegal payments, if you try to lean on the cost and benefit model for guidance so that this Commission can take a position on the specific issue of disclosure of illegal payments? Let's address that specific one because it is with us. It was mentioned earlier, and I think we sort of walked away.

Discussion Leader (RE): Well, on the cost side, we could probably cost it out. So, the real question is, what is the benefit?

(RK): It would possibly be a function of the level of payments you want to detect. If you want to detect a 20 million dollar payment to a corporation, that will cost a certain amount. If you want to detect a $1,000 payment, that will cost somewhat more. So, there is a whole envelope of cost functions, depending upon the level of payment you want to detect.

(MS): I would like to hear about the benefit, particularly to the security holder, the analyst, if there is a benefit there. Or else are we looking for other kinds of benefits, if there are any, if they can be determined? Do we have something with costs and no benefits? Won't most of our problem areas be in this kind of a situation?

(LL): Does the disclosure bring further costs or, rather, does it bring benefits or just further costs?

(MS): If there are more costs then we will stay on the cost side. I'm searching for a benefit for someone.

(WN): I think that, as you say, that the disclosure of these illegal payments does not seem to have any perceptible effect on the market; but, of course, there are a lot of other effects, a lot of other forces in the market at any one time, so it is hard to sort them out. We have a questionnaire in process among analysts, so we can get a little clue on it. I think in general, it has not had much effect. However, I would say that investors would probably rather invest in companies that do business the right way than the wrong way.

(MS): I have some question on that, because of the history of those companies which limited their portfolios to investments in companies which were concerned with environmental conditions and the rest. They didn't quite make it. So you say there is a preference to the investor in an "honest" versus a "dishonest" management.

(WN): I assumed all other things being equal.

(MS): Even other things being equal, I raise the question. This enters into the decision model.

(WN): Let me finish. I think that the substantive question here is the right of the corporation to exist in a private enterprise economy in which the public has confidence in it carrying out its operations in what it regards as an ethical manner. Now, the standards of ethics are going to change; and I think we have had a change here in what we regard as proper all of a sudden in terms of these kinds of payments to do business abroad. Maybe the next focus will be on payments we make to do business within the United States.

(MFC): They are in the works and will be coming out very soon.

(WN): So, the security holder has an indirect interest in maintaining a private corporation with a franchise to do business, and if society demands that corporations be audited to prove their ethical behavior, well then that is what you are going to have to pay for. That is about the size of it, as I see it.

(MFC): In the taxi ride down here today, which Bill and I shared, either he or I posed the example of a company whose business in a particular area was declining and it just couldn't compete very effectively with its competitors. They were considering closing the plant and putting 1,000 people out of work, and then someone suggested that if you take care of the purchasing agent of X,Y and Z companies, perhaps you could get some business. So, you have got the ethical question of is it illegal, or is it bribery? On the other hand, you would be putting 1,000 people out of work. And what does management do with that? Now, obviously that is a strange example, but it was used for our discussion down here in 20 minutes.

Discussion Leader (RE): It goes back to the statement of objectives. If you take as objectives maximization of GNP and minimization of distributional anomalies of wealth, you can't measure any benefit of honesty or dishonesty against those two objectives. If you had a further societal objective that we want to have some ethical standards, I think that is a value statement, that it is fine, and the people will probably vote for that, but then the benefits have to be measured against that, which is not a financial type of benefit at all. It is a separate societal benefit.

(DRC): There is the other side of it. There is one valid point raised about the corporate accountability system and the fact that when the means are used for one purpose, the corporation does lose control. The only case that I'm aware of that is public where that was true was Exxon, where the improper or illegal payments duly authorized by the corporation were exceeded in the Italian subsidiary by the payments that the head of the subsidiary went ahead and made on his own, unknown to the corporate hierarchy, using essentially the same means of payment as the authorized payment. So, the loss of accountability is a fact. I wouldn't necessarily equate that, as the SEC has, with materiality, in saying that because of that it is automatically material, but I think it is an important factor.

(MFC): This morning's Wall Street Journal had a story about Firestone Rubber. Which has all of that and a whole lot more—I mean General Tire, sorry.

(GB): In terms of the benefits, looking at it very positively and not making any value judgments, I think one can identify a number of benefits in terms of illegal payments. One is the externality so far as the nation is concerned, namely, what is the benefit of not permitting Lockheed to bribe Japanese officials? And I refer to Edwin Reichauer's column in Newsweek last week in which he points out that this is so contrary to accepted behavior in Japan, that it has caused the government to topple and, indeed, is very seriously detrimental to our relationship with that country. Now, that is an externality; it affects the rest of us, even though it may be in Lockheed's own benefit to have made the bribery. But then that becomes not something that an auditor is concerned with, it is something the State Department is concerned with. It has something to do with U.S. foreign policy; and there should be a role for the people who are charged with that responsibility. I didn't know that the SEC was in the foreign policy department, and I rather wonder whether it is their governmental responsibility to be concerned with that, although it may very well be Department of State's responsibility. The second benefit has to do with the thing that Doug mentioned, namely, that it would mean a violation of internal control and thereby a possibility that the corporation is out of control. Another benefit is also a question of the violation of the ethics of a specific group of people.

Discussion Leader (RE): Well, that comes back to value; you said you were excluding values—

(GB): No, no, I'm excluding my values. I'm not making a personal value judgment on it, but I'm saying value judgments then enter into it. It may be horrendous for some groups of people to believe that governments ought to operate in a certain way, and they want to impose these values on the rest of society. They feel this very strongly. This is true of things like smoking marihuana, smoking cigarettes, abortions, divorce, you name it. There is a whole range of values that people want to impose on other people, because they feel them very strongly. And then you have one other thing and that is the question of the police requirement. At our conference that Doug was at in Rochester, Lloyd Feller of the SEC mentioned that he thought it was a citizen's responsibility (I hope I'm not misquoting. I mentioned Doug because I don't want to misquote someone who isn't here. Someone who is here can defend themselves.) to see to it that the laws of the nation are upheld. That is to say, any miscreant is brought to the bar of justice. So, if you see a crime being committed, you are required as a citizen to report that act to the police authorities. In that case, the auditors now become—if that is correct—an arm of the police authorities, and have the responsibilities of operating as a policeman. That bears cost, of course.

(DRC): Mr. Feller, didn't say that exactly. He said that his position was that silence—given knowledge of the crime—silence he thought was a crime.

(GB): How is that different?

(DRC): No, I wasn't saying it was different. I just wanted to interject the fact that there is a substantial body of opinion on the other side. Silence alone is not an affirmative enough action to constitute a crime. But he did say that.

(GB): These are some of the benefits against which we match the costs, but I can't see any other benefits.

(JR): Doesn't an illegal payment impose a potential legal cost on the firm and thus become also a private benefit, in that sense?

Discussion Leader (RE): But, in most cases, the reason we haven't looked at these illegal payments is that, when you see these companies, confessing and settling—you know they paid in a million dollars to a presidential election fund and they were caught and forced to cough up a $10,000 fine—these things are not important on the basis of financial materiality in most cases. If you look even at bribes in foreign countries and you say,"well, holy mackerel, we could get kicked out of the country altogether." That has been going on this way--this is the way they have been doing business—for 50 years. They have never yet been kicked out. So, what is the magnitude of the risk if we don't disclose it? It only happens if we disclose it. So, from a financial point of view, these things may not be material enough to bother about. And if we are interested in these because of financial materiality, how about violations of all other laws which have possible monetary effects--violations of anti-trust laws, and pricing, you name it?

(JR): Legal enforcement disincentives are not adequate.

Discussion Leader (RE): That is not our problem as auditors, but it is probably a true statement from the legal point of view.

(WN): Some poeple think those things ought to be audited, too.

Discussion Leader (RE): Well, the problem is whether we should be the ones to audit them or not. And that brings up the question of the availability of information. The lawyers feel strongly that they don't want their confidence violated because they feel that they can't do a decent job where their clients feel that if they divulge any information, the lawyers are going to run down to the police department. We have precisely the same situation. We are operating in a situation where we have a great deal of cooperation, in that our clients—when we ask them for something—they are forthcoming with the information. If they thought that we were arms of the district attorney, we would in effect be able to get only information out of them that we are able to subpena, or something very closely akin to it. So, you have to say, "well, what is the benefit here in terms of extensions of police state, police powers, versus the costs in the reduction of value in the audit function" because now no one will cooperate with auditors anymore. So, that is a cost-benefit tradeoff, also.

(MSh): That brings up the fact that there is a wide variety of values and goals being held by a wide variety of parties. When you try to take a hard look to at least identify them, you realize all the conflicts that are going on. It may be that one should simply look for those kind of values and goals which can be agreed on, on a consensus basis. Those may be very limited, may only be one or two or three, and for that kind of thing, the Commission can say that yes, auditors should do this, and the rest of it has to be left open, left up for, perhaps, just a general values, cultural, ethical principles which pervade in society and left to an individual auditor, in an individual case acting as a professional, because professional has all this in it, to decide for himself. We may not be able to lay out ground rules covering all of these values. Maybe if you just come up with some ground rules on a few that we could get a consensus on, that in itself would be a big step forward.

(GS): It seems to me, Bob—I'm sorry.

(PR): I don't know if this is changing the focus of the discussion, but I was very much interested in the remark that Bob made about who should define the role of the auditor. If I got it down correctly, you said that it shouldn't be auditors; perhaps auditors might be in on it, but that others ought to define his role.

Discussion Leader (RE): Well, what I meant Paul was that I don't think it is up to auditors to decide that our function is to improve the level of honesty of business transactions in the American economy. If that is a role of auditors, I think it should be dictated to us by legislation or by judicial means but we auditors shouldn't sit around saying that I think it would be nice if business proceeded ethically, so we are going to take it on ourselves to audit for that.

(PR): I think that is a very important point, and I just wondered how far you would carry it, because we are in the midst—this Commission—of trying to define the role of the auditor. We are also dealing with various other levels, and there are two aspects that I would like to speak to, if you would. First of all, how far down would you go with it? We start out perhaps at the top with the role of the auditor. You can get down—you used the word function—to what the function of the auditor should be, what his objectives should be. Then you come down to what the standards should be, the accounting/auditing procedures should be, the rules, and so on. I wondered if there is any use in deciding how far down you would go before you let the auditor make the judgment. That is one aspect of it. The other is, if you believe that other than auditors ought to get into the definition, at least, at the top...

Discussion Leader (RE): They are, through the Cohen Commission.

(PR): The Cohen Commission has a limited life. What kind of recommendations, for example, should the Cohen Commission make for a continuance of the proper parties coming together to help define what the role should be, what the function should be?

(GS): Could I react to that, because I think we are asking the wrong question. In your cost-benefit framework, there certain costs and benefits which are appropriately identified by the profession, by the Cohen Commission. They are those dealing with the economic or financial benefits and costs. The other costs and benefits which are—or at least benefits—which are totally inappropriate for the profession and the Cohen Commission to identify, and those are the ones we are talking about in illegal payments, and so on. It seems to me society can insist on a compliance audit because society, through its duly constituted policy agencies, can say that in order to do interstate business, or in order to be chartered as a corporation, and in order to do whatnot, you must do certain things that we think are socially desirable.

(GB): And when the government has decided that that is the case, they take care of it. There is compliance auditing in taxes, environmental controls...

(GS): Exactly, that is what I'm trying to say. It is the responsibility of those agencies that are responsible for setting these social objectives to insist on compliance audits in these areas and that this is not an appropriate area where the profession itself is in a position to identify, or appropriately identify, cost-benefit relationships. I think society on the broader level has to do that.

Now, as far as the other one about the fact that it is a crime not to report illegal acts, misprison or whatever its called, is that true of everybody, or aren't there some limitations on that? Does—is it the duty of everyone to report?

(CW): I don't think there is any such general principle. It is a person involved in active concealment.

(GS): Well, therefore I'm saying, prima facie, there is no such obligation within the law as it/is presently constituted, and therefore I think we are dealing with a straw man.

(EH): It is probably only a matter of time.

(MFC): I think that that is right, but George, to take up your point, what is the situation with respect to illegal payments that are material, according to conventional tests?

(GS): There is no question about that.

(MFC): Do you mean that there is no question that the auditor should look for it, or no question that he should uncover it? So what we are really talking about is the nonmaterial payments in conventional terms.

(CW): From a financial point of view.

(GS): And that society must establish a compliance standard, it seems to me, and not the financial recording profession.

(JR): Society for what party?

(GS): The duly constituted authorities that regulate interstate commerce and regulate the chartering of corporations, and so on.

(GB): Let me just say with respect to what George said that I think it should be considered as a responsibility of the Commission to speak to that issue about society. You don't want to confuse society with legislators and basically with regulators. It is not the same thing, and their goals are very often different. This isn't to say that democracy is probably not the best system that we know; it is to say that it has imperfections. So, that as the profession speaks and talks about the costs and benefits to other citizens of these kinds of impositions, I think it is important to point these things out.

(GS): They may educate but they may not legislate.

(GB): But I am suggesting that the education aspect is important to try to communicate to shareholders what legislators want is not necessarily in their best interest or in society's best interest. There is a positive benefit to legislators to jump on things that look like scandals and to say that we need to have corrective legislation to stop this pernicious practice. They hold hearings, get into the headlines, get re-elected, and the rest of society bears the cost of that re-election campaign.

(HJ): Once in a while they pass laws, too. Last Friday's Times reported a bill introduced by Senator Church that would seem to—very brief article—would seem to imply that the bill would include requirements for compliance audits on these illegal and improper payments.

Discussion Leader (RE): By whom?

(HJ): From the way that I read the article, Bob, it was the independent auditor. Did I read incorrectly?

(WN): Let's turn this thing around about determining the proper role of the auditor. As it has been put here so far it is in the context that the auditor seems to be sitting here, passively, waiting for somebody to tell him what his enlarged role is.

What if Peat Marwick, for example, came out with a new handy-dandy system for detecting illegal behavior of corporate executives, and then they go out and sell companies on the idea of having this additional audit. Pretty soon all the stockholders say that we want that kind of an audit, and whether Peat, Marwick or whoever, everybody has now got to have one of those audits, because there is some kind of a market demand for it. Would that be the proper way to determine the enlarged role of the auditor in this kind of area, for example?

Discussion Leader (RE): That is an interesting question. It really gets back to some of the points we made earlier, that George and some of the others made, about whether the marketplace, acting without government interference, would, in fact, do this, or whether they wouldn't. I also think that it is a highly technical question. But, on the other hand, I would say the specific example you have come up with is probably moot, because neither we nor anyone else knows particularly well how to audit for these things. Really, when you look at what the SEC is saying, they are not saying, at least as I read it, they are not saying that we auditors have the responsibility to find these things. What they are saying is that if we stumble across them, what should we do about it, and that is a much different question.

(WN): Yes, but you have had all these directors' audits, and they found all kinds of little payments. So, I think you can audit it.

(MFC): Those are special costs.

Discussion Leader (RE): There is a high cost involved in that.

(RK): I think the profession's responsibility here is to identify the costs, and merely try to lay out to whatever level of illegal materiality people might want to get, what would it cost to get that in the cost of doing all their audits. There is a tendency on the part of SEC-type agencies to look at the ones which they know about and think about what it would have cost to have found that out, given that it occured, and they know it occured. Those costs are not very high. I think the profession has to say first that the benefits are here—and I think I got three out of the four that George indicated. That was not a bad list. These are the benefits, but we are not sure how to measure them and we are not sure where the people are who should be doing the analysis as to how much these benefits are worth. Our comparative advantage is saying, if you want it for whatever reason, here is what it costs, and cost is an increasing function of the degree of materiality.

Discussion Leader (RE): I think the Cohen Commission must address this question because if they don't at least talk about it in their report, they are going to be criticized for having ignored the issue. But, given that they talk about it that is a very reasonable thing to say. We don't know what people are willing to pay for it, but through our research we find that if we did this across the whole economy, looking for payments down to $1,000 would cost so much.

(RK): And how many more auditors would you need?

Discussion Leader (RE): Well, given that we have had these audits in special cases, we could probably at least get an order of magnitude estimate of how much it costs to do these things, and you could project that across all clients.

(DRC): I'm not worried about that, but that is a little like where we were with fraud detection when we said that well, if you want a detailed audit, if you want us to look at every transaction, we can do that, but the cost is horrendous, and so one. But that is not too relevant because no one wanted to pay for that consistently. Only when there were circumstances to indicate that yes, there was a fraud here, and we were concerned with its magnitude, then yes, we do a detailed audit. So, you have the extreme cost, and I recognize that we can measure that. But how good do you think the ability would be to introduce variables into that? So, raising the materiality limit and looking for the various small payments and setting a higher limit, how well can we scale that cost?

Discussion Leader (RE): Well, you ask that question, and we have been talking about comparative advantages all day. I would say that even though we couldn't get a close measure on that, we can do a better job than anybody else could of measuring that.

(RK): Yes, we could do it, because, my understanding is, you don't spend a lot of time auditing transactions other than testing internal control. You really rely on the balance sheet type of audit. I'm not talking about the classification of certain payments, whether something is an advertising expense, versus a bribe.

(CW): Then we do very little of that, very little.

(RK): That is right, but at least you have an idea as to how many transactions you have to look at, how many vouchers or how many payments you have to look at in order to find a fifty thousand dollar illegal payment.

(DRC): Well, that is not the source of my concern, though.

(LL): Bob, are you suggesting that the cost would not be very high?

(RK): No, I'm saying the cost would be extremely high. I'm saying that you should be able to estimate them, because you know how many transactions there are. I don't know how many transactions there are at General Electric.

(DRC): You know how many there are, and you pick them.

But you have another variable, how deeply do you look at the ones you pick? And that is going to be, I suspect, a much more difficult cost to measure.

Discussion Leader (RE): If a company wants to conceal these things, we can't find them.

(RK): And the unrecorded ones are a problem.

(LL): We had one situation where we quoted a fee and it was 20% of the year's audit fee. This was a world-wide sort of a thing that we wouldn't be doing at all. It was 20% of a full year's fee. Now, I don't know whether we were right or not; we weren't hired to do it.

(RK): But you might say that, if you want us to look at every payment of $20,000 or more, every expenditure, and make sure that none of those $20,000 payments, as recorded on the books, went to illegal campaign contributions, bribes, or whatever, we could do it, and it would cost you this much, which is not to say that there would not be some other payments that had been made that were not recorded. You know, you limit the scope to what is recorded.

(EH): The problem, I might point out, is in the use of the words "and make sure" because the difficulty of deciding, once one selects the particular transaction, and looks at it and looks at the support behind it, the problem doesn't get discussed adequately at a session of this kind, is the difficulty of deciding whether that particular transaction is one of these.

(RK): I think it is incumbent upon the profession to make these points very clear.

(EH): I'm trying to, if you would only let me. And the risk of misleading ourselves and our clients in this regard is very, very substantial.

(LL): Alright, let's say that society decided that this was worth it, that they made that decision, I think we are in a better position to find it than probably anyone else. But that is a big "if," yes.

(EH): But that isn't a very strong position.

(JR): But the thing here is an input to society's decision whether or not to require it is the cost that it would take.

(LL): I think the costs that would be incurred are measurable. I think the benefits that would be derived from it are another matter. I think that the society has to make the decision as to whether they really want it.

DISCUSSION LEADER (RE): The Cohen Commission said to find these things would approximately triple the audit fees in the U.S. economy. That tells legislators something they might use in deciding whether to require it.

(GB): I would like to raise one other different question, which I suspect is more important, that the Cohen Commission might consider. When I say consider, what I mean is put it in a report and bring it to public attention.

(MFC): I am sorry that we had this meeting today.

(GB): One is the difference between ex ante and ex post problems. As a matter of pointing out, I would like to think in an educational way, to investors and the general public, that in advance of a situation, ex ante, they are willing to take a certain amount of risk. Everyone does; we cross the street against the light, and so on. And ex post, you look around and say: "Who can I stick for the loss I took?" To be the specific, ex ante, I bought New York City tax anticipation notes at 9 percent. I knew I was taking a risk; that is why I got 9 percent. Ex post I want to stick somebody, and I do. It turns out that the accountant is the first to get stuck because the corporation, as was pointed out in our meeting, is bankrupt and the people have run off, and the accountant is a partnership, and they are the ones to sue. So, it is a question really of what is the cost to society of a situation in which you are in fact requiring more insurance —which is what we are really talking about—that people would be willing to pay for.

The second aspect of that—I just want to mention two aspects and I will quit—is the question of the lawyers' fees and the particular legal situation in the U.S., where if an accountant is sued and wins, then the only thing that the suing attorney loses is his own time and expenses. Costs are not assessed, as they are in England, against the unsuccessful plaintiff, and that gives you a situation in which the value of lawsuits is greater than you would expect in an unbiased situation. I think that might be mentioned. I think that is a situation that is going to be worse, because the law schools are spewing forth graduates in enormous numbers whose opportunity costs and time is very low. They have nothing to do. They haven't any jobs, and they are going to look around and say: "well, what the hell. It would be good experience to sue an accountant! Why not?" I think that is a very serious problem.

(LL): I have been trying to introduce champerty, which as I understand is where you sue the lawyer for a frivolous suit, but Manny just won't let it get on the agenda.

(GB): When we talked about benefits, in your cost-benefit analysis, you left out the benefits to the attorneys.

(RK): Well, to comment on the first point, we move to the system where somehow the accountant is there as the insurer of the poeple who got stuck with a bankrupt company. Clearly, one of the costs would be the difficulty that young and marginal companies will have in finding auditors. Again, an ex ante consequence of the results which say that every time a company goes bankrupt, we are going to go out and sue the auditors, is that auditors will start withdrawing from clients as they get nearer to marginal conditions, just the point where they may need the auditing the most.

(LL): Well, we will charge an adequate insurance premium.

(RK): To whom, your good customers?

(LL): The whole works, society.

(RK): You are still better off avoiding the marginal customers, given whatever level of insurance premium you charge, you are going to be better off avoiding the failing company.

(LL): Well, that is just pulling out theory. We were looking into the audit as an insurance model, as Chuck mentioned earlier today. Yes, we actually looked into that.

Discussion Leader (RE): That wouldn't work. If he wanted to charge his clients a bigger fee—his good clients bigger fees—and I was willing only to audit really top quality firms, I would offer lower premiums and lower cost, so I would get his clients away from him. So, there would be adverse selection and he would be left with nothing but the dogs. So, then he would change his strategy. It is really too complicated, I think.

(RK): It would still lead to marginal firms having difficulty finding auditors, certainly newly formed firms.

(MFC): Yes, all of the assigned risks.

(CW): All of the retail land companies are going into the assigned-risk pool.

(MS): Or like compensation, the state would do them, like compensation insurance.

(GB): One possibility is that this is very similar to the malpractice insurance problem, of raising the cost of doing business, of raising the cost of investing in the company. There is also the other aspect of the SEC. They are shifting the bias in the U.S. away from larger companies, in that the bias against companies is towards the larger companies who are under the SEC, in terms of all these requirements, as against companies who are not. Now, that has some very interesting aspects in terms of the distribution of income in the country. One, I know when I was in tax practice, the only cheating I really saw was among small companies. The large ones almost never did cheat; they took advantage of the law, but the real cheating was the small guys who had a personal ownership stake in the company and for whom every dollar of cheating went right smack into his own pocket, as against the accountant working for a large company who only got a salary.

(MFC): That doesn't surprise me, that wasn't cheating, that was just an exercise of judgment.

(GB): That was cheating. That is why I got out of the business, frankly, I couldn't take it.

(CW): The larger companies steal through a different vehicle, though. They steal through jacking up EPS and selling stock.

(GB): Yes, you know and deducting all that kind of stuff. The other aspect of it, even with the larger companies, if you look at the maldistribution of income or if that is a problem then you really want a bias against small businesses, because large companies tend to be owned by small people through pension funds and in small shareholdings, while small businesses tend to be owned by people in the relatively high end of the income distribution because they are personally owned. And so all of our laws are biased against the poorer elements in society and in favor of the richer elements. Not that this should surprise anyone, but I think it is rather interesting.

(LL): There are one or two environmental laws that try to help small business, but that is alright.

(MFC): I think that on George's last note, there is an approriate opportunity for me to thank all of you for coming here today. I have enjoyed it very much; I have learned some things. I did indicate some regret at the very end when you began to add on the jobs that the Commission must undertake and fulfill. We will try, with your help.

(MS): And on behalf of the Ross Institute, thank you all for joining us. It has been a real pleasure. We hope to have a publication out based on the tapes of this session in the reasonably near future.

(MFC): We need that almost immediately, Mike.

(MS): We propose to do a little better than the Journal of Accounting Research. Thank you very much.